Insights: February 2018

Market Overview and Performance

My, how things change. When we sat down to write this month's Insights letter during the first few days of February, the script was largely going to be a re-emphasis of what we said at the end of 2017. Namely, that optimistic market sentiment had gotten carried away, that equity valuations were stretched well beyond what would be considered reasonable for the earnings being produced and that record low levels of volatility across asset classes were not likely to persist. Regular readers will recognize that we have been concerned about these conditions for some time now. While no one can forecast which snowflake will be the one to push the avalanche over the cliff, we did believe that the widespread extrapolation of current conditions well out into the future was setting up investors for disappointment. January seemed only to intensify these conditions with retail investor money pouring into stocks, vaulting the S&P 500 7.5 percent higher over the first 18 trading days of 2018 – a reasonable expectation of return for a full year. As we know, this did not last as stocks began to fall sharply after the peak seen on January 26th. While there is likely no single impetus for the sell-off, as usual, clues were found in the bond market. As we discussed last month, the yield on the ten-year treasury bond had been moving higher and by the end of January, had reached levels which signaled distress in equity markets during prior unsettled periods seen over the past 30 years. While there is no way to know for certain, we believe there is still more volatility to come and that we have not seen the last of the market gyrations.

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	5.73	5.73
Russell 2000 Index	2.61	2.61
MSCI EAFE Index	5.02	5.02
MSCI Emerging Markets Index	**8.33**	8.33
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-1.15**	-1.15
Barclay's U.S. Aggregate Credit Index	-1.28	-1.28
Barclay's U.S. Aggregate Corporate High Yield Index	0.60	0.60
Barclay's Municipal Bond Index	-1.18	-1.18
Macro Measures		
Gold	2.58	2.58
Crude Oil	7.13	7.13
CBOE Volatility Index	**22.64**	22.64
USD Dollar Index	-3.25	-3.25

Current Theme – January Euphoria Quickly Turns to Market Turmoil

Although the Recent Equity Moves Lower are Not Significant When Put into Context, Market Uncertainty is Likely to Persist – Longer Term, the Budget Deficit Looms Large

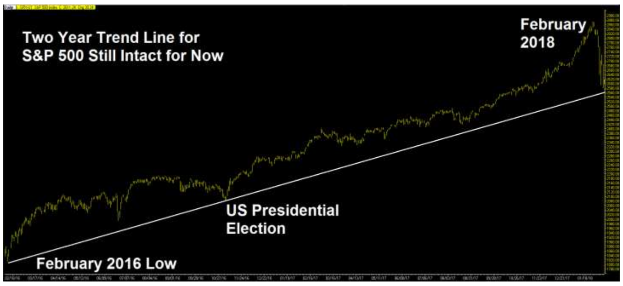
"Relentless". "The New Money Market Fund". "The Stock Market that Never Goes Down". Last month, we pointed out that these terms used to describe equity markets in 2017 were not going to age well. However, as you can see from 2017 chart below, who could blame their authors. Post the US Presidential election, the market moved higher on the "Optimism" of the Trump pro-business view, then to "Belief" as growth gained strength globally, then onto the "Thrill" of tax cuts boosting earning, which finally lead to the "Euphoria" of the notion that the market would never go down – except it did.

2017 S&P 500 Path - Optimism, Belief, Thrill, Euphoria

Source: Twitter @StockCats

There are numerous indicators that point to the overextended conditions this blind-eyed sentiment produced, and many of them have been discussed by us over the past year. The S&P hit a current price to earnings level of 24 times. Equity markets went 402 trading days without a correction. High yield bond spreads, a reflection of the risk perceived in the market collapsed to 2007 pre-crisis levels. There are of course many other data points we could highlight that approached "record" levels, however the message is the same. Equity markets were simply overextended by a wide margin, projecting out a growth path that was highly unlikely to come to fruition, and with a 7 percent run-up to start the year, it did not take much to trigger a correction. In this case, a move higher in bond yields. We specifically use the term "correction" because that is exactly what is was – a correction in price from the overshoot back to the longer term trend as can be seen in the chart below.

