Insights: October 2017

Market Overview and Performance

Monday October 9th marked exactly 10 years since the Dow Industrial Average and the S&P 500 posted their highest closing levels before the Financial Crisis hit. Following that date, the indexes began their precipitous decline that would not abate until they lost half of their value. This painful memory combined with echoes of the October 18, 1987 -22 percent crash tends to leave investors a bit cautious heading into the fall months. As a result, September monthly returns for equities have historically been the worst of any month as investors traditionally take the opportunity to de-risk their portfolio before any October trouble comes to fruition. Surprisingly, nothing even close to that happened this year. We say “surprisingly” not because indexes slavish repeat historical patterns, but because September was a bad month in terms of global developments. North Korea launched a ballistic missile over Japan which was followed by Donald Trump standing in front of the United Nations body and incredibly threatening to “totally destroy North Korea.” And of course, hurricanes Harvey and Irma delivered a one-two punch with an estimated $150 to $200 billion in damage to Texas and Florida and another $85 billion to Puerto Rico. These are unquestionably de-stabilizing events, however, as Deutsche Bank described it, we are witnessing a market where “shocks no longer shock.” Optimistic sentiment data also reflects this notion. Markets it seems are virtually assured that the only future outcome will be a positive one. History is filled with plenty of examples to the contrary, particularly when optimism is as prevalent as it is today.

As always, thank you for reading our latest Insights.

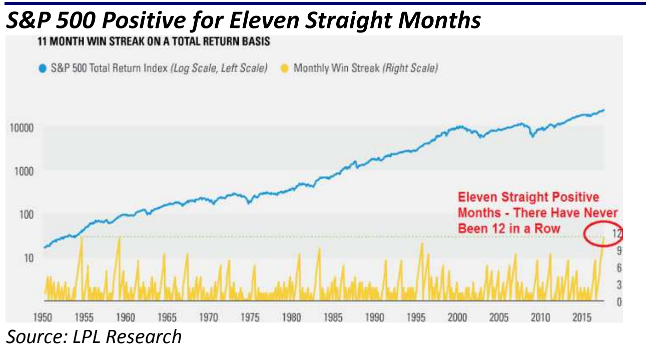
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.06	14.24
Russell 2000 Index	**6.24**	10.94
MSCI EAFE Index	2.49	**19.96**
MSCI Emerging Markets Index	-0.40	**27.78**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.48	3.14
Barclay's U.S. Aggregate Credit Index	-0.15	**8.75**
Barclay's U.S. Aggregate Corporate High Yield Index	0.90	7.00
Barclay's Municipal Bond Index	-0.51	**4.66**
Macro Measures		
Gold	-2.91	**11.56**
Crude Oil	8.59	-3.82
CBOE Volatility Index	**-11.36**	**-32.26**
USD Dollar Index	0.44	-8.93

Current Theme – The Beat Marches On – Equity Markets Continue Their Historical Streak of Gains While the Market Ignores Macro Risks

"Full Steam Ahead" for Most Investors as Reflected by Extended Sentiment Measures Despite the Looming End of Quantitative Easing

So much for the September swoon. Heck, forget swoon, there was hardly even a down *day* in September, much less a negative month. The "incredible streak" as many are now referring to it, relentlessly marches on.

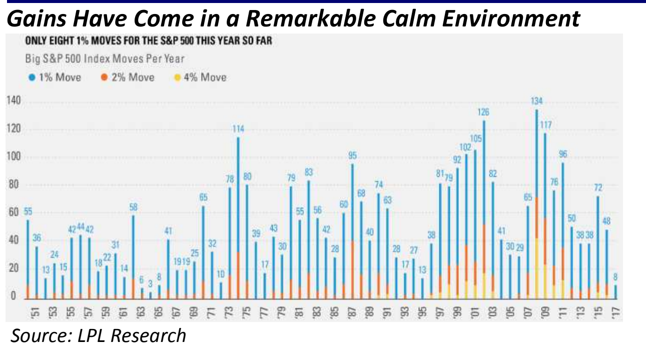
S&P 500 Positive for Eleven Straight Months



Source: LPL Research

Consider the following statistics. As of October 6th, the S&P 500 closed higher for 8 days in a row for the first time since 2013 and had closed at all-time highs 6 days in a row for the first time since 1997. The Index has closed higher for 11 consecutive months on a total return basis – this has only happened two other times since 1950. As of September 30th, the S&P 500 has been up for 8 consecutive quarters for the first time ever and since 2013 has experienced 18 positive quarters out of the last 19.

