Insights: June 2017

Market Overview and Performance

Is this as good as it gets? That is the question proposed in a recent note by Charlie Bilello at Pension Partners. As he states, “If you had to describe the perfect market environment what would it look like? The following attributes might come to mind: 1) High returns with low volatility 2) low drawdowns 3) global participation 4) both stocks and bonds rising 5) the economy expanding (moderately) 6) earnings growing and 7) easy central bank policies. Sounds too good to be true…” Yet that is where we are. This is truly astounding given all that has happened over the last 6 months since Donald Trump was elected. The list is quite long, but domestically, we have seen zero progress on fiscal stimulus like infrastructure spending and tax reform (not to mention a complete failure on healthcare reform) while globally, tensions are on the rise in both Asia and the Middle East at a time when Trump is looking to pull away from a U.S. leadership role in both trade and diplomacy. On top of this we have seen a terrible escalation in terrorism. Yet the markets continue to elevate higher. Even FBI Director James Comey’s firing and the appointment of a special counsel to investigate Trump’s ties to Russia couldn’t phase the market. After a -2.8 percent decline, the “worst” in nine months, the market was making new all-time highs three days later. As we have said in the past, ultimately, it will be economics and earnings that determine the direction of the market not a political narrative. And despite the seemingly “Goldilocks” scenario we have experienced as of late, there is cause for concern in our view.

As always, thank you for reading our latest Insights.

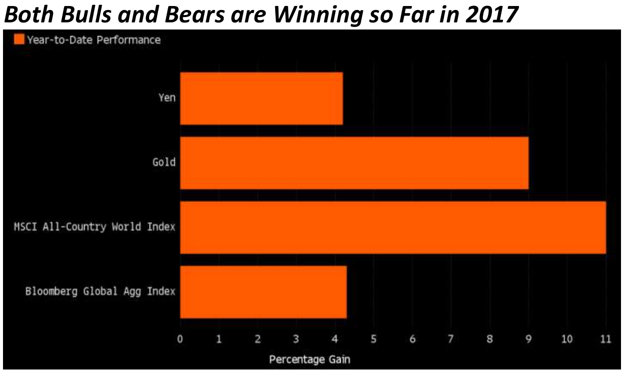
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.41	8.66
Russell 2000 Index	**-2.03**	**1.48**
MSCI EAFE Index	3.67	**14.01**
MSCI Emerging Markets Index	2.96	**17.25**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.77	2.38
Barclay's U.S. Aggregate Credit Index	2.07	5.37
Barclay's U.S. Aggregate Corporate High Yield Index	0.87	4.79
Barclay's Municipal Bond Index	**1.59**	**3.94**
Macro Measures		
Gold	0.56	**10.74**
Crude Oil	-2.09	-10.05
CBOE Volatility Index	-3.94	**-25.85**
USD Dollar Index	-2.12	**-5.12**

Current Theme – The Trump Reflation Trade is Most Certainly Dead – Yet Market Participants React by Buying all Assets?

Asset prices are almost universally higher, but market internals are telling divergent stories about the most likely path going forward

Despite the fact that there are good arguments to be made about why risk assets should either be up or down, at present it really doesn't matter because both sides are winning. As the chart below highlights, global equities, global bonds, gold and the Yen, the de-facto safe haven currency, have all risen thus far in 2017.

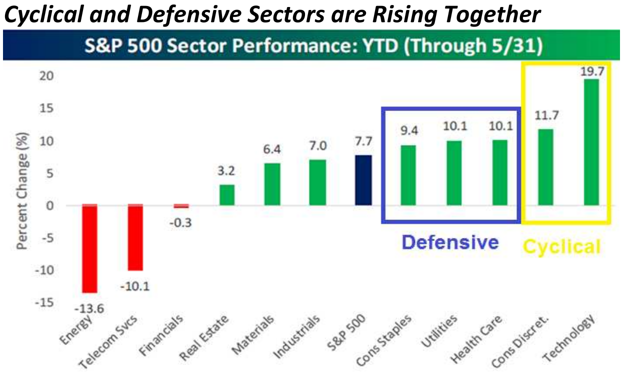
Both Bulls and Bears are Winning so Far in 2017



Source: Bloomberg

The market generally doesn't work this way. Global equities, and U.S. stocks in particular, have climbed steadily higher in the belief that current sluggish growth will be re-ignited by stimulative measures. Fine. But then why are we seeing risk-off assets like bonds and gold rising as well?

