Insights: March 2017

Market Overview and Performance

As much as we'd like to focus solely on the things that drive prices like cash flows and valuation, we along with the rest of the Market, remain chained to the daily machinations of the Trump administration. The good news is that investors seem to be taking the sometimes confusing ebb and flow of information in stride, slowly but steadily bidding equity prices higher over the first two months of 2017. However, as the realities of the challenges that lie ahead for the Trump agenda begin to take hold, investor sentiment can shift quickly. As the philosopher Alfred A. Montapert once stated, "Don't confuse motion with progress. A rocking horse keeps moving but does not make any progress." Market Veteran Byron Wein, Vice Chairman of the Blackstone Group summarized the current environment effectively when he said, "Most elected presidents talk about the first 100 days, but Donald Trump seemed to be in an executive order sprint during his first 100 hours. When you are trying to get your cabinet approved, organize your White House staff and issue several important executive orders all at the same time, a few missteps are likely. He didn't seem to reflect on the full implications of what he was doing…" Tax reform would be the quickest impetus for growth, but as everyone is coming to learn, there is a long busy road ahead before we see the announcement of a plan much less passed legislation. In the meantime, we will share some of the market dynamics that indicate a cautious stance is merited before we see signs of the progress that will definitively take risk assets higher.

As always, thank you for reading our latest Insights.

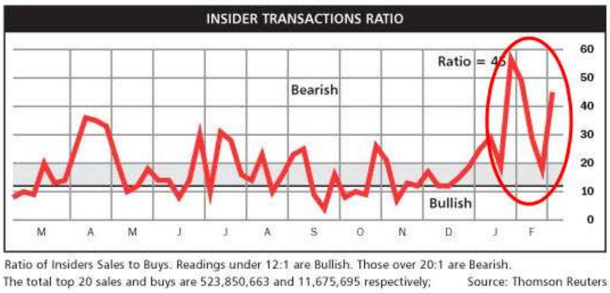
	Month to Date	Year to Date
Equity	**Total Return % (USD$)**	**Total Return %**
S&P 500 Index	3.97	5.94
Russell 2000 Index	1.93	2.33
MSCI EAFE Index	1.43	4.37
MSCI Emerging Markets Index	3.06	**8.70**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.67	0.87
Barclay's U.S. Credit Index	1.11	1.45
Barclay's Corporate High Yield Index	1.46	2.93
Barclay's Municipal Bond Index	0.69	1.36
Macro Measures		
Gold	3.39	**8.87**
Crude Oil	2.22	0.54
CBOE Volatility Index	7.20	-7.98
USD Dollar Index	1.79	-0.83

Current Theme – The Reality Sets In: Getting the Trump Agenda Passed and Implemented Will Take Time

Markets Mostly Take Developments in Stride But Potential Pitfalls are on the Horizon

As the equity market floated higher over the recent weeks, continuing the trend up since the election, the unanswered question in many minds was, "Who is putting money to work at this point? Who is the remaining buyer?" When the passive index ETF for S&P 500 – (SPY), took in a near record $12 billion in assets during the final week of February, it was a fairly clear that the answer is primarily retail investors. As we noticed last month, Insider Sales, or stock sales by corporate officers has spiked in the first part of 2017.

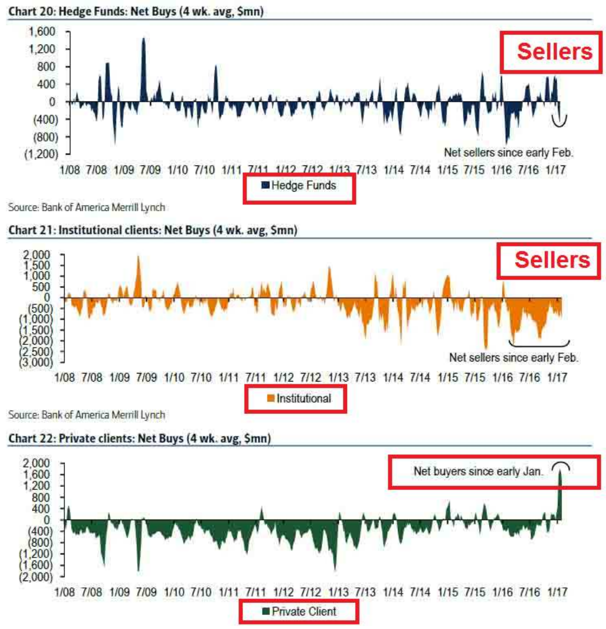
Insiders Continue to Sell Shares with Prices at High Levels



