Insights: May 2017

Market Overview and Performance

Things have been quiet lately. Very quiet. Historically quiet in fact. Stocks and bonds have been treading water and volatility has been surprisingly absent. Now calm markets are not necessarily a good or bad thing – it's usually a mixture of both. On the positive side of the ledger, we have seen generally good results from first quarter corporate earnings reports. Additionally, it has taken six months, but the market seems to have finally lost its interest in reacting to the daily curiosities of the Trump administration. And finally, one cannot dismiss the resiliency of the market in the face of a relentless stream of potentially disruptive events such as the French national election. On the negative side however, economic data in the U.S. (and China) have disappointed and attempts at Trump agenda items like healthcare and tax reforms were met with a huge amount of skepticism by the market. So now we are left with an uncomfortable calm. There are signs however that investors aren't buying it and a feeling of unease lies just below the surface. As evidence, hedge fund Elliott Management was able to raise $5 billion in just *24 hours* last month for a new opportunistic fund that will take advantage of the moment when confidence, correlations and prices all change course. CEO Paul Singer stated, “Markets may be in a situation somewhat akin to a coiled spring,…we don't know exactly what factor, event or combination of actions could release the possible pent-up revaluation of markets, but we think that there has never been a larger (and more undeserved) spirit of financial market complacency in our experience.” We will see if he is right.

As always, thank you for reading our latest Insights.

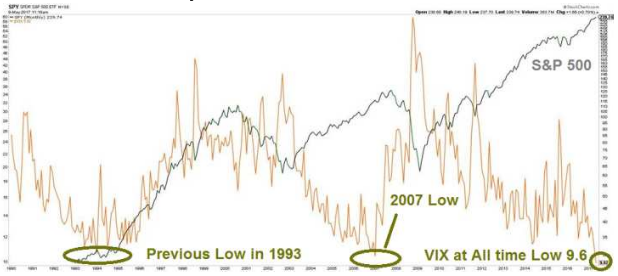
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.03	7.16
Russell 2000 Index	1.10	3.59
MSCI EAFE Index	2.54	**9.97**
MSCI Emerging Markets Index	2.19	**13.88**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.77	1.59
Barclay's U.S. Aggregate Credit Index	1.56	3.24
Barclay's U.S. Aggregate Corporate High Yield Index	1.15	3.89
Barclay's Municipal Bond Index	0.73	2.32
Macro Measures		
Gold	1.35	**10.12**
Crude Oil	-2.57	-8.17
CBOE Volatility Index	-14.33	**-22.93**
USD Dollar Index	-1.53	-3.10

Current Theme – An Uncomfortable Calm. Markets Move Away from Reacting to Trump and Shrug Off Macro Uncertainties

Investor Attention Rotates Back to Fundamental Market Indicators – Both Positive and Negative

Without a doubt, the most talked about narrative about the markets during April was the lack of volatility. Consider this, in 2015 the S&P 500 Index moved by more than 1 percent on 29 percent of trading days. In 2016, that measure fell to 19 percent of trading days. So far in 2017, there have only been three 1 percent moves or just 3.5 percent of trading days. Despite the onslaught of headline grabbing events, nothing seems to be capable of shaking the CBOE VIX Index out of its depressed levels. In April, we saw a U.S. bombing in Syria, North Korea nuclear weapon testing, a dramatically important French election, a commodity collapse, a correction in Chinese equities – the list goes on – but nothing. In fact the volatility measure only marched lower notching an all-time low on March 9th, a record that goes back 24 years as seen in the chart below.

CBOE VIX Volatility Measure at Historic Low

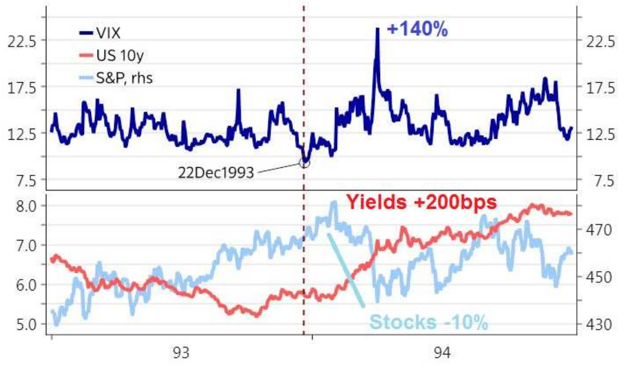


Source: Stockcharts.com

What is glaringly obvious when one looks at long-term charts of stock performance and volatility is they move inversely. Stocks climb and volatility falls and volatility rises as concern over falling stocks grows. The uncomfortable part about this chart is that historically when the volatility hits the very bottom of its trading range around 10, bad things tend to happen to stocks. Now stocks don't and won't just begin to fall because volatility is low. Something unforeseen will happen that will trigger a change in sentiment. That is why many have spoken about an uneasy feeling in the market. It has been smooth sailing so to speak for the last six months and a lot of the "known unknowns" such as the contentious French election which could have altered the future course of the European Union have for lack of a better phrase, come and gone.

