After a Volatile Start, Where Do We Go in 2018?

Opportunities lie with Small Caps and in China

By Bob Deitrick, CEO
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This year has re-introduced volatility back into the markets - a setting we have not witnessed in quite some time. After three months of "Stormy Daniels-like" weather, the VIX tiptoed beneath 15 for the first time since January - just two weeks ago. This explains the rally we have experienced over the past ten days as well. To the extent the VIX can remain stable, below 15, we may see some nice gains ahead, of course, time will tell.

So where do the opportunities lie ahead for you in this mature market? We believe opportunity does indeed exist, but one needs to be stock and sector specific this year more so than any time in recent memory. A sector we truly admire this year is the small cap space:

Small Cap stocks, as measured by the Russell 2000 and the S&P 600 hit all times highs last Friday, once again. One reason the small caps are outperforming their large-cap brethren this year is that they are a greater net beneficiary of the tax reform bill which became law in December. Also, small caps have a lot less exposure to the overseas markets by a margin of 23% compared to 47% relative to the S&P 500, and with the U.S. dollar strengthening - this benefits the small cap sector. Finally, the effect of tariffs – to the extent any kind of trade war does materialize, small cap stocks are less affected by tariffs and trade policy because 77% of their business is domestic, so for these three viable reasons small caps should continue to outperform this year and we will continue to overweight this unique opportunity. All the discussion of tariffs and trade policy may act as a headwind for the S&P 500, but time will tell. So, when you wrap those three items together, the Russell 2000 appears poised to be a leading sector this year.

One might argue that some of this is already baked into cake, but with all due respect, we disagree. The Russell underperformed the large cap space in 2017 by 400 basis points (or 4%) and we feel this conversion of awareness of the Russell outperforming is just being understood by most for the first time. CNBC just started paying attention to this for the first time in the past two weeks. We see this as a unique opportunity having legs to it this year.

Another opportunity that emerged last Saturday is that China and the United States have agreed to "substantially reduce" the cavernous trade imbalance between the two countries - a move that will involve the Chinese boosting more of what they buy from American producers.

Amid fears of a global trade war and rising tensions between the world's two largest economies which began in February, both China and the U.S. have now entered bilateral talks fostering cooperation. In a statement issued by the White House recently both parties forged a: "consensus on taking effective measures to substantially reduce the United States trade deficit with China." Last Friday, both countries were sharply at odds over a claim that Chief Economic Advisor Larry Kudlow made that China would move "to cut its trade deficit with the U.S. by $200 billion annually." Today, that may be happening, and if so, this is potentially huge for the United States and the financial markets.

Left unclear was precisely how much the Chinese would boost its purchases of U.S. goods. The Wall Street Journal reported Saturday that American negotiators fell short in their efforts to get the Chinese to commit to an exact deficit reduction figure, with the two sides bickering over the statement's language. Our trade deficit with China has long been a thorny topic in this relationship. Commerce Department data recently showed that imbalance between what China buys from the U.S. and vice versa hit a record in 2017 surpassing $375 billion. However, President Trump has made this dispute a cornerstone to his administration and he is staking his personal relationship with Chinese President Xi Jinping on this changing... It now appears as though China may be "meeting many" of the administrations demands to cut its U.S. surplus. A statement released last Saturday struck a very conciliatory tone:

> *"To meet the growing consumption needs of the Chinese people and the need for high-quality economic development, China will significantly increase purchases of United States goods and services. This will help support growth and employment in the United States."*

China is a major source of demand for U.S. farmers, soy bean farmers specifically, who have agonized over the fate of key agriculture exports in the wake of the trade dispute over the past three months... Still, Beijing and Washington have agreed to "meaningful increases in United States agriculture and energy exports. The United States intends to send a team to China to work out the details. This is extraordinary news - to the extent the deal closes.

The two countries also agreed to expand cooperation on areas such as manufacturing and intellectual property or IP - one of the stickiest disputes between the U.S. and China given China's lax enforcement regime. In March, Trump slapped $50 billion in tariffs on Chinese goods, in retaliation for what it alleges is rampant IP theft. So, this is great news for this year, and if this does in fact materialize, look for the VIX to come and stay down and for the market to potentially appreciate as well…