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2018 1ST QUARTER REVIEW

Stocks rose sharply in January, but gave most of it back in February, and then a bit more in March. For the first quarter of 2018 the S&P 500 showed a small loss.

While real GDP growth came in at 2.3% in 2017, it would appear that the impact of fiscal stimulus and deregulation will increase that rate to 3-4% in 2018. Likewise, S&P 500 operating earnings, which were flat for three years, accelerated roughly 10.8% in 2017 to $132 and are on course to reach $148-150 in 2018. Why then, are the markets not marching to new highs?

One factor is that markets hate uncertainty. In the past several weeks both domestic and foreign markets have been shaken by several events—including rising inflation, currency volatility, trade tensions, White House staff turnover, the Mueller investigation, the potential impact of the November U.S. midterm elections, and the end of quantitative easing. That said, despite these uncertainties, the economic fundamentals remain sound with rising consumer spending, growing corporate profits, a recovering CapEx, solid employment, faster money velocity, a more normal monetary policy, and historically high consumer and business confidence. These are simply not the signs of an economy which is about to roll over. In fact, if we look at the leading indicators, the current expansion may be one of the longest on record, and should continue.

We have written in the past about the two main influences on equity prices—corporate profits and interest rates. Arguably, corporate profits have never been better and will continue to rise. We must conclude, therefore, that rising interest rates have upset the market the most. The fear is that a rapidly expanding economy will stoke inflation, force the Federal Reserve to preemptively raise interest rates, eventually resulting in a recession. In actuality, all inflation numbers are presently hovering around the Federal Reserve's 2% target, and, historically, inflation has rarely been a problem for the equity markets until rates reach 4%.

Perhaps another cause of upset is the return of market volatility after several years of barely any movement at all. This factor is further complicated by the historical track record of midterm election years—generally flat-to-down until the 4th quarter, with an average correction in the S&P 500 of 18% (2002 saw a correction of 34%). The good news is that these corrections have turned out to be buying opportunities, with strong fourth quarter performances. Even better news is that the S&P 500 has not declined in the twelve months following a midterm election since 1946, with an average gain since 1950 of 15.3%.

We suspect the next few months may be volatile, and that it will be prudent to maintain some cash reserves. We do not believe, however, that the economic expansion or the bull market in equities is over, and we expect we may see higher stock prices by the year's end.

April 2018

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