Excluding the Global Financial Crisis that kicked off at the VIX lows of 2007, investors can look to what happened at the preceding low in 1993.

Post 1993 VIX Low, Stocks Corrected and Yields Increased



Source: Nordea Markets and Macrobond

History doesn't repeat, but it does rhyme, so 1993 is the best guide we have. At that time, the VIX dipped below 10 at the end of the year. By Spring, 10 year yields had started to creep up despite a lack of signs of inflation, Greenspan surprised the markets by beginning to tighten and the trends reversed. Volatility spiked by over +140 percent and stocks fell by more than 10 percent. Now nothing is ever the same, however something will inflict change soon and no one seems to be looking very hard for it. By way of example, in early May, many of the most prominent hedge fund managers gathered at the recent Sohn Investment Conference to discuss their views. Not one was bearish. In fact, the only note of caution came from the day's first speaker, former Fed official Kevin Warsh, who said simply when asked about the low volatility readings, "I would not take comfort, I would take fear." Undeniably, it's a difficult task to identify what will awaken that fear, so we prefer to focus on the data that the market gives us. One of the more reassuring developments has a been a resurgence in earnings growth. Now after five straight quarters of earnings declines in late 2015 and early 2016, a rebound in earnings growth was well anticipated as we entered 2017 and hence has not moved markets higher despite a growth rate of close to 9 percent. Now again, while this is a positive – we need earnings to come through to help justify high market valuations – the follow through has not quite been there. By that we mean earnings revisions, or what analysts believe will be a change in the level of growth going forward. After earnings are reported, analysts revise their outlook for a change in growth over the next twelve months. As you can see from the chart below, in June of 2016 revisions moved up significantly, over 7 percent higher than what was anticipated. That trend has declined to roughly 5 in September, to 3 percent in December to 1 percent by March and to just 0.5 percent (essentially no movement higher) by end of April. Additionally, growth estimates may fall further as consumer companies begin to report their traditionally weak first quarter numbers this month.

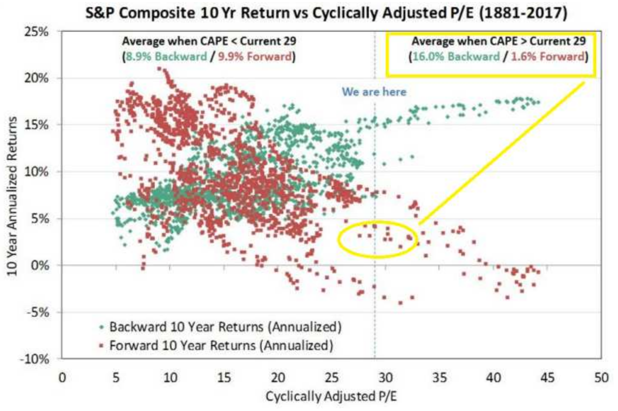
Earnings Revisions Have Failed to Project Optimism

	Current (4/28/2017) NTM EPS Revisions Vs. Prior Periods				
Sector/Index	6/30/2016	9/30/2016	12/31/2016	3/31/2017	4/21/2017
S&P 500	7.1%	4.8%	2.7%	1.2%	0.5%
Consumer Discretionary	-0.4%	0.5%	1.7%	1.0%	0.4%
Consumer Staples	3.9%	1.5%	1.3%	0.8%	0.2%
Energy	72.8%	36.6%	9.1%	-0.4%	0.1%
Financials	18.0%	9.8%	5.1%	1.5%	0.3%
Health Care	1.0%	-0.6%	-1.1%	1.1%	0.4%
Industrials	3.6%	4.5%	5.3%	2.2%	1.0%
Info Tech	12.0%	7.4%	3.2%	1.5%	1.0%
Materials	0.7%	-3.5%	2.5%	2.1%	0.8%
Telecom Services	-1.6%	-2.6%	-2.8%	-1.1%	-0.4%
Utilities	2.7%	2.0%	2.1%	0.6%	0.1%
Real Estate	2.3%	0.0%	0.8%	0.6%	0.1%

