Insights: September 2017

Market Overview and Performance

We think it would be fair to say that this past August did not go exactly as planned. August is typically a month of long vacations and low trading volumes in U.S. markets resulting in a market that historically floats lazily along, eventually drifting somewhat downward before the Labor Day Weekend signals a return of the "back-to-business" attitude on trading desks. To a certain degree this proved accurate – trading volumes were light, but there was an astounding amount of significant, potentially high risk events during the month. Not surprisingly, the distasteful cocktail of Korea ramping up its nuclear testing and launching missiles directly over Japan, two historically destructive hurricanes making landfall in the U.S. and a ticking debt ceiling deadline caused some indigestion mid month. On August 8Th the S&P 500 was at an all-time high of 2491. However, nine trading days later the Index had backtracked by roughly three percent. This occurred in an orderly fashion and was a completely rational response to the events that were unfolding. What was not expected (or justified in our view) was the complete rebound back to new highs by the end of the month. North Korea continues to warn of "greatest pain and suffering" for the U.S., hurricanes Harvey and Irma have inflicted an enormous amount of damage to the economic landscape and Trump has at best kicked the "debt ceiling issue" can down the road and at worst put us on a path of never ending debt in the U.S. We are students of the past and note that markets seem to be sleepwalking through history, demonstrating a dangerous ignorance of what experience has taught us.

As always, thank you for reading our latest Insights.

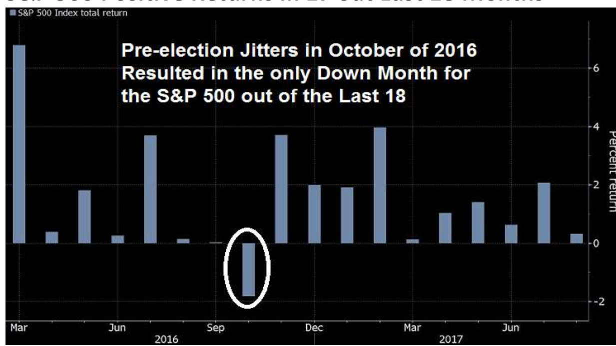
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.31	11.93
Russell 2000 Index	**-1.27**	4.42
MSCI EAFE Index	-0.04	**17.05**
MSCI Emerging Markets Index	**2.23**	**28.29**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.90	