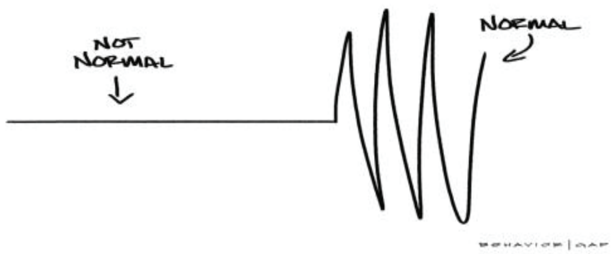
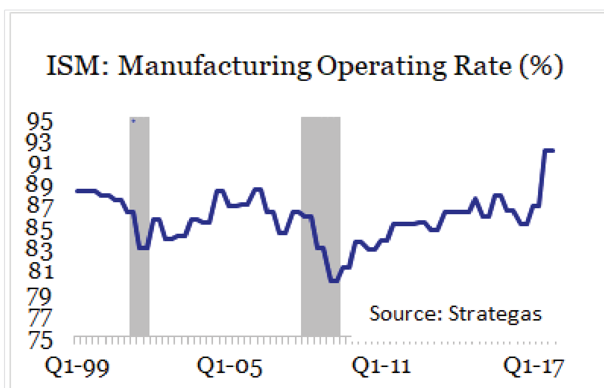
PALLADIUM
REGISTERED INVESTMENT ADVISORS
The value of trust. The wealth of experience.

PERSPECTIVES

Volume 11, Issue 1 | Spring 2018



- **It's baaaack!** … *Volatility*, that is.
- **In our Fall 2017 issue…** we contrasted the hurricanes -- both natural and political -- with the eerie calm seen in the financial markets. The calm of the "eye" continued through January, eclipsing over 400 days of advancing share prices without so much as a 5% decline. Broadly, stocks were up over 35% from start to finish.
- ***"Happy dance, right?"*…** Quite the contrary. We found ourselves looking over our shoulder for months.
- **Let's be clear…** Volatility, while always uncomfortable, is normal.
- ***"So what changed in February?"*…** We're glad you asked.
- **Good news can be bad news…** and February's employment report was ***too*** good.
- **Goldilocks…** For over nine years interest rates have been near-zero as the Federal Reserve has thrown money at the economy. The post-Great Recession era has been dominated by caution and by regulations designed to thwart economic excess. The combination produced the longest, slowest recovery on record. Not too hot or too cold.
- **And Goldilocks' friend, TINA…** Interest rates were so low, individuals were forced into the stock market. Indeed, "there is no alternative," TINA, became a mantra. Those desperate for income piled into utility stocks, REITs and long-term bonds despite the risk these investments can pose when rates rise.
- **Here's the thing…** The global economy is perking. In the U.S., the output gap is closing, capacity utilization is rising, wages are accelerating, and consumer demand is so strong supplier delivery times are slowing. After nine years of slow economic improvement, the economy appears to be in full stride.



- **Zoom, Zoom…** With the economic wind at our backs, Washington is cutting taxes, easing regulations and embarking on a huge fiscal spending plan…. the economic equivalent of pushing the pedal to the floor in an already fast-moving vehicle. If demand grows faster than supply, prices tend to rise.

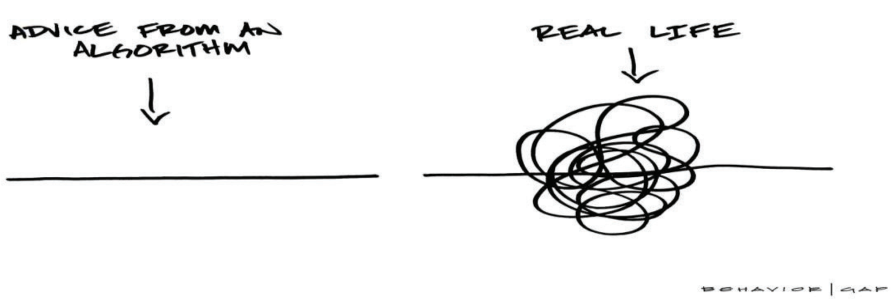
- **And so it was…** February's extraordinarily strong employment report turned the market's attention to the future prospect of inflation, which poses a threat to stock prices and to bond prices.

