Insights: July 2017

Market Overview and Performance

As we wrapped up the first half of 2017, June market behavior was quiet. By far, the most interesting development was the surprise announcement that Amazon planned to acquire Whole Foods, another stepping stone on its way to global dominance. Fundamentally though, not a lot changed during June. As we discussed last month, 2017 has delivered something positive to almost all investors. Stocks, both in the U.S. and abroad are up significantly, global bonds have bounced along nicely, gold has maintained its gains and volatility remains exceptionally low. The last few trading days of June did see some portfolio rotation that resulted in a very minor reversal of the first half trends, but this is very typical of a quarter end period when fund managers look to book profits. Due to the re-positioning during the last week of the month, small cap stocks edged out large cap, value stocks outperformed growth stocks, U.S. stocks fared better than non-U.S. names and bond prices fell slightly. As normal trading resumed after the July 4th holiday however, this blip in the year to date trend had come and gone. What hasn't come and gone unfortunately are the lingering signs that the economy just cannot kick into a higher gear. While we continue to see evidence of sluggishness in fundamental economic indicators, market sentiment and stock valuations show no signs of weariness. In fact, as we head further into a summer with no hope of fiscal stimulus any time soon, investors seem quite content with a "noisy calm" that keeps things not too hot or not too cold.

As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.62	9.34
Russell 2000 Index	**3.46**	4.99
MSCI EAFE Index	**-0.18**	**13.81**
MSCI Emerging Markets Index	1.01	**18.43**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.10	2.27
Barclay's U.S. Aggregate Credit Index	**1.01**	**6.44**
Barclay's U.S. Aggregate Corporate High Yield Index	0.14	4.93
Barclay's Municipal Bond Index	-0.36	**3.57**
Macro Measures		
Gold	**-2.66**	7.87
Crude Oil	**-4.95**	**-14.30**
CBOE Volatility Index	6.89	**-20.37**
USD Dollar Index	-1.41	-6.44

Current Theme – First Half of 2017 Proves to be Winner for Virtually all Asset Classes – Lack of Fiscal Stimulus and Noise out of Washington Now Being Largely Ignored by Markets

Despite the lack of progress, investors seem quite content with the status quo. This is in direct conflict with the fact that economic data continues to show broad based weakness in the U.S.

Steady as she goes. With the first six months of 2017 in the books, the market appears to be totally unfazed by all of the daily drama stemming out of Washington. Why worry, right? It's been eight straight years (2017 would mark the ninth) of positive returns for the S&P 500 and its been about five and half years since the last -20 percent decline. With the tranquil conditions, no one, and we mean no one, is talking about a pending pull-back of anything close to -20 percent. In fact, just a -5 percent drawdown would be a pretty significant event at this point. As you can see below, it has been roughly 260 trading days since the last -5 percent decline in stocks – and that was when the Brexit vote took nearly everyone by surprise.

Fifth Longest Period on Record Without A 5% Pull-Back

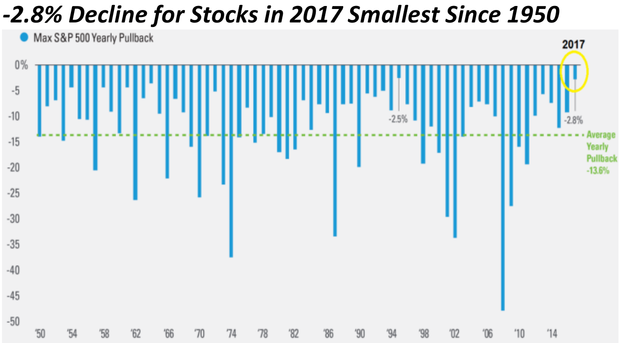
S&P 500: Longest Streaks Without A 5% Drawdown (1928 - 2017)