Source: Barron's; Thomson Reuter's

Sale ratios of 20:1 (20 sells for every one purchase) are considered bearish and the reading at the end of February stood at 45:1. As we said last month, company insiders are the "smartest" of all investors since they have complete transparency on their business. When they are aggressively selling, it is therefore a decent indicator that perhaps now is not the ideal time to be a buyer. Their $7.8 billion of sales in February was the most in six years. Additionally, more evidence that the second tier of "smart money" if you will, namely hedge funds and large institutional investors have also been selling into this rally. Bank of America Merrill Lynch reported that when they parsed their own flow data hedge funds and institutions had been notable sellers over the previous four weeks while private clients, or retail investors, had been taking the other side of the trade, buying equities as they rose since the end of last year.

BoAML – Hedge Funds and Institutions Selling to Retail



Source: Bank of America Merrill Lynch

While financial headlines are largely still pre-occupied with psychologically appealing round numbers, a quick review of market internals soon reveals some caveats to the new highs. For example, while there were many stories written about the 12 day positive streak of the Dow Jones Industrial Average, that benchmark is simply a price-weighted collection of 30 stocks meaning that the stocks with the highest price hold the greatest weight. As a result, just four stocks accounted for 50% of the Dow's move from 20,000 to 21,000. That is a very narrow market which benefits just a handful of investors.

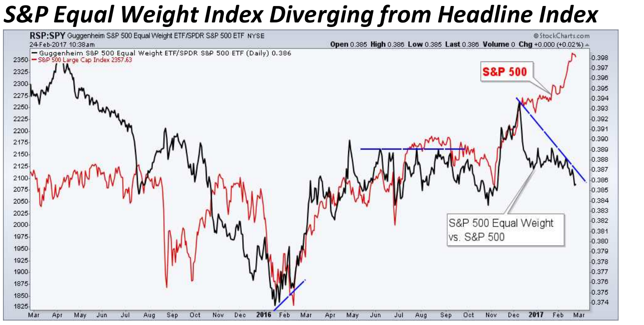
Market Has Been Led Higher By Just a Handful of Names

Ticker		Name	End Price	Chg	%Chg	Points	%Idx Mv
GS	UN	Goldman Sachs Group Inc/The	253.56	+23.4914	+10.21	+160.876	+12.83
BA	UN	Boeing Co/The	184.57	+21.9984	+13.53	+150.652	+12.01
MMM	UN	3M Co	190.22	+16.1834	+9.30	+110.829	+8.84
AAPL	UW	Apple Inc	139.94	+11.7458	+9.16	+80.4390	+6.41
JNJ	UN	Johnson & Johnson	123.87	+11.3843	+10.12	+77.9835	+6.22
HD	UN	Home Depot Inc/The	146.95	+9.51	+6.92	+65.1275	+5.19
IBM	UN	International Business Machine	182.22	+9.2973	+5.38	+63.6708	+5.08
JPM	UN	JPMorgan Chase & Co	93.86	+8.91	+10.49	+61.0185	+4.86
TRV	UN	Travelers Cos Inc/The	124.84	+8.30	+7.12	+56.8410	+4.53
MCD	UN	McDonald's Corp	129.40	+7.8745	+6.48	+53.9269	+4.30
V	UN	Visa Inc	89.02	+6.7366	+8.19	+46.1345	+3.68
UTX	UN	United Technologies Corp	113.94	+6.40	+5.95	+43.8289	+3.49
UNH	UN	UnitedHealth Group Inc	168.19	+5.48	+3.37	+37.5288	+2.99
AXP	UN	American Express Co	81.925	+5.165	+6.73	+35.3716	+2.82
NKE	UN	NIKE Inc	57.93	+4.91	+9.26	+33.6252	+2.68
PG	UN	Procter & Gamble Co/The	91.85	+4.52	+5.18	+30.9544	+2.47
WMT	UN	Wal-Mart Stores Inc	70.65	+4.42	+6.67	+30.2696	+2.41
MRK	UN	Merck & Co Inc	66.26	+4.16	+6.70	+28.4890	+2.27
CVX	UN	Chevron Corp	114.02	+4.0724	+3.70	+27.8892	+2.22
CSCO	UW	Cisco Systems Inc	34.46	+3.96	+12.98	+27.1193	+2.16

