# INVESTMENT OUTLOOK

A PUBLICATION OF QUADRANT CAPITAL MANAGEMENT

## FIRST QUARTER 2018: TRUMP BUMP SLUMP

*All right, now you know:*
*Life is crummy.*
*Well, now you know.*
*I mean, big surprise:*
*People love you and tell you lies.*
*Bricks can fall out of clear blue skies.*
*Put your dimple down,*
*Now you know.*
*-Stephen Sondheim*

So now we know. Markets can go down. Investors could be forgiven for having forgotten that lesson. The S&P 500 notched nine consecutive quarterly increases before it lost value in the first quarter this year.

The decline in US large cap stocks was accompanied by similar declines in US small cap stocks, international developed markets, real estate, and commodities. Only emerging markets equities posted a modestly positive return.

And, it wasn't just stock prices that fell…bond prices fell, too. It was the first quarter since the Great Recession that saw stock and bond prices fall together.

Here's the data:

| Asset Class | Index | 1st Quarter Results |
|---|---|---|
| US Large Cap Stocks | S&P 500 Total Return | -0.8% |
| US Small Cap Stocks | Russell 2000 | -0.1% |
| International Developed Markets | MSCI EAFE | -1.7% |
| Emerging Markets | MSCI EM | 1.3% |
| Real Estate | MSCI US Real Estate | -8.1% |
| Commodities | Bloomberg Commodity | -0.8% |
| Bonds | Bloomberg Barclays Aggregate | -1.5% |
| Cash | Citigroup 3 month UST Bill | 0.4% |

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, MARKETWATCH.COM

To be clear, these declines are modest in magnitude, even if the predominance of minus signs is unwelcome. But beneath these relatively bland returns is a more volatile picture. Markets ran up sharply in the first four weeks of the new year, continuing their strong run from 2017 amid historically low volatility. Then markets hit a brick wall, with spiking volatility and a full 10% correction from January highs.

President Trump has frequently cited the stock market as a referendum on his economic policy. So, with the market's reversal this year, we thought it would be informative to ascertain the Investor-in-Chief's perspective on the economy and financial markets. What follows is an edited transcript from a recent interview.

## MAKING THE ECONOMY GREAT AGAIN

*It seems pointless to be quoted if one isn't going to be quotable…*
*It's better to be quotable than honest.*
*-Tom Stoppard*

INVESTMENT OUTLOOK: Mr. President, you have promised to make America great again by creating jobs. But the March employment report was disappointing—the economy produced only 103,000 new jobs, the second-lowest level in the past year. The report also lowered January's previously reported job gains by 63,000 and February's job gains by 13,000. The average work week was unchanged, and wage growth has not accelerated.

PRESIDENT TRUMP: Look, I'm the greatest job creator ever. In case you didn't notice, it snowed a lot in March. You got to look at the right numbers. Manufacturing jobs increased by 22,000, and mining employment increased by 9,000. Unemployment is 4.1%. More Americans are working than ever before. And they get to keep more of their pay. The 2017 Tax Cuts and Jobs Act is just kicking in, and you'll be amazed at how many new jobs American businesses create. Buh-lieve me.

INVESTMENT OUTLOOK: Recent housing data were soft. Building permits fell 5.7% in February. Housing starts were off by 7% versus January, and 4% below the February 2017 rate. How do you explain the weakness in real estate?

PRESIDENT TRUMP: Look, I'm the greatest builder ever. I know how to get buildings built. We have to eliminate the red tape, the terrible permitting process, all those Obama regulations that get in the way of builders. We've already gotten rid of more regulations than any president in history. Oh, you're gonna see more new houses all right. Trust me on that.

INVESTMENT OUTLOOK: One of your key campaign pledges was to fix America's aging infrastructure. You put a price tag of $1.5 trillion on this initiative, with the federal government providing seed funding of $200 billion over ten years, and a combination of state and local governments and public-private partnerships providing most of the funding. Could you give us an update on your infrastructure plans?

PRESIDENT TRUMP: Look at our airports. They're a disgrace. Our falling down bridges. And our roads—terrible. I've told [Speaker] Ryan and [Majority Leader] McConnell they have to get this done. I've told them I'm waiting. I'm still waiting, but I won't wait forever.

INVESTMENT OUTLOOK: The Bureau of Economic Analysis reported that fourth quarter 2017 real GDP growth was 2.9%. This is a slowdown from the third quarter's 3.2% growth rate. The Atlanta Fed's GDPNow model estimates that the economy grew by 2.3% in the first quarter. As Clara Peller once asked, "Where's the beef?"

PRESIDENT TRUMP: Fake news. Everyone knows the GDPNow estimates are garbage. And those so-called economics experts have no idea how to make seasonal adjustments for the first quarter. We are the best friend the American economy has ever had. We are cutting regulations that strangle American business. We are spending on our military to ensure our country stays strong. We have cut taxes more than any previous administration ever has. Businesses are bringing overseas cash home. Foreign investors are pouring money into the United States—pouring in money, buckets and buckets of money—because they see so many opportunities. This economy is going to grow so fast it'll make the Roaring Twenties look like a recession.

