McQueen, Ball & Associates
Private Wealth Management

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THE RETURN OF VOLATILITY

Despite an active political climate, threats of a nuclear confrontation with North Korea, and devastating hurricanes, the stock market's 2017 action was one of the calmest years on record. The CBOE Volatility Index (VIX), known as the "fear gauge", which reflects the market's expectation of 30-day volatility remained subdued. In the first quarter of 2018, the VIX level has risen sharply as the market begins to anticipate a bumpier road ahead.

The economy remains on firm footing with fourth quarter GDP clocking in at a rate of 2.9%. Consumer spending remains strong and the fiscal stimulus provided by the tax bill will only help GDP growth to accelerate. Employment numbers are healthy; the unemployment rate remained unchanged at 4.1%. Even the stubbornly low, oft-cited, Labor Force Participation Rate moved higher to 63%.

Fourth quarter earnings are strong with a year over year growth rate of +20%. Earnings estimates for 2018 are being revised higher with analysts expecting a healthy economic environment along with tax reform to underpin a continuation of earnings growth.

With such good economic news why has the fear level risen? We believe there are a number of factors that are coming into focus this year that market participants are concerned about.

The first is inflation and the level of interest rates. Inflation while still low (below 2%) is beginning to show signs of life. With the economy now at or close to full employment, the Fed is shifting its focus to the other half of its dual-mandate: stable prices. Inflation reports are a lagging indicator and the Fed is now tasked with raising rates to prevent economic overheating while avoiding tightening so much that they choke off growth. With the recent 25 bps hike in the Fed Funds rate at end of the quarter, we expect 2 (possibly 3) hikes remain for the year. A normalization of interest rates will ultimately be beneficial for a sustainable growth rate.

Rising interest rates highlight another concern - equity valuations. Valuations have steadily risen as investors have gravitated to equities as opposed to low yielding bonds. It follows that as long as interest rates remain low they support higher equity market valuations. A combination of the Fed unwinding its balance sheet (selling bonds it bought through quantitative easing), rising inflation, increased economic growth and a hawkish Fed presents us with an economy in transition. While some investors may rotate back into bonds as rates become more attractive, higher rates have a multi-dimensional impact on the underlying economy.

Announcements away from the current fundamentals of the economy are also weighing on investors. In early March, President Trump proposed a 25% tariff on all steel imports and a 10% tariff on all aluminum imports. Later in the month, the administration announced a larger package of tariffs ($60 billion) targeting Chinese imports. While the steel and aluminum imports represent a fractional portion of the US GDP (0.2%), the specific tariffs targeted at China are meaningful.

One objective of the action against China is to penalize Chinese firms for the theft of Intellectual property. Currently, US firms looking to conduct business in China in industries such as energy, telecom, and autos need to form joint ventures with local partners. That requires the transfer of technology. At the same time, Beijing has been accused of requiring confidential information for product approvals as a way to procure technological information.

China's initial reaction to the tariffs was muted with a retaliatory $3 billion worth of tariffs on imported US goods. That modest reaction may indicate that China has no interest in escalating this skirmish any further. Should a "trade war" develop, the top categories of US exports to China include agricultural goods (soybeans in particular), aircrafts, machinery, and vehicles. The European Union, which is the 2nd largest supplier of steel to the US responded with threats of tariffs on bourbon, blue jeans, and Harley Davidson Motorcycles. The EU has since been exempted from the tariffs.

Depending on your point of view, the White House trade restrictions are either correcting a long overdue un-level playing field or are courting an unnecessary trade war for political gain. Regardless, the announcement of proposed tariffs followed by a more moderate subsequent tone seems to be a strategic Trump negotiating pattern. While there remains reason to be skeptical about the Trump Administration's ability to govern, the recent breakthrough between the U.S. and North Korea is an encouraging sign that some issues may actually be resolved.

Market nerves this quarter were further jolted by the data privacy crisis spawned by market darling Facebook and its relationship to the little-known data firm Cambridge Analytica. Cambridge obtained 50 million Facebook profiles from a third party which had mined the site using an app that downloaded not only a participant's data but also that of their friends. Cambridge apparently attempted to use that data in an effort to influence voters.

Interestingly, the data from Facebook wasn't "hacked" but obtained through legitimate means when Facebook allowed the third party to gather the data. The shift to the internet, cell phones, and social media has offered up vast amounts of information on users to firms like Facebook, Google, and others. How that data is then used or even sold to manipulate consumers and possibly voters is an issue that is just developing. It goes without saying that the government wants more control.

We are encouraged by the strength of the current economic environment, but our outlook is that 2018 is tempered by the threat of increased volatility. It is these concerns that remind us why our strategy remains balanced and diversified.—Todd Fungard & Jerry McQueen

THE IMPACT OF RISING INTEREST RATES ON BONDS

With the bond market bracing for more rate hikes by new Federal Reserve Chairman Jerome Powell, bond investors are faced with an environment last seen over a decade ago. It is important for bond investors to understand the inverse relationship between bond prices and interest rates. Quite simply, bonds with fixed coupons that were issued earlier become less attractive as new, higher yielding bonds are issued.

What is often not understood is just how dramatic those bond price declines can be. A commonly used tool to measure the impact of this is called duration. Duration is the approximate change in a bond price assuming a 1% change in interest rates. Expressed in terms of years, duration takes into account many different factors that can affect a bond's interest rate sensitivity such as its maturity date, coupon payment, and call features. Typically, bonds with shorter durations are less sensitive to changing rates than those with longer durations and therefore are less volatile in a changing rate environment. By way of example, a bond with an average duration of 5.0 would lose approximately 5.0% of its value if interest rates were to increase 1.0%. Of course, longer maturity bonds generally have a higher starting yield to compensate investors for taking on interest rate risk. In today's environment we don't believe the additional yield is enough compensation for the additional interest rate risk.

One of the cornerstones of our bond strategy is to maintain a low average duration. This is in addition to our focus on bonds with high credit quality. We are targeting our bond portfolios to have an average duration of less than 2 years. Therefore, the impact of rising rates on our bond portfolios as a whole will be relatively muted. Given where we are in the current interest rate environment this is important in order to both dampen volatility and mitigate losses as best as possible. An additional benefit to the low duration strategy that we employ is that as bonds continually mature they can then be reinvested at what will likely be more favorable interest rates.

We believe that given the expectation of a higher interest rate environment in the future that this is a conservative way to invest capital and one that will allow for even greater opportunity as interest rates eventually rise.—Brett Dublick & Todd Fungard

CHARITABLE GIVING FROM IRAs

Clients who are required to take Required Minimum Distributions from retirement accounts may find that making charitable gifts directly from the IRA to a charity is more tax efficient that direct gifting based upon changes in the tax law. Due to the limitation of the deductibility of both income and real estate taxes against Federal income, many taxpayers will no longer itemize deductions but will opt for the standard deduction. In some of these cases, charitable contributions may have limited deductibility.

Under current tax law, a Qualified Charitable Distribution (QCD) allows those over age 70 ½ to donate money (up to $100,000 per individual) to charities directly from their IRAs. This gift will count towards satisfying the individual's Required Minimum Distribution for the year and will also be excluded from the taxpayer's income. The net effect is a tax savings for the charitable contribution even if the standard deduction is taken.

Please let us know if you have any questions about this strategy.

For more information about McQueen, Ball & Associates and our products and services please contact us at 610-954-0400 or by email at info@mcqueenball.com

McQueen, Ball & Associates, Inc.

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