Insights: August 2017

Market Overview and Performance

As is often advertised, July was a quiet, albeit positive period for stock, bond and commodity investors alike. With the summer vacation schedule kicking into full gear and trading volumes receding, the most interesting developments came from the theatrics in Washington. Thankfully though, the quick rise and fall of the colorful Anthony Scaramucci and the lack of progress on literally every agenda item in Congress was scarcely met with little more than a passing glance by market participants. Instead, most of the attention in July was focused on earnings reports which have been by and large very good this quarter. This is important because earnings growth is really the only concrete impetus that can be depended on to propel (or at least maintain) equity markets that have reached extreme valuation levels based on history. The Bulls would suggest that a combination of strong earnings growth, low interest rates, a reasonably healthy consumer, low inflation and a solid employment backdrop (and perhaps even decreasing regulation and lower taxes at some point in the future) paints a very accommodative environment for further gains. That may perhaps prove to be true, but with valuation readings now at levels only seen before previous crash episodes, there is little margin for error. In fact, there is virtually no possibility of a negative outcome being priced into markets when we look at sentiment and volatility data. That type of "everyone on the same side of boat" environment typically does not end well, and as we have said for some time now, there are cracks in both the market and economy that would be foolish to ignore.

As always, thank you for reading our latest Insights.

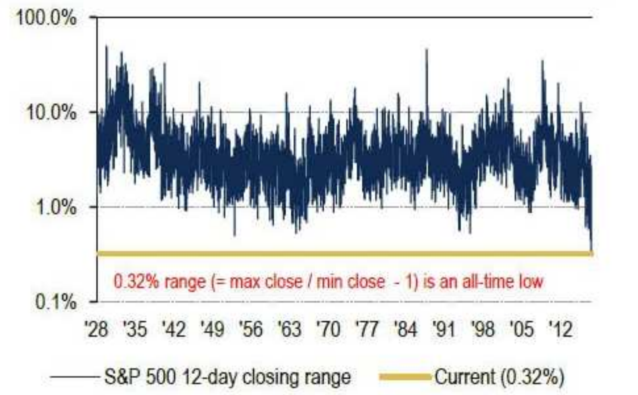
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.06	11.59
Russell 2000 Index	0.74	5.77
MSCI EAFE Index	2.88	**17.09**
MSCI Emerging Markets Index	**5.96**	**25.49**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.43	2.71
Barclay's U.S. Aggregate Credit Index	0.85	**7.35**
Barclay's U.S. Aggregate Corporate High Yield Index	1.11	6.09
Barclay's Municipal Bond Index	0.81	**4.40**
Macro Measures		
Gold	2.44	10.57
Crude Oil	8.23	-6.61
CBOE Volatility Index	**-8.97**	**-26.92**
USD Dollar Index	**-2.98**	**-9.15**

Current Theme – Markets and Washington Both Settle Into a Summer Lull of Muted Activity.

Tepid Environment and Complacent Sentiment Belie the Obstacles that Await in the Autumn Months

July and August have always traditionally been quiet periods for markets, but things are *really* quiet right now. Historically so. The S&P 500 has now gone 73 trading days without a 1 percent gain according to Deutsche Bank. Further, as of writing, the S&P has gone 14 consecutive trading days without moving more than 0.3 percent in either direction. This has *never* happened before.

Stocks Trading in Tightest 14 Day Range in History



Source: Bank of America Merrill Lynch

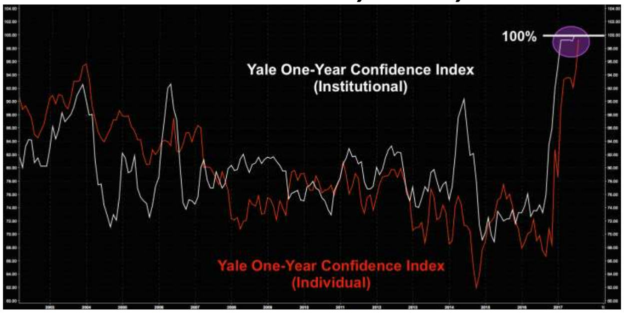
And as long as the market continues to grind out slow but steady gains, few are complaining. In fact, if one looks at the implied future volatility reflected in the purchase of put options (downside protection), we are again at historic levels.