Source: Morgan Stanley Investment Management

As we have discussed many times in our Insights, the current valuation levels of the stock market are very extended. As measured by the Shiller cyclically adjusted price to earnings ratio, the S&P 500 trades at over 29 times earnings. That is rarified air only seen in 1929 and 2007, so earnings (the "E" in P/E) are crucial to maintain the ability of stocks to continue to move higher. With that said, we are certainly aware of the fact that valuation does not dictate where the market will go –things can stay expensive. However, as the following chart highlights, future ten year returns when the Shiller P/E is above 29 tend to be disappointing, in the range of just 1-2 percent annually. So while valuation may not be able to predict whether stocks will go down over the next year, they can give you indication of what to expect longer term if you buy in at elevated levels.

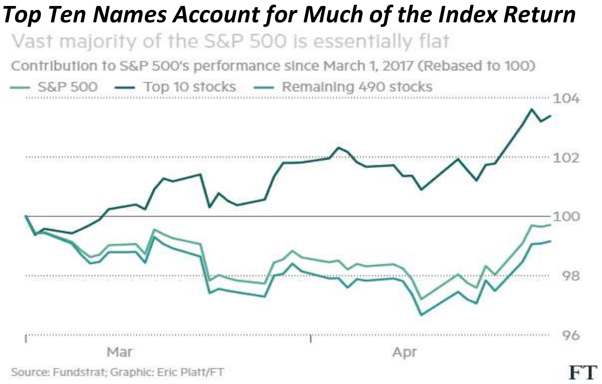
Forward 10 Year Returns when PE>29 are Just 1.6 %



Source: Econompicdata

To be fair, there are some who would say to that argument, "I don't really care about valuations, stocks are going up and I want to participate in that momentum." Completely valid. Many have reached this conclusion and simply put their money in broad market ETFs as fund flow data shows us. But what has evolved this year is an extremely narrow market. As the chart below shows, if you don't own the top ten stocks in the S&P 500, you are getting left behind. Those top ten names are not unfamiliar – Apple, Facebook, Amazon, Alphabet, Microsoft, Visa, Philp Morris, Home Depot, Comcast and Oracle. As a group these names are up over 18 percent year to date versus the S&P return of just 7 percent. So a handful of names are clearly doing the heavy lifting.

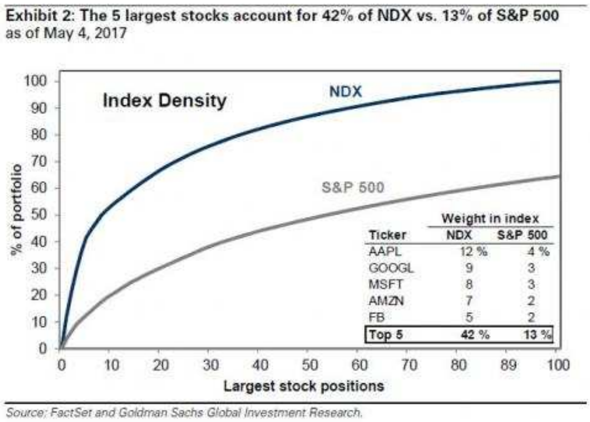
Top Ten Names Account for Much of the Index Return



Source: Bloomberg

We view this as an opportunity since as much as a third of the rest of S&P has come down by close to 20 percent according to Bill Bain at Mint Partners. However, the dangerous side of having just a few stocks lead the market is that they essentially become the market which could lead to disruption once they stop working. Consider the chart from Goldman Sachs. Just five stocks now comprise 42 percent of the Nasdaq 100 Index.

Just 5 Stocks Represent Almost Half of the Nasdaq Now



Source: Goldman Sachs

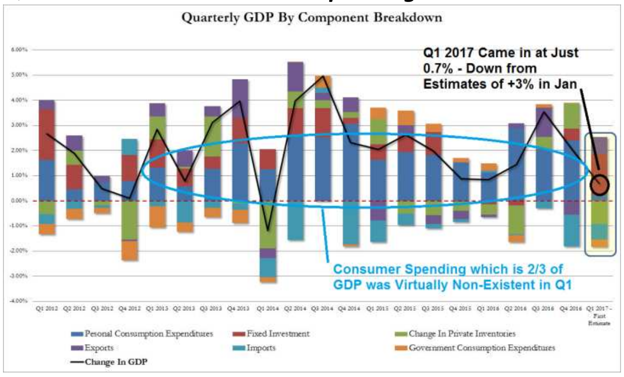
Further, Goldman Sachs estimates that as of May 10th, the top ten names in the S&P 500 are responsible for 46 percent of the entire year to date return. The push back argument to this is similar to the momentum approach, with some adhering to the belief that a market trending higher, regardless of drivers, will "lift all boats". This can certainly be true at points, but generally only when the economic backdrop is doing well. This is a major divergence that developed in April.

