MONTHLY MARKET REVIEW

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PARADIGM SHIFTS

From Goldilocks to Late Cycle Gyration; Gathering Storm of Populism, Round II

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On February 2, Janet Yellen's second-to-last day as the Fed Chair, she finally got the data that she had worked so hard for – the average hourly wage gained a stronger-than-expected 2.9% in January. The elusive inflation may have finally arrived. Investors, however, did not take it well – the Dow Jones Industrial Average (DJIA) dropped an ominous 666 points and the 10-year U.S. Treasury yield rose above 2.8% for the first time in three years. On the following Monday, Fed Chair Jerome Powell's first day at the helm was greeted with the biggest one-day equity volatility surge in history – the VIX Index shot up 116% and the DJIA at one point plunged nearly 1,600 points before closing the day down 1,175 points, or 4.6%. The sell-off lasted for about a week and was followed by a spirited rally as fundamentals remained solid. The S&P 500 Index wound up losing 3.9% for the month. The U.S. Treasury yield curve, after a few sessions of steepening in early February, reverted to the flattening trend. The risk-off environment also took down the energy and commodity complex. To the relief of European policymakers, the euro ceded some ground to the U.S. dollar after twice failing to get above the 1.25 level. Recent Eurozone economic data has largely surprised on the downside. Coincidentally, the Citi Economic Surprise Index for Major Economies has also been steadily losing altitude since the turn of the year. However, at his debut testimony to Congress on February 27th, Chairman Powell stated that his personal outlook for the economy has strengthened since December. It is refreshing to have a Chairman who tells it like it is rather than hiding behind the committee's view.

EQUITY MARKETS INDICES[1]	1.31.18 PRICE	2.28.18 PRICE	MTD CHANGE	YTD CHANGE
MSCI All Country World	542	518	–4.4%	1.0%
S&P 500	2824	2714	–3.9%	1.5%
MSCI EAFE	2153	2052	–4.7%	0.0%
Russell 2000®[2]	1575	1512	–4.0%	–1.5%
NASDAQ	7411	7273	–1.9%	5.4%
TOPIX	1837	1768	–3.7%	–2.7%
KOSPI	2566	2427	–5.4%	–1.6%
Emerging Markets	1255	1195	–4.7%	3.2%
FIXED INCOME				
2-Year US Treasury Note	2.14%	2.25%	11	37
10-Year US Treasury Note	2.71%	2.86%	16	46
BBG US Agg Corp Sprd	0.86%	0.96%	10	3
BBG US Corp HY Sprd	3.19%	3.36%	17	-7
CURRENCIES				
Australian *(AUD/$)*	1.24	1.29	–3.7%	–0.6%
Brazilian Real *(Real)*	3.19	3.25	–1.8%	2.0%
British Pound *($/GBP)*	1.42	1.38	–3.0%	1.8%
Euro *($/Euro)*	1.24	1.22	–1.8%	1.6%
Japanese Yen *(Yen/$)*	109	107	2.4%	5.6%
Korean Won *(KRW/$)*	1068	1083	–1.4%	–1.4%
US Dollar Index *(DXY)*	89.13	90.61	–1.6%	1.7%
COMMODITIES				
Gold	1345	1318	–2.0%	1.2%
Oil	64.7	61.6	–4.8%	2.0%
Natural Gas, Henry Hub	3.00	2.67	–11.0%	–9.7%
Copper *(cents/lb)*	320	311	–2.8%	–5.8%
CRB Index	197	194	–1.7%	0.0%
Baltic Dry Index	1152	1192	3.5%	–12.7%

SOURCE: Bloomberg

With positive catalysts—tax cuts and the budget deal—in the rearview mirror, markets now have to deal with some potentially destabilizing issues.

LA GRIPPE DE KANSAS

Nestled in the southwest corner of Kansas and midway between New York and San Francisco, Haskell County was a typical mid-western farm community dotted with sod houses and livestock at the turn of the last century. In late January 1918, local physician and drugstore owner Dr. Loring Miner noticed an unusual development – one after another, many of the county's 1,720 residents were suddenly struck with a debilitating flu, which then morphed into pneumonia and, in some cases, death. Dr. Miner thought the flu was so dangerous that he wrote to the U.S. Public Health Service and the warning was published in the agency's weekly *Public Health Reports.* Little did he know at the time that Haskell County was ground zero for one of the deadliest pandemics in human history.

In March 1918, soldiers in Camp Funston, 300 miles east of Haskell County, were hit with the spreading flu. By April, the camp had reported 1,127 cases of flu and 46 deaths. Camp Funston was the largest of the 16 divisional cantonment training camps in the U.S. during WWI to house and train draftees. In early 1918, U.S. soldiers in large numbers started to make the long journey to Europe's Western Front, which gave the H1N1 influenza virus a free ride to the Old Continent. In May, the flu had allegedly killed millions in Spain, earning it the name "Spanish Flu" or "La Grippe". The Great War's close quarters and large-scale troop movement further facilitated the spread of the flu. It was estimated that 20% to 40% of U.S. Army and Navy personnel were sickened by the flu and pneumonia during the autumn of 1918. By the time the pandemic was over in late 1919, it was estimated that 500 million people worldwide, or about one in four people, were infected, and the death toll was pegged at 50 to 100 million.

