CHOATE

2018 First Quarter Review

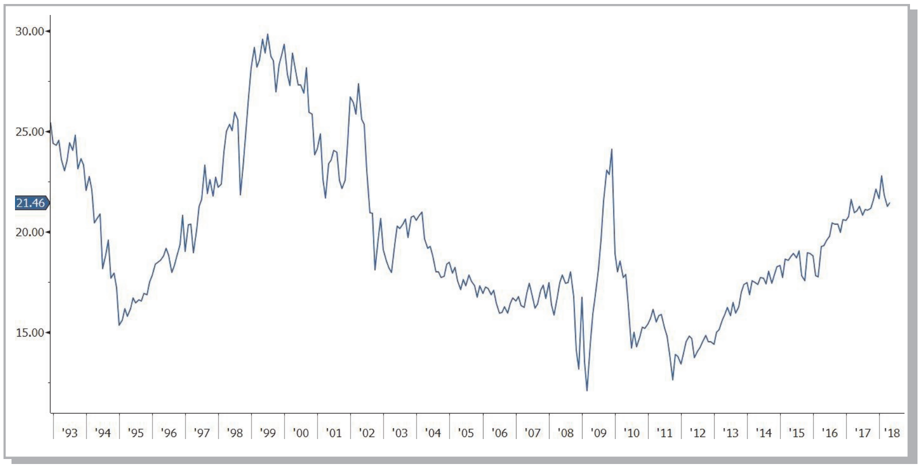
Despite a sharp increase in volatility, stock market returns were just slightly negative during the first quarter of 2018 and actually outperformed bonds. A rise in yields depressed bond returns as market participants became more concerned about growing inflationary pressures and tensions around global trade continued to rise. Although the economic backdrop remains positive, it is particularly important for investors to focus on risk given potential long-term issues.

Quarterly Review

With perfect foresight, the value of a stock would simply be the discounted sum of future earnings and the value of the S&P 500 would be the weighted average of expected earnings for the constituent companies. But the future is uncertain and investors' expectations often swing between optimism and pessimism. If investors are optimistic, they ascribe more value to future potential earnings and therefore are willing to pay a high multiple for current earnings. If investors become pessimistic, multiples decline even if current earnings are strong. After several years of market gains, stock multiples are elevated for the S&P 500, and earnings expectations are high as well. Investors are clearly optimistic.

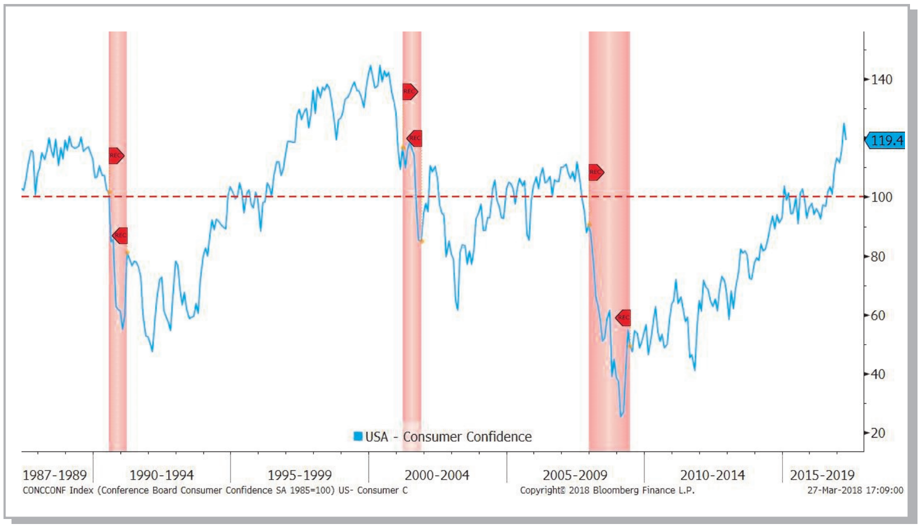
This optimism is well-founded. The global economy is undergoing a rare synchronized expansion, fiscal and monetary policy in the United States and around the world is accommodative, and consumer sentiment is reaching multi-year highs.