Implied Volatility is at Lowest Level in 25 Years

Source: Bloomberg

As we have stated in the past, a quiet trading environment and low volatility are not "bad" characteristics, particularly if they are accompanied by increasing prices, however, they have the tendency to lull investors into somewhat of a false sense of security. And we are seeing evidence of that now.

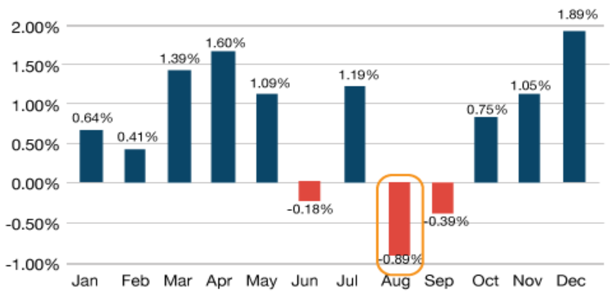
Both "Smart" and "Dumb" Money See Only Gains Ahead



Source: Yale School of Management; Bloomberg

There are several investor sentiment measures available, but perhaps one of the most straightforward is the survey conducted by the Yale School of Management which simply asks both individual and institutional investors whether or not they believe stocks will be higher in one year's time. Incredibly, both investor groups are virtually 100 percent convinced that stocks will be higher by this time in 2018. Now, they could very well turn out to be proven right, but I think you would be hard pressed to find anyone who would give you 100 percent odds of that outcome occurring. This type of "everyone on the same side of boat" scenario is typically not a good one, especially as we enter what has seasonally been a very weak period for stocks as evidenced by the chart below.

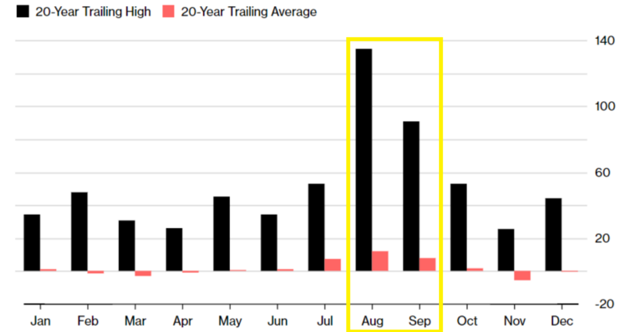
SPX – Average Monthly Performance (1987 – 2016)



Source: MKM Partners; Bloomberg

We will freely admit that averages are just that, a compellation of higher and lower numbers, however we do have further historical data which confirms generally rougher waters in the late summer months.

Average Monthly Percentage Change of the VIX Index



Source: Chicago Board of Options Exchange; Bloomberg

As the chart above highlights, both the average and 20 year high measures of change in the VIX Index (a measure of volatility) tend to reach their most elevated points in August and September. Ok fine, you say, but isn't everything still hitting new record highs everyday? Not quite. As we and others have discussed, the market has become increasingly narrow.

Average Stock Trailing Broader Index – Narrow Market

Source: Andrew Thrasher; Stockcharts.com

Put quite simply, the market is currently being dragged along (higher for the moment) by just a handful of stocks – most of which you could easily name. The chart above illustrates the ratio of the equal weighted S&P 500 index versus the traditional index where names like Apple represent a larger portion of the index relative to other names. What this tells you is that if one were to look at all securities equally, the average stock is lagging the performance of the top level index. It is not hard to understand why. I am sure if you asked the Average Joe on the street what the best stocks are he would say Apple, Facebook or Amazon. And he would be right. As of late July, just five stocks accounted for roughly 34 percent of the S&P 500's year to date gains.

