PORTSIDE
INVESTMENT ADVISORS

Synthesis

A composition that pulls together the primary themes, analysis and portfolio views from Portside Investment Advisors

---

March 5, 2018
Yellow Flags Emerge

The last few years have yielded very few signs of concern from the major drivers of market returns - corporate earnings, the economy and monetary policy. This led to record low volatility in the equity and credit markets. A number of circumstances, though, may be starting to cast some shade on the impressive run in the markets.

Success in boosting growth has tightened the labor market and is likely leading to an increase in inflation. This has been the goal of the Federal Reserve all along, but they are now inclined to continue a steady path of raising interest rates. At the same time, central banks globally are showing a desire to move towards more standard monetary policy as a way to limit unwarranted risk taking. They have become wary that another financial bubble could undue their successes in employment and inflation.

In the US, the Federal Reserve is now shrinking its holdings of bonds. They did not waiver from the sale process even during the market volatility in February. European and Japanese central banks are still keeping rates low and buying securities but they are signaling and end to those programs.

Economic tailwinds are still relatively strong. The manufacturing sector is booming and the consumer is more confident than any time during the last decade. However, the housing market has struggled the last few months likely due to interest rates climbing. Additionally, most of the strong economic data has been factored into market expectations and the recent data has been trending in line or lower than what was anticipated. The global economy has been in a similar state, with respectable growth being maintained but not surprising to the upside.

The picture with corporations also remains strong but sets a high bar going forward. Earnings are solid and the 2018 impact of tax cuts will be a significant boost. The challenge is that inflationary pressures and productivity that may have peaked are headwinds to added profitability. The overall valuations of equities will require very impressive performance from the income statements in order to keep the market marching upwards.

The markets themselves are telling an interesting tale. The US market remains above the level reached during the February correction. It is a different story, though, in other regions. Japan, Germany, Britain and South Korea have all seen lower equity levels in recent days. Additionally, some economic sectors in the US such as energy, REITs and utilities have marked new lows of the year.

The net result is that most factors are still positive but the rate of change in the positive stories is slowing quite a bit. Given the successes realized over the last few years, it is prudent to watch the changing fundamental environment with an eye of increased caution.