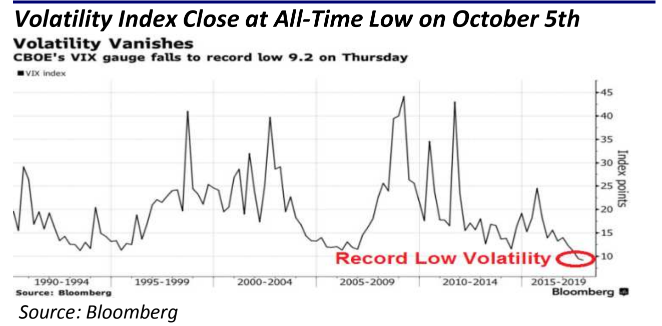
Gains Have Come in a Remarkable Calm Environment



Source: LPL Research

And these gains have been occurring in a remarkably controlled way. As the chart at the bottom of the previous column shows, stocks have traded in a very consistently tight range with only 8 moves of at least 1% so far this year, the fewest since 13 in 1995 and the second lowest on record. Further, if the calendar year were to end today, the -2.8% drawdown during March and April would be the smallest intra-year decline *ever*. In other words, volatility has just been non-existent. As market strategist Ryan Dietrich wrote, "If you had forecast that the 11 months after the 2016 election would be one of the least volatile periods ever, you would be in the minority. Then again, the last time we saw a streak of calm like this was the year after John F. Kennedy was assassinated in November 1963. Once again proving that the market rarely does what the masses expect."

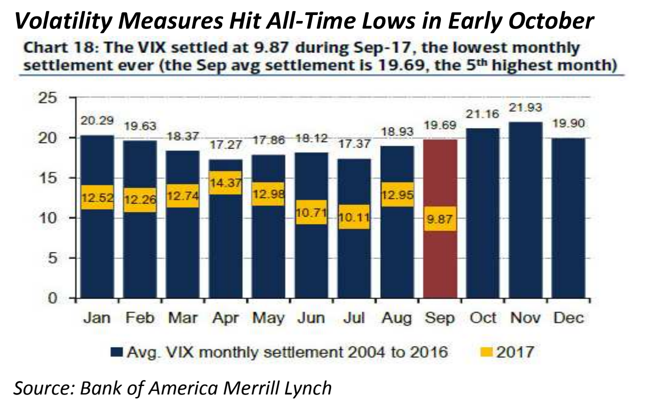
Volatility Index Close at All-Time Low on October 5th



Source: Bloomberg

This is all the more astounding given the current macro environment. As you can see above the CBOE Volatility Index hit an *all-time low* on October 5th. And September's volatility was just *half* the historical average and only the second sub-10 month on record.

Volatility Measures Hit All-Time Lows in Early October

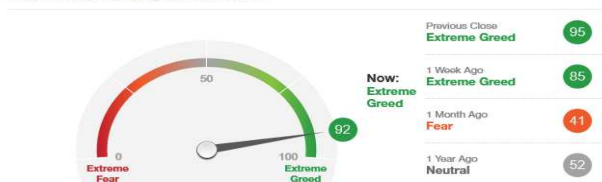


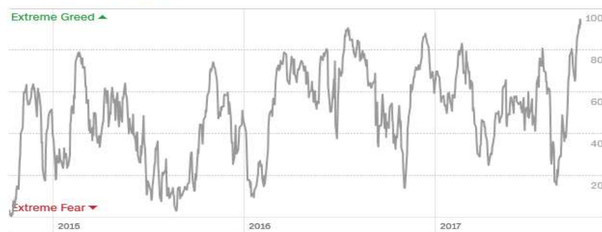
Source: Bank of America Merrill Lynch

With these two factors in place – consistent returns and low volatility, it's not hard to understand why we are now seeing signs of "overly confident" sentiment measures. Perhaps the easiest way to comprehend is the CNN Fear & Greed Index below, a composite measure of seven risk, demand and technical indicators combined into one measure of overall market tone. Not much of a question where the current mood of inventors lies.

