The Weekly

Economic & Market Recap

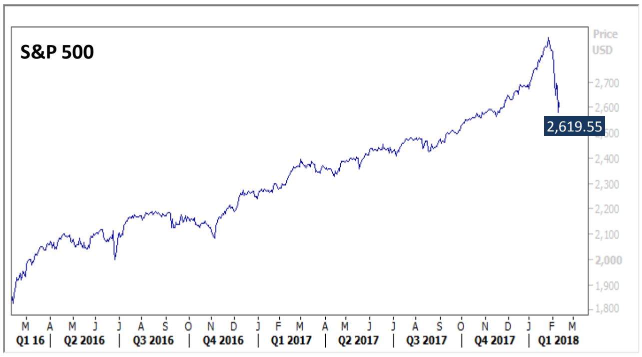
Peapack-Gladstone Bank, Private Wealth Management

February 9, 2018

As of 02/09/2018		Wk Net	Wk %	Div	YTD %	12 Mos %
STOCKS	Close	Change	Change	Yield	Change	Change
DJIA	24,190.90	-1330.06	-5.21	2.18	-2.14	19.92
S&P 500	2,619.55	-142.58	-5.16	1.94	-2.12	13.39
NASDAQ 100	6,412.68	-347.61	-5.14	1.05	0.25	23.03
S&P MidCap 400	1,820.93	-96.81	-5.05	1.57	-4.20	6.39
Russell 2000	1,477.84	-69.44	-4.49	1.37	-3.75	7.21

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	2.07	Euro/Dollar	1.22	-1.85
5-Year	2.54	Dollar/Yen	108.78	-1.22
10-Year	2.85	Sterling/Dollar	1.38	-2.13
30-Year	3.16	Dollar/Cad	1.26	1.25

Source: Thomson Reuters & Bloomberg



What Caught Our Eye This Week

Volatility is back! The Dow Jones Industrial Average is down 9.1% from its high two weeks ago, and wide market fluctuations have appeared for the first time in a number of years. The most commonly used measure for market volatility is the Chicago Board Options Exchange Volatility Index (VIX). This is also considered a gauge of investor “fear” level. Historically, a VIX reading over 30 constitutes high volatility, and a VIX reading below 20 denotes low volatility. During the depths of the Great Recession panic in 2009, the VIX rose to almost 90, and it has generally trended downward ever since. In 2017, the average was 11, the lowest in 27 years. Last Tuesday the VIX jumped to 50, reflecting an increased level of volatility and anxiety in the marketplace. As global central banks reduce or unwind their quantitative easing efforts, we can expect to see greater volatility going forward. The nearly one-directional stock market with ever-lower volatility that we experienced over the past nine years will most likely adjust to a more normalized operating environment in the future.

Economy

It was an uneventful week for economic data with the best news coming on Monday with the release of the ISM non-manufacturing index. This metric increased to 59.9 in January, easily beating the consensus expectations of 56.7. The new orders index surged to 62.7 from 54.5 in December, while the employment index rose to 61.6 from 56.3. Overall 15 of 18 industries reported growth in January. On Tuesday, the JOLTS (job openings and labor turnover survey) report showed 5.811 million job openings in December, which was less than expected and a seventh month low. The quits rate was unchanged at 2.2%, and the layoffs and discharges rate was 1.1%. Overall when reviewing the last 12 months, the net employment gain amounts to 2.2 million. Also on Tuesday the trade deficit in goods and services came in at $53.1 billion, which was larger than the consensus estimate of $52.1 billion. This happens to be the largest trade deficit going back to late 2008. Exports increased by $3.5 billion and imports increased by $6.2 billion. Finally on Thursday we were pleased to see weekly jobless claims decline by 9,000 to 221,000 during the week ending February 3rd. The four-week moving average is now at 225,000.

Fixed Income/Credit Market

Using the 10-year U.S. Treasury Note Volatility Index (TYVIX) as a gauge, it was a volatile week for U.S. Treasuries. Week-over-week the TYVIX surged 28.35% from 4.48 to 5.75 peaking at 6.07 at Thursday’s market close. The volatility came on the heels of a rapid sell-off in the equity markets which many investors believe would have caused a flight-to-quality trade in the U.S. Treasury market. However, the lack of demand during this week’s 3-year, 10-year, and 30-year auctions told a different story. With interest rate increases across the U.S. Treasury curve expected to continue, demand was weak even for safe-haven assets, despite the uncertainties surrounding credit and equity markets. Over a one-year time horizon, even just a 50 basis point increase in interest rates would have a total return of negative 0.79% at the 10-year tenor. Investors in fixed rate assets need to continue taking caution in a rising rate environment by maintaining a short overall duration profile in portfolios.

Equity Market Correction

Equity market volatility, which began to increase last Friday, picked up considerably this week and precipitated a substantial risk-off trade. The catalyst behind the spike in volatility is the recalibration of interest rate expectations with a tightening labor market, increased consumption and spending due to the recently passed tax reform bill. An increase in the supply of U.S. Treasury debt to fund the widening budget deficit and the continued reduction of the Fed’s balance sheet added to the concern of further Fed rate increases. It is interesting to note that the bond market recognized the previously mentioned factors months ago as the 10-year U.S. Treasury yield increased over 80 basis points since September 7th of 2017. The rise in U.S. Treasury yields does make sense as market based inflation expectations have increased recently and are a very good predictor of future realized inflation. The projected breakeven 5-year inflation rate, according to the TIPs market, increased 28 basis points from December 6th of 2017 to February 2nd of 2018. However, the recent spike in volatility has actually caused the projected breakeven 5-year inflation rate to compress approximately 12 basis points this week to 1.92%. So, with all the recent focus on rising inflation, it is important to keep in mind the massive structural forces working against inflation in the form of slowing birthrates in developed markets, high sovereign debt levels around the world and technology’s ability to innovate individuals out of the labor force. From a fundamental standpoint, global growth is accelerating, credit markets are very healthy, liquidity is still freely flowing and earnings growth projections remain robust. The muted volatility experienced in 2017 was highly abnormal and although the current high levels of volatility appear to be exaggerated, the recent turmoil has imposed a much needed element of discipline to global equity markets.

After a two-year period of relative calm, it can be jolting to investors when markets become erratic with high levels of volatility. We have been cautioning clients that financial markets were heading into a period of increased volatility as markets recognize and reflect policy normalization by the major central banks. Market corrections remove excesses and occur regularly in normal functioning markets. We expect global equity markets to stabilize. Economic fundamentals are strong, not only domestically, but cyclical expansion has taken hold in Europe as well. Earnings growth has been robust. With almost 70% of S&P 500 companies having reported fourth quarter earnings, Thomson Reuters expects earnings growth of 14.7%. Rising earnings expectations and the recent equity correction have reduced the forward price-to-earnings multiple to a manageable 17 times. Although the volatility will take time to moderate, current market levels should prove to be a reasonable valuation.

COMING UP NEXT WEEK		**Est.**
02/14 CPI MM, SA	(Jan)	0.3%
02/14 Retail Sales MM	(Jan)	0.3%
02/15 Industrial Production MM	(Jan)	0.2%

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