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INVESTMENT PERSPECTIVES

>> SECOND QUARTER 2018

How would Massachusetts fare in a trade war?

By Michael A. Tyler, CFA
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Most mainstream economists agree that trade wars are harmful to all participants. Higher import tariffs cause inflation, depress domestic demand, and invite retaliation that makes exports less competitive. This is true both within and among countries; it was sheer genius that our Constitution placed interstate trade under jurisdiction of the federal government and not of the states. Free flow of trade across state lines has always been a major contributor to our nation's economic growth.

When it comes to international trade, though, individual states are likely to be affected to varying degrees. The implementation of steel and aluminum tariffs would be most painful to Texas (17.5% of U.S. imports, and no competing in-state producers), while Hawaii would be most adversely affected by the European Union's (E.U.'s) proposed tariffs on some U.S. agricultural goods (12% of the state's total exports to the E.U.).

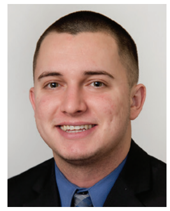
Yet while Texas and Hawaii sing the trade war blues *(Save me from this squeeze / I got a big fat tariff trying to break me)*, Massachusetts is humming a different Kinks verse: *And I love to live so pleasantly / Lazing on a sunny afternoon.*

Massachusetts is home to many global companies and manufacturing enterprises, but it ranks as only the 18th largest state for trade, accounting for 1.8% of exports and 1.5% of imports nationwide, according to Census Bureau data. The state's share of trade in goods targeted by proposed tariffs is even lower: Massachusetts accounts for only 0.6% of U.S. steel and aluminum imports, and these metals represent only 0.8% of the state's overall imports. Similarly, only 1.1% of the state's exports are in categories targeted by the E.U.'s proposed tariffs. New Hampshire fares even better in the same analysis.

The fear, even in Massachusetts, is that ever-escalating retaliations would expand the breadth of goods and services covered by rising tariffs. This fear drove the stock market's erratic volatility through the first few months of this year: With each threatened action, stocks dove; with each report of behind-the-scenes negotiation, stocks recovered. We can't know how this trade spat will end, but we can at least take comfort that any impact here will likely be indirect and small.

>> PERSPECTIVES ON THE ECONOMY

The return of volatility and normality



By Timothy Garvey
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After the lullaby of 2017 (sweet dreams of rising asset prices and no rude shocks), early 2018 has stung investors with sharply higher volatility. Markets last year were remarkably consistent; the S&P 500 set more than 70 record highs. Any negative news was shrugged off, and markets kept chugging along on the back of strong economic and company performance. Investors were lulled into complacency, as the S&P 500 moved more than 1% up or down on only eight trading days all year.

The CBOE Volatility Index (VIX) was remarkably subdued (see graph). In normal markets, the VIX is about 20, yet last year it rarely surpassed 15; markets were not normal. Conversely, volatility is indeed higher this year, as the S&P registered 27 trading days with 1% moves just in the first quarter. Perhaps this explains why investors seem so worried by 2018's market behavior.

It is important for investors to maintain perspective through the normal ups and downs in the market. It's easy enough to justify the turbulent start to this year — political uncertainty in Washington, a more hawkish Federal Reserve, and a potential trade war with China, for starters. Yet despite these qualms, the main drivers of last year's market rally remain intact: The U.S. economy is still on pace to grow by about 3%. Consumer spending and business equipment investment remain very strong. Employment reports indicate a strong job market with steady wage increases. Companies are also well positioned for robust earnings growth. We recognize the uncertainties, but more importantly, we also recognize the economy's strengths. Our outlook remains positive.

CBOE VOLATILITY INDEX (VIX)

Volatility has spiked upward after a prolonged lull.

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>> FOCUS ON EQUITIES

Will equity markets continue their bull run?

By Rose Grant-Brooks
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The current bull market turned nine years old in March, making this the second longest bull market in history. The bears warn that this bull is about to die of old age, and indeed stocks seemed more vulnerable in early 2018 than they had been in years.

Last year was extraordinary, after all: The S&P 500 rose 21.8%, with almost no volatility. The index gained ground for 15 consecutive months starting in November 2016 — a first in the 90-year history of the index. Yet after a strong performance for January, the S&P 500 experienced its first correction in two years, prompting the question: What is wrong with the equity markets?

Fundamentally speaking, nothing is wrong. Earnings and revenue growth look solid, based on a growing U.S. economy. The corporate tax cut has led to increased earnings expectations; we think corporate profits can grow by 12% this year. Corporate confidence is improving and company management teams are increasing capital spending, hiring, share buybacks, and dividends. This positive backdrop gives the bulls room to move upward.

Last year was also good for international markets; it was the first time in eight years that international stocks topped those in the U.S. market. Central banks and fiscal policy converged worldwide to produce a synchronized recovery in economic growth; previously, growth in some areas had been offset by weakness in other geographic zones. International stocks should continue their upward momentum in 2018, as economic and earnings growth should persist with valuations being reasonable and international central banks accommodative.

Even so, global equity markets are in a different place than they were a year ago, with more challenges: Interest rates are rising here in the U.S.; inflation may return; ongoing talk of tariffs and retaliation scares investors with the prospect of a long and costly trade war; and stability is scarce in a White House riven by the constant turnover of staff and the everlasting investigation of Russian interference in the 2016 election.

Valuations have come down since the equity markets have sold off, and look more reasonable in relation to rising earnings prospects. When the equity market returns to fundamentals, economic and earnings growth will be attractive lures.

>> FOCUS ON FIXED INCOME

Is this the beginning of a bond bear market?

By Tom Bussone
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Was it a false start? For a few weeks this year, it looked like the bond bear market had finally arrived. U.S. Treasury yields jumped sharply as synchronized global growth along with a tight labor market caused investors to pull money out of the Treasury market. The 10-year yield hit 2.95% in late February, more than double its yield less than two years ago; the last time it closed above 3% was in 2013.

The selloff stalled, however, as the 10-year yield ended March at 2.74%. In a global context in which trillions of dollars' worth of bonds yield below zero and uncertainty abounds in Washington (most notably about trade policies), yields reversed and moved lower. Not even the Federal Reserve, led by new Chair Jerome Powell, could stop investors from pouring money into the Treasury market. Mr. Powell struck a more hawkish tone than that of his predecessor, Janet Yellen, calling for at least three rate hikes this year and a steeper path through 2020.

Despite the recent drop, we do expect the 10-year yield to test the 3% level this summer. Earnings remain strong, manufacturing is trending higher, and hourly earnings have been increasing by more than 2.5%. To protect against rising rates, we have maintained our holdings in an investment grade floating-rate bond ETF along with a short duration high-yield mutual fund. We also added to our Treasury Inflation-Protected securities to hedge against the threat of inflation.

U.S. TREASURY YIELDS

The 10-year Treasury yield is hitting levels last seen five years ago.