Mitch on the Markets

Don’t Miss These Investment Lessons from Q1 2018

By Mitch Zacks
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The first quarter served as a wake-up call for investors and investment professionals in a few ways. We were reminded what real volatility felt like. We learned the Trump administration (or at least Trump himself) is serious about tariffs and trade. We were pleasantly surprised by how much S&P 500 corporations raised earnings estimates for the year.

In short, it was not a dull quarter! In this piece, I’ll take time to examine each lesson from Q1, while looking ahead.

On Volatility

January 26, 2018. With the benefit of hindsight, we can see that date as the ‘local peak’ of the market in Q1,[1] when the correction took hold. In my recollection, the possible reasons cited for the downside volatility ranged from rising inflation concerns, worries about rising interest rates and overvalued stocks, fears about global central bank tightening, the possibility of trade wars, and even an obscure ETF that fell 85% betting on the inverse of the VIX. Given the nature of corrections, however, we still cannot pinpoint the actual cause of the correction, and probably never will.

Regardless, investors were reminded – in classic correction fashion – of the sudden, sharp, and oftentimes scary nature of downside volatility. Prior to the decline, the S&P 500 had just completed its longest stretch ever without a drawdown of at least -5%,[2] and many investors had grown accustomed to very low volatility levels. Though we had long warned of an impending market correction, no one actually knew when the day would come.

As it stands today, the market has yet to recoup the sustained losses since January 26, though it has started to claw its way back.[3] It could be some time yet, if at all, before the market eclipses that January 26 level and reaches new highs. We believe it will, however, and we encourage investors to remain patient and to remember – volatility is a normal, natural feature of equity investing.

On Tariffs

The first tariff to address involves steel and aluminum, with tariffs set at 25% and 10%, respectively. The puzzling facet of this tariff decision was that it appeared to be aimed at China, but Canada is actually our largest steel trading partner. In fact, China is barely in the top ten of steel exporters to the U.S.[4]

While somewhat confusing, the key lesson regarding these tariffs happened a few days later, when the administration announced that Canada and Mexico would be exempt from the tariffs, pending the outcome of ongoing trade negotiations. Then, shortly thereafter, the European Union was also excluded, and it was announced that countries could apply for relief from the new duties. So, for all the hubbub about how damaging tariffs could be, the lesson here is this: *at the end of the day, and for now, the steel and aluminum tariffs turned out to be a big dog…with a small bite.*[5]

I think the same could be said of the threatened action against China, which involved President Trump signing a presidential memorandum seeking to slap tariffs on $50 billion on Chinese imports,[6] due to disputes over the forced transfer of intellectual property from the U.S. $50 billion is a huge number and could have major market impact, but I wonder if this could also be a paper tiger of sorts.

The market went into a tizzy in the wake of these tariff announcements but seemed to settle after a *Wall St. Journal* report that Washington and Beijing may be in the process of quietly negotiating improved U.S. access to Chinese markets, which is the thrust of the administration's rationale for the tough action.[7] Time will tell, and I do believe that a trade war would be a negative for markets. But, I'm just not convinced it will come to that.

On Earnings

As of this writing, the estimated earnings growth rate for the S&P 500 in the first quarter is +17%, which – if it stands – would mark the highest earnings growth since Q1 2011 (+19.5%). So, we could be looking at the highest earnings growth rate in seven years. [8] That's big, particularly this deep into the expansion.

But, the bigger story, in our view, is the record-breaking increase in earnings *estimates* looking ahead for the year. For S&P 500 companies, Q1 marked the **largest increase in the annual bottom-up EPS estimate** for the first two months of the year since tracking began in 1996. From Dec. 31st through Feb. 28th, the current year 2018 bottom-up EPS estimate increased by a staggering +7.3%.[9] The only way we can think to describe this data is, simply put, *bullish.*

The Bottom Line for Investors

Q1 marked one of the more eventful quarters we've seen in the last several.

The current volatility may be a reflection of the tug-of-war between what in my view are positive and negative forces – tax cuts (positive), rising interest rates (negative), strong earnings (positive), tariffs and threats of trade war (negative), broad based global growth (positive), potential regulatory action against technology companies (negative). You get the idea.

In my view, the positives continue to outweigh the negatives. So instead of seeing the volatility as a sign that the market is becoming more fragile, we see it as a sign that markets are actually behaving more normally.

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.

[1] Source - Yahoo Finance
[2] Source - Goldman Sachs
[3] Source - Yahoo Finance
[4] Source – Zacks Investment Management's Stock Market Outlook Report
[5] Source – Zacks Investment Management's Stock Market Outlook Report
[6] Source – Rueters
[7] Source – Wall Street Journal, https://www.wsj.com/articles/u-s-china-quietly-seek-trade-solutions-after-days-of-loud-threats-1522018524?mod=djemalertNEWS&mod=djem10point
[8] Source – Zacks Investment Management's Stock Market Outlook Report
[9] Source – Zacks Investment Management's Stock Market Outlook Report

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