Rank	# Trading Days	Start Date	End Date	Start S&P	End S&P	% Change
1	394	12/21/1994	7/12/1996	457	646	41.4%
2	386	11/26/1963	6/8/1965	70	86	23.4%
3	370	10/12/1992	3/28/1994	403	460	14.2%
4	266	8/19/1958	9/8/1959	47	58	22.2%
5	261	6/28/2016	7/11/2017	2001	2426	21.2%
6	255	1/4/1961	1/9/1962	58	69	20.1%
7	210	10/21/2014	8/20/2015	1904	2036	6.9%
8	188	10/14/1985	7/11/1986	184	242	31.4%
9	182	1/27/1972	10/13/1972	103	108	5.3%
10	171	2/6/2014	10/9/2014	1752	1928	10.1%
11	170	1/9/1985	9/10/1985	164	187	13.97%
12	165	8/1/1996	3/26/1997	640	791	23.53%
13	156	12/17/1982	7/29/1983	135	163	20.15%
14	153	6/25/2013	1/31/2014	1573	1783	13.32%
15	145	8/4/1965	3/1/1966	85	90	5.38%
16	137	1/12/1998	7/28/1998	928	1130	21.83%
17	135	3/15/1955	9/23/1955	35	46	30.52%
18	127	4/9/1992	10/8/1992	395	408	3.36%
19	106	1/22/2013	6/21/2013	1486	1592	7.16%
20	104	6/6/1967	10/31/1967	88	94	6.19%

Source: Pension Partners

Further, as we have highlighted in the past, 2017 has been a complete outlier in the narrowness of it's trading range. In any given year, the S&P 500 can be expected to experience a pullback of close to -14 percent. Thus far in 2017, investors have only allowed the Index to decline by -2.8%, the smallest reading on record since 1950.

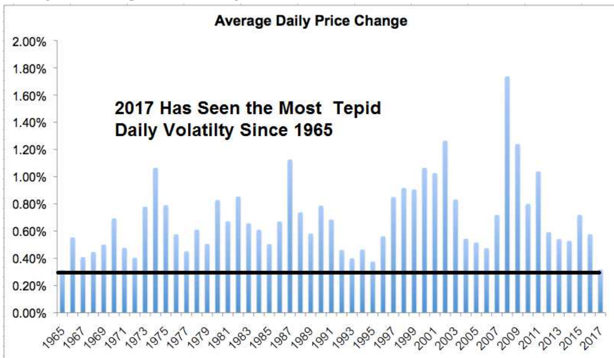
-2.8% Decline for Stocks in 2017 Smallest Since 1950



Source: LPL Financial; Factset

In this environment, a -14 percent "crash" would seem like Armageddon to some since absolutely nothing has been able to rattle the markets. Not politics, not terrorism, not weak economic data. Nothing. And its getting quieter. Consider the chart below from strategist Michael Batnick. He calculates that the average daily price change (either positive or negative) for the S&P 500 this year has been just 0.32 percent. That is the smallest daily average since 1965.

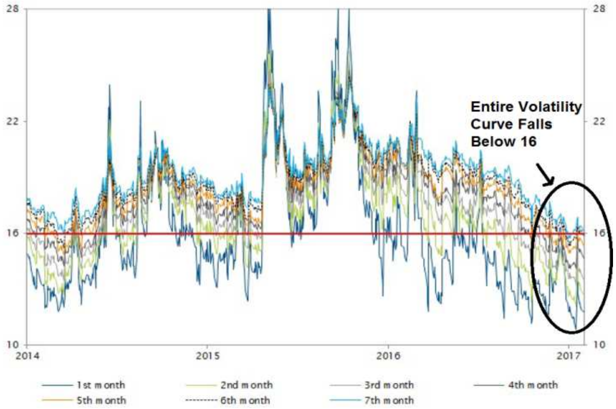
Daily Average Moves for the S&P 500 Have Diminished



Source: Michael Batnick

This is somewhat hard to square with all of the uncertainty that exists. There is no obvious path forward from a policy, economic or global relations point of view, yet in June we saw the CBOE VIX Index, a measure of expected volatility, collapse to its record low of 9.75 – a level not seen since 1974.

