BALLENTINE PARTNERS

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Market Correction: Passing Squall or Tsunami Warning?

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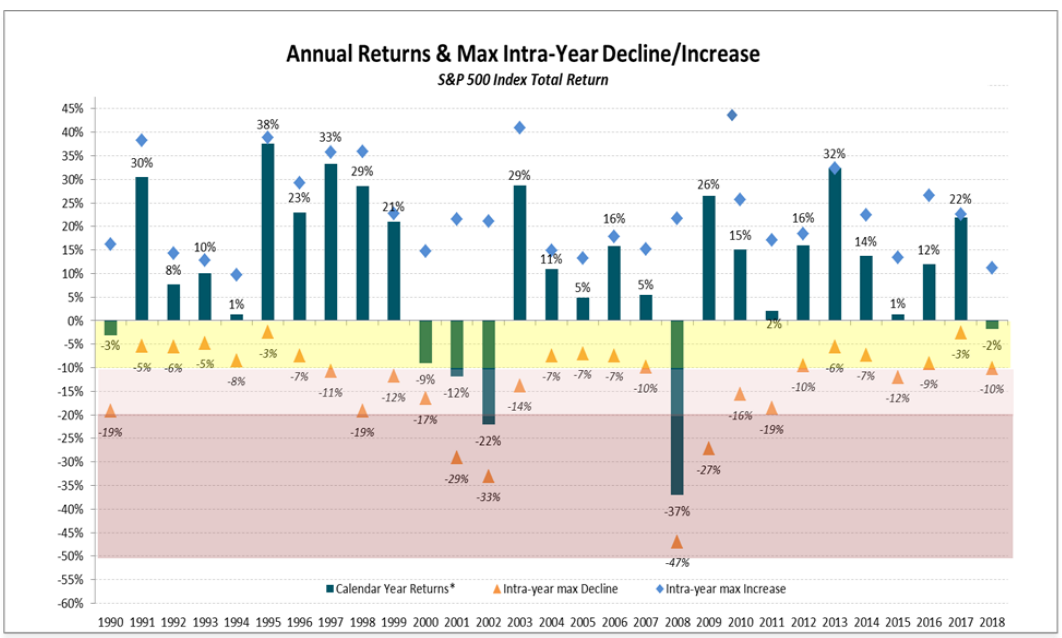
Investors awoke from their multi-year slumber in late January to a nasty reminder that stock prices are volatile. After a period of calm in the stock markets that rivals the longest in recorded history, a jump in average hourly earnings and the recent backup in bond yields refocused investor concern on the prospect of higher inflation down the road. That sent equity investors rushing for the exits, driving the S&P 500 down 10.2% in the span of just 8 trading days. Global markets followed suit, with the riskiest parts of the financial markets taking the biggest hit.

As quickly as the market fell, the rebound has been almost as fast. As of last Friday (February 16), the US stock market had recouped more than half of the losses from those tumultuous 8 days. Was the sharp "correction" and subsequent recovery just a passing squall, or a harbinger of more pain down the road?

Let's first recognize that this recent dip is well within the normal range of market volatility. On average, since 1991 the S&P 500 experiences a decline of 10% or more in almost half of all calendar years:

Also note that during this 26 year span, the market ended the calendar year with losses only 5 times (2018 data is through February 9 only). So it is fair to say that the recent dip represents a return to normalcy more than a surprising change in behavior.

More importantly, is the fundamental reason for the selloff (higher expected inflation and interest rates) a legitimate cause for the increased anxiety? After several years of warnings from market prognosticators of higher inflation that failed to materialize, it now appears that



Source: Morningstar Direct & Ballentine Partners as of 2/9/2018 modestly higher inflation is on the horizon, at least in the US. Wage pressures are increasing, and the downward pressure on the dollar is increasing the cost of imports, allowing domestic manufacturers to raise prices without losing their competitiveness. The threat of an overheating economy, juiced by recent tax reform and big increases in government spending, will likely put further upward pressure on interest rates.

While the deflationary forces that have held prices in check for the last several years remain in place, it is likely that the factors described above will generate an uptick in inflation in coming quarters. But despite all of the hand-wringing over higher inflation, the latest reading of CPI showed a 1.8% year on year increase, still below the Fed's stated 2% target. And the Fed, under the new leadership of Jerome Powell, is determined to keep inflation in check by raising short-term rates as many times as is necessary.

Our view is that inflationary pressure is likely to increase in coming quarters, but will not be enough to drive interest rates substantially higher. Under this scenario, equities are likely to remain attractive to investors, supported by a strong economy and solid earnings growth. In fact, equities are relatively good inflation hedges, as companies can protect margins by increasing prices. The threat to equities would come from an overheated economy which causes the Fed to raise rates aggressively, setting the stage for the next downturn. As investors grapple with these uncertain outcomes, we expect there will continue to be market squalls.

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Bruce is a Managing Director and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.