Two Year Positive Trend Line Tested but Still Intact



Source: Thomson One

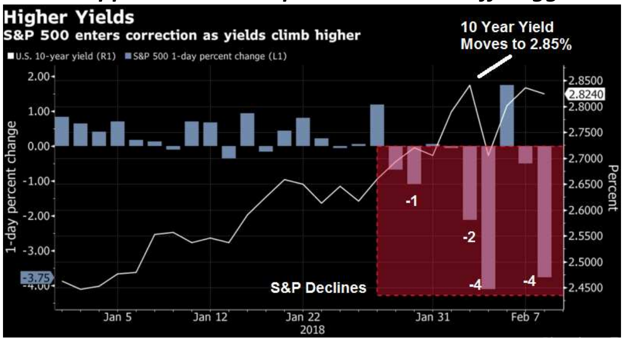
Thanks in part to the "euphoric" move higher in January, a 10 percent correction merely brought the S&P 500 Index back in line with the strong uptrend that began after the last pullback in February of 2016. You can also see that the trend was tested right before the US election, but stocks bounced right off of that support line.

Nine and Two Year Support Lines Have Both Held so Far

Source: AXI Trader; WSJ Daily Shot

Again, we would stress the emphasis on the notion of price correction, since for the time being, nothing fundamentally has changed in the brief period since the peak on January 26th. There is speculation that shifts are occurring underneath the surface which we will discuss, but for now that trend line support going back to 2009 in the chart above represents a pretty significant line in the sand. In fact, when we were trying to write this letter last week, we had to put the process on hold since the incredible intraday swings threatened to violate this long term support. If the market had recorded a close significantly below the 2530 level or so, many trading models would have initiated sell programs which would have exacerbated the losses further. That has not happened yet, but what exactly did happen?

What Happened? Yields Up to Previous Selloff Trigger



Source: Bloomberg

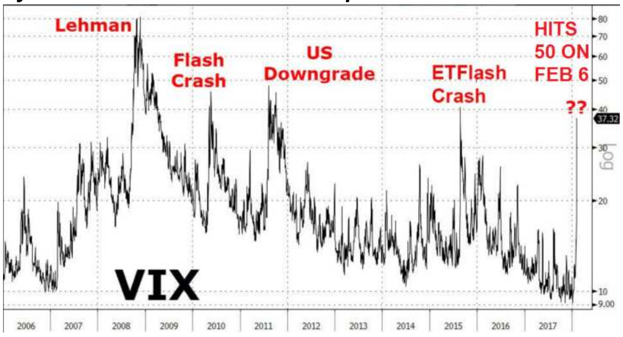
As we said, it was price correction that was in all likelihood initiated by a pretty severe move up in bond yields that began in early December after the passage of the tax cuts. We will get into the reason for that in a moment, but as the yield moved higher and people started to do the math on the implication of the tax cuts – a meaningful loss of revenue for the government – it became clear that rates were going to have to move higher and a new period of re-flation was beginning.

10 Year Yield Violates 30 Year Trend = Equity Tops

Source: The Atlas Investor

The chart above is updated version of one we have used in the past as a warning sign of potential trouble. As notable voices like Jeff Gundlach and Bill Gross have stated, if 10 year bond yields spiked up to near 3 percent, it would likely trigger trouble for equities. That level would be a breach of the 30 year trend line that has seen at least seven instances of a market reaction which resulted in unpleasant episodes like the October 1987 Crash, the S&L Crisis, the Tech Bubble bursting, the Global Financial Crisis. We are there now. This is well communicated among market participants and it has not been a welcome message. In fact, volatility, which had almost literally been absent in the market for the past 15 months, came roaring back to pervious crisis levels with the CBOE Volatility Index VIX hitting 50 on February 6th

After Two Years in Decline VIX Spikes to 50 = Prior Crisis



Source: ZeroHedge

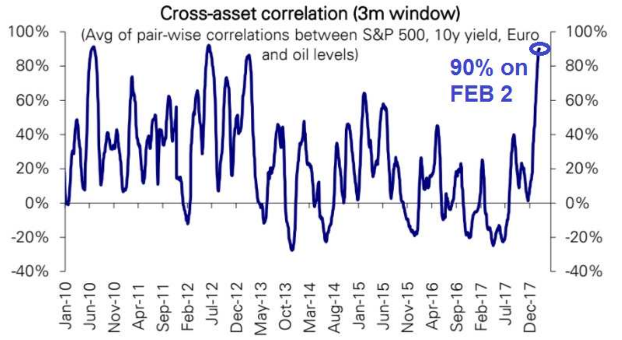
Volatility spikes were in fact seen in bonds, foreign currency exchange and commodities as well.