Source: Bloomberg

If one digs a little deeper, it becomes clear that not all stocks are elevating up at the same time. We have written about the decline in the breadth of the market in the past, a measure of the ratio of companies advancing relative to those declining. Another way of assessing overall market health is by looking at the trend of the Equal Weighted S&P 500 Index. Instead of being dominated by the absolute largest companies like Apple and Exxon, the equal weighted version treats all 500 companies equally which provides a more accurate view of total market behavior. As one can see below, the equal weighted index has diverged from the headline index since late December, indicating that many stocks are lagging.

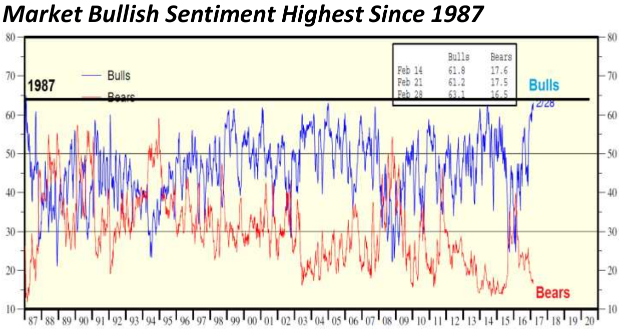
S&P Equal Weight Index Diverging from Headline Index



Source: www.stockcharts.com

None of this is to say that the Market cannot continue to march higher, but in a "normal environment" these would certainly be things of note that might suggest taking a pause. As Warren Buffet famously said, "Be fearful when others are greedy and greedy when others are fearful." And at present, sentiment measures would certainly suggest that market participants are on the "greedy" side of things. Looking at the 2/28 Investors Intelligence survey, Bullish sentiment reading has now risen to its highest level since before the market crash in October of 1987.

Market Bullish Sentiment Highest Since 1987



Source: www.yardeni.com

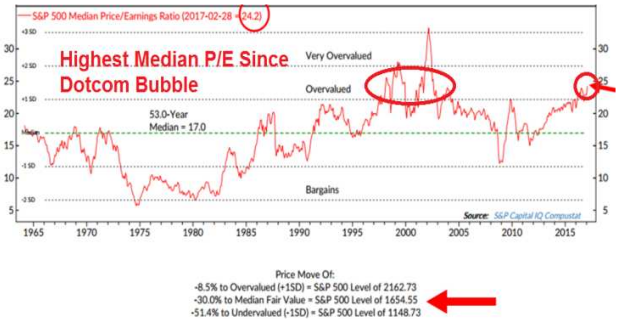
Again, all of these indicators have been present in market topping patterns we have seen in the past, but in and of themselves they say nothing about whether things can continue moving along on their current trend for an extended period. More concrete signposts of future direction have historically been valuation and earnings – prices are directly tied to both. Unfortunately, right now neither one is instilling much confidence. Of particular concern are valuation levels. In no uncertain terms, U.S. equities are expensive. Very expensive.

