Insights: November 2017

Market Overview and Performance

As good as it gets? When we were reviewing research for this month's Insights, that term came up over and over again in either the headlines or the opening paragraphs of the market commentaries and strategy reports that we read. And we would not disagree. Despite all the drama, it's been an incredible 12 months since the US presidential election in 2016. As Bespoke Investment Group posed earlier this month, "On November 7th 2016, which of these outcomes would you have thought more likely? 1) Trump wins the election, or 2) the S&P 500 rallies 20%+ over the next year IF Trump wins the election?" It's a tough one to answer, but frankly, what is more surprising is the absolute lack of volatility experienced in the market given the pervasive general level of uncertainty largely stemming from the activities, or lack there of, in Washington. For better or worse the market simply does not seem to care. As the tantalizing prospect of tax cuts moved closer to the front burner, it was full steam ahead for risk assets in October. The S&P 500 for example, notched new all-time high on 11 of the 22 trading days during the month. As Pension Partners framed it – the S&P 500 is " the new money market" with 12 straight months of gains and 19 out of the last 20. That is certainly the kind of environment that fosters low volatility (complacency) and high sentiment. As we said in the past, those ingredients combined with other weakening market internals have been the forbearer of rough times in the past. And we would conclude that no, this time is not different. Given that, we are especially mindful of Black Swans at the moment (Saudi Arabia…?).

As always, thank you for reading our latest Insights.

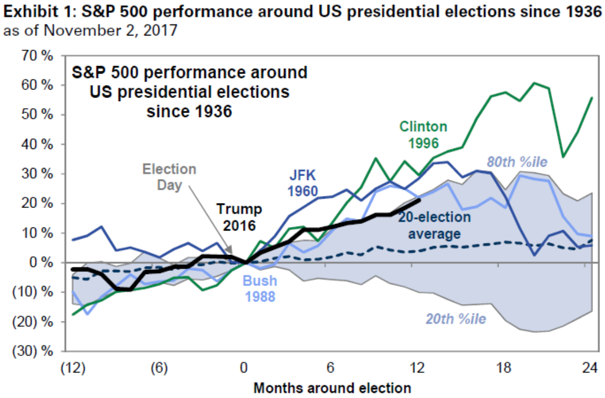
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.33	16.91
Russell 2000 Index	0.85	11.89
MSCI EAFE Index	1.52	**21.78**
MSCI Emerging Markets Index	**3.51**	**32.26**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.06	3.20
Barclay's U.S. Aggregate Credit Index	0.72	**9.53**
Barclay's U.S. Aggregate Corporate High Yield Index	0.42	7.45
Barclay's Municipal Bond Index	0.24	**4.92**
Macro Measures		
Gold	-1.13	**9.35**
Crude Oil	4.98	1.21
CBOE Volatility Index	6.58	**-37.92**
USD Dollar Index	1.55	-8.10

Current Theme – As Good as it Gets – Equity Markets Continue to Hit All-Time Highs Based on Hope While the Bond Market is Flashing a big "Nope" to Expansion Expectations

October Prices Continue to Climb Aggressively Higher While Market Internals Suggest Cracks are Forming

Undoubtedly, the past twelve months have been very good to holders of risk assets and equities in particular. Despite what some might want you to think however, the roughly 20 percent climb in prices since last November is not because of Donald Trump, it is because of good market fundamentals combined with the enticement of potentially lower corporate taxes.