INVESTMENT OUTLOOK: In March, Congress passed a $1.3 trillion spending bill that you signed, calling for substantial increases in military and domestic spending. The non-partisan Committee for a Responsible Federal Budget estimates that the combined effects of tax cuts and spending will be trillion-dollar deficits for years to come. And funding these deficits may cause interest rates to increase. Does this concern you?

PRESIDENT TRUMP: I signed that bill because we needed to get the military funded. But wasteful domestic spending has to stop. That's why I'm looking forward to the mid-term elections. There's going to be a red wave, or the Senate will take the nuclear option and make it easier to pass responsible budgets. But sometimes you have to borrow to invest in the future. The investments we're making in our economy, in our military, in our infrastructure, will assure America's prosperity for generations to come.

## MAKING MARKETS GREAT AGAIN

*It is not only for what we do that we are held responsible,*
*but also for what we do not do.*
*-Moliere*

INVESTMENT OUTLOOK: President Trump, you took credit for the market's strong rise in the first year of your presidency. But, more recently, the stock market has been in retreat. Some people believe that recent market action reflects concerns with your administration's policy initiatives. What do you say to them? Do you accept responsibility for the market's decline?

PRESIDENT TRUMP: Markets fall for all reasons, and for no reason.

INVESTMENT OUTLOOK: The market's decline coincided in time with your tweets regarding the invoking of trade tariffs, first on steel and aluminum broadly, then on Chinese imports more specifically.

PRESIDENT TRUMP: No one but me has the guts to say this, but China's grossly unfair trade policies have cost millions of American jobs. It's time to take those jobs back. Don't worry about markets. American business, with lower taxes and less regulation, is a winner. Bigly. When investors realize what fantastic growth we've restored to America, markets will be higher than they ever were.

INVESTMENT OUTLOOK: Isn't it possible that the trade war with China will escalate, and if it does, won't US exporters–Boeing, hog producers, soybean farmers—suffer? And won't US consumers have to pay more for imported goods?

PRESIDENT TRUMP: I'm not going to let that happen, and China's not either. China has so much more to lose. We have a $500 billion trade imbalance. We have the best technology in the world that China wants to steal. We're not going to let them do that. China's going to do the right thing. And America's going to be the winner.

INVESTMENT OUTLOOK: Thank you for sharing your views, Mr. President.

## MAKING GREAT INVESTMENT DECISIONS

*To be prepared is half the victory.*
*-Miguel de Cervantes*

We must acknowledge that the President's pro-business policies, particularly with regard to taxes and regulation, create a favorable backdrop for the stock market. The economy is unlikely to achieve the growth the President aspires to, for any extended period of time, but is growing sufficiently, in concert with global growth, to support corporate profit growth. Of course, tax cuts provide a considerable lift as well. Earnings are expected to rise 16% in the first quarter, driven by revenue growth of 7.4%. That said, these lofty earnings expectations themselves represent a risk, as investors punish harshly companies that under-perform versus expectations. Typically, analysts lower their earnings estimates throughout the quarter; in this first quarter, however, earnings expectations have been steadily rising, creating a higher bar.

We subscribe to the belief that earnings drive stock prices. But the context for earnings is valuations, which can also drive stock prices. The market's recent correction has reduced valuations to about 16.5 times this year's earnings forecast, down from 18.5 times in January. That puts the market at approximately fair valuation—assuming earnings come through.

If the earnings/valuation equation is somewhat tricky to solve, the trade skirmish is even more so. On one side is a President who loves a fight and doesn't back down; on the other, a proud nation that will not accept losing face on the global stage. The outcome is not predictable, and the resultant uncertainty is an unwelcome development. Taken all in all, these circumstances reinforce the appeal of international markets, which are currently less subject to geopolitical trade issues, feature more modest valuations, and are at an earlier stage of the business cycle. From a domestic perspective, sustained multi-year under-performance in small cap and large cap value stocks draws our attention. However, the appeal of cyclical stocks is diminished in a protectionist trade environment. We also note the newly negative narrative of globally dominant US technology companies, as they face antitrust actions in Europe and privacy/data integrity concerns domestically.

For the bond market, we continue to enjoy generally accommodative global central bank monetary policy, and modest inflation. At home, the Fed is on a trajectory to increase rates twice more, after the March raise, which should not substantially slow the economy. We are watchful for higher inflation, given fiscal stimulus from both lower taxes and higher government spending, but wages and prices remain contained for now. Unless global economies slow considerably, fixed income investors are unlikely to be rewarded for taking duration risk, but will benefit at the short end of the maturity curve from rising rates.

The first quarter has been a useful if modestly painful reminder that investing is not a risk-free undertaking. But that only renews our efforts to separate those investments that justify the risks from those that don't. As the old serenity prayer says, we strive for the wisdom to know the difference.

QUADRANT CAPITAL MANAGEMENT

*A Subsidiary of Peapack-Gladstone Bank*


100 PASSAIC AVENUE, SUITE 301
FAIRFIELD NJ 07004
TEL 973-276-0830 • FAX 973-276-0845 • www.quadrantcm.com