30x Cyclically Adjusted P/E Only Seen in 1929 and 1999

Source: Robert Shiller

The cyclically adjusted P/E ratio developed by Professor Robert Schiller, compares stock prices to earnings over the previous ten years. Since it is a longer term measure, it has not proven to be a very accurate timing tool for the market – unless it is at extreme levels which is clearly where we find ourselves today. At roughly 30 times earnings, the Schiller P/E has only been this high twice before in history. Those peaks occurred before the market collapses of 1929 and 2000. We are not suggesting that a similar calamitous market event lies just ahead, however, academic research has shown that when the Shiller P/E has been in the upper half of the tenth decile (above 27.7) future ten year stock returns on average have been lower than those on ten year treasuries. (Dimitrov & Jain). We don't assign a lot value in trying to predict future ten year returns, however, the point remains, stocks are historically very, very expensive. An obvious question would be, "Well, perhaps popular high P/E stocks like Amazon are skewing that reading and the average stock must be more reasonable valued?" It is a valid idea however if we look at the median P/E ratio for S&P 500 stocks, or the midpoint of valuations, we see a similar pattern of elevated levels. According to S&P Capital IQ, the median P/E now stands at 24.2, a level only seen around the Dotcom boom. S&P considers this to be "overvalued" relative to a 53 year history and suggest that an -8.5% decline would be required to fall below overvalued and that a -30% decline would be necessary to get back to historical fair value of 17 times.

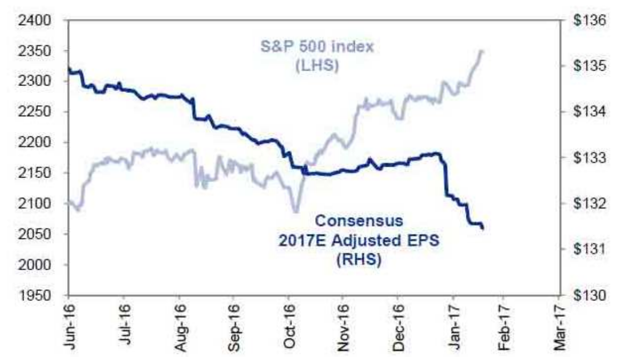
Median P/E Levels Also Approaching Historical Highs



Source: S&P Capital IQ; Compustat

Clearly both P/E charts show that high valuations can and have moved even higher in the past and we would agree that there is no magical threshold, however, extended valuations can only be somewhat tolerated if they are based off of expanding earnings. That is simply not the case now. As the chart below reveals, earnings during the first two months of this year, and in fact over the past 9 months, have declined while stock prices have climbed notably higher.

Estimates for 2017 Earnings Have Fallen Sharply



Source: Goldman Sachs Global Investment Research

This suggests that America has not been made great again quite yet. Frankly, its a bit shocking to realize just how stark the contrast is between now and the last time P/E levels were this high. Consider the table below.

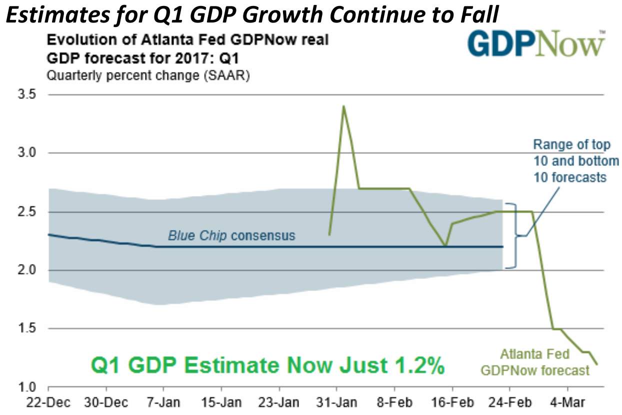
Late 1990's Marked by Stronger Growth and Less Debt

720GLOBAL	1995-1999	2012-2016
GDP Growth	4.08%	1.90%
GDP Trend	2.30%	1.80%
Productivity Growth	1.84%	0.49%
Federal Debt (Trln$)	5.36	17.47
Federal Debt : GDP	60.23%	101.40%
Personal/Corp. Debt (Trln$)	15.493	41.11
Personal/Corp. Debt : GDP	156.09%	220.13%
Govt. Deficit (% of GDP)	-0.33%	-3.29%
10-Year Tsy. Rate	6.05%	2.13%
Fed Funds	5.38%	0.18%
S&P 500 3yr Earnings Growth	7.53%	-3.84%
S&P 500 5yr Earnings Growth	9.50%	0.49%
S&P 500 10yr Earnings Growth	7.74%	0.89%

Source: 720 Global

In the five year period of the late 1990's, earnings growth was close to 10 percent versus less than 1 percent over the past five years. GDP growth was over 4 percent versus less than 2 percent now. Productivity growth was almost 2 percent, four times there current level, and debt to GDP was 60 percent compared to 100+% level of today. Clearly, the late 1990's was a period of much more robust growth and less debt than we have today. Accordingly, investors were willing to pay much a higher multiple to own stocks. Whether we can get back to those kind of growth levels remains to be seen, but as the chart below shows, GDP growth is actually receding to even more muted levels than we have experienced since 2012.