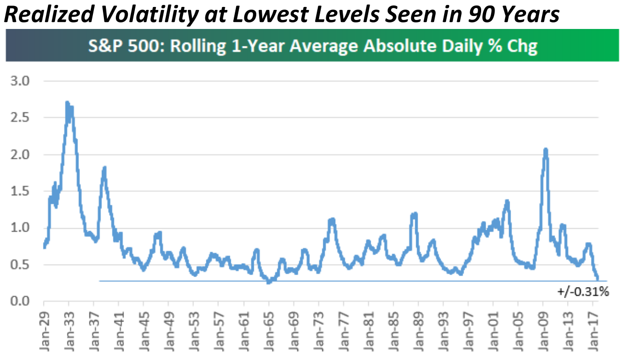
Trump Rally Solid, But 12-18 Month Exhaustion Looms



Source: Goldman Sachs Global Investment Research

As the chart above highlights, while this year's rally has been strong, other post election periods have been similar and tend to run out of gas sometime between the 12 and 18 month mark. And while that provides helpful context, we would suggest that frankly, the market doesn't care about the politics in Washington all that much. Rather, prices have been rising because earnings have rebounded nicely in 2017, with the aggregate S&P 500 profits growing at 9.5 percent and the technology sector, now the largest constituent in the index at a 25 percent weighting, growing almost 50 percent faster at roughly 14 percent. On top of that, investors have always known that if corporate tax rates are cut, the benefit falls immediately to the bottom line and companies become both instantly more profitable and cheaper since the "E" (earnings) in P/E ratios becomes larger. That is a legitimate driver of price increases, not healthcare reform, or the promise of job growth in what is already a very healthy employment environment. We would suggest that the more remarkable phenomenon over the past twelve months is not high stock returns, but the astounding compression in volatility.

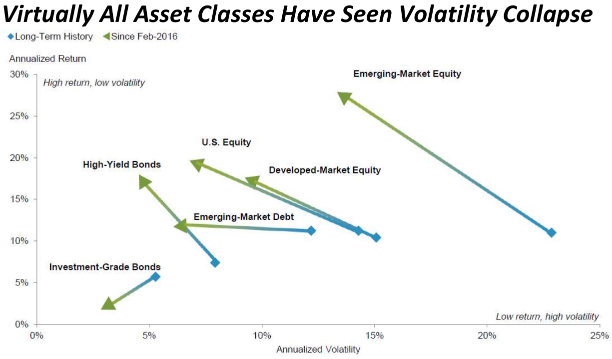
Realized Volatility at Lowest Levels Seen in 90 Years



Source: Bespoke Investment Group

As the chart above illustrates, the average daily change in the S&P 500 has been just +/-0.31 percent. That minute amount of daily movement over a full year time frame is the lowest in close to 90 years and was only seen one other time in 1965. What few people talk about however is the fact that since 2016 virtually every asset class has experienced both strong returns *AND* much lower levels of volatility. For a diversified investor, that is as good as it gets.

Virtually All Asset Classes Have Seen Volatility Collapse

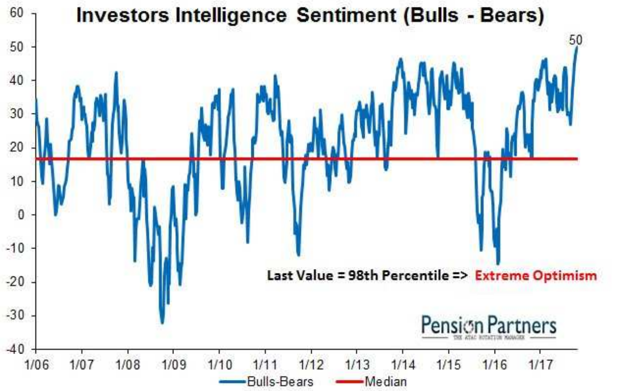


Source: Fidelity Investments; Haver Analytics

It is completely understandable then that investors are feeling good. But when looking more closely at a number of indictors perhaps that exuberance is becoming a bit much.

For example, look at the chart below from Pension Partners. As of the end of October, Bulls now outnumber Bears by a factor of 3 to 1. That is the largest gap seen since 1987, which we all know, did not work out well.