Volatility was Wide Spread – Hit Bonds, FX and Commod.

Source: ZeroHedge

Not surprisingly, this coordinated rise in volatility caused the trading in multiple asset classes to become correlated; i.e. they all began to trade in the same direction at the same time, either up or down. This is surprising, one because correlations in 2017 had fallen to almost zero, an two, because cross asset correlation rocketed up to 90 percent in just the first few weeks of 2018 according to Deutsche Bank's Chief Strategist, Binky Chada.

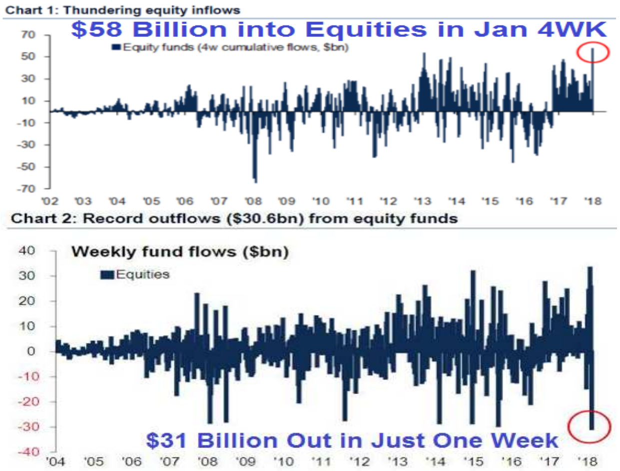
Cross Asset Correlation moves from 0 to 90% in 2018



Source: FRB; Haver; Deutsche Bank

This makes for a challenging environment for professional investors, however, compounding the problem was the fact that retail investors who had resisted chasing the market's relentless move higher in 2017, finally capitulated and put money to work aggressively in January. A record $58 billion went into equity funds during the first four weeks of January according to BoA Merrill Lynch. Unfortunately, over half of that amount, $31 billion, was ripped right back out during the rough waters experienced in the first week of February, another record.

Record Flows Both In and Out of Equities in Jan and Feb



Source: BoA Merrill Lynch Global Investment Strategy; EPFR Global

Well okay, you might say, so the dumb money got whipsawed (badly) so far in 2018. At least they always have the safe haven assets to turn to during times of duress, right? I am sure their bond funds did just fine. Well, that is actually where we find evidence of the "this time is different" element present in this sell-off. As we said, this was a price correction in stock prices, but it was perhaps the start of a regime change in the bond world as well.

Safety of Bonds Absent During this Sell-Off – Not Typical

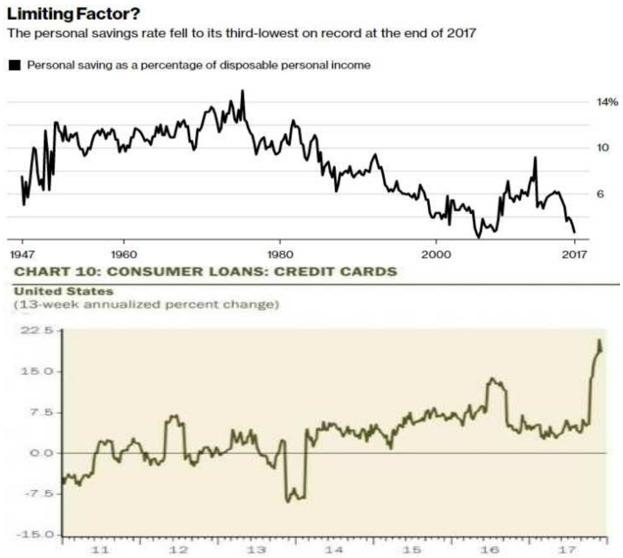
S&P 500 Sell-offs vs. Δ in 10yr Yield

	S&P 500 Δ	10yr Yield Δ (bps)
2010: Apr - Jul	-16.0%	-75
2011: Jul - Aug	-16.5%	-90
2012: Apr - Jun	-8.9%	-48
2015/2016: Jul - Feb	-12.3%	-65
2018: Jan - Feb	-10.2%	24

Source: Driehaus Capital Management; Bloomberg

What is going on here? The common narrative you will hear across the broad based financial news outlets is that a higher than expected wage growth number released on February 2nd sparked a fear of "wage growth explosion" that would quickly lead to run-away inflation since the labor market is so tight. There is frankly no evidence for this. Wage growth has been very steady if slow at just over two percent for the past 2.5 years. Whats's worse, 'Non-Supervisory Workers" which make up 80 percent of the labor force are not seeing any dramatic changes in their wages. In fact, rather than spurring an overheating economy with this supposed new found wealth, most workers are simply still trying to make ends meet as anemic savings and increasingly credit card debt are at concerning levels.