US Economic Surprise Data Has Collapsed

Source: Bloomberg; Barclay's Global

We, and many others, have discussed the gap between "soft" data (sentiment) versus "hard" data (manufacturing, industrial production, etc.) which has transpired since the election. Well, that trend reverted sharply in April as both sentiment and hard data disappointed. Worryingly, as the chart at the bottom of the previous column highlights, market behavior has been closely correlated to the path of the surprise data. If that correlation held, the market would be in for a decline of over -10 percent.

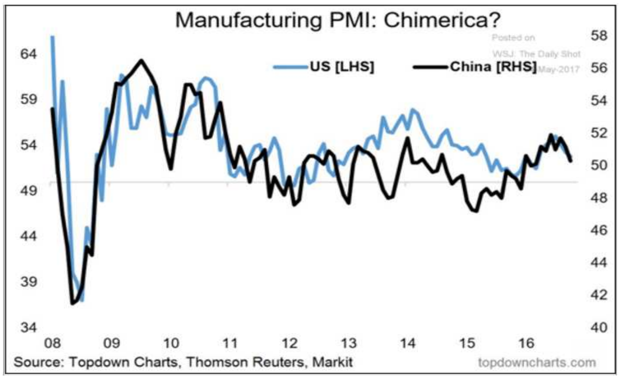
Q1 2017 GDP Just 0.7% - Con Spending Lowest Since '09



Source: Zerohedge

The Q1 GDP report in April confirmed this slowing trend, with growth of just 0.7 percent. Importantly, consumer spending, which is tightly tied to sentiment historically, and accounts for almost 2/3 of GDP, collapsed. Admittedly, the first quarter tends to be seasonally weak compared to the rest of the year, but data is clearly pointing to slowing growth rather than the "Trumpian" hope and promise of 3 or even 4 percent growth. In fact, this week Commerce Secretary Wilbur Ross admitted that the 3 percent growth target "is certainly not achievable this year."

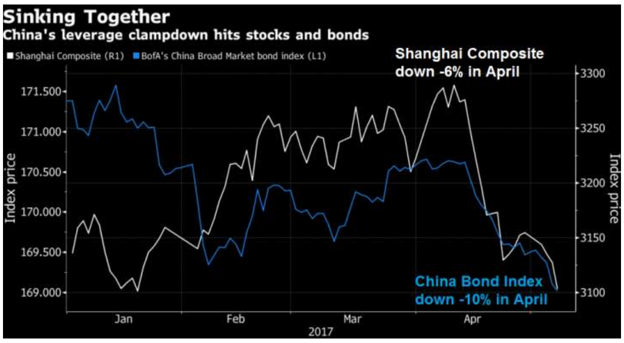
US and China, 40% of Global GDP, are Perhaps Slowing



Source: Topdown Charts

On top of the disappointing growth in the U.S. so far this year, investors were also presented with a sharply slowing Chinese economy as well. As the previous chart indicates, manufacturing activity in both the U.S. and China are slowing. That is potentially a problem since together, their economies account for roughly 40 percent of global growth. This has not gone unnoticed to investors in Chinese assets with over $500 billion of value in local stocks and bonds being wiped out this year according to Bloomberg.

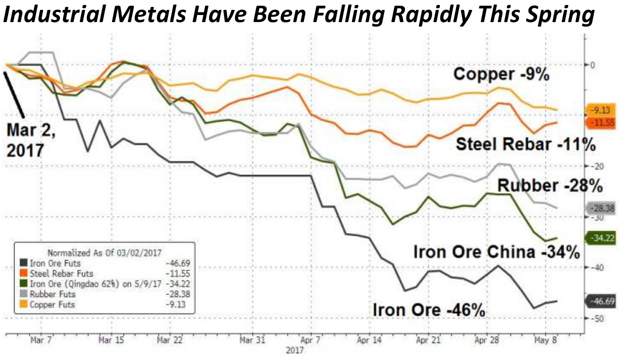
Deleveraging Has Erased over $500 Billion out of Assets



Source: Bloomberg, BofA Merrill Lynch

We will touch more on what's driving this downturn in China in a moment, but when China slows, commodities demand slows almost immediately. This has a ripple effect throughout the global economy as prices shift dramatically. Consider the fate of industrial metals since the beginning of March shown in the charts below. Most notably Iron ore, the backbone of industrial activity, is down an astounding -46 percent over the past two months. The impact is real with Chinese home sales falling by 30 percent in the final week of April for example. The obvious question is what's causing this sudden shift in demand and activity this year in China?