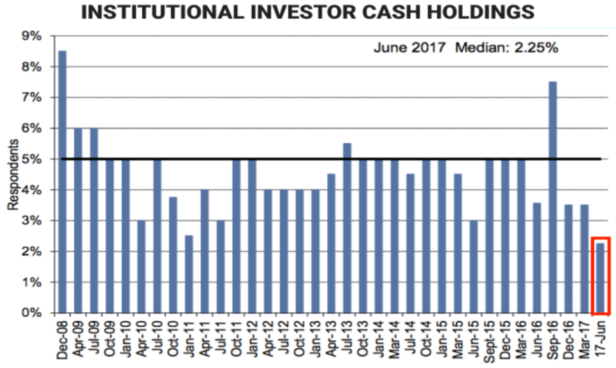
Volatility Curve Collapses to 2007 Levels



Source: www.syzbank.com; Bloomberg

In fact, the entire future volatility curve, a measure of what investors are expecting up to seven months out, broke down to below 16 for the first time since 2007 before the Global Financial Crisis hit. As reference, the long term average is about 25 percent above these levels, at just a little over 20. So things are fine, right? Nothing to worry about for now, right? That would seem to be the consensus of the "big" players in the market right now.

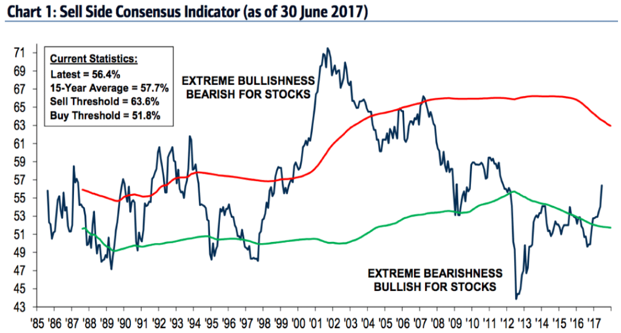
Asset Managers' Cash Levels Lowest Since 2008



Source: Citigroup; Business Insider

As the research from Citigroup in the above chart highlights, Institutional Investors, the largest asset managers, have decreased their cash holdings from 7.5 percent to just 2.3 percent over the last year, the smallest balance seen during the last eight years of recovery. Similarly, Bank of America Merrill Lynch attempts to track Wall Street sentiment and at present they find that bullishness among people "who do this for a living" is at its highest level since 2011.

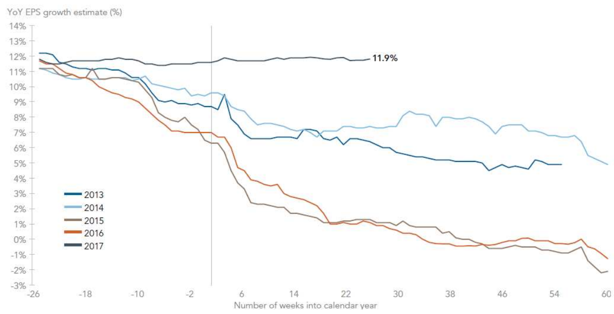
Wall Street Strategist Sentiment Most Bullish Since 2011



Source: Bank of America Merrill Lynch

Without a doubt, it is always easier to simply go along with the crowd. As Thomas Lee at Fundstrat, one of the few bears around recently commented about his year end target of 2275, "It's an uncomfortable call to be honest, because our clients don't like the idea that - look, a market being so strong actually has downside risk." Most bulls right now will dismiss most of the day to day noise and point to the following.