Cyclical and Defensive Sectors are Rising Together



Source: Bespoke Investment Group

As the chart at the bottom of the previous column shows, even within risk assets like equities, the same pattern holds true. Traditionally defensive sectors like consumer staples, healthcare and utilities are all up about 10 percent this year while the more pro-growth oriented sectors like consumer discretionary and technology have risen 12 and 19 percent respectively. Again, this is unique, but as long as everyone is making money, investors don't seem all that bothered by it.

Current Volatility Levels Among Lowest in 90 Years

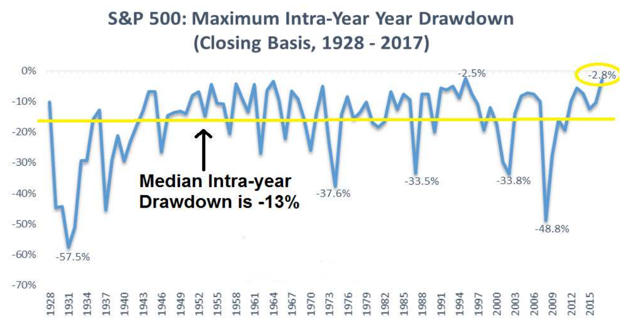
S&P 500: Lowest Annualized Volatility (1928 - 2017)

Rank	Year	Ann. Vol	Total Return
1	1964	5.2%	16.4%
2	1965	6.8%	12.4%
3	2017	7.0%	9.7%
4	1995	7.8%	37.6%
5	1952	7.9%	18.2%
6	1972	8.0%	18.8%
7	1961	8.0%	26.6%
8	1967	8.3%	23.8%
9	1993	8.6%	10.1%
10	1963	8.8%	22.6%

Source: Pension Partners

In fact if you look at the chart above, realized volatility has averaged only 7 percent this year, marking the third most tranquil period in roughly 90 years. As we have discussed in previous Insights, we cannot predict exactly when the calm in markets will end but we can say that the status quo will not last. History tells us so. Consider the chart below. Over the past 89 years, the median stock market decline in any given year has been -13 percent. The largest move off the highs in 2017 has been only -2.8 percent. Further, since 1928 there have only been 5 years (out of 89) in which the market did not decline by at least 5 percent.

Median Intra-Year Drawdown Since 1928 has Been -13%



Source: Pension Partners

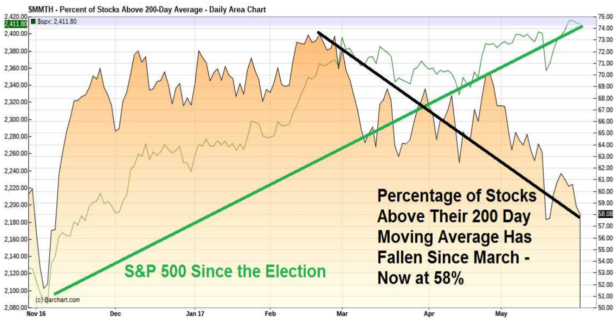
So to be clear, a pause in the market is overdue. And in fact, we are seeing some signs of fatigue. When we look at technical indicators of how stocks are behaving we find that relative strength, or momentum, peaked in March and has since fallen. Similarly, market breadth, or the number of stocks participating in the rising tide, has moved lower since March as well.

Market Internals Suggest a Summer Pause May Develop

Source: Bloomberg

As we wrote about last month, the market has become quite narrow, meaning only a handful of stocks are doing well while the majority are lagging behind. Without question, this has been a very good year to hold exposure to virtually any equity, however, Goldman Sachs calculates that the top ten names in the S&P 500 are responsible for roughly 45 percent of the Index return. Hence, we see the pronouncement of "new all-time highs" almost daily as predominantly large cap tech names move higher. For the rest of the market, the peak was in March. Since that time, the percentage of stocks trading above their 200 day moving average, an indication of price trend, has fallen from roughly 75 percent down to 58 percent.

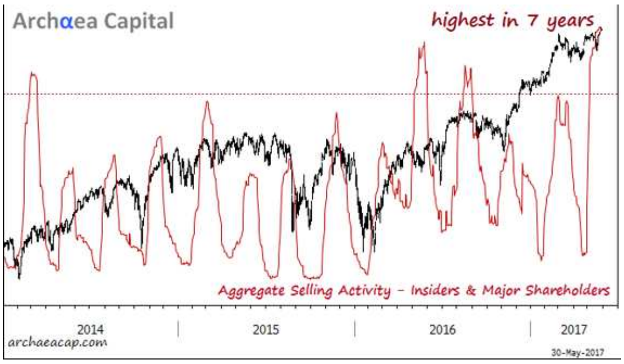
% of Stocks Above 200 Day Moving Average Falling



Source: Barchart.com

We like to use technical indicators like breadth and momentum to give us guidance on price trends but other more fundamental indicators help us understand the current mentality or sentiment of market participants. One aggregated measure that is particularly informative is the aggregate selling of company insiders and major shareholders. Archaea Capital Research finds that this measure is at a 7 year high. Essentially, the "smart" money has been taken profits at a rate not seen since 2010.

