THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – FEBRUARY

US Markets and Economy:

The inevitable correction for stocks finally arrived in February, and US stocks had their first down month in almost a year. All major indexes fell, but a recovery mid-month moderated the damage. Nonetheless, from the late-January peak to February trough, US stocks lost 10%, which is the Wall Street definition of a major correction. This was the first 10% correction in over two years, which means investors had been having a very smooth ride for many months of a very long bull market. In fact, during the last two years, there was not even a 5% (minor) correction. While corrections are part of any healthy bull market, this latest decline was unusual in its speed: only 13 days for the S+P 500 Index to drop 10.2%. The previous two major corrections were slightly deeper, but lasted 96 and 100 days, respectively. Investors must now deal with the return of volatility, which can shake out the faint of heart, but not rattle the experienced long-term investor.

What set off the sharp decline? Stock traders became unnerved when it appeared that wage inflation was beginning to pick up, after remaining near dormant for the entire economic recovery. While faster rising wages are a plus for many working Americans, it raises the specter of faster rising interest rates, as the US Federal Reserve clamps down on inflation before it exceeds the Fed's target of 2%. Since monetary policy affects the economy with a significant lag, the Fed often acts preemptively. While it is true that wage inflation does not necessarily lead to price inflation, that is often the case, particularly when the economy is close to "full" employment. Many economists believe that "full" employment is achieved when the unemployment rate is around 4%, and the current rate of unemployment is only a tad higher at 4.1%. While the bull market can certainly continue even while the Fed is raising interest rates, fears that they will raise them at a faster rate can clearly unnerve markets in the short run. Wall Street also dislikes uncertainty, and with a new and untested head of the Fed (Jerome Powell) and four vacancies on the Fed's Board of Governors, there is more uncertainty than usual.

The recovery from the correction was itself reversed by another fear: that US trade policy would lead to a trade war between the US and its trading partners. President Trump announced that he would impose tariffs on all imported steel of 25%, and impose tariffs of 10% on all imports of aluminum. Economists have long taught that there are few winners from trade wars, and that

countries as a whole usually lose even though protected industries may gain in the short run. Steel is a perfect example: while the steel producers applauded the tariffs, steel-using industries (which employ many more workers) expressed their dismay. US exporters also noted that their products would be affected by retaliation, which could in fact lead to counter-retaliation, and so on. Investors should not be diverted by fears of an all-out trade war, since cooler heads should eventually prevail. But higher volatility may afflict the markets in the short run. Any negative headline could send stocks into another tizzy. In the long run, however, the US economy is still sound: economic growth is likely to pick up to a faster pace, corporate profits will be up sharply this year, and inflation and interest rates are still very low.

So, on balance, the path of least resistance for US stocks is still upward, but it appears long-term investors will be "earning their stripes" in 2018.

World Markets and Economy:

In the Americas, Canadian and Mexican stocks sold off with the US market early in the month, and then fell again on the prospects of a trade war, since both rely heavily on access to the US market. US Steel and aluminum tariffs could make it even harder to renegotiate the NAFTA agreement, which has been a boon to both countries, as well as a net gainer for the US.

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, followed the US market lower in February, also dropping by 10%. The recovery from the correction was sharply reversed after the announcement of tariffs, since Europe depends on trade more than the US. For example, German stocks, as measured by the DAX Index, dropped to their lowest levels in a year on March 2nd. (Germany is the export powerhouse of Europe and has much to lose in a trade war.) German stocks are now down 7.7% for the year. France's economy is less tied to exports, and thus French stocks had a smaller correction, and are only down 3.3% for the year. But the general declines in the US, Europe and even Asia suggest that there would be no winners in a full-scale trade war.

Japanese stocks were not immune to the selloff, and had their own correction of more than 10% early in February, but the Nikkei rallied late in the month to cut its losses. Relative strength in Japan can be traced to a stronger economy, as evidence mounts that the Japanese have turned the corner after two decades of deflation and economic stagnation.

OUTLOOK:

The long-term path for US stocks is still up, driven by booming corporate profits and a strong economy. However, the ride upward now looks bumpier, after the first major correction in two years. Long-term investors must have the patience and discipline to ride out these inevitable corrections which occur regularly in every bull market.