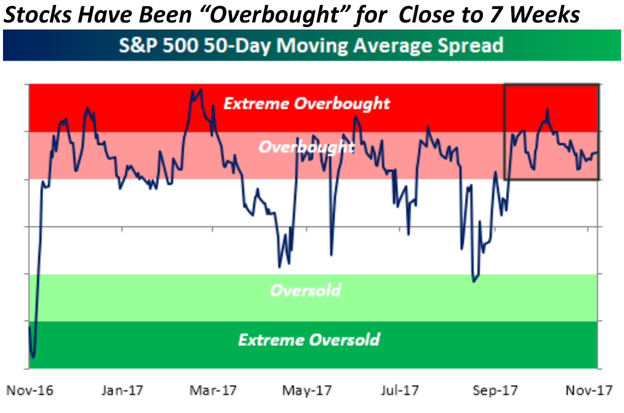
Bulls Outnumber Bears by 3 to 1 – Highest Since 1987



Source: Pension Partners

This optimism is clearly being felt elsewhere resulting in very high readings in momentum factors like relative strength. As seen below, according to that measure, the S&P 500 has been overbought for 42 straight days. According to Bespoke Investment Group, there have only been three other instances of similar streaks since the current Bull market began in 2009.

Stocks Have Been "Overbought" for Close to 7 Weeks



Extreme Overbought (Oversold) = 2+ Standard Deviations Above (Below) 50-DMA
Overbought (Oversold) = 1+ Standard Deviation Above (Below) 50-DMA
Source: Bespoke Investment Group

That is an indication that a lot of money has come into stocks over the past two months, but not all names are benefitting. As we mentioned earlier, technology is clear and away leading this market and October provided a very distinct example of that. The technology sector has grown so much this year that it now accounts for 25 percent of the weight of the S&P 500 – the highest exposure since October 2000. And with sector wide quarterly earnings growth of over 19 percent and revenue growth of over 10 percent, it's no wonder that dollars have been attracted to the space.

Technology Names Accounted for 75% of Oct S&P Return

Table 6: Sectors, Quality Indices, and Selected Strategies' Performance (Absolute Price Return) - 10/31/2017

	October				2017	2 Year Performance	
	1 M	3 M	6 M	12 M	YTD	Gross	Anlzd
S&P 500 Sectors							
Energy	-0.72	2.76	0.83	-0.36	-9.27	0.19	0.10
Materials	3.80	8.09	10.96	26.07	18.43	29.88	13.96
Industrials	0.15	3.83	6.35	22.42	12.49	28.47	13.34
Consumer Discretionary	2.02	0.73	2.13	17.96	12.99	13.95	6.75
Consumer Staples	-1.59	-3.95	-3.53	0.97	2.78	6.70	3.30
Health Care	-0.84	1.65	7.58	20.49	17.75	13.74	6.65
Financials	2.81	6.01	12.90	34.60	14.13	36.17	16.69
Real Estate	0.68	-0.34	2.65	5.79	5.43	na	na
Information Technology	7.67	11.82	18.09	36.93	35.69	49.29	22.18
Telecommunication Services	-8.69	-8.39	-7.53	-6.04	-16.05	-0.74	-0.37
Utilities	3.86	3.45	6.56	11.37	13.18	25.76	12.14

Source: Bank of America Merrill Lynch Global Research

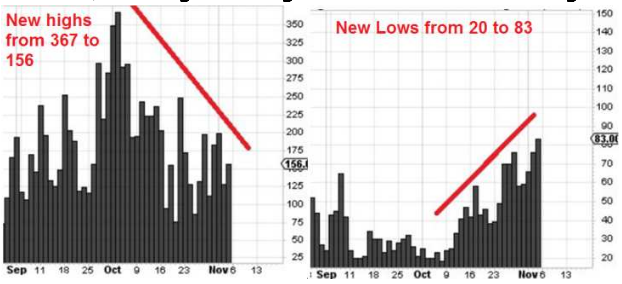
In fact, technology names fared so well in October that they accounted for an incredible 75 percent of the S&P 500's return in October with Facebook up 15%, Amazon up 13%, Apple up 8%, and Google and Microsoft each up 6%. If you are reading this and thinking, "Wow, this all sounds a lot like the DotCom Bubble" there are reasons to be cautions. Now let's be clear, companies like Apple and Google are generating huge amounts of free cash flow unlike the days of companies such as Pets.com which never made a dollar. We like Apple and Google. But there are concerns about what people are paying for this growth as can be seen in the chart below. The number of companies trading at 10x revenues or greater is rapidly approaching levels not seen since late 2000 before the bubble burst.