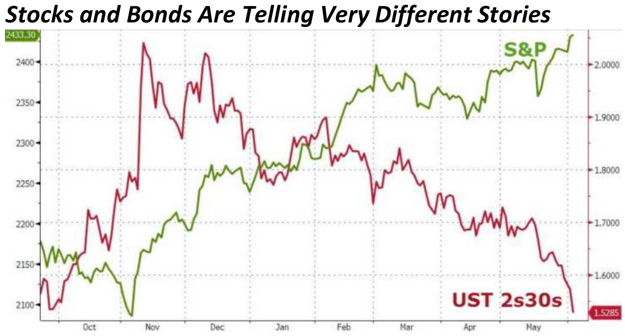
Insiders and Major Shareholders are in Sell Mode



Source: Archaea Capital; Wall Street Journal

No one indicator is any more valuable than the next, but taken together, they help paint a picture of the overall environment. By far, the biggest red flag among them right now is the divergence between the stock market and the bond market.

Stocks and Bonds Are Telling Very Different Stories

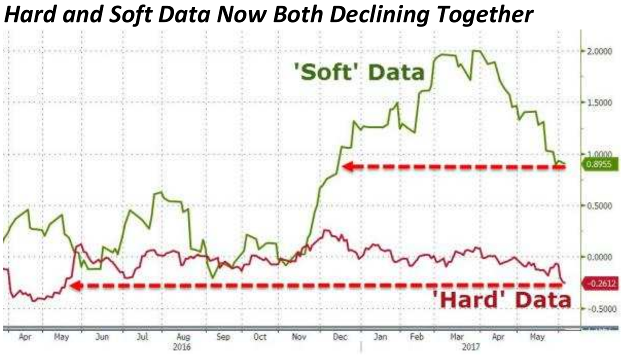


Source: Zerohedge

Basically, the stock market is saying "all is well" while the bond market, via a flattening yield curve, is strongly suggesting otherwise. As noted investor Mohamed El-Erian remarked on June 2nd, "This (simple yet powerful) chart from @zerohedge warrants a PhD thesis in Finance." He is right, and unfortunately, so is the bond market more often than not.

As Dr. El-Erian intimates, there is a lot of finance and economic theory behind what is going on here, but in plain and simple terms, the bond market is telling us that it expects lower growth, lower inflation and fewer interest rate hikes in the future. The stock market is reflecting the exact opposite view. This is a very important measure to watch. The previous chart used the difference between the 30 year bond and the 2 year, but the benchmark indicator is the spread between the 10 year and 2 year. At present, the difference is only 84 basis points. To give you a sense of what that means, in December 2013 the spread was 260 basis points, 150 in December 2014, 123 in December 2015, and before the election it was 101. If the curve inverts, meaning the yield on short term bonds is higher than longer dated bonds, a recession has resulted in each of the last 5 instances. So why is the bond market so worried? Essentially, the Trump inspired reflation trade looks to be a mirage and fundamental economic data continues to deteriorate.

Hard and Soft Data Now Both Declining Together

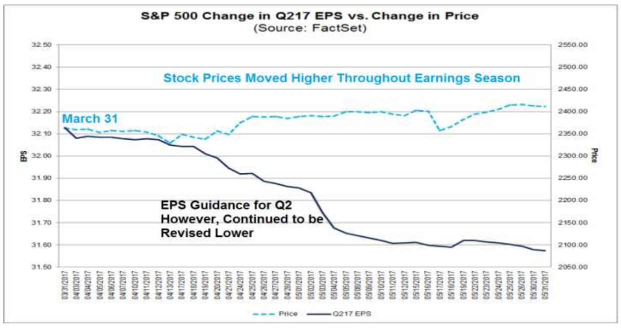


Source: ZeroHedge

As we have written about over the last few months, economic data has been surprising to the upside since the election, however, that trend was driven almost entirely by sentiment readings rather than "hard" measure of manufacturing and other industrial activity. That is no longer the case. Both hard and soft data reading are in decline. When we look more closely, there are in fact many worrying signs which suggest future growth many be tepid at best. The US Dollar has retraced its entire post-election rally. Oil prices (and other important industrial components like iron ore) have given back all their gains since November as well. Wage growth has begun to decline again. Auto sales are collapsing. These are important drivers of the economy and cannot simply be dismissed.

