NORTHWESTERN MUTUAL WEALTH MANAGEMENT COMPANY

MARKET COMMENTARY

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FIRST QUARTER 2018

Singles and Doubles, Not Home Runs

2018 began much as 2017 ended, with steadily rising equity markets, low interest rates and burgeoning market optimism. Indeed, investors were increasingly convinced that the lowest stock and bond market volatility since 1965 was set to continue in 2018. Who could blame them? Already, there was strong economic growth against a backdrop of moderate inflation set to get a boost from the successful passage of the Trump administration's tax cuts, not to mention continued monetary accommodation from global central banks. On Jan. 4, the American Association of Individual Investors Sentiment Index showed that bullish responses to their market survey hit a high last seen in 2010 – and before that, 2004.

Just then, a couple of strong economic data reports perversely caused investors to question whether the economy was beginning to overheat and inflation was beginning to rise. Quickly, the narrative shifted to a fear of rising inflation, increased central bank tightening and, most importantly, rising bond yields. This change caused previously (over)emboldened investors to quickly reposition for a shifting environment. Much as we opined in our fourth-quarter commentary, as bond investors pushed yields higher, stock investors pushed equities lower. Why? Because equity markets are trading at today's elevated levels due to bond yields trading at such low yields. Put simply, if bonds offer low future return possibilities, investors are often willing to bid equities up because they are relatively attractive. With bond yields moving up during the quarter, stocks sold off.

After a few weeks of rumbling and investor repositioning, this selling eventually subsided only to see the market be hit once again after President Trump announced tariffs on imported aluminum and steel. As the quarter drew to a close, these actions caused equity market weakness as fears of a global trade war – possibly leading to a global economic recession – intensified.

The Art of the Deal

Investors continue to react – and, in some cases, overreact – to the president's tweets and "opening bids." To state the obvious about a man who is the subject of a book titled "The Art of the Deal," the president views himself as a negotiator. And we believe that in any negotiation, the conversation starts with an opening bid or anchor from which to negotiate. Indeed, the aluminum and steel tariffs were initially broad based in their application, but over the past few weeks they have been winnowed down. After initially being subject to the tariffs, Australia, Canada, Mexico, the European Union, Argentina, Brazil and South Korea are now exempt, as they are allowed to negotiate a different path forward. And while China is not on the above exempt list and has since been subject to more potential tariffs, we continue to believe that the United States and China will eventually find common ground.

Most importantly, we believe the market's overriding worry that these tariffs will cause a recession and falling inflation – a la the Great Depression – is overstated. Many point to the Smoot-Hawley tariffs in 1930 to make their recession case. We believe that the economic conditions today are much better than those during the Great Depression.

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Let me ask you a question: If we close the borders and make imports more expensive and, at the same time, flood the domestic economy full of fiscal stimulus – think tax cuts, increased government spending and lower regulations, all piled on top of still accommodative monetary stimulus – what do you think will happen? We struggle to find many scenarios that cause consumer and business demand to plunge as well as prices to fall, which is what happens during a recession. Rather, we think demand continues to grow with rising inflationary pressures.