Just 5 Names Account for 34% of the Year to Date Gains

TICKER	COMPANY	Contribution To Index	% of Contribution	Cumulative Contribution	% of Cumulative Contribution	Rank
AAPL	Apple	1.06%	0.13%	1.06%	12.84%	1
AMZN	Amazon.com	0.47%	0.06%	1.53%	18.51%	2
FB	Facebook	0.43%	0.05%	1.96%	23.72%	3
MSFT	Microsoft	0.29%	0.04%	2.25%	27.27%	4
GOOGL	Alphabet 'A'	0.28%	0.03%	2.53%	30.65%	5
GOOG	Alphabet 'C'	0.28%	0.03%	2.81%	33.98%	6
PM	Philip Morris International	0.22%	0.03%	3.02%	36.59%	7
JNJ	Johnson & Johnson	0.18%	0.02%	3.20%	38.71%	8
V	Visa	0.17%	0.02%	3.37%	40.73%	9
CMCSA	Comcast 'A'	0.15%	0.02%	3.51%	42.51%	10
HD	Home Depot	0.14%	0.02%	3.65%	44.15%	11
AVGO	Broadcom Limited	0.13%	0.02%	3.78%	45.75%	12
MCD	McDonald's	0.12%	0.01%	3.90%	47.18%	13
ORCL	Oracle	0.10%	0.01%	4.00%	48.43%	14
MDT	Medtronic plc	0.10%	0.01%	4.10%	49.62%	15

Source: www.whotrades.com

Again, this not necessarily a bad thing, but when you have a group of just five large stocks who if you held them equally would have returned roughly 30%, or almost three times what the Index has done, it becomes clear that the rest of market is not keeping up. And even strong fundamentals have not made a difference recently. Factset claims that 73% of companies have beaten expectations so far this quarter. A higher than normal figure, and typically one that would compel investors to favor those companies whose businesses are performing well. However, as Bank of America Merrill Lynch has found, for the first time in their 17 year data history, stocks that have reported better than expected results in both their earnings and revenues have not been rewarded. Instead, their stock prices have only matched that of the Index on both the day they issued the positive surprise and in the subsequent 5 trading days after.

EPS and Revenue Beats Not Being Rewarded in 2Q17

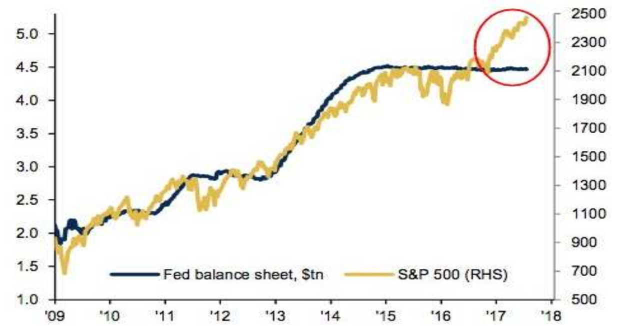
Table 3: Post-reporting 1-day and 5-day relative performance (vs. S&P 500, in ppt) based on surprise

	1 day	5 day	Start of reporting season to 1 day after reporting	Start of reporting season to 5 days after reporting
EPS Beat	-0.2%	-0.6%	0.0%	-2.4%
EPS Miss	-1.9%	-2.5%	-2.8%	-3.7%
EPS In-Line	-0.2%	-0.6%	-2.4%	-0.5%
Sales Beat	0.0%	-0.1%	0.2%	-1.1%
Sales Miss	-1.7%	-2.6%	-3.3%	-5.2%
Sales In-Line	-2.0%	-6.3%	-1.2%	-6.1%
Both Beat	**0.0%**	**0.1%**	**0.7%**	**-1.1%**
Both Miss	**-3.1%**	**-4.9%**	**-4.2%**	**-4.8%**

Source: Factset; BoA Merrill Lynch US Equity and US Quant Strategy

The lackluster reaction to what is overall a solid earnings season is a bit of a concern. As we and others have discussed at length, U.S. equity markets are exceedingly expensive right now. The Shiller Price/Earnings ratio for example, now stands at 30.25 times, a level only eclipsed once which was during the Dot.com bubble. With that said, the hope was that as corporate earnings rebounded from their trough of the last 18 months and began to expand once again, these tangible economic improvements would pick up the baton from what has been a relentless underpinning of the market gains thus far – central bank liquidity injections.