And there is more. Take a look at earnings, or earnings revisions to be precise.

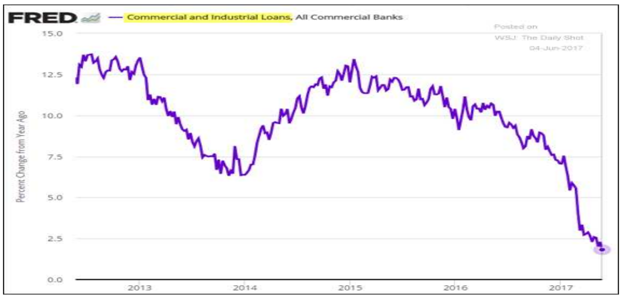
Earnings Revisions Have Been Negative for Q2 and 2017



Source: Factset

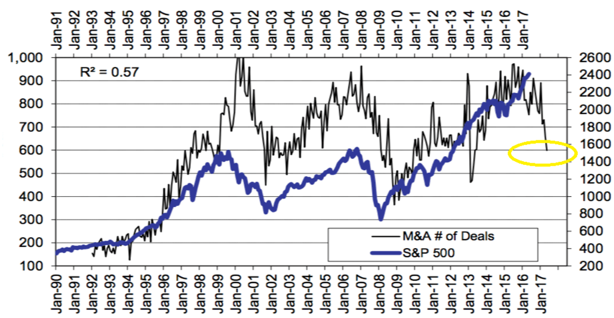
Q1 earnings were unquestionably solid growing at an aggregate level of 14 percent. However, forward guidance turned progressively negative as seen above. Estimates for Q2 growth have fallen from 8.6 percent on March 31st to 6.6 percent on June 2nd. Revenue estimates have fallen as well, moving down from an estimated 5.4 percent to 4.9 percent. While still positive, the trend is clear. And aggregate measures of business growth like loan growth and M&A activity have virtually ground to a halt.

Loan Demand Has Completely Collapsed in 2017



Source: Fed Reserve Bank of St Louis

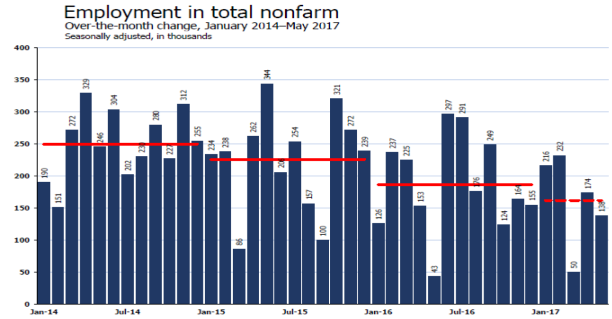
Mergers and Acquisitions Activity Has Fallen Rapidly



Source: Citi Research, Business Insider; Factset

Even the jobs data, a pillar of the recovery since the Financial Crisis, has begun to wane. The May labor report showed a disappointing 138,000 jobs added which brought the 2017 average down to 162,000. In 2016, average monthly growth was 187,000 down from 235,000 in 2015 and down from 250,000 in 2014 as seen below.

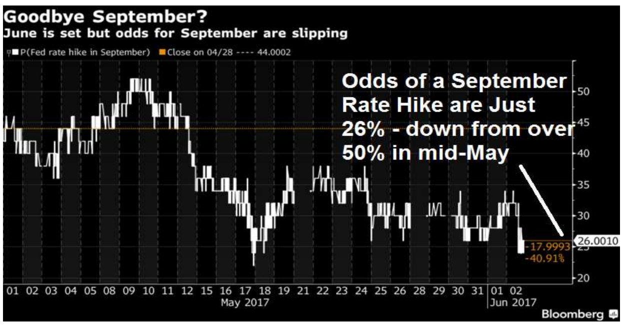
The Trend in Jobs Growth Has Been Moving Lower