Price to Earnings Multiple of S&P 500



Source: Bloomberg

Conference Board Index of Consumer Confidence



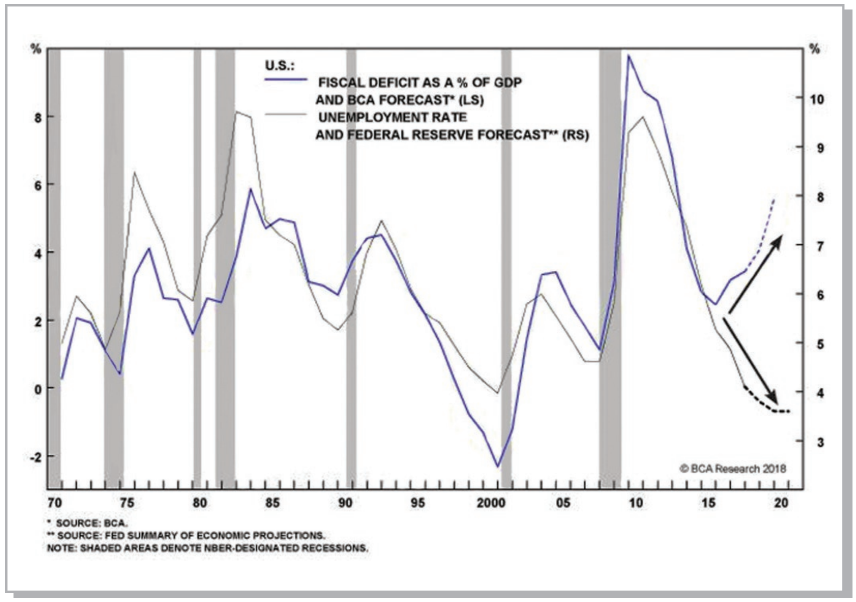
Source: Bloomberg

It is common for investors to “anchor” off current conditions and project that recent good times will continue. Indeed, it is entirely rational to assume that conditions tomorrow will be very similar to those experienced today. Looking a bit further ahead, however, there are several developments that give us pause. Taken together, these five factors may combine to depress future stock multiples. In our view, even a relatively shallow recession could have a significant impact on the stock market, for several reasons:

1. **Fiscal policy.** The recent tax cut legislation provides a fiscal boost to the economy in the near term, but likely exacerbates budgetary pressures longer term. The fiscal pulse from the recent tax cut has the greatest impact on the economy and corporate earnings in 2018, when it is arguably least necessary. In a downturn, deficits will rise further, perhaps well above 10% of GDP. In addition, many states have not been increasing their rainy day funds but are instead lowering taxes. As states need to run balanced budgets, without these additional reserves there will inevitably be pressure to cut spending during the next downturn. We therefore do not expect the same level of fiscal stimulus in a future downturn that was present in both the 2001 and 2008 recessions. Instead, there may be push for budget cuts and austerity, which would prolong an economic slowdown and delay an eventual earnings recovery.

2. **Monetary policy.** Given that interest rates are quite low on an absolute basis, it is likely that the U.S. Federal Reserve will have less scope to provide monetary stimulus than was the case in 2001 and 2008. It may be that even a shallow economic downturn will see interest rates drop quickly back down to zero. Once interest rates reach the lower bound, the Federal Reserve may need to employ aggressive and creative policy, as it did in 2008. It remains to be seen whether the current Federal Reserve leadership will be willing to do this.

Growing Structural Deficit Could Prevent Stimulus Response to Recession



Source: BCA

3. **Deglobalization.** Recent events indicate that the free trade consensus that governed Washington since World War II may be coming to an end. Even prior to President Trump’s election, the Obama Administration’s effort to ratify the Trans Pacific Partnership was deeply unpopular with Democrats and Republicans alike. President Trump’s latest protectionist actions have met little political resistance. Historically, calls for protectionism surge during difficult economic times. Therefore, tariffs and quotas may increase significantly during the next slowdown, with negative impact for the economy and the markets.

