



Southern Capital Perspective

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2018: Shaping Up to Be the Year of Volatility

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We are now one quarter of the way through 2018 and the volatility has been in high gear. The S&P 500 graph on page 2 shows the amazing amount of gains and losses incurred in this brief period of time.

The important questions that need to be explored are what will the final three quarters of this year look like in terms of volatility and what issues might drive that volatility? We believe the four big issues are:

1. The bloated budget deal that puts the US on the path to \$1 trillion annual deficits.
2. The recently imposed tariffs that constitute the threat of a trade-war.
3. FED policy and how many times that they raise interest rates in 2018 in response to inflation.
4. The success or lack thereof regarding negotiating with North Korea about denuclearization.

First, the 2018 Budget Deal has been called "The Start Of 'The New Normal'." In U.S. Politics and Economy" by Stan Collender of Forbes, he is referring to an era of permanent \$1 trillion deficits. Previously, the conventional wisdom was that trillion dollar deficits would only occur as temporary spikes as a result of economic downturns. These huge deficits will result in greatly increased government borrowing which in turn bring about higher interest rates. Mr. Collender believes that the interest on the federal debt will be the fastest growing part of the federal budget. The implications are that the hope of regaining control of deficits and the budget are gone.

His pessimism arises from the fact that the Democrats, the Republicans, and even the President were all a part of enacting this abomination. However, President Trump said that he will never sign a bill like that again. He said that he only signed it because our military was so decimated by budget cuts that he agreed to Congress' outrageous spending for our nation's safety. Time will tell if he is able to live up to his strong statement.

The other budget busters, which have been considered the main problem, are the social programs: Social Security, Medicare and Medicaid. It is sad to say that at this point in time, our government officials have neither a plan nor the resolve to deal with these unfunded programs. Leadership is needed, yet our politicians are too fearful.

Second, the tariffs that President Trump recently imposed on steel and aluminum have raised the specter of a trade war. Furthermore, China has reacted initially with a modest amount of tariffs on US products and then another set of larger ones along with threats of tariffs from other countries around the world. The stock markets had sharp sell-offs in February and March because of trade war fears.

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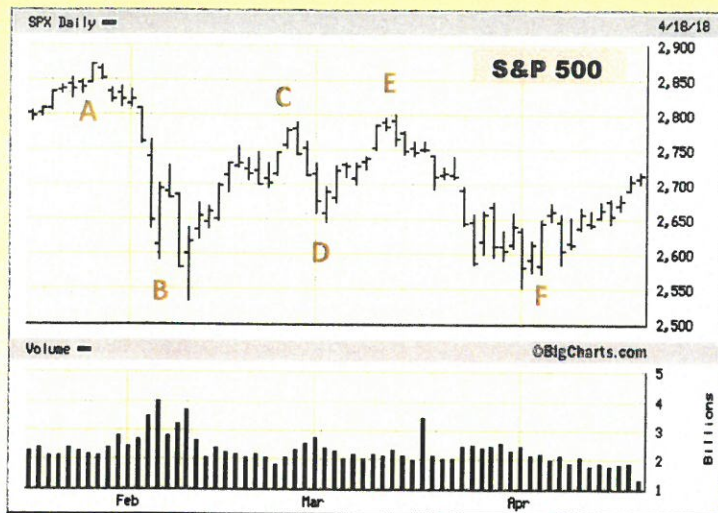
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2018: Shaping Up to Be the Year of Volatility (cont.)



| Date | Index | Label | Change | Direction | % Change |
|------------|---------|-------|----------|-----------|----------|
| 12-29-2017 | 2673.61 | | | | |
| 1-26-2018 | 2872.87 | A | + 199.26 | Up | 7.45% |
| 2-19-2018 | 2532.69 | B | - 340.18 | Down | 11.84% |
| 2-27-2018 | 2789.15 | C | + 256.46 | Up | 10.13% |
| 3-02-2018 | 2647.32 | D | - 141.83 | Down | 5.09% |
| 3-13-2018 | 2801.90 | E | + 154.58 | Up | 5.84% |
| 4-02-2018 | 2553.80 | F | - 248.10 | Down | 8.86% |

Why is the President taking these actions? Does he want a trade war? Does he realize the danger to the US and the global economy if an actual trade war breaks out? Or, is this a calculated risk and are these negotiating tactics intended to win trade concessions for the benefit of the USA? It seems that Donald J. Trump usually has a "method to his madness" as in the case of his approach to North Korea and its leader Kim Jong Un. The President seemed unhinged with his tirades about "Little Rocket Man" and yet, thus far, he has secured a cessation of nuclear and missile tests along with a forthcoming meeting with Kim Jong Un. Therefore, it may be reasonable to give him the benefit of the doubt in regard to his tariff negotiating strategy.