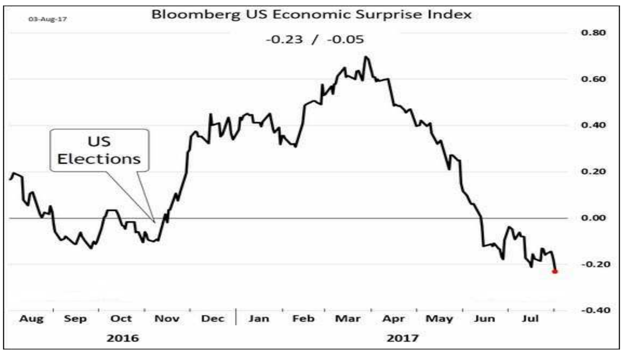
Until 2017, Stocks Followed Fed's Balance Sheet Expansion



Source: Business Insider; BoAML Investment Strategy; Bloomberg

We are now on the cusp of the Fed unwinding some of that balance sheet and the consequences of that action can not be predicted. What can be said however, is that we continue to see signs of a weak economic backdrop, or at the every least not one expanding at a pace which would require the Fed to be "tapping the brakes" in the form of higher rates. As you can see below, economic data has consistently failed to match expectations in 2017.

Economic Data Continues to Surprise to the Downside



Source: The Daily Shot; Bloomberg

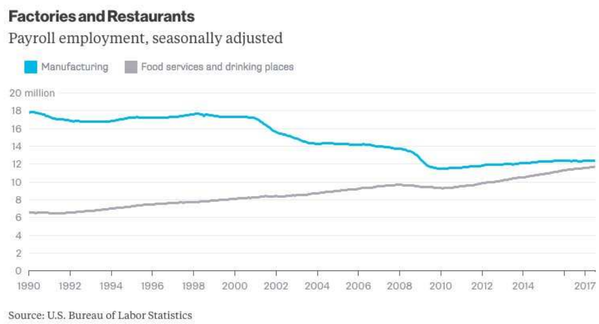
One of the factors that is actually not reflected in the softening Surprise Index are the jobs numbers. Employment data at the headline level has been solid if slowing, but the details behind the aggregate numbers paint a different picture.

Labor Market Breadth Showing Dramatically in 2017

Source: Pervalle.com

As the chart above illustrates, while the total number of jobs created remains at a comfortable level, the bulk of those jobs are coming from an increasingly narrow source. In other words, jobs in industries like retail, healthcare and information have declined this year while jobs in food and beverage have accelerated.

Food Service Jobs On Track to Outpace Manufacturing



Source: 13D Research

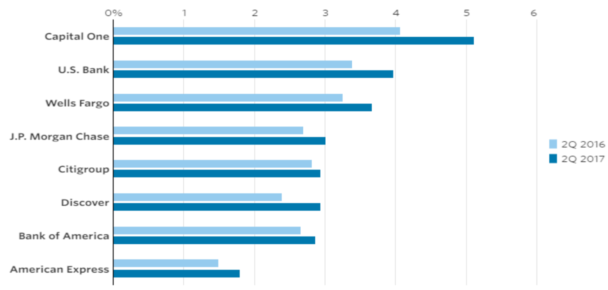
What is the difference you might ask, a job is a job. The key is that the industries experiencing a shrinking job pool tend to be those that pay higher wages and have a steeper trajectory of salary gains in the future. Unfortunately, the change in wage growth is highly correlated to the jobs breadth chart above, so when we see a large influx of jobs coming from generally low paying jobs associated with food and beverage service, overall wages tend to decline as well. This is a serious issue and it gets to the heart of why many Americans feel left behind during what is advertised as a "fully" recovered economy. Even with timid overall inflation, the cost of things like housing remains a factor for virtually everyone, particularly those who are in and out of the job market. And so these trends become extremely important. Take a good look at the next chart.