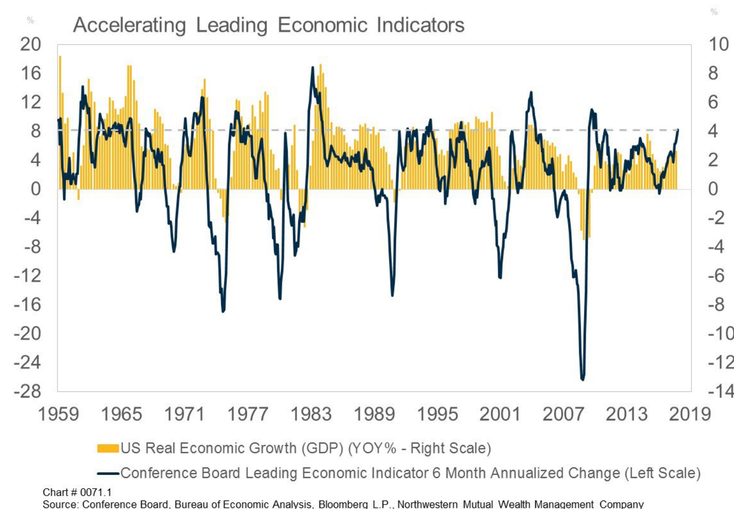
We continue to advise that investors not overreact to any political actions because the overall United States economic machine is a bigger force. However, we will concede that presidents and their administrations can target/impact individual stocks and certain economic sectors. For example, after being heavily regulated in the past administration, it appears as if the banking industry is set to get some relief, and it's obvious this administration wants to see a vibrant domestic manufacturing sector. On the other side of the equation, it appears as if the technology sector could find itself in political crosshairs in the coming quarters as we debate its use of the massive amount of data it collects.

The U.S. economy is like a giant tanker; it may not move fast, but once it is set in motion, it takes a large force to stop it. Right now, the underlying economic fundamentals continue to point to an economy (tanker) that is still very much moving forward, even as the political narrative is evolving.

It's Still More Than a Feeling

One year ago, weak first-quarter economic growth caused many investors to question whether strong consumer and business survey data would eventually show up in overall U.S. economic growth or gross domestic product (GDP). We are having a bit of déjà vu as the world seems to be pondering this question once again. First, let us state our belief that the weakening global growth worry is an oversold story. Although some indicators of economic growth in the U.S. are showing a slight pullback, we remind you that in the recent past, the trend for first-quarter economic growth has been abnormally weak while the rest of the year is strong.

And much like last year, we again point out that leading economic indicators (soft data) continue to suggest that the U.S. economy will strengthen over the coming quarters. During the first quarter, a broad leading indicator of future economic growth, the Conference Board's Leading Economic Index, continued to rise. Indeed, the Expectations Index growth rate was up 8.2 percent. This number not only points to future rising growth but, in revisiting our tanker story, shows that a recession is likely still years away.



If we review the last 59-plus years and note when the index was up more than 8.2 percent and then count how many months passed before a recession ensued, we can identify six distinct points. For the sake of conservatism, we are counting only the last time in that economic cycle that the index was up 8.2 percent or higher and started falling. Currently, we are at 8.2 percent, but it is rising and could keep moving higher. That data shows that the shortest time before a recession began was approximately nine months in the early 1970s, and the longest time was 73 months in the 1980s. The other four data points were all between 28 and 43 months. While this is only one data point to consider, if we had to place odds off this measure on a recession in the coming year, it would be very low. And this doesn't even take into account the Diffusion Index, which you can think of as how broad the increase in the indicators is, which currently stands at 100 percent. We also note that other broad economy indicators, such as the Institute for Supply Management Manufacturing Index and the Non-Manufacturing Index, continue to show strength.

We continue to believe that the economy is set to move forward and that it will eventually push the market higher in the intermediate term, albeit at a moderated pace and with heightened volatility. Indeed, we surmise that market volatility over the past few weeks could be due to short-term buyers of the "Trump trade" becoming short-term sellers of the "Trump trade" as the narrative shifted from positive (tax reform) to negative (tariffs). We bought the market because of its underlying economic fundamentals in the intermediate term. Therefore, we continue to stay the course.

The Bottom Line

If 2017 was defined by extreme calm, 2018 will likely be marked by heightened volatility. Not only do we have shifting political sands and a U.S. administration intent on renegotiating various trade deals, we also have an economy that is inching closer to the end of the economic cycle. While we believe that the Federal Reserve does not want to cut off this expansion by tightening rates too quickly, it will continue tightening rates over the coming years. This is important because, historically, a tightening Fed leads to higher bond and stock market volatility. When the Fed cuts interest rates and floods the world with liquidity, it is attempting to push down risk. Put simply, it wants you to feel more comfortable and take on more risk. When the Fed raises rates and removes liquidity, it is attempting to push up the price of risk. It wants you to behave in a more responsible and moderated manner.

