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OBSERVATIONS ON THE MARKET

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What changed? We went for more than a year with subdued volatility, and few market moves that were 1% or more. Now it feels like we are getting a 1% move in the stock market weekly. Unlike the previous year, some of these moves are now down. We have always had the news headlines. A president that is unpredictable, or predictable depending on how you look at it, terrorist events in Europe, and threats of war from North Korea. So why now?

Maybe it is because the news has become too good. Slow and steady is good, it is really what the markets dream about. It is hard to build excesses in the economy when growth is slow and steady. It keeps inflationary pressures low and allows assets to be priced at higher valuations. However, we are now showing signs of moving out of the slow and steady stage. Job creation continues to be robust. Unemployment is now approaching an almost 50-year low. That is great news for the economy, to a point. Not so good news for the markets. Average hourly earnings in the last three months are now growing at a 3.2% rate. That is a core indicator for the seeds of inflation. A look at commodity prices is showing the same trend. Oil is now up to $65/barrel. In the last year cotton is up 10% and lumber is up 25%. These are all ingredients of things we use every day. We haven't been worried about inflation for almost a decade. After the recession of 2008, we were more worried about deflation. The markets are now beginning to worry more about inflation.

This takes us to a new chapter, it is one where sometimes good-news is really bad-news. It also means bad-news is not as good as it used to be. Anything that was perceived to keep the economy and inflation in check was ultimately good news. With inflation entering the picture, the market valuation story has changed. This helps explain why volatility has picked up and we have finally seen a market decline of about 10%, and now two of them in the last two months, when previously we went for more than a year without one. Your house is a simple example of how the story has changed. If interest rates increase, the mortgage payment also goes up for the same size mortgage. Or, your same income lets you afford a slightly smaller house. This is the same affect that interest rates have on stock and bond prices. We need to remember that it is not a one for one correlation. The market is in the business of discounting the future, so what may make sense today, doesn't always matter. The market is trying to figure out what is going to make sense next year based on today's news. Thus, we now have more volatility.

Ok, it may seem easy, interest rates are now moving higher, so I should just take a long vacation and invest later after rates have moved higher. However, what if your mortgage payment has increased, but so has your income? Maybe we are back to square one, you can still afford the same house. This is also part of the new story. Corporate earnings are expected to hit $160 this year for the S&P 500. We finished 2017 at about $125. The tax cut helped this number, but it is mostly a one-time bump. It is amazing that the previous high for earnings before the recession of 2008 was $85 in June of 2007. We have recovered and almost doubled earnings in 10 years. In this tug of war between higher inflation and higher corporate earnings, the winner is hard to predict short-term. It probably does imply that the market may end the next year essentially just digesting all this. However, predicting is an inexact science. For a reminder of that, just look at the *Wall Street Journal's* obituary for David Mullins.

He was a finance professor at Harvard, senior Treasury official under George H. W. Bush, and he spent some time as the vice chairman for the Federal Reserve. He was also a possible candidate to become the Federal Reserve chairman. His resume has more on it, however, it also includes Long-Term Capital Management. He was part of the team at Long-Term Capital that had to have a Federal Reserve intervention in 1998 to rescue the economy from a possible collapse. He was quoted in 2000 as saying: "One of the big lessons is that the world changes. There will always be some event that you can't foresee."