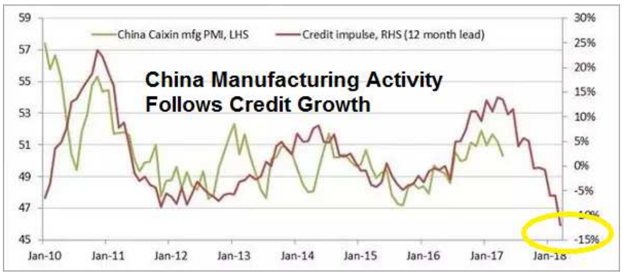
Industrial Metals Have Been Falling Rapidly This Spring



Source: Bloomberg

What we are witnessing is a real-time view of China trying to manage the balance between the conflicting goals of curbing credit expansion (leverage) and maintaining economic growth. As you can see in the chart below, Chinese credit growth is tightly tied to manufacturing activity.

China is Trying to De-lever without Crushing Growth



Source: Financial Times; PIMCO

Starting in 2012, China began its most recent program of massive credit stimulus. This drove Chinese real estate investment and commodity demand (and prices) higher. Emerging markets generally and global reflation both benefitted from this stimulus. However, Chinese authorities saw that their efforts had begun to overheat growth by late 2016. As a result they have been slowly increasing the nation's borrowing rate from 2.3 percent in August to 3 percent by April. Why do investors care? China is a controlled environment right? The problem is that China has been driving global reflation for the past two years.

China has Been Driving Global Reflation Since 2014

Source: PIMCO; UBS

And with an estimated $9.3 trillion (or 87% of GDP) now residing in shadow banking products with an asset-liability mismatch, the market is worried that Chinese authorities will mishandle the process, causing asset corrections as they did in 2015.

Going Forward

The market's lack of enthusiasm about the Trump administration's attempts to move the ball forward on healthcare and tax reform provide evidence that investors believe these changes will not be accomplished anytime soon. And of course, the global saber rattling with North Korea (and Russia and Syria) continues. Investor tension therefore remains elevated. Combined with the fact that "Trump Hope" trade pushed valuations a bit too far too fast, we maintain our cautious posture. We are still in "show me" mode regarding Trump's actions until economic fundamentals indicate otherwise. And surprises like the unexpected firing of FBI Director James Comey continue to erode Trump's capital with Congress. We believe reform progress will therefore be slow. 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. The financial and industrial sectors have benefited from an anticipated rising interest rate environment, increased fiscal spending on infrastructure and a lower corporate tax environment. Despite recent relative underperformance, we believe these sectors are still attractive going forward as well. Although small and mid cap stocks are well positioned to benefit from domestic growth initiatives, that area of the stock market has become notably expensive. Since mid-December, the smaller segment of the market has trailed the larger cap components and we are patiently waiting for a better entry point.

Equity markets outside of the U.S. underperformed significantly in 2016 and therefore are an area of focus for 2017. Valuations outside off the U.S. have long been attractive relative to stocks here, however, no catalyst for change has been present. That inertia appears to be developing in 2017 as economic growth is now outpacing that of the U.S. in many parts of the world. With U.S. equities at such extended valuation levels, we feel that there is a better risk reward trade off in global equities outside of the U.S. Europe is by no means, "out of the woods" but the resolution of the French election with a moderate taking control was a significant milestone. Italy and Greece continue to face daunting challenges but broadly speaking, the European economy is on the upswing. Japan and Asia-ex Japan are attractive in our view as well, with many companies trading at reasonable valuations, paying solid dividends, and exhibiting above average growth rates. After an extended period of underperformance, emerging markets as a whole have taken a leadership role so far in 2017. Valuations levels have been cheap in emerging markets for some time, but now we are seeing some evidence of accelerating earnings growth and the once "sure thing" of U.S. Dollar strength, a headwind for the group, appears to be waning.

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 (odds of a June rate hike are 100% according to the futures markets), we 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 . While Gold is still up 10 percent in 2017, it has been volatile as of late. 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 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.

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