RESEARCH TEAM
WILL GUTHRIE
WHIT DAVIS
STEPHEN HALKOS
HOWELL HOLLIS, CAIA®
STUART HUSTON
HARRY JONES
BRENDAN KEELAN, CFA®
ELIZABETH MACKIE, CPA
JACOBI PADGETT, CIMA®
DENNIS SABO, CFA®
WILL SKEEAN, CFA®

EDGE RESEARCH INSIGHTS | FEBRUARY 2018

The Return to Normal

With the opening this morning, the S&P 500, and most other major equity market indexes, entered correction territory (defined as a 10% pullback), ending one of the longest unabated market advances in recent history. Defined by its lack of volatility, global equity strength, and stubbornly low fixed income yields, 2017 was an abnormal year and one that we communicated was unlikely to repeat in 2018. In our recently released Outlook we stated the following: “where we think 2018 will differ dramatically from 2017 is that the volatility of returns will accelerate – with inflation and interest rate volatility being the culprits.” While we were accurate in the catalyst, we certainly did not know when or how quickly interest rates would begin to re-price global growth and the associated inflation tendencies.

CLOSING IN ON A -10% CORRECTION

Source: Strategas

Over the past several weeks, the 10-year US Treasury yield has increased from 2.3% in the fourth quarter to a recent high approaching 2.8% - an advance that is not surprising in the context of the acceleration of global growth, but one that has caught some investors off guard. Rate shocks are not uncommon and generally trigger a negative equity market response. This time is no different. Investors are extrapolating that the increase in rates will continue unabated and stall the economic momentum, influencing the behavior of the Federal Reserve in its attempt to "normalize" monetary policy following years of accommodations. Equity markets are soothed by predictability, especially as it relates to interest rates. While the recent lift in rates has been quick, we do not believe that the current level (approx. 2.7% at this time) is an impairment to the near-term growth outlook nor that rates will rise materially from current levels. Aside from the moderate forward growth expectations, the global search for yield and income will likely contain US rates for the foreseeable future.

The equity selloff has been quick (exacerbated by computer-driven trading), and is generating its fair share of media attention. We believe the fundamentals and economic backdrop remain robust – even when accounting for the increase in rates. To start, corporate credit conditions are sound, supported by strong balance sheets and ample cash flow, both of which will be further strengthened by the decline in tax rates and the repatriation of foreign cash. Despite the lift in rates, spreads (i.e. difference between treasury and corporate yields) remain tight, suggesting that the recent move is not a reflection of weakening corporate fundamentals. While credit spreads are important to monitor as a recessionary indicator, other conditions also suggest health for the US economy - these include the level of wage growth, earnings quality, job growth, and manufacturing data, all of which suggest continued economic expansion.

Against a long backdrop of declining volatility and higher equity prices, we are not surprised that the recent market correction is eliciting such a strong reaction by investors and media outlets. As a reminder, the average annual equity market correction since 1980 is 14%, suggesting the recent decline is well within normal tendencies. Rather than try and "market time" a future correction, we believe the best approach for investors is to follow their asset allocation plan and to not let volatility alter that plan, especially when fundamentals are supportive. We have no reason to believe that the current correction is anything but a return to normal volatility and expect investor attention to revert back to fundamentals in the weeks ahead.

ABOUT EDGE CAPITAL

Edge Capital is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

For more research and commentary, visit us online at **www.edgecappartners.com**.

CONTACT EDGE

1380 West Paces Ferry Road
Suite 1000
Atlanta, GA 30327
Phone: 404-890-7707
Email: info@edgecappartners.com