Companies Trading Over 10x Revenues Rising Sharply

Source: The Felder Report

The logical first response to these stocks doing well is, “Great, almost everyone owns them”, however if one thinks about it for a moment you realize that if a handful of stocks are carrying the market higher, what is happening to the rest of the companies. And that is where we are seeing some cracks.

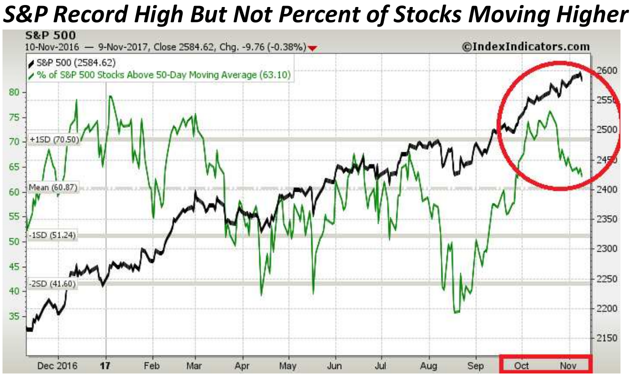
NASDAQ New Highs Falling While New Lows Climbing



Source: Helen Meisler; Stockcharts.com

As the chart above illustrates, despite the strong moves in the large tech names, other technology names in the Nasdaq Composite were declining. During October, stocks making new highs fell from 367 to 156 and stocks making new lows increased from just 20 to 83. This is what is referred to as weak breadth, meaning the whole market is not participating in the gains. It is a sign of exhaustion in the market. It held true outside of tech in October as well. Look at the decline in the percentage of S&P 500 stocks trading above their 50 day moving average.

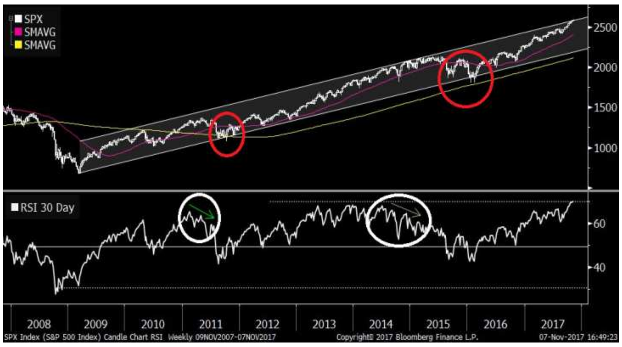
S&P Record High But Not Percent of Stocks Moving Higher



Source: IndexIndicators.com

As Chief US Equity Strategist at Bloomberg Gina Martin Adams points out, these declines in the relative strength of indexes have been reliable leading indicators of market declines in recent years, most notably in 2011 and late 2015. Of course, this says nothing about how large of a pullback may occur, simply that conditions are similar to past episodes.

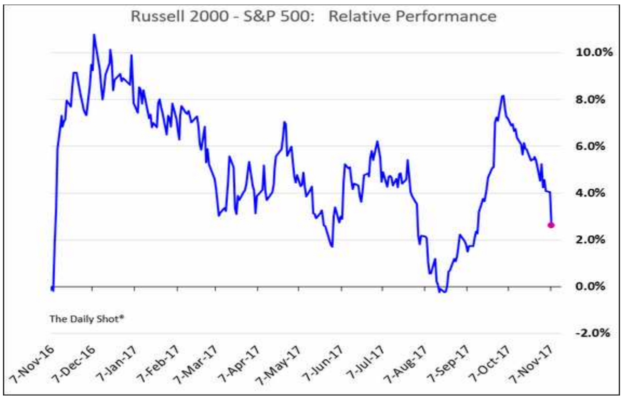
Declining Relative Strength Preceded Prior Declines



