OmniStar financial group

Market Perspectives

A Glance at How the World Affects You

May 2018

Economic expansion may be reaching its end

Every week brings new developments that grab the attention of investors. Political and economic developments dominated headlines last week, and, in general, most investors focused on the positives. President Trump announced our withdrawal from the Iranian nuclear accord and renewed sanctions on that country's oil exports, sending oil prices to their highest levels in 3 years. Crude has remained in a solid uptrend, supported by rising global demand, adherence by OPEC countries to production cuts, and trouble with Venezuelan exports. It is plausible that we have returned to the risk-on trade and volatility has retreated, for now. The S&P 500 Index jumped 2.5% for the week with energy, financials, technology and industrials all climbing more than 3%.

Interest rates are also making headlines as the 10-year Treasury yield ended Friday at 2.97% and climbed above 3.00% on Monday. Rising interest rates suggest inflation but Thursday's consumer price index came in below-consensus for April and likely alleviated fears of inflation concerns. This was one more catalyst for the recent stock rally. Markets have been sensitive to inflation readings while looking for direction on whether the Fed is likely to raise interest rates two or three more times in 2018. In spite of a slower than expected first quarter, we are anticipating a total of three interest rate increases during the current year. Supporting our thesis, the Atlanta Fed sees real GDP rising to 4% over the next few months. Inflation moved higher in the first quarter, but remains at a level that should not impede growth. Finally, Fed balance-sheet tightening is expected to accelerate later this year; unwinding the Fed's bond supply began at just $10 billion per month in (2017) with plans to reach $50 billion per month by late 2018.

We are not suggesting that inflation will remain low forever. Indeed, we expect it will continue to rise, but only gradually. The April's Consumer Price Index rose slightly to 2.5% year-over-year, while core inflation held steady at 2.1%. Looking across the back half of 2018, higher levels of capital expenditures and improving productivity should prevent inflation from escalating faster than the economy can digest. Headline inflation is projected to land between 2.5% and 3% by the end of the year, with core inflation trending around 2.5%. All things considered, these levels should allow the current economic expansion to continue.

Earlier this year, trade war threats quickly dampened investor confidence and volatility came in with a vengeance. Fast forward to present and those same tensions are acting as a tailwind for equity markets. Investors took a deep breath with hope of ongoing negotiations being a sign of mutual respect and a willingness to work together. President Trump and Chinese officials are scheduled to be in Washington D.C. this week for additional talks and perhaps some motivation to import more U.S. goods. This would be a boon for the U.S. economy. Still, we cannot remove this element from the big picture; stocks fell on Tuesday amid renewed global trade concerns.

The Bottom Line: Softness in first quarter economic data stimulated fears that the economic expansion may be reaching its end. We believe such concerns are speculative with little or no basis. In fact, the current economic cycle appears intact and the probability of a trade war has eased. However, it is conceivable that negotiations collapse before agreements between the U.S. and China are reached.

Conditions produced by tightening labor markets and moderate inflation will likely force the Federal Reserve to continue increasing interest rates. Nevertheless, the Fed has been vigilant throughout this complicated puzzle and continues to make it clear that rates will rise gradually so as not to jeopardize the economic expansion.

Looking to the charts for market direction, many technical indicators are showing positive signs. Over the last week, we have seen a sequence of higher lows and higher highs. The S&P 500 has delivered higher lows, but the absence of higher highs is somewhat concerning. However, the potential is there following the close of trading on May 11, 2018.

Looking at our technical indices on a more granular level, NYSE breadth improved sharply as cyclicals rose and defensive sectors fell. NYSE breadth posted its biggest rise since February 20, led by big gain in stocks trading north of their 150-day moving averages and a big positive swing in net advance-declines.

Our strategic composite pushed further into positive territory, as market internals surged higher even though external markets were more mixed. Market internals benefited from market rotation back into cyclical favorites, including Technology, Industrials and Financials, as well as big drops in defensive groups including Utilities, Staples and Healthcare.

Given this backdrop, we expect the environment for corporate earnings will remain positive. The pace of earnings growth may slow from incredibly strong levels reached in the first quarter, but we expect results will be strong enough to limit downside equity risk as investors contend with positive and negative crosscurrents. Accordingly, at some point we expect equity markets will break out of their current trading range to the upside.