Wages & Salaries - Rent Inflation Has Turned Negative

Source: Bureau of Economic Analysis; Eric Basmajian

It shows that the sum of wages and salaries minus rent inflation has turned negative. Essentially, what people are getting paid is not keeping up with the increases they are experiencing in the cost of their shelter needs. The only time this metric was negative during the past 30 years was in recessionary periods. And we are starting to see the follow-on effects of the pressure on consumers as well.

Net Charge Offs (Losses) for Card Cos. Highest in 4 Years

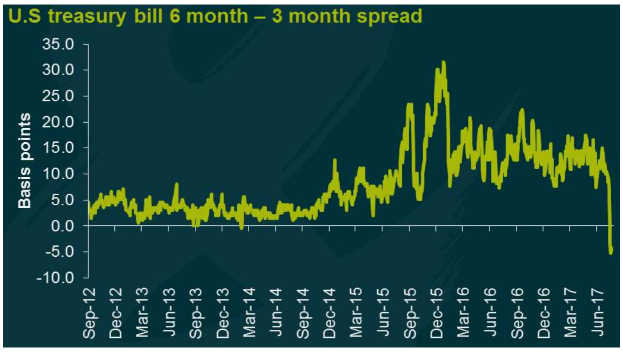


Source: Wall Street Journal

During the second quarter, the net charge off rate (debt written off as a loss) for credit card companies was 3.29%, the highest in four years. It marked the fifth consecutive quarter of increases and all eight major issuers saw an up-tick. As the CEO of Discover Financial put it succinctly, "The overall environment is deteriorating". This is unusual and concerning given the backdrop of an economy that is said to be at "full employment".

Finally, we must address the current situation regarding the debt ceiling. After failing to achieve any progress on healthcare, Congress returns to session on September 5th which gives them just over a month before they must vote to either raise the debt ceiling or risk a default on U.S. debt. This is a serious episode and the market is reflecting that.

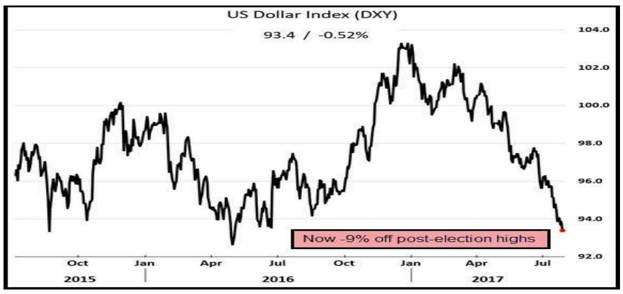
Bond Market Worried About a Possible Govt Shutdown



Source: M&G Investments; Bloomberg

The chart above shows that the short term yield curve has inverted meaning that investors are demanding a higher yield on 3 month government debt than they are for 6 month debt. As you can see, this is an unusual occurrence and clearly reflects investor angst regarding the turmoil that will invariably surround the vote. Further signs of distress can be seen in the US Dollar value which fell sharply in July.

US Dollar Declining on US Instability Concerns



Source: The Daily Shot; Bloomberg

In other words, a potential repeat of the government shut-down in September of 2013 is undoubtedly being price into the market. As a reminder, during that period, Congress argued over tying the debt ceiling to the budget, America's credit rating was downgraded, and money fled into gold and Treasuries - wiping out over $2.5 trillion of stock market value in the process.

Going Forward

With the collapse of the healthcare bill and a looming budget ceiling difficulties, the market has now discounted the chance of any stimulus coming to fruition this year as essentially zero percent. 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 within a very short time frame this fall.

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. Additionally, with 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 implemented 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.

Amidst all of the macro turmoil, Gold has served its purpose as a diversifier 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 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.