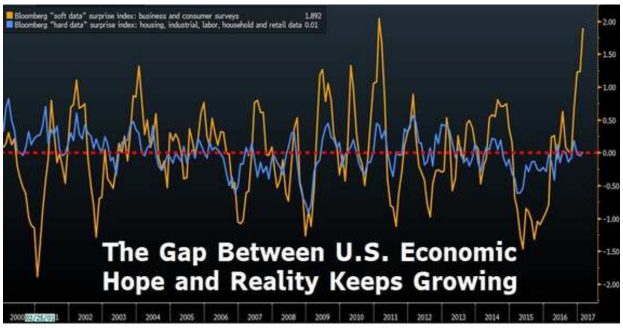
Estimates for Q1 GDP Growth Continue to Fall



Source: Federal Reserve Bank of Atlanta

This would seem counter intuitive since most headlines as of late have been touting the robustness of data being reported. However, the big caveat can be seen in the chart below.

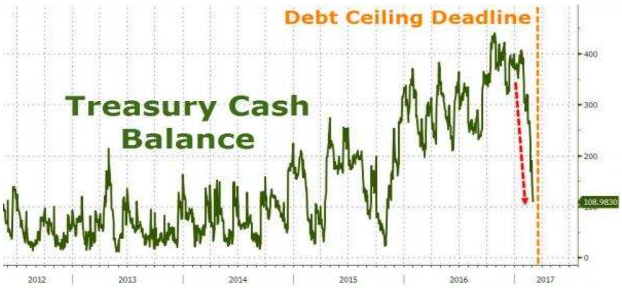
"Soft" Data Improving While "Hard" Data Softens



Source: Bloomberg

"Soft" economic measures, namely sentiment readings, have been strong since the election, but "hard" data on things like housing, labor and industry have actually disappointed. And now, after some aggressive messaging during the month, the Market expects (with 94% probability) that the Federal Reserve will raise interest rates on March 15th, an action which serves as a theoretical brake on economic growth. Coincidentally, March 15th also marks the U.S. debt ceiling deadline. If you recall, this caused much consternation in the markets in 2011. The problem was essentially pushed out with a "holiday" until 2017 (now). After the 15th, the debt ceiling will "freeze" at $20 trillion(!) – that's the law. The problem is we are kind of running low on cash. As the chart below shows, we will run out by summer. Somewhat surprisingly, the Market does not seem to care about this, presumably under the assumption that some sort of emergency measures will be passed.

Debt Ceiling Holiday Deadline Approaches – March 15th

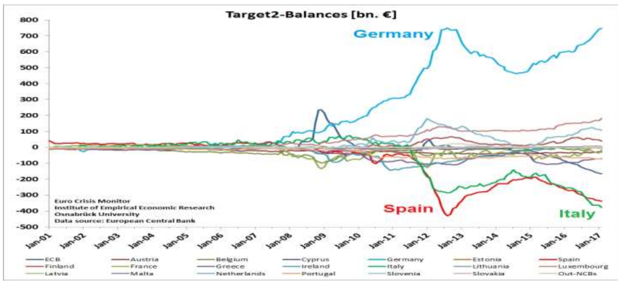


Source: ZeroHedge

This is indeed probably what will happen, but there is the somewhat inconvenient factor that President Trump is aggressively pursuing a large spending program somewhat similar to what Reagan enacted after he was elected in 1980. The big difference is that debt to GDP for Reagan was around 35% (and the Shiller P/E was just 6.5) while Trump is facing a level close to 105%. Current policies would add another $10 trillion, and that's before Trump gets to enact his policies. The point here is that the road ahead will not be easy. Trump has said that he will launch "extraordinary" measures to buy time likely until around August. But a Trump program of lower taxes (fewer revenues for the government) and increased spending will not help future deficits. As we have seen in the past, Trump will likely have to give concessions to Congress in order to get his agenda through. It should be an interesting summer.

