Review & Outlook

First Quarter 2018

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Review and Outlook

The stock market continued its steady upward climb in early January. By month-end, the economy and underlying fundamentals had not changed, but overall sentiment became more cautious, and stock prices started to reverse. In early February, the market dropped sharply when a strong jobs report led to fears about inflation, and speculation that the Federal Reserve might raise the Federal Funds rate four times in 2018. The yield on the 10-year Treasury rapidly climbed to 2.9% (the highest level since early 2014) following a jobs report that suggested inflation was on the rise. Stock prices partially recovered later in February, but then went up and down with tweets about tariffs, the resignation of Trump's top economic advisor, and more. The announcement of tariffs on steel and aluminum, as well as additional tariffs imposed on Chinese imports, combined with turmoil in the tech sector in the second half of March led to a significant increase in volatility, and a retest of the February lows.

Indices[1]	Total Return as of 3/31/2018	
	Q1 2018	Trailing 12 Months
CRSP US Total Stock Market Index (Total Return)	-0.60%	13.87%
MSCI Global ex-US Total Stock Market Index	-1.62%	14.32%
Bloomberg Barclays 1-5 Year US Investment Grade Bond Index	-0.67%	0.67%

Looking ahead, the labor market continues to expand. Wage growth, while modest, is stronger than it has been in recent years. The Blue-Chip forecast for real GDP remains at 2.8% for 2018, and the forecast for 2019 increased slightly to 2.5%. Participants in the forecast also predict inflation at roughly 2.6 percent in the second and third quarters of 2018, declining to 2.3 percent for the fourth quarter. The Chief Investment Strategist for Charles Schwab also gave a positive outlook for 2018 and 2019. She noted that Europe is earlier in the business cycle than the U.S., which gives a type of synchronized growth that should help all countries. Emerging markets are also seeing more internal growth, which is another sign of strength. While the economic indicators are largely positive, there are always factors that could upset economies and markets. We have already mentioned the on-again, off-again flap over tariff policy and potential trade wars. An unrelated issue is the rate of retail store closures, which are running significantly ahead of store openings. Debt and too many square feet per shopper present real challenges. Rising interest rates could be a particular problem in that sector, causing ripple effects across other sectors.

The reality is that short term forecasting of financial markets is notoriously difficult. There are always unanticipated factors that could have major impacts, and we do not expect 2018 to be an exception.

In Focus

This quarter, we're focusing on stock market indices; what they tell us, how to use them, and why they are important. Investors are always trying to understand how to measure the performance of stocks, and how their own portfolios are doing in relation. But with thousands of individual common stocks trading on the US stock exchanges every day, what does "the stock market" really mean?

This is not a new question. In 1896, Charles Dow and Edward Jones introduced the Dow Jones Industrial Average (DJIA or the Dow) to serve as a proxy for the stock market. It was an index based on the prices of 30 important companies. Today, there are hundreds of different indices that serve as proxies for the performance of many different groups of stocks. The DJIA and the S&P 500 Composite Index are the two most widely recognized indices for the US stock market, and are often used interchangeably. But they measure very different universes, are calculated in very different ways, and are both limited to the stocks of the largest US companies.

Indices are important to investors because they can provide a benchmark to evaluate the performance of their own stock portfolios. However, it is important to understand how an index is constructed in order to ensure that it will be useful as a benchmark. The DJIA is probably the most recognized index, yet it is probably one of the least appropriate indices to use as a benchmark for the broad US stock market, since it is composed of only 30 stocks, each of which is ranked as either Giant or Large Capitalization. (Capitalization, or cap, is a measure of the size of a company.) The diversification of the DJIA is markedly different from almost all other indices because it was not designed to track the broad stock market. It is also price weighted, which means that the higher priced Dow stocks have a heavier impact on the index than the lower priced stocks. The Dow is a great benchmark for the Dow, but for any other portfolio there are better alternatives.

The other widely recognized index is the S&P 500 Composite Index, often referred to as the S&P. However, there are many S&P indices, like the S&P 600, the S&P 400, etc., and each is composed differently. While the S&P 500 has many more stocks (500) than the Dow, and is more diversified by capitalization, it is a capitalization-weighted index. As a result, the performance of larger capitalization companies has a much bigger impact on the index than the performance of smaller cap companies. Since Intel has a slightly larger capitalization than Boeing, its impact on the S&P is slightly greater than the impact of Boeing. However, Boeing has almost seven times the impact on the Dow versus the impact of Intel because it is $330 per share vs. Intel’s price of about $50 per share. While all of the Dow companies are either giant or large cap, 14% of the S&P is ranked as mid-cap. In addition, the companies included in the S&P 500 are intended to represent all industrial sectors. This assures much greater diversification than is found in the Dow.

When using a benchmark, we consider whether it is investable, measurable, and relevant. It should be unambiguous and transparent, independently managed, and accessible. Based on these factors, we have decided to start using the Center for Research in Security Prices Total US Market Index (CRSP) as a benchmark for our US equity and stock mutual fund holdings, replacing the S&P 500 Composite Index. It covers the universe of US publicly traded companies as a whole, and reflects the universe of domestic equities from which we select stocks. The CRSP Total Market Index is not generally well known, but it is a much better benchmark for stock portfolios that hold more than just the largest stocks. While the economic sector diversification is similar to that of the S&P 500, it has a much larger proportion of stocks with capitalization less than large, and it includes a representation of small cap stocks that are not included in either the S&P 500 or the DOW. It also has many more holdings, resulting in less concentration in any given stock. However, like the S&P, it is a capitalization-weighted index. As a result, larger cap companies have a larger impact on the index than smaller cap companies.

For our global, or “non-US” equities and funds, we use the MSCI ACWI (All Country World Index) ex US IMI (investable Market Index) index. This covers more than 9,000 securities across large, mid and small-cap segments in 46 developed and emerging markets.

While there can be no perfect benchmark, the goal is to have an independent measure from which you can gauge relative performance given a similar pool of assets, including a similar risk profile for those assets. Time also plays an important role; a benchmark should be relevant over a long period of time, not necessarily day to day.

1. CRSP US Total Stock Market Index: http://www.crsp.com/products/investment-products/crsp-us-total-market-index#performance-report. MSCI ACWI ex-US IMI Index: https://www.msci.com/acwi. Bloomberg Barclays Indices: https://www.bbhub.io/indices/sites/2/2017/03/Index-Methodology-2017-03-17-FINAL-FINAL.pdf