Quarterly Outlook

APRIL 2018

First Quarter 2018

The volatility conspicuously absent from equity markets throughout 2017 returned rather swiftly after a hopeful start to the first quarter. By the second week of February, the S&P 500 had racked up more trading days with a 1% change (both positive and negative) than were seen last year in total. The trend continued throughout the second half of the quarter, with indices making frequent, large moves in response to trade tensions, data breaches, corporate scandals, and ongoing political tumult. The S&P 500 dipped into correction territory (down 10% from a peak) twice before closing the quarter with a total return of -0.76% - its first quarterly loss since the third quarter of 2015.

After an extended period of unusual calm, some market turbulence is to be expected – especially in the later stages of the economic cycle.

Of the S&P 500's eleven economic sectors, only the information technology and consumer discretionary sectors posted positive returns in the quarter, despite the former being a major contributor to recent volatility in the index. The nine remaining sectors posted single-digit losses, with the worst performance coming from telecommunications and consumer staples. Small-cap stocks, which benefit disproportionally from tax cuts and fiscal stimulus, outperformed their large-capitalization counterparts in the quarter, with the S&P SmallCap 600 posting a total return of 0.57%. At the close of the quarter, small-caps had outperformed large-caps for both 5-year and 10-year periods.

While headlines rattled the markets, underlying economic conditions remained generally favorable as the US economy continued its ninth year of expansion. The Leading Economic Index (a composite of 10 economic metrics) rose 0.6% in February, surpassing economists' expectations of a 0.4% rise. Fourth-quarter GDP growth was upwardly revised from 2.5% to 2.9%. March unemployment remained unchanged at 4.1% for the sixth consecutive month. At its first meeting under new Fed Chair, Jerome Powell, the Federal Reserve Open Market Committee voted unanimously to raise the target federal funds rate another 0.25% to a new range of 1.5%-1.75% in March.

Though the global economic outlook remains hopeful, February Eurozone growth indicators showed signs of lost steam. Nevertheless, the European Central Bank changed its tone with respect to its quantitative easing program, removing language from its communications indicating a willingness to expand bond purchases in the case of economic deterioration. Interest rates were left unchanged for the time being, while the timing of an increase remains the subject of much speculation. The MSCI EAFE Index (an index of developed market equities) posted a net return of -1.53% in the quarter. Despite their sensitivity to trade concerns, emerging markets gained 1.42% (net return – MSCI Emerging Markets Index).

Gains have been similarly scarce in fixed income markets year to date, with floating rate notes providing the only positive returns for the quarter. U.S. Treasuries declined -1.18% as the yield on the 10-year U.S. Treasury rose to

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2.74% from 2.41% at the end of 2017. On the last trading day of the quarter, the spread between the 2-year and 10-year Treasury note shrank to just 47 basis points – the narrowest spread seen in over a decade.

Going Forward: Tandem's Outlook

An obvious shift in the investment landscape has occurred. Whereas the market displayed uncharacteristic immunity to unwelcome news throughout 2017, investors repeatedly reacted to troubling headlines in dramatic fashion in the first quarter. However, the recent uptick in volatility largely represents a return to normalcy rather than an arbitrary descent into chaos. After an extended period of unusual calm, some market turbulence is to be expected – especially in the later stages of the economic cycle.

With the US economy still on solid ground and fundamentals remaining supportive, domestic equities remain attractive, although continued volatility is expected. Recent corrections coupled with strong corporate earnings have brought valuations closer to neutral levels. Small-cap stocks may continue to outperform thanks to recent tax reform and less sensitivity to trade tensions due to their domestic focus.

The two largest threats the market now faces are inflation and trade concerns. If inflation were to accelerate unexpectedly, the Fed could be forced to raise interest rates more rapidly than currently anticipated. Needless to say, an all-out trade war between the US and China would have powerful, far-reaching effects on markets worldwide. However, the avoidance of such a scenario is in the interest of both parties, and we are cautiously optimistic that an amicable resolution will be reached.

Tandem continues to seek risk-adjusted returns through a balanced and diversified approach to investing while encouraging clients not to let volatility derail their long-term goals and objectives.

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