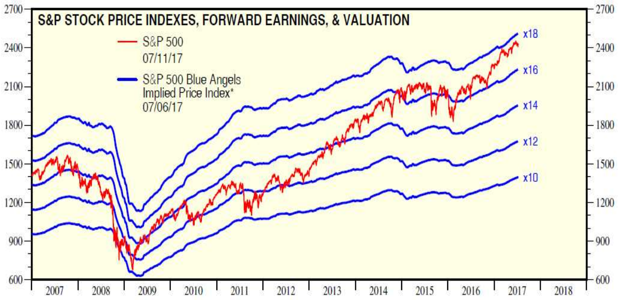
2017 Earnings Estimates Have held Steady Thus Far



Source: Fidelity Investments; Bloomberg

As the chart above demonstrates, estimates for 2017 earnings have encouragingly remained close to 12 percent since the beginning of last year. This is an anomaly. Most years, estimates start out overly optimistic and slowly ratchet down over time. The 12 percent growth this year is somewhat inflated by an outsized snap back in the energy sector earning (+275%), but regardless, this is a good level of growth. The consensus holds to the notion that if these earnings come to fruition, investors can be comfortable holding equities even at the elevated valuation levels we are experiencing right now as the chart on the following page illustrates.

Valuations at the Higher End of Their Historical Range



Source: www.yardeni.com

We wouldn't disagree with that thinking, however, it is predicated on the fact that nothing occurs which would upset the trajectory. And quite simply, as we have discussed for months, there is a good amount of evidence suggesting that things will not go as planned. The chart below is probably the most concerning one around right now and it only got worse in June. Essentially, U.S. economic data continues to disappoint expectations while risk assets like stocks completely diverge.

Economic Data Continues to Show Weakness in 2017

Source: ZeroHedge

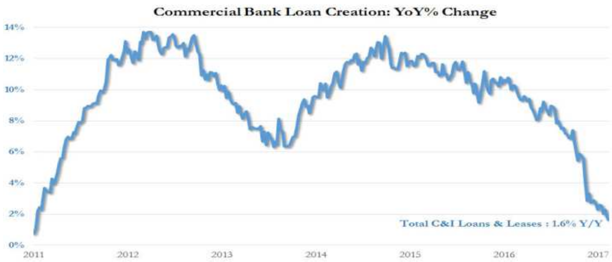
In the face of this disconnect, we also now have the Fed suggesting that the overall economy is expanding at such a rate that they need to increase interest rates to keep the pace of growth in check. Other segments of the market, most notably bond investors on the other hand, simply do not believe this at all. As we have discussed in the past, the yield curve continues to flatten, i.e. the difference between long term yields and short term yields is declining. Historically, this is a sign that investors believe that the economic outlook is weak and when the measure inverts, it has always been a pre-cursor to recessions. We are a ways off from that, but the trend is concerning.

Yield Curve Flattening Accelerated in June to just 78 BPS

Source: Bloomberg

The picture we are getting on the pace of economic activity confirms these concerns. The growth level in commercial and industrial loans has now fallen to just 1.6 percent - the slowest rate since 2011. If the pace of the decline continues on its current path, the U.S. will post its first negative loan growth number since the Global Financial Crisis in just 4 to 6 weeks.

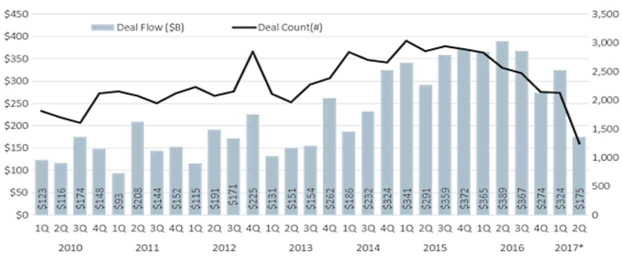
Loan Demand Has Completely Collapsed in 2017



Source: Fed Reserve Bank of St Louis; Zero Hedge

Beyond borrowing for operating activities, companies are not eager to borrow for strategic reasons either as mergers and acquisition activity continues to wane. These are not indicators of a robust economy where people are willing to invest in future endeavors. On the contrary, they show a lack of confidence about the committing capital within an uncertain outlook.

