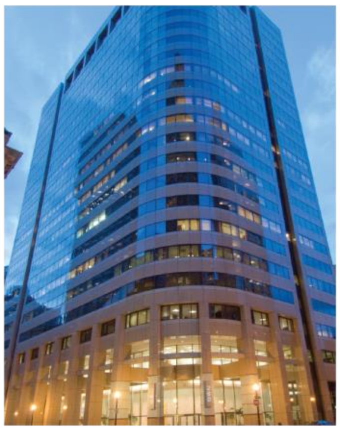
TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
February 6, 2018

OUR VIEW



Market Volatility

The stock market sold off sharply to start February, and Monday's losses have erased January's stock market gains. The S&P 500 Index fell 4.1% on Monday, and the Dow Jones Industrial Average fell by more than 1,100 points. The market drop comes after a year in which volatility was at its lowest level since the mid-1990s. We think that January's strong market performance was in part fueled by investors rushing into the market because of a "fear of missing out." Given the excessive exuberance to start the year, the market may have been due for a reversal.

The global economy continues to be in pretty good shape. U.S. companies are benefiting from the strong economy, with corporate earnings continuing to beat expectations. 4th quarter U.S. earnings results to date have 75% of companies beating consensus earnings estimates and 80% beating sales estimates. We think the market reversal is in part attributable to a sentiment shift from investors who think the market has moved too far, too fast. However, changing expectations about economic growth, inflation and Fed policy are also contributing to the market selloff. Long-term interest rates are rising in response to the strong economic environment, with 10-year U.S. government bond yields breaking 2.8% last Friday for the first time since 2013. Wage inflation, stubbornly low since the Global Financial Crisis, appears to be picking up as Friday's report of average hourly earnings showed a year over year rise of 2.9%. The combination of strong economic growth and early signs of potential wage inflation makes it more likely that the Federal Reserve will raise interest rates at least three times in 2018.

It is our view that we have entered an era of episodic volatility, in which markets are "quiet" for long stretches of time. The quiet periods will end abruptly when the consensus is disrupted, with a reaction that is magnified by the influence of computer trading strategies, ETFs and index funds. Some of yesterday's sharp moves during the trading day were probably attributable to computer algorithms selling in response to preset risk parameters. Dramatic moves in the market at the end of the trading day may be tied to index funds that sell stocks at the market close in response to investor redemptions.

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The market downturn over the past week is understandably stressful, but we think this is more likely to represent the start of a stock market correction rather than the initial stage of a bear market. A stock market correction is commonly defined as a market decline of 10% from its 52-week high. A market correction is often a healthy thing, serving to unwind some excesses in valuation and sentiment. Most investors welcome a market correction during a bull market, as corrections allow the market to consolidate before moving toward higher levels. Corrections are a normal occurrence during bull markets, and the current bull market is no exception. Other than the 2011 correction caused by the downgrade of U.S. government and European government debt, corrections since the Global Financial Crisis have been reasonably shallow and short-lived. Even the 2011 market correction was relatively brief, providing buying opportunities in a long-term bull market.

A bear market is a period of several months or years in which securities prices consistently fall. Bear markets, defined as a market decline of 20% or more, typically are associated with recessions. There have been bear markets that haven't coincided with recessions, such as in 1987 and 2011, but those bear markets reversed course relatively quickly. We expect to face a bear market in the not-too-distant future, but with most economies growing at an above-trend pace and inflation remaining low, the bear may stay in hibernation for the next year.

Our outlook for 2018 hasn't changed. Economic growth and corporate earnings growth continues to be strong in most of the world. We've expected rates to rise because of the strong economic environment, but rates and inflation are still under control. Tax cuts should provide a near-term boost to the U.S. economy in 2018, and the negative implications of an overheating economy and budget deficit are more likely to be felt in 2019 or 2020 than this year. We expect the Federal Reserve to raise short-term rates this year, but at a moderate enough pace to allow economic growth to continue.

Benjamin Graham, the "father of value investing", stated, "The day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment." Sentiment often swings between extreme optimism and extreme pessimism, and emotional swings are often disconnected from fundamentals. We will continue to share our thinking and will update you when we make portfolio or fund changes.

I will be sharing my thoughts on the markets on Monday, February 12 at noon in the TFC quarterly market outlook webinar. (Registration link). The webinar will also be posted on the TFC website for those who can't attend the live broadcast.

Feel free to contact your TFC Advisor, or me directly, if you'd like to discuss this in more detail.

Sincerely,

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