ZACKS INVESTMENT MANAGEMENT

Mitch on the Markets

The Four Biggest Risks Facing the Market Today

By Mitch Zacks
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In this week's Mitch on the Markets, I was pleased to bring in a special guest to talk about the markets with me. He is the Fixed Income Portfolio manager here at Zacks Investment Management, and also one of our top analysts on the macroeconomic side – Manish Jain.

I had a sit-down conversation with Manish about the biggest risks he sees today in the equities and fixed income markets, and what investors should be doing in response. Below is a transcript of our conversation:

Mitch: Thanks for joining me today, Manish! Let's get right to it. What do you see as the biggest risks in the markets today?

Manish: Happy to be here. There are four main macroeconomic risks I see today.

1. The first one is the winding down of the so-called 'Trump trade.' One of the main premises of the strong six-month run in the equities markets has been based on hope for pro-business policy changes. I think the reality now is that the timeline for making any legislative changes in healthcare or taxes or trade is delayed. That's the reality. The *risk* is if it gets delayed too long or diluted to the point where the changes are unsubstantial or disappointing, or both. Remember that midterm elections are not that far away now – November 2018 – and if the Republicans lose seats then their ability to legislate will deteriorate even further. They are in a race against time, and recent developments in the White House have not helped their cause. The one item I think would give the markets additional hope is if the administration decides to carve out corporate tax reform and handle that part of tax reform first, which could lower the corporate tax rate *and* encourage corporations to repatriate overseas earnings. That would be a positive, in my view, but far from assured.

2. Number two is weaker than expected economic data. The early part of the year brought some disappointing metrics with it – the consumer was notably weak in January and February, home and auto sales showed signs of softening, and Q1 GDP was around 1.2%. As of now, we expect Q2 GDP to

be around 3%, but if we were to see weak jobs numbers that could make the markets leery of setting expectations too high. Weak numbers could cause traders to back off previous bets made about accelerating U.S. economic growth.

3. The third risk I see is the notable lack of breadth in the U.S. equities markets. I saw a study using Factset data that showed that 10 companies were accounting for 50% of the S&P 500 gains year to date (that study was as of May 10). So, when you see data showing that the S&P 500 is up 7 or 8% on the year, it is a bit misleading – since only a few companies are accounting for most of the gains. If you break it down even further, you would find that five huge technology companies – Amazon, Alphabet, Facebook, Microsoft, and Apple – account for about a third of the gains of the S&P 500. This makes me a bit nervous, when a rally is so narrow. But, I think the positive here – and what makes this different from the tech bubble in 2000 – is that these companies actually have earnings to stand by their valuations. And those earnings are set to continue growing.

4. The last risk I see is, no surprise here, a political risk. This risk is tied to the first one I mentioned, since politics and legislative actions are of course intertwined. In my opinion, the market's upside potential is closely tied to the Trump administration's ability to advance its economic agenda. The political risk is that so many distractions and missteps in Washington will become a barrier to advancing reforms. I also worry about an unsettling feeling on the global spectrum, with Trump not necessarily extending a friendly or warm hand to trading partners like Europe. The last thing I think we want is a trade war, and if Trump continues to show an unwillingness to work with Europe it could have some unintended consequences that can impact growth.

Bottom Line for Investors

Mitch: So, what is the bottom line for investors? How should investors respond to these risks in portfolios?

Manish: It's important to remember that these risks coexist with a slew of positive factors that we see right now, which I believe still outweigh the risks. We expect earnings growth to be strong all year, perhaps hitting high single digits or better. In Q1, S&P earnings were up 14.7% with sales up 8% - those are solid numbers. Employers are even struggling in some cases to find new employees, and that amongst other factors has put some upward pressure on wages. That should help the consumer all year. We expect two interest rate increases this year, but interest rates are still very low, and the borrowing environment is still good for companies. There are a lot of strong positives that I think could justify even higher valuations as the year progresses, assuming the risks we discussed remain in check.

I would also remind investors that when one sector or area of the market outperforms, like information technology in this case, it could mean that some value plays are opening up in other areas of the market. This gets back to the pure value of diversification – if your assets are spread across sectors and regions, you can participate in narrow rallies like the one we've seen in the last few months, but you also own some of the value plays that result from one sector greatly outperforming another. The key for investors is to avoid "chasing heat," or using the tech rally as a motivation to bump up the technology weighting in your portfolio. If you have a diversified approach already in place, you don't have to worry about missing a rally in one region or sector. You'll already have exposure.

Mitch: Thanks Manish. Your final point speaks to the approach we've long advocated here at Zacks Investment Management, and its why we have strategies that target various market capitalization, regions, and provide investors with exposure to the 10 S&P 500 sectors, one of which is obviously information technology. An investor can get the diversification you advocate right here at Zacks, all in house, with managers like you at the helm! Thanks for your time.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.