- **Goldilocks has left the building…** The stage is now set for the return of a more traditional, boom-bust economic cycle and, accordingly, the financial markets are displaying more typical volatility.

- ***This is what changed in February.*** Having grown complacent by years of slow economic growth, low inflation and an accommodating Federal Reserve, the financial markets have suddenly awakened to accelerating growth, upward pressure on wages, rising interest rates (falling bond prices) and the potential for higher inflation. Eighteen months ago the yield on the 10-year Treasury was a mere 1.30%. Today the yield has more than doubled and is approaching 3.00%.

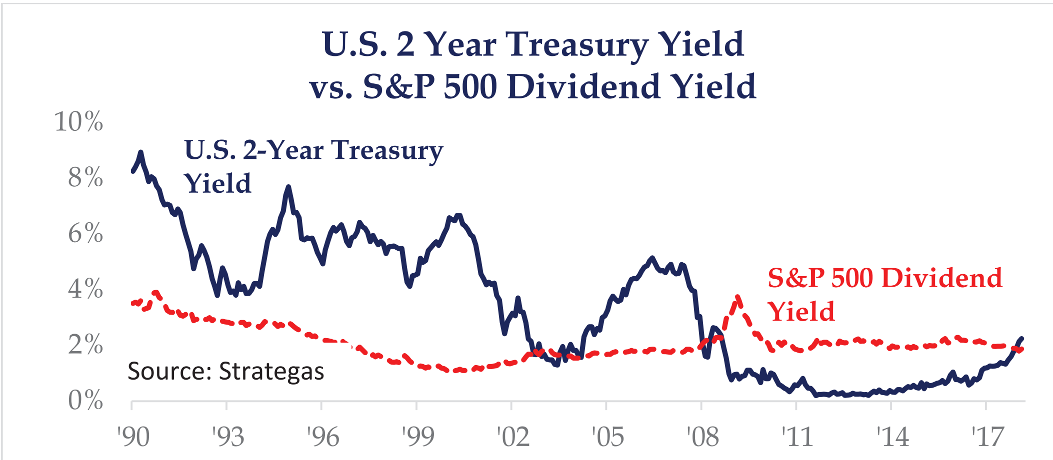
- **And so…** After over 400 days of ***La-Ti-Da***, the market has retreated sharply and is negative for the year.

- **Ironically…** large, sophisticated, algorithmic-driven programs, designed on the premise of a low-volatility environment, were forced to reset their mathematical parameters when the market suddenly grew volatile. These resets caused huge and abrupt swings in the markets. For those who were led to believe that these "If X, then Y" programs could be engineered to avoid extreme outcomes:



- **Bad behavior on display…** The abrupt volatility unnerved the public, who, with an all-too-predictable assist from the media, went quickly from complacent to fearful. Watching minute-to-minute the market value of their investments on their devices, the **"Sell All"** button at their brokerage web portal begged an emotional response. Robo-advisor sites crashed as investors ignored the robot and hit the button.

- **TINA is on her way out the door…** Five years ago the yield one could earn on the 2-year U.S. Treasury was less than one-half of 1%. Today the yield stands at 2.29%...higher, for the first time in nearly ten years, than the dividend yield on the S&P 500 Index. Investors have choices again:



- **Trade tensions…** have further heightened the market's angst. Globalization and free-trade, while helping economic tides rise in developing nations, came largely at the expense of an ill-prepared middle-America. Today's populism and the bias toward protectionist trade policies are the result.

- **Tariffs…** are taxes. Almost always, they beg a retaliatory response. They are not new. This kind of tit-for-tat has been seen in every Administration and the economic outcomes are almost always bad for both sides.