His argument — that we have been in a trade war for decades yet America has not been fighting back — has merit. Post World War II, the US has given most nations of the world favorable trade agree-

ments to help them rebuild. It is now almost 75 years later and because the world has developed so much, we find that we can no longer afford trade deals that are tilted against us. For example, in 2017 the Council on Foreign Relations put out a blog post on "Auto Trade with China." In it Brad W. Setser stated:

"China has a high tariff — which clearly encourages production in China for the Chinese market. The 25 percent tariff is a real barrier. It is consistent with the global rules: China's auto tariff is bound at 25 percent, the EU's (European Union) tariff is bound at 10 percent, and the U.S. tariff on autos is bound at 2.5 percent."

America is clearly at a disadvantage and Donald Trump, the candidate, promised to remedy the situation. It was never going to be easy because no nation wants to voluntarily give up an advantageous trade situation without a struggle. Hopefully, he will be able to level the playing field without the pain of a trade war by using his "Art of the Deal" negotiating tactics; and, as he frequently says, "We will see what happens." The concern is that escalating rhetoric could get out of control and end up in a trade war. Both President Xi and President Trump, however, understand the potential negative impact; therefore, a full-blown trade war is not impossible, but it is improbable.

Third, FED policy always has a very significant effect on markets. According to the Kiplinger publication: "The Fed will keep raising short-term interest rates because the central bank is focused on indicators showing a tightening labor market. The Fed very much wants to stay ahead of any inflation that rising wages may generate and will lift short-term rates by a quarter of a percentage point three times in 2018 (March, June, and December). That would put the federal funds rate at 2.25% heading into 2019." The first part of their

prediction has come about; the Fed raised the interest rates by ¼ % on March 21.

The Fed has two basic reasons to justify the raising of rates. First, they want to “reload their gun” so that they have more ammunition to combat the next downturn when it happens. The higher interest rates are, the more they can lower them to combat the next recession. Second, and more importantly to keep inflation under control. According to the Fed’s Monetary Policy Report – February 2018: “Consumer price inflation has remained below the FOMC’s longer-run objective of 2 percent. The price index for personal consumption expenditures increased 1.7 percent over the 12 months ending in December 2017, about the same as in 2016... Measures of longer-run inflation expectations have, on balance, been generally stable, although some measures remain low by historical standards.”

The Fed’s decision to increase interest rates always has the effect of moving the market. In the latter part of 2017, the conventional wisdom was that there would be at least four rate increases in 2018 because of inflation concerns. However, as the two articles quoted above indicate, the inflation expectations have cooled off; the outlook is for three rate increases instead of four. Therefore, the impact on market volatility would be reduced.

Fourth, the status of US relations with North Korea could have an enormous effect on the markets because the stakes are so high. The growing threat that North Korea poses has evolved to the point of being a grave threat to the US homeland. Kim Jong Un has developed his ballistic missiles and nuclear weapons to the level where a deliverable nuke will be available to him in the not too distant future. US intelligence and military experts indicate that this capability will be reached in terms of months, not years.

US Presidents have failed to deal with North Korea for decades. Now President Trump does not have the luxury of kicking the can down the road as his predecessors have. He has had to take the problem head-on and deal with it. So far, he has had some success in suspending missile and nuclear weapons tests and has tentatively set up a summit for the two leaders. This was accomplished by im-

posing strong economic sanctions on North Korea along with frequent reminders that all options are on the table meaning military solutions. It is clear that if negotiations are successful, the markets would be relieved; but if the result is Kim Jong Un with a nuke or a shooting war, the markets would experience volatility.

Conclusion: The balance of 2018 is likely to remain volatile. Each of the four issues discussed above is likely to have moments of exuberant optimism as well as moments of deep pessimism causing the market to gyrate. As a dramatic example: on April 4, the market (Dow Jones Industrial Average) on tariff war fears opened down 510 points and ended the day UP by 230 points ...

Incredible volatility!

“It’s normal to get scared about your investments when the market is crazy. Stick with it long-term and you will win.

The only way to get hurt on a roller coaster is to jump off!”

— Dave Ramsey

Outlook

2017 was a great year – strong stock market returns along with volatility that was the lowest in decades. January of 2018 started out the way that 2017 ended, but by the end of the month, the long-awaited correction was underway. We had the first 10% decline in almost two years. Then the volatility began in earnest – please review the graph on page 2 of this newsletter. Volatility does not necessarily equate to market losses although many times that is the case. In fact, as of April 5, the market (in terms of the S&P 500) is virtually unchanged on a year-to-date return basis. Volatility has definitely returned but what will be the direction of the market for the rest of the year?

The four issues that were noted in this newsletter will weigh upon the direction of the market, but the underlying strength of the US and the global economies will act as a counterbalance to any weakness. This does not mean that the market must go up, but it does indicate that unless government spending, tariffs, Fed policy or North Korea get wildly out of control, then the fundamentals of economics should prevail. Therefore, our best judgment is that economics will ultimately win out and that 2018 will be a positive year. As is always the case, however, there are no guarantees.