Fear & Greed Index Showing "Greed" at Extreme Levels

Fear & Greed Index beta
What emotion is driving the market now?





Source: CNN

It's important to note here that this measure does not incorporate any sentiment data, and particularly any sentiment data from retail investors who tend to be more fickle. Instead, it focuses on generally more institutional investor oriented tools like put options and trading breadth. We see this exuberance echoed in data from Bank of America Merrill Lynch, who finds the Sell Side to be dangerously bullish.

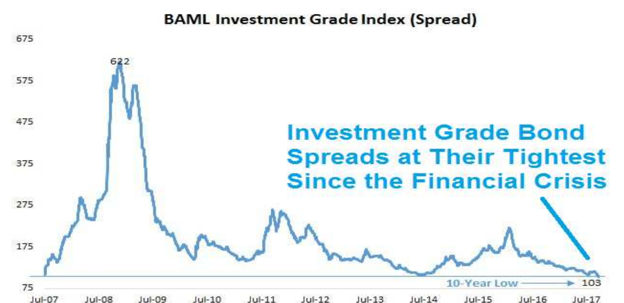
Wall Steet Extreme Bullishness Historically Bad for Stocks

Chart 2: The Sell Side Indicator says "Sell"

Source: Bank of America Merrill Lynch Global Research

And we do see other evidence of heightened enthusiasm elsewhere as well. Relative strength indicators of the S&P 500 indicate highly overbought conditions and retail investor cash levels at investment banks are now lower than they were at the peak in 2007 before the Financial Crisis. Similarly, in the credit space, investment grade bond spreads are now tighter than they were in 2007 – an indication that investors feel risk levels are so slight that they are demanding low levels of compensation for taking on company credit risk.

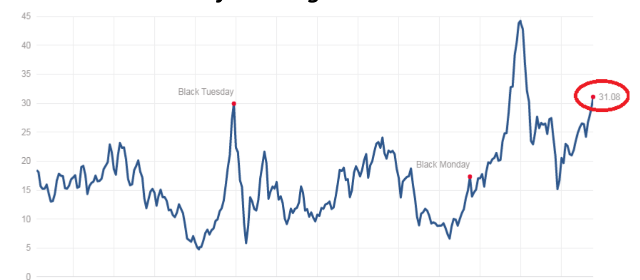
Risk Priced into Corporate Bond Market Lowest in 10 YRs



Source: Pension Partners

You might be tempted to ask, "So people are happy that they have made money this year, so what? That's not a bad thing." And we would agree, however, when "all boats are rising" so to speak, human tendency is to project that trend out beyond what might be a reasonable expectation of reality. And there is not a lot of room for error at present. We have written about valuation in various permutations throughout the year and as we have said, high valuations do not automatically mean prices will go down. It simply let's you know, that based upon history, expected future returns are likely to be muted. It therefore cannot be ignored that the current Shiller P/E has only been eclipsed by the runaway days of the Dotcom era.