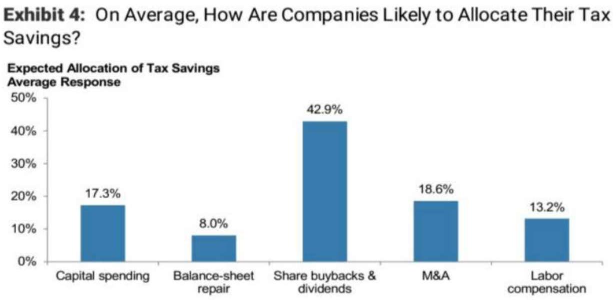
Average Consumer is Not in Good Financial Condition



Source: BEA; Glushkin Sheff; Haver

As we alluded to earlier in this letter, the tax cuts are the real factor driving the sell-off and the bond market has been telling us this since they were passed in December. Wait, wouldn't tax cuts have a stimulative impact on the economy? One would think, but as Morgan Stanley points out most, 43 percent will go toward stock buybacks and not directly back into the economy.

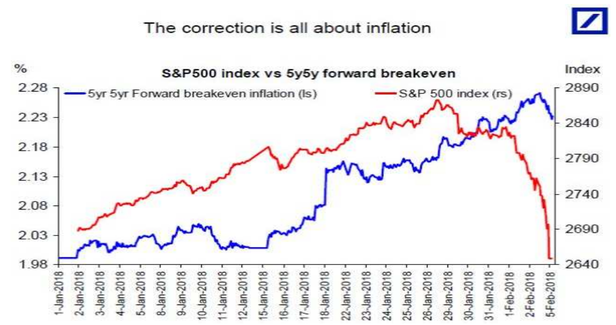
Only 13% of Tax Cut Saving to Labor – 43% to Buybacks



Source: Morgan Stanley

If that's the case, why is inflation still the big worry behind the sell-off as Deutsche Bank claims when they look at inflation expectations?

Rising Inflation Expectations Driving Market Declines

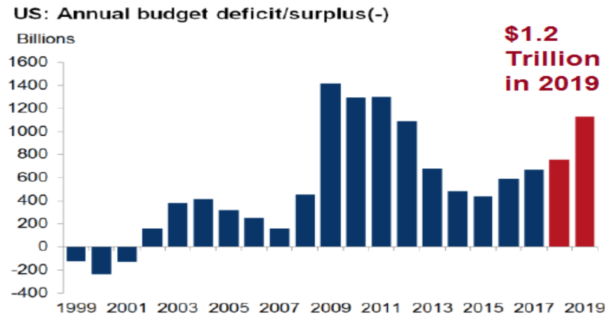


Source: Deutsche Bank

It is because the tax cuts put the federal budget into very tenuous territory. The result of the cuts, again a loss of revue for the government, combined with the recently passed budget last week is that the US government will now be saddled with a budget deficit of over $1.2 trillion dollars by 2019. This is a huge number and parallels only the emergency budget deficit spending enacted during the Global Financial Crisis. We are not in a crisis. We are in the ninth year of economic expansion, one of the longest in history, with record corporate profits and an unemployment rate near all time lows.

There is simply no need for this "fiscal overkill" as some have called it – others contend it's flat out dangerous.