- **Diplomacy…** The President has been clear that he prefers to keep everyone off balance. *Everyone*.

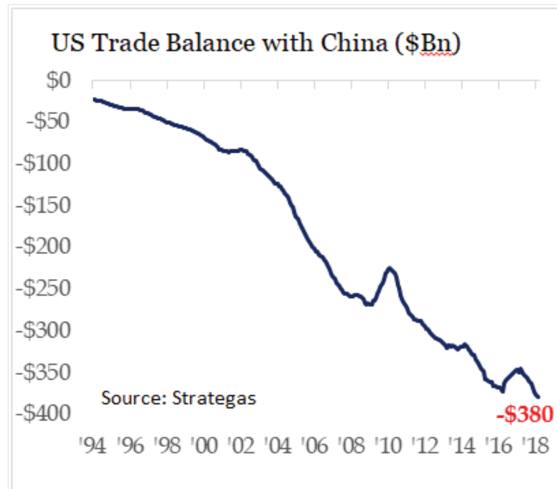
- **"You started it!"** Today's diplomatic exchanges remind us of when we were children. As a negotiating technique, we can only hope this banter doesn't end badly and understand and appreciate the market's angst. Sadly, the threat of trade wars has eclipsed the substantial near-term benefit from tax reform.

- **Speaking of tax reform…** any notion of simplification is laughable. Still, the near-term result should be better for most individuals and significantly better for most American businesses. Having reduced the corporate tax rate from 35% to 21%, U.S. businesses will be much more competitive globally and their earnings --*here at home*--should grow significantly. Further, the ability to immediately depreciate capital expenses should encourage investment in plants and equipment. This would create more employment and improve productivity.

- **We have to hope so…** Business activity and productivity must improve if we are to avoid elevating our national debt from huge to gargantuan.

- **On China…** In his book Destined for War, author Graham Allison observes that in 1980, China's trade with the rest of the world amounted to less than $40 billion. By 2015, it had increased to $4 trillion ---a one hundred-fold increase in a mere thirty-five years. Further, today, *"workers in China are one-quarter as productive as their American counterparts. If over the next decade or two they become just half as productive as Americans, China will have an economy four times that of the U.S."*

- **Thucydides's Trap…** Mr. Allison draws a parallel to the threat China poses to the U.S. via Greek historian Thucydides, who observed: *"It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable."*



- **As for China…** we're inclined to think that any such "war" is more likely to be a technological cold war than a conventional one. To thwart such a possibility, we'd prefer a spirited U.S. response to a retaliatory one. Instead of tariffs and the blocking of mergers, why not a "Let's do this America!" response similar to the 1960's space race with the Soviets? Give Americans a mission and the education, research and engineering to accomplish it, and we can wash away any fear of becoming number two.

- **Beware doom and gloom…** While Mr. Allison's book is loaded with economic data, it is equally full of opinion and dire predictions. Recall global population growth has been predicted for decades to outstrip the world's food supply *[One of the more recent was a 1980 State Department study titled Global 2000].* Yet today, obesity is the growing problem and, where malnutrition exists, it's largely the result of distribution failures and corruption, not food shortages (source: United Nations, 2015).

- **Y2K and Peak Oil…** Two more doomsday predictions that completely whiffed after much angst and hand-wringing.

- **Things are better than you think…** Fostered by politics and fueled by the media, anger, violence and pessimism get all the attention despite rising employment, wages, wealth, health and life spans. Treat yourself to some data-supported good news and read Greg Easterbrook's, It's Better Than It Looks. We quote: *"History is not deterministic, teleological, or controlled in any manner"*. Thanks to human ingenuity and effort, *"the arrow of history points forever upward."*

Spring 2018

PALLADIUM
REGISTERED INVESTMENT ADVISORS
The value of trust. The wealth of experience.

999 Waterside Drive, Suite 1000
Norfolk, VA 23510

Phone: 757-305-1500
Toll Free: 866-495-6498

Fax: 757-305-1538
www.palladiumllc.com