Current Shiller PE of 31.1 Highest Since Dotcom Period



Source: Robert Shiller

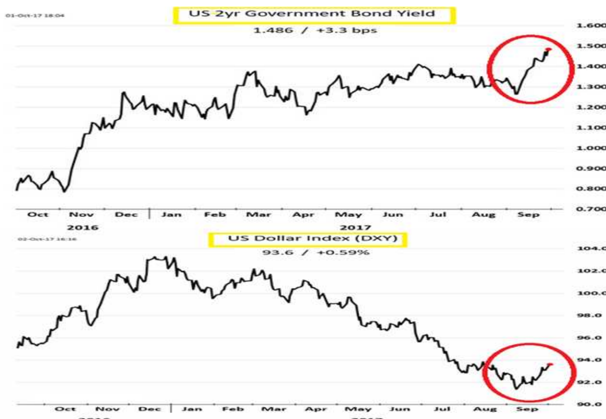
At present, the market simply does not care at all about any "high valuation " talk. After a sluggish August when it appeared that both the economy and the Trump agenda might be heading in reverse, Trump released the "new shiny thing" in front of the markets' eyes in the form of a rough tax plan outline. Without any concrete details whatsoever, that announcement was enough to breathe life back into the re-flation trade that the market has been clamoring for since Trump was elected. The tax plan is by no means a done deal, but investors don't seem to be too worried about that. The fourth quarter is usually a strong period for equities and with the potential tail wind of a tax cut in the wings, it was time for a more aggressive "risk-on" positioning. The results were seen immediately.

Small Cap Stocks UP Over 10% Since August Lows

Source: Stock Charts; Daily Reckoning

In addition to the sharp rebound in small caps, bonds were sold and the U.S. Dollar reversed, moving higher.

Bonds and The U.S. Dollar Reversed Course in September



Source: The Daily Shot

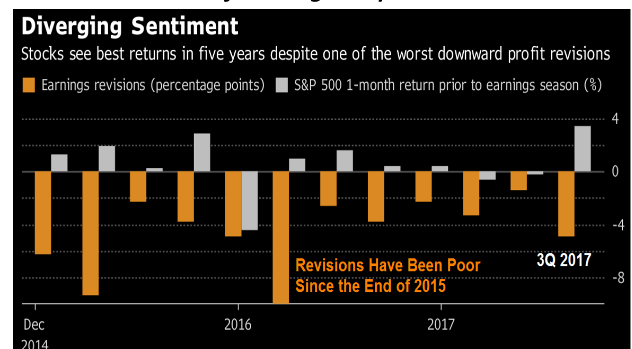
With valuation clearly providing no speed limit to this risk-on attitude, it helps to identify catalysts that just might provide a speed bump or two. In the near term, we have earnings to think about and in the longer term, we have the new era of Quantitative Tightening or QT to adjust to. First, with regard to earnings, third quarter results are expected to be just OK, with an overall growth rate of just 2.8 percent versus 1Q and 2Q growth rates of 14 percent and 10 percent.

Earnings Growth is Expected to Be Just 2.8% in 3Q 2017

Source: Factset

Interestingly, as the chart above illustrates, companies with greater than 50 percent of their sales derived from outside of the United States are expected to fare much better. Regardless, the market is clearly ignoring any potential bad news. Consider the data in the chart below on earnings revisions. The S&P 500 climbed 3.6 percent in the one month period leading into earnings season – that is the best result in five years according to Bloomberg. Additionally analysts have trimmed their 3Q estimates by more than half, reducing expected growth rates by 4.9 percent – almost twice the average cut seen over the past few years.

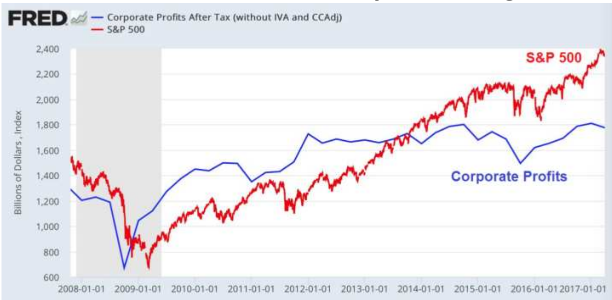
Stocks Rise Ahead of Earnings Despite Poor Revisions



Source: Bloomberg

Now earnings growth is still growth, even at an uninspiring pace. What is more concerning is the trend below. Stock prices are said to anticipate profits, and if that's the case, then we are looking at a discouraging trajectory. If companies use the hurricanes as an excuse to walk down early 2018 estimates, the market reaction could be somewhat unpleasant.