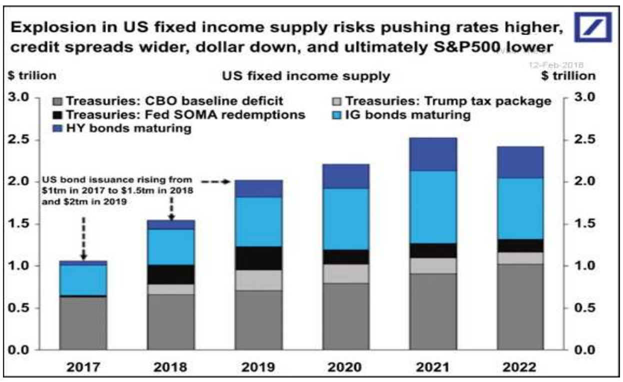
Budget Deficit Ballooning to Levels Only Seen in GF Crisis



Source: US Treasury

In no uncertain terms, this is going to require the Treasury Department to issue a tremendous amount of debt to cover their costs. This intimidating increase in bond supply – 2019 will be double the level seen in 2017 – will have the inevitable consequence of driving prices down due to less demand and conversely, bond yields meaningfully higher. The image below is an important chart for the future. As Trosten Slok at Deutsche Bank sates, "The bottom line is that investors should spend less time looking at US economic fundamentals and more time on where a doubling in demand for US fixed income can come from, in particular in a world where central banks are at the same time stopping doing QE". This is a significant issue, and one that some like private equity firm KKR recently stated, has pushed the odds of a recession by the end of 2019 to 100%. Unfortunately, if this proves true, the government will have very little ability to respond since deficit spending is already at crisis levels.

Explosion of Fixed Income Supply – Double By 2019



Source: Deutsche Bank

Going Forward

Last month we began our outlook section by saying, "With the recent surge higher to start 2018, we are concerned that the combination of overly optimistic sentiment in the US, stretched equity valuations, overbought conditions, international tensions, and Trump's unpredictable behavior with both other global leaders and members of his own Congress is setting the stage for disappointment further down the road." We were justified in that concern and believe we will see more price disruptions throughout the balance of this year. As a result, although the US may end the year with modest gains, we believe that risk reward scenario is more compelling outside of the United States for 2018.

While never pleasant to see the value of holdings decline, the recent sell-off has only made the prices of companies we like more attractive. We favor the information technology, financial and energy sectors in particular and have been adding to these areas on a selective basis. The technology sector continues to display very strong growth and profitability. Financial names are still reasonably priced and will benefit from a raising rate environment and a reduction in their tax rates. The energy sector is recovering from what was a -20 percent return in the summer of 2017 and the fundamental supply and demand environment has now become a tailwind reinforced by the recent move higher in oil prices. Energy stocks were hit particularly hard during the sell-off, providing compelling entry points. We also look to selected industrial and material names to outperform in 2018 as the demand dynamics and global growth look to be a tailwind for 2018.

With the momentum in non-US economies and a trending of weaker dollar this year, domestically focused small and mid cap stocks have been out of favor. With valuations relative to large cap almost exactly in line with historical averages, we would not choose to commit new capital to those segments for the time being. Although smaller companies could see a tax benefit boost, borrowing costs, which are substantial for small companies are likely to rise along with interest rates keeping us on the sidelines.

Equity markets outside of the US are compelling in our view. After years of lagging the US market, International equities now display faster economic growth than the U.S., combined with reasonable valuation levels and stimulative fiscal policies. Europe and Japan in particular are attractive in our view. With regard to emerging markets, we also see opportunity. As a group they are demonstrating strong profit growth and improved balance sheet stability. While EM equities experienced solid gains in 2017, valuations still remain very attractive relative to the rest of the world due to the multi-year period of underperformance.

Our biggest concern from the bond market has now shifted from a flattening yield curve to a rapid increase in rates. At a minimum, the market consensus is for four rate hikes this year and as we discussed the supply of bonds this year will be substantial, pushing yields even higher. As a result, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Our exposure to municipal bonds and short term corporate bonds performed admirably in 2017 and we continue to believe that the opportunity in these segments of the fixed income market are attractive with reasonable valuations and compelling yields for the remainder of 2018.

Amidst a rapidly changing macro environment, Gold served its purpose in 2017 as a stabilizing diversifier in a time of policy uncertainty. We have also experienced the added benefit of the commodity producing above average absolute returns with gold rising roughly 13 percent in 2017. Somewhat surprisingly, the equity sell-off did not cause a "flight to quality" move that traditionally benefits gold. Given what we view as an unsettled environment as 2018 progresses, we have maintained a position in many of our portfolios as a non-correlated asset and continue to do so, adding when appropriate.

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.