One hundred years since that outbreak, the world is still vulnerable to the pandemic as a universal flu vaccine has yet to emerge. Public health agencies in the U.S. and Canada have warned that this year's flu season ranks among the worst in recent years, as the vaccine has been just 36% effective. Many hospitals have reported shortages of IV-fluid bags and intensive care unit beds. The British media even used the headline *Patients 'dying in hospital corridors'* to sensationalize the outbreak in England. While these situations are nothing to sneeze at for healthcare workers and patients, they pale in comparison to the century-old La Grippe.

CONTAGION WATCH

The February equity sell-off was akin to the market suffering a quick bout of the flu. The initial hit was debilitating with aches and pains, fever and cough. However, with economic fundamentals in fairly strong shape, markets were able to mount a decent recovery. Importantly, the pullback did not trigger wider contagion in most other asset classes. Spreads in investment grade and junk bonds did widen, but remained roughly flat from the year end 2017 levels. Commodity prices also held up relatively well, signaling that investors did not expect much economic fallout. Interestingly, Bitcoin, which some may consider an asset class (digital gold?), was hit hard on February 5th, dropping 17% to close at $7,100, down more than 60% from its December 2017 peak. However, as a sign that investors' risk appetite was only slightly dented by the market correction, Bitcoin has bounced back nearly 50% from the February lows to finish the month at $10,538.

The real and lasting damage was done to speculators who were betting against a rise in market volatility. We have cautioned in one of our recent reports ("A Vixing Puzzle") that the artificially suppressed VIX Index was an accident waiting to happen, but the speed at which things actually unraveled was still startling. Two of the most popular investment vehicles to short the VIX – the VelocityShares Daily Inverse VIX Short-Term ETN (XIV) and the ProShares Short VIX Short-Term Futures ETF (SVXY) – lost around 90% on February 5th. More shockingly, a liquid alternative mutual fund with capital preservation as its objective lost 80% over two trading sessions, perhaps the biggest ever two-day decline for a mutual fund. It should make people think twice about picking up nickels in front of a steamroller.

PARADIGM SHIFTS

While the sell-off can be viewed as a healthy, long overdue adjustment to rein in irrational exuberance, it also appeared to have ushered in a paradigm shift in the investment environment. Unlike equity corrections in recent years that had investors flocking to U.S. Treasuries as potential safe havens, the latest correction was accompanied by a steady rise in U.S. Treasury yields. This signaled that the Goldilocks environment – subdued but steady growth, disinflation, lower-for-longer monetary policy – may be giving way to potentially higher inflation and more aggressive central bank tightening.

There was another unusual development – the U.S. dollar remained rather weak in spite of the rising U.S. Treasury yields and the widening interest rate spreads between the U.S. and many foreign sovereign bonds. There was a growing concern about America's long-term fiscal health as the combination of tax cuts and increased federal government spending will materially increase the budget deficit for years to come. With the debt ceiling theatrics over for now, the U.S. Treasury has returned to the market with large supplies of bond issuance. The costs of funding Uncle Sam's shorter-term debt obligations have climbed to the highest levels since mid-2008.

POPULISM AND PROTECTIONISM REDUX

In the aftermath of Brexit and Donald Trump's surprise electoral victory in 2016, there was a concern that populism and protectionism were on the rise. That anxiety did not last long as markets were soon assuaged by centrist parties' general election victories in the Netherlands and in France. President Trump's campaign pledges to get tough on China over trade issues were put on the back burner as he sought to enlist China's help in pressuring North Korea. However, 2017 may have been just a pause in the West's growing embrace of populism as a backlash against globalization and immigration.

German Chancellor Merkel has had a difficult time forging a coalition government at home, and her plan for migrant settlement among European Union members has run into stiff resistance from Poland, Hungary, and the Czech Republic. In the upcoming Italian general election on March 4th, the anti-establishment Five Star Movement (M5S), led by the 31-year-old Luigi Di Maio, is likely to emerge as the largest party in the Chamber of Deputies, the lower house of the Italian Parliament. The consensus is that there will be a hung parliament as the M5S is so shunned by the establishment that it will not be able to form a coalition government. Be that as it may, it is still amazing that these once-fringe populist parties are gaining on the establishment during a period of solid economic growth in Europe. Imagine what would happen in the ballot boxes during lean times.

On this side of the Atlantic, President Trump's imminent move to impose stiff tariffs on imported steel and aluminum is hitting the market at the time of this writing. The NAFTA negotiation has remained contentious. The expected promotion of trade hawk Peter Navarro to the position of assistant to the president was yet another sign of the Trump Administration's pivot to more protectionist measures. On the immigration front, it appeared that politicians have been more interested in playing up Deferred Action for Childhood Arrivals (DACA) and the border wall to fire up their respective bases rather than finding common ground. Ironically, south of our border, anti-Trump sentiment has catapulted leftwing populist, Andrés Manuel López Obrador, to the top of the polls for Mexico's presidential election in July.

With positive catalysts – tax cuts and the budget deal – in the rearview mirror, markets now have to face some potentially destabilizing issues such as trade wars, rising inflation, and less market-friendly monetary policies. While we believe the strong earnings growth trajectory will likely prevail, there is the irony that, should Washington's unconventional late-cycle fiscal stimulus pack too much punch, valuations may contract further on the concern that the Fed will finally get serious about taking away the punchbowl. In short, the February market gyration may be just a warm-up act for further volatility ahead, which is not unusual for the bottoming process. We will be on the lookout for potential contagion to corporate bond spreads; it would be more complicated if the flu were to morph into pneumonia.

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