Lastly, March 15th also kicks off the start of the European election season when the Dutch election looks to begin the continent wide shift toward the right. There are many unknowns as we have discussed in the past, but the concern is growing that as populist or far right candidates look to have a legitimate shot at winning the elections in both France and Italy, the European Union could soon fall apart since candidates there have both promised to initiate a departure. This is being reflected in capital flows. Below is a graph of Target 2 balances. To simplify, capital has been surging into German (safety) and away from Italy and Spain. Mario Draghi has said that any country that choses to leave will have to repay this imbalance. German two year bonds have also been bought aggressively. These are clear signs that investors see real signs of danger for the European Union in the coming months.

Caution Signs Flaring Up in Europe – Back to 2012 Crisis



Source: Euro Crisis Monitor; European Central Bank

Going Forward

As we have stated since the election, there is very little in Trump's policies going forward that can be viewed with any certainty. With valuations at historically high levels and tax and fiscal policy implementation not likely to appear anytime soon, we maintain our cautious posture. We are still in "show me" mode regarding Trump's actions during the first 100 days of his Presidency. His administration has been moving at rapid pace, however it has lacked the focus on domestic growth policies which many market participants had hoped for. If he disappoints on the details of his domestic agenda or turns his attention more sharply toward creating disruption internationally or to items relating to past election, the "Trump Rally" could easily reverse lower in short order. We choose to be nimble at present allowing us to take advantage of both positive and negative developments.

Within equities we continue to favor the large cap segment of the U.S. market specifically within the financial and industrial sectors which would benefit from a raising interest rate environment, increased fiscal spending on infrastructure and a lower corporate tax environment. We also favor the technology and healthcare sectors which have rebounded since an initial post election sell-off and have now outperformed the broader market year to date. If the Trump administration can succeed in getting tax holiday legislation passed, it would also allow these companies to re-patriate billons in cash currently trapped overseas. This has the potential to unleash a tremendous wave of mergers and acquisitions since both sectors derive a large amount of revenue from outside of the United States. Although small and mid cap stocks are well positioned to benefit from Trumpenomics' domestic growth bent, that area of the stock market has become notably expensive. Beginning in mid-February, the smaller segment of the market has trailed the larger cap component.

Equity markets outside of the U.S. underperformed significantly in 2016 and therefore are an area of focus for 2017. Despite attractive valuations and an accommodative backdrop, Europe remains a question mark. The heavy European election calendar will shape the trend going forward as will the debt situation in the periphery countries. Protectionist policies and tariffs would further alter the landscape. Japan is attractive in our view with many companies trading at reasonable valuations, paying solid dividends, and benefitting from central bank asset purchases. After an extended period of underperformance, emerging markets have taken a leadership role so far in 2017. While growth remains strong in these areas, many emerging markets are particularly vulnerable to punitive Trump measures.

As the post election down-draft clearly demonstrated, traditional fixed income is in fact vulnerable to periodic declines. As interest rates look almost certain to climb throughout 2017, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. With the recent sell-off after the election we feel that the opportunity in the muni markets is very attractive at present with reasonable valuations and compelling yields.

Despite the OPEC production cut in late November, the price of oil has declined as supply data continue to show robust production. Energy companies themselves however, should benefit from an end to challenging environment seen in 2015 and 2016. After a notable and surprising post-election sell-off, gold has rebounded nicely in 2017. Given the macro outlook of a rising interest rate environment and a strong U.S. dollar, we are not buyers of gold for fundamental reasons, however, we have maintained a small position in certain portfolios as a hedge and the commodity has been an additive exposure thus far in 2017. With the risk/reward profile of both equities and fixed income not compelling at the moment, gold could prove to be an area we would add to as global uncertainty increases.

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.