Stocks Have Become Disconnected from Earnings



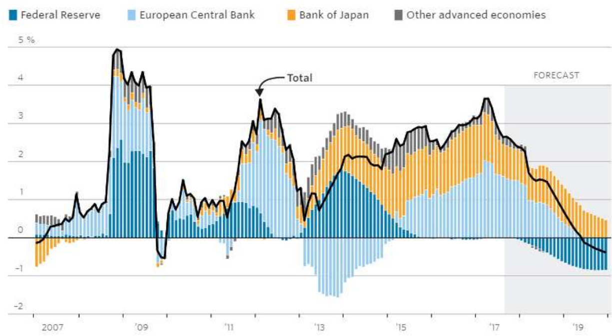
Source: Federal Reserve Economic Data; St. Louis Fed

While a disappointing earnings season would certainly be unwelcome, by far, every single investor is more worried about the "Great Unwind". Beginning this month, the Federal Reserve will begin reducing its $4.5 trillion in bond holdings by $10 billion to $50 billion per month over the coming year. Additionally, the European Central Bank and the Bank of England will be reducing their activities resulting in central banks *removing* liquidity from the system by 2019.

Global Central Bank Liquidity Coming to an End

The Great Unwind

The era of massive expansion of global central bank balance sheets is coming to an end. Total change in central bank assets as a share of GDP



Source: Wall Street Journal

This is an enormous change to the system and one with no play book. If you look at the graph below, central bank actions have undeniably helped to inflate risk asset prices while failing to do much of anything to stimulate the "real" economy.

Quantitative Easing Inflated Assets Not Real Economy

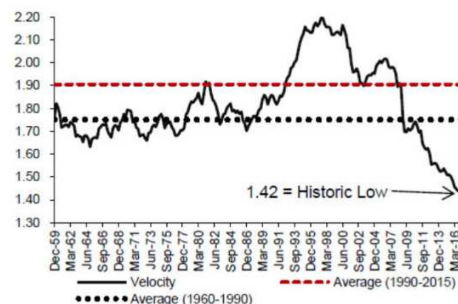
Exhibit 17: Wide dispersion between asset price inflation and 'real economy' inflation
Total return performance in local currency since January 2009

Source: Goldman Sachs Investment Research

So taking away the punch bowl creates two worries; one what happens to the prices of risk assets if there is no longer anyone there to backstop them; and two, is the economy strong enough to stand on its own after almost nine years of being supported by "crisis level" measures. Unfortunately, the chart below would suggest that the answer is "not at all". According to Macquarie Research, the "velocity" of money, or the rate at which customers use money for goods and services is now at historic lows, suggesting the economy is declining, a condition that in the past has been met with more money supply, not less. As Macquarie characterized it, "risk has been so low because invertors feel that liquidity cannot be withdrawn, volatility must be arrested…and hence financial assets are in many ways underwritten". Going forward however, we are now literally in uncharted territory, and unfortunately an area that will be marked with unintended consequnces.

Velocity of Money Now at Historic Low Rate

US Velocity of money (GDP/M2) (x) – … velocity of money is not rising



Source: Bloomberg; Thomson; Macquarie Research; October 2017

Going Forward

As we outlined, we are concerned that the combination of overly optimistic sentiment, stretched equity valuations, international tensions, and Trump's now completely unpredictable interactions 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 (and that may well be the case again this year too), we are mindful that delays in advancing the "sure thing" of a tax cut combined with increased international tensions could easily upset the apple cart. 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. We favor the technology, healthcare and consumer discretionary sectors which have outperformed the broader market. Additionally, given their underperformance versus the indices and other sectors this year, financial stocks are attractive in our view. Financials will benefit from a rising rate environment in 2018, a lighter regulatory environment and solid consumer and corporate balance sheets.

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.

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, low commodity/oil prices, 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. Despite fears that municipal bond market would be negatively impacted by Trump policies, municipal bonds have 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 almost 12 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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