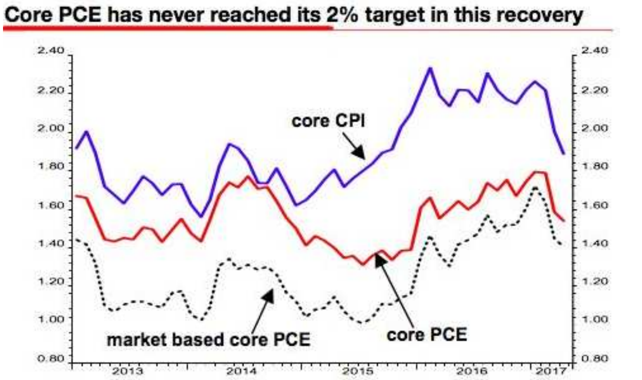
Mergers and Acquisitions Activity Has Fallen Rapidly



Source: Morningstar; Pitchbook

This probably best understood in light of the fact that despite raising interest rates in combination with a robust labor market, the Fed simply cannot get inflation to move higher.

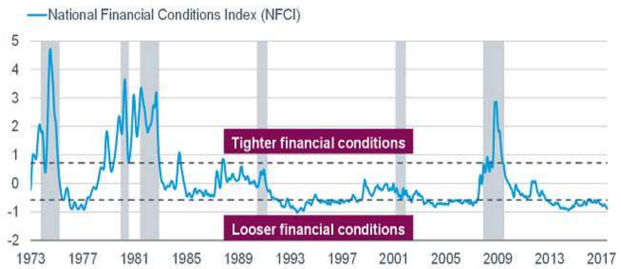
Inflation and PCE (ex Food and Energy) Not Expanding



Source: Bureau of Labor

Why is low inflation a problem? It's not for temporary periods of time, but we are now seeing evidence that financial conditions continue to lag which suggests that the Fed's monetary policies, along with a lack of fiscal progress, are failing to generate any significant stimulus for the economy.

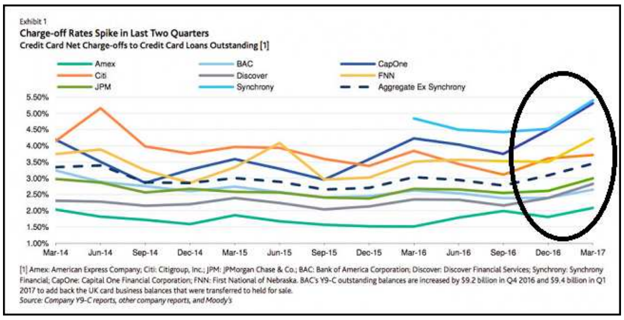
Despite Rate Increases, Credit Conditions Remain Loose



Source: Federal Reserve Bank of Philadelphia; Charles Schwab

If the Fed cannot tighten conditions by raising rates (as is their intention), consequences often follow, usually unpleasant ones. The Fed is very aware of the fact that the combination of prolonged low rates and easy financial conditions can produce undesirable effects. And to a certain degree, we are already seeing evidence of that in the credit markets. From a consumer stand point, June showed a notable rise in credit card net charge offs (uncollectable bad debt), not typical in an environment with such a solid employment backdrop. In fact, June data showed the worst deterioration since 2009.

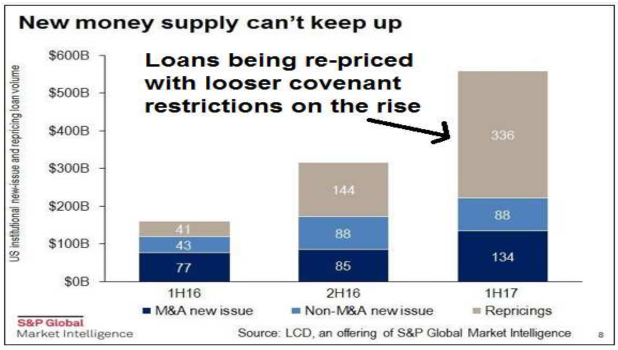
Credit Card Net Charge-Offs Surprisingly On the Rise