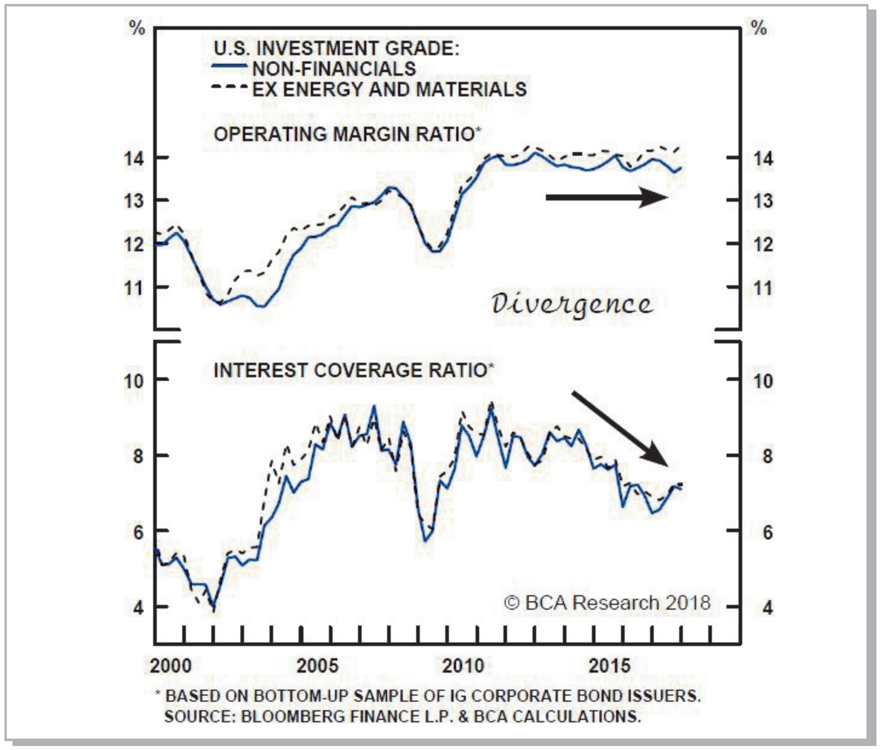
4. **Corporate debt.** Over the past five years, corporate leverage has increased significantly. High levels of corporate borrowing could intensify the negative

effects of the next downturn as companies cut wages or capital expenditures to meet debt obligations. According to an analysis by the economic research firm Bank Credit Analyst, interest coverage ratios (a measure of the level of corporate indebtedness) have declined even while corporate margins are at highs and interest rates are very low.

5. **Valuations.** Equity market valuations currently reflect an optimistic view of future economic growth and corporate earnings. While valuations are not at the stratospheric levels of the late 1990s, they are well above the valuations levels of the market in 2007. Much of the stock market gains in the U.S. over the past five years were the result of higher valuations rather than improved corporate earnings. In fact, corporate revenue growth and margin expansion over the past five years was below the historic long-term average.

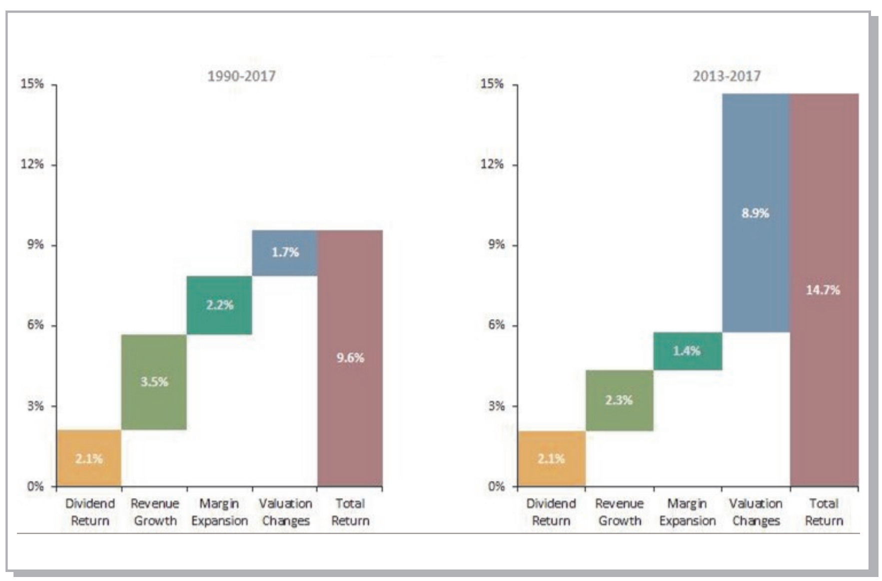
Economic growth remains robust and we do not expect an imminent recession. It is tempting for investors to "chase" returns and add to riskier assets in the hope of capturing further near-term gains. As always, we believe a wiser path is to maintain discipline and, at the margin, harvest profits. Although there are no obvious areas of concern in the economy at present, we expect that inevitably the business cycle will eventually turn. Even if the next recession is relatively mild, it could trigger an outsized decline in market values for investors. As such, we have begun to gradually reduce risk across our portfolios. In this environment it is particularly important for investors to understand and be comfortable with the level of risk exposure in their portfolios.

Corporate Leverage is a Growing Concern



Source: Bloomberg Finance L.P. & BCA Calculations

S&P Annual Components of Return



Source: Choate Investment Advisors, Bloomberg

For More Information

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