Source: Gina Martin Adams; Bloomberg

Other leading segments of the markets appear to be fading as well. Small cap stocks for example are essentially viewed as a proxy for risk appetite. When investors are feeling bullish on stocks and the economy small cap stocks (which are more directly tied to the US economy) tend to react more than the broader market – they are a higher Beta asset meaning they move more than the broader index. And the period from October into November has seen a precipitous retrenchment in the Russell 2000 Index. After a sharp run-up in performance relative to large cap stocks in August and September, small cap stocks have surrendered almost all of their relative gains for the year – a trend widely viewed as indicating a risk-off sentiment.

Small Cap Stocks Have Fallen Sharply Relative to S&P

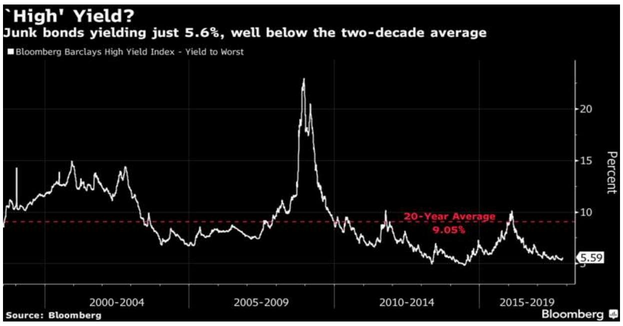


Source: The Daily Shot

More concerning than this decline in equity risk appetite is what we are now seeing in the credit risk space as of late. As a parallel to small cap stocks and the equity market, high yield bonds are viewed as risk proxy for investor behavior in the bond market.

High yield bonds are by and large issued by smaller companies with fewer resources to meet debt obligations. As a consequence, investors have in the past demanded a higher return to compensate them for being exposed to that more volatile credit risk. However, in this "as good as it gets" environment, high yield investors have not been demanding much of a yield premium at all suggesting that the risk level is viewed as being very low.

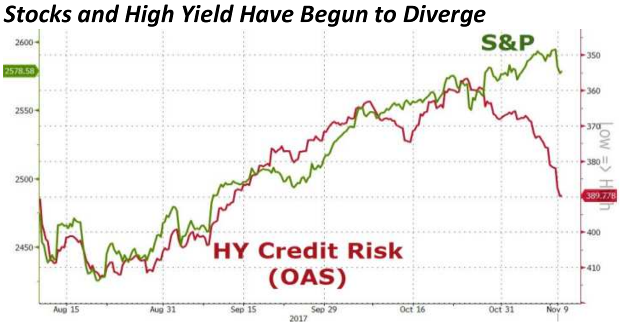
High Yield Not Really "High" – Yield Well Below Average



Source: Bloomberg

And with the asset class returning roughly 14 percent per year since 2009, it's not surprising that "risk" of the bonds are viewed as low. However, what we are starting to see over the recent weeks is a reversal in the trend as high yield bonds have sold off markedly. One could easily dismiss this as a correction in the extended conditions seen in the chart above, however what has people worried is the fact that high yield bonds and stocks have historically been highly correlated. As you can see in the chart below the two have moved virtually in lock step during the move up since the August lows.

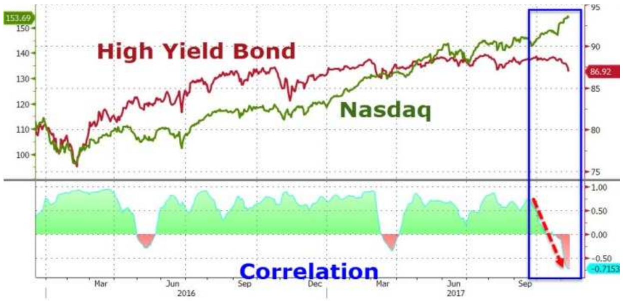
Stocks and High Yield Have Begun to Diverge



Source: ZeroHedge

And if you think that is a short term anomaly, its not. As one can see in the chart below, longer term correlations have been very high, north of 60 percent. That measure has now turned negative.