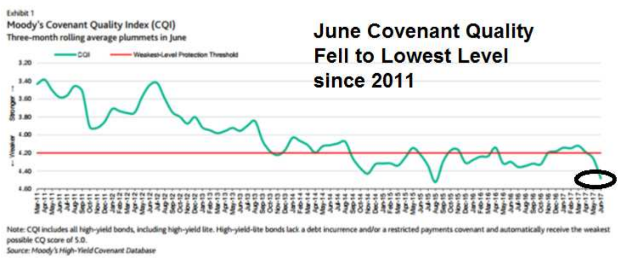


Source: Moody's

On the corporate side, ratings agency Moody's is also seeing a sizable increase in loans being repriced with looser covenant restrictions and a decrease in the covenant quality of high yield bonds. This is not the kind of activity the Fed was hoping to stimulate.

Signs of Credit Quality Deteriorating Moody's





Source: Moody's

One last thought- Congress only has a very limited amount of days in session left this summer (about 35) to craft and approve a laundry list of items including Healthcare Reform, a federal budget deal to keep the government running, and at a minimum, a framework on a tax code that would at least address a way to introduce a Trump budget that would exceed the caps imposed by the Budget Control Act of 2011. It will be a busy summer.

Going Forward

As we said last month, the market has now discounted the chance of any stimulus coming to fruition this year as essentially zero percent. This is a big change from earlier this year when optimism for a pro-growth agenda peaked in March. As a consequence, the market has now made the transition to a state where any concrete action could actually present a positive catalyst. In the meantime however, we can not ignore the signals of the bond market, stretched equity valuations, international tensions and the investigation into Trump's dealings with Russia and his unpredictable interactions with other global leaders. As a result, we choose to be nimble at present and feel that the present risk/reward proposition is tilted towards the downside for the near term, especially given the short window for Congress to address imperative issues like the budget ceiling this summer.

Within equities we continue to favor the large cap segment of the U.S. market. We favor the technology, healthcare and consumer discretionary sectors which have outperformed the broader market by a significant margin thus far year to date. With the recent underperformance versus the broader market this year financials now appear attractive. This is particularly true given that the capital constraints imposed by Dodd Frank look to be eased later this year. Similarly, we have also taken a more favorable view of small and midcap stocks. They have trailed the large cap segment significantly in 2017 and with attractive growth characteristics, perhaps offer more upside for the remainder of the year.

Equity markets outside of the U.S. are compelling in our view. After years of lagging the U.S. market the Euro zone is now displaying accelerating credit growth, falling unemployment, rising wages and GDP growth that exceed the U.S. European stocks also trade at a discount to their U.S. counterparts. Banking system problems certainly do exist across Europe but there is evidence for optimism in our view. Japan is seeing a similar benefit to the policies it has tried to implement over the past few years. Earnings growth is accelerating notably and manufacturing and trade statistics are improving while the Yen remains contained. We are therefore constructive on our outlook for the region going forward. With regard to emerging markets, we also see opportunity. China will always be the wildcard, but as a group they are demonstrating strong profit growth. While EM equities have experienced solid gains thus far in 2017, valuations still remain very attractive relative to the rest of world due to the multi-year period of underperformance.

Our biggest concern from the bond market is the continued flattening of the yield curve. Historically, this has been an ominous precursor to economic trouble ahead so we will be monitoring it vigilantly. As interest rates look almost certain to climb throughout 2017 we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. After a marked post election sell-off based off the belief that Trump would diminish their tax advantage, municipal bonds have rebounded and we feel that the opportunity in the muni markets is attractive at present with reasonable valuations and compelling yields.

As mentioned, the price of oil has now retreated back to its pre-election levels and close to mid-2016 lows. Forecasts for the remainder of the year call for oil to hold below $50 as supply and demand dynamics do not appear to be shifting. Amidst all of the macro turmoil, Gold has served its purpose as a diversifier this year, rising almost 8 percent. Given the macro outlook of a rising interest rate environment and a generally strong U.S. dollar, we are not buyers of gold for fundamental reasons, however, we have maintained a position in certain portfolios as a non-correlated asset and will continue to do so given the uncertain environment.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.