Lastly, societally, we appear to be continuing a gradual global shift toward more protectionism and populism. Globalization (the opposite of protectionism and populism) is part of a disinflationary trend that has been prevalent for more than 30 years. The problem with globalization is that the benefits aren't as explicitly visible to Main Street as some of the detriments. Think cheaper goods, services, and – many may argue – a higher standard of living/economic growth versus job displacements and muted wages in various industries. We believe that society is shifting and wants higher wages and increased job security even if it is potentially accompanied by higher goods and services prices (think inflation) and, perhaps, even less economic growth.

The most overused phrase in investing is that this is an "uncertain time period." However, we will concede that on a relative level it appears as if some of the trends that have lasted many decades look set to change. Against this backdrop, investors need to embrace diversification, not reject it. In our opening paragraphs we mentioned that emboldened investors were likely overconfident in the future and were forced to revisit their conviction and shift their portfolios after they were caught taking too much risk. With the start of baseball season upon us, let us close with this analogy: We continue to focus on meeting our clients' long-term goals and objectives using a disciplined process that focuses on singles and doubles, not home runs.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance and are not indicative of any specific investment. Diversification and strategic asset allocation do not assure profit or protect against loss. Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market. The securities of small capitalization companies are subject to higher volatility than larger, more established companies and may be less liquid. With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions. When interest rates fall, bond prices typically rise; and conversely, when interest rates rise, bond prices typically fall. This also holds true for bond mutual funds. When interest rates are at low levels, there is risk that a sustained rise in interest rates may cause losses to the price of bonds or market value of bond funds that you own. At maturity, however, the issuer of the bond is obligated to return the principal to the investor. The longer the maturity of a bond or of bonds held in a bond fund, the greater the degree of a price or market value change resulting from a change in interest rates (also known as duration risk). Bond funds continuously replace the bonds they hold as they mature and thus do not usually have maturity dates and are not obligated to return the investor's principal. Additionally, high-yield bonds and bond funds that invest in high-yield bonds present greater credit risk than investment-grade bonds. Bond and bond fund investors should carefully consider risks such as interest rate risk, credit risk, liquidity risk and inflation risk before investing in a particular bond or bond fund.

The 10-year Treasury Note Rate is the yield on U.S. Government-issued 10-year debt.

The American Association of Individual Investors is a nonprofit organization with about 150,000 members whose purpose is to educate individual investors regarding stock market portfolios, financial planning and retirement accounts.

The European Union (EU) is an economic and political union of 28-member states located primarily in Europe.

The gross domestic product (GDP) is the amount of goods and services produced in a year in a country.

The Conference Board Leading Economic Index is intended to forecast future economic activity and is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of 10 key variables. These variables have historically turned downward before a recession and upward before an expansion.

The Expectations Index is a sub-index that measures overall consumer sentiments toward the short-term (six-month) future economic situation. It is used to derive (about 60% of) the Consumer Confidence Index, a widely used economic indicator. The sub-index is compiled from data gathered from a survey of 5,000 households on questions regarding expected business and employment conditions as well as expected income in the near term.

The Diffusion Index represents how many of the Conference Board's 10 key variables are moving in agreement with the overall Conference Board Leading Economic Index. The Diffusion Index can be calculated on a one-month or six-month basis.

The Institute for Supply Management (ISM) is a not-for-profit U.S. association for the benefit of the purchasing and supply management profession, particularly in the areas of education and research.

The ISM Manufacturing Index tracks the amount of manufacturing activity that occurred in the previous month by surveying more than 300 manufacturing firms and monitoring employment, production inventories, new orders and supplier devices.

The ISM Non-Manufacturing Index is based on a sample survey of purchasing and supply executives, weighted according to industry contribution to GDP. The Index is calculated using 50 percent as the centerline between positive and negative expectations; the figure is reported in headlines as the percent change.

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