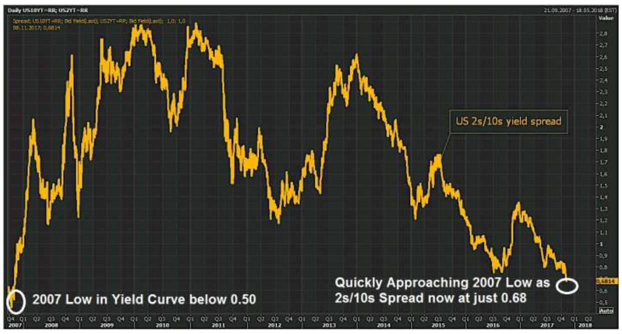
High Yield and Stock Correlation has Averaged Over 60%



Source: ZeroHedge

As noted bond manager Jeffrey Gundlach wrote recently, "JNK ETF down six days in a row, closing near its seven month low. SPX up five of the last six days, closing at an all time high. Which is right?...Looking like JNK was right. Per usual." This is something to watch carefully as it's creating a high degree of worry in the market at present. On top of this development, we have the continued flattening of the yield curve to levels not seen since 2007. As we have discussed previously, this has historically been a sign that investors do not believe in the prospect of growth going forward and that trouble lies ahead.

Yield Curve Continues to Flatten – Close to 2007 Lows



Source: Thomson Reuters

We would also be remiss if we did not mention the potential for a government shutdown in just a few weeks. While the proposed tax bill is dominating the legislators' time, they only have until December 8[Th] to approve a spending measure to keep the government open with hurricane relief, defense spending, immigration, children's health program, and other items in the mix. Could be an interesting Thanksgiving.

Going Forward

As we outlined, we are concerned that the combination of overly optimistic sentiment, stretched equity valuations, overbought conditions, international tensions, and Trump's unpredictable behavior with both other global leaders and leaders of his own Congress is setting the stage for disappointment further down the road. Although the fourth quarter has historically been a strong period, we are mindful that delays in advancing a tax plan, a battle over a government shut down in December or a deterioration in the situation in the Middle East or North Korea could easily result in swift negative consequences. As a result, we choose to be nimble at present. Although we have participated in the markets' gains this year, we are prepared to quickly harvest gains should developments warrant it.

Large Cap U.S. equities have led the market by a wide margin this year and we continue to place our emphasis on this area. Looking forward into 2018, we favor the information technology, financial and energy sectors in particular. The technology sector continues to display very strong growth and profitability. Financial names are still reasonably priced relative to their history and to the market and will benefit from a raising rate environment. And the energy sector is recovering from what was -20 percent return in the summer of 2017 and the fundamental supply and demand environment has now become a tailwind.

With the momentum in non-U.S. economies and a trending of weak 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, however, changes in the corporate tax policy could quickly change the business environment for many of these companies, a scenario that would cause us to increase exposure to the group.

Equity markets outside of the U.S. are compelling in our view. After years of lagging the U.S. market, International equities now stand to benefit from the following trends: in general faster economic growth than the U.S., continued quantitative easing, low interest rates, structural reforms, fiscal stimulus, and finally, generally reduced political risks. The relative advantage becomes even more pronounced when one looks at the historical valuation discount which is currently the largest it's been in the last 15 years. With U.S. equities trading at a cyclical adjusted P/E of over 30 times, future returns are not likely to be as compelling as those potentially found in Europe and Japan. 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 and improved balance sheet stability. While EM equities have experienced solid gains thus far 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 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. With a re-ignited anticipation of rising interest rates in the near future, 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 has performed nicely in 2017 and we continue to believe that the opportunity in the muni markets is attractive with reasonable valuations and compelling yields.

Amidst a rapidly changing macro environment, Gold has served its purpose this year 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 10 percent. We have maintained a position in many of our portfolios as a non-correlated asset and will continue to do so given the challenging environment that lies ahead.

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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