Source: Bureau of Labor

If the Trump Reflation trade is in fact not going to come to fruition any time soon, as the bond market seems to be telling us, what about the Fed? In mid March, the Fed raised interest rates, theoretically keeping the pace of growth in-check, just as the data was reverting back to a slower pace. An additional rate hike is priced in for June, however, the odds of another rate increase in September have fallen to just 25 percent. Further, the market is now expecting just *one* rate hike for all of 2018. The Fed is charged with a duel mandate of managing both employment and inflation and the data is signaling that there is simply no need to continue raising rates. In fact, as the chart at the top of next column shows, after a brief spike after the election, inflation expectations have been ratcheted back down to just 1.86, very near the

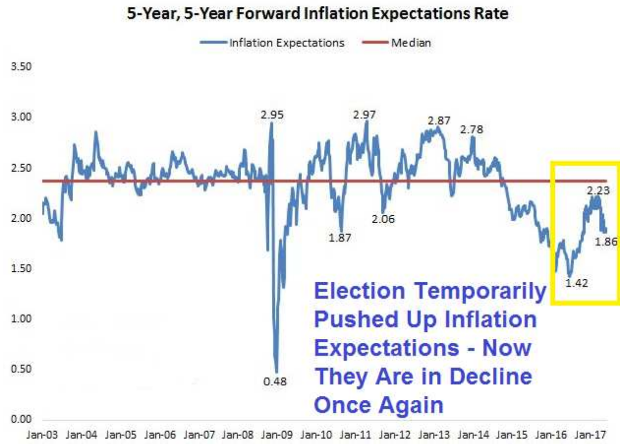
Odds of September Rate Hike Have Fallen to Just 25%



Source: Bloomberg

lowest levels since the Financial Crisis.

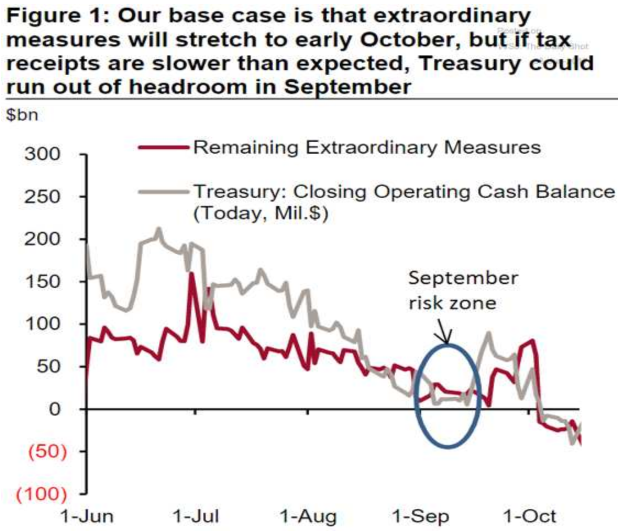
Inflation Expectations Have Declined as Data Disappoints



Source: Pension Partners

Despite the possibility that the pro-growth agenda might actually gain traction at some point, it is not going to happen in 2017. There simply is no time. Congress is scheduled for their annual recess in August and they have no choice to but to resolve the debt ceiling issues before their last session on July28th. This is not a simple rubber stamp process since many in the Republican Party, the majority in both Houses, have a strong view against increasing the national debt. As a result, the stimulative impact from tax reform and infrastructure that the market has been desperate for since the election will unfortunately have to wait.

Debt Ceiling Must Be Addressed Before September



Source: Credit Suisse; Haver Analytics

Going Forward

As we said at the opening of this month's letter, there is very little doubt that the Trump reflation trade has come and gone. Instead, we and others are looking at what is front of and not at "what *could* be". Ironically, Trump administration's complete lack of ability to get anything done has a created a perverse upside optionality. In other words, the market has now discounted the chance of any stimulus coming to fruition this year down to essentially zero. Therefore, any concrete action could 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 resulting actions. As a result, we choose to be nimble at present and feel that the present risk/reward proposition is tilted towards the downside.

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 appeal attractive. This 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 stock also trade at roughly 15 times next year's earnings while the U.S. trades at 18 times. 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 (up 28 percent in the first quarter), manufacturing and trade statistics are improving and 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 profit growth of roughly 17%. While EM equities have experienced strong gains thus far in 2017, valuations still remain very attractive relative to the rest of world due to the multi-year period of underperformance.

As the post election down-draft clearly demonstrated, traditional fixed income is in fact vulnerable to periodic declines. However as we discussed, much of the sharp post-election move has been retraced. 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. However, selected energy companies themselves could benefit from an end to the challenging environment seen in 2015 and 2016 and we look to take advantage opportunistically . Amidst all of the macro turmoil this year, Gold has served its purpose as a diversifier well this year, rising over 10 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 hedge and 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.