Tragedy, Market Rebound and What Next!

The tragedy, of course, is the mass shooting at a Florida high school which left seventeen dead. The tragedy is twofold: the terrible occurrence last week and the fact that it is not an isolated incident. It has occurred with some frequency and the country still awaits some type of protective action. In fact in Kansas a congressional candidate, Tyler Tannahill, reiterated his goal to give away an AR-15 assault rifle as a political prize.

On a much lighter note, the financial markets had a very positive week! In fact, the Wall Street Journal reported that the S&P 500 had the best week since 2013. This wouldn't be particularly earth shaking, except it follows one of the worst weeks in the market's history. So, to paraphrase Mark Twain, 'the rumors of the death of volatility have been greatly exaggerated'. The rally should have been expected, just as the correction should have been. The stunning part of both, the drop and subsequent rebound, was the magnitude of the moves and if last week's rally wasn't a temporary respite, the shortness of the correction. Both economic reports and company earnings were encouraging to investors. Housing starts were very strong. Housing starts lead to consumer spending and has implications about household formation, which implies the same thing. A troubling statistic was the inflation number which was quite high. Investors are concerned about this because they fear higher inflation will force the Federal Reserve to move quicker and raise rates higher than previously anticipated. Two important points: first, the inflation statistic is quite volatile and can be reversed or moderated in the months to come and second, the major players on the Fed Open Market Committee[1] have signaled they, at this time, have no intention of changing policy.

We wrote last week about the possibility of a dramatic federal deficit and debt obligation. Of course, it is very difficult to forecast very far into the future, but the sequence of events points more and more to this possibility. We wrote last week we did not see this happening until mid or late 2019 and that remains the case. As government policies roll out, a sequence of events looks more possible. The new tax overhaul has taken place. Most budget analysts have argued that this program will cause a large deficit and therefore a large debt obligation in the out years of the budget. This was followed by a budget agreement which, again, will create an additional increase in the deficit. Now the White House is floating its Infrastructure program. All of these programs taken alone may be very worthy, but taken in sequence they may lead to disaster.

The tax reform was sold on the premise that the proposers believed the extra funds flowing into consumers' pockets would be a strong enough stimulus to give the country a minimum of 3% GDP growth for ten years, and that would cover the deficit. We have argued in the past how that is highly unlikely! And, finally, there is the matter of paying for things, for example, the budget deficit. For example, the idea of an additional $0.25 tax on a gallon of gas has been floated as a way to replenish the Highway Fund. If that comes about, that 25 cent tax will eat up a large portion of the consumers' gain from the tax overhaul. It is not hard to see how that leads to a very high deficit. Interestingly, each item is quite worthy. It's only when taken collectively they may lead to a very serious problem.

Two final points about the market volatility. First, the return of market volatility leads us to believe active equity management will continue to do well. Second, which we will write about in the coming weeks, is the role that new market instruments played in the market and what, if anything, should be done.

[1] A committee of the Federal Reserve that votes on Monetary Policy.

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The Week Ahead:

- **MONDAY:** Russia Unemployment Rate expected at 5.30%; Russia PPI m/m expected at 1.30%
- **TUESDAY:** Germany PPI m/m expected at 0.50%; EC Consumer Confidence expected at 1; Japan All Industry Activity Index m/m expected at 0.40%
- **WEDNESDAY:** US Existing Home Sales m/m expected at 0.90%; US Markit US Services PMI expected at 54; EC Markit Eurozone Services PMI expected at 57.6
- **THURSDAY:** US Leading Index expected at 0.70%; Canada Retail Sales m/m expected at -0.10%; UK GDP q/q expected at 0.50%
- **FRIDAY:** EC CPI m/m expected at -0.90%; Canada CPI NSA m/m expected at 0.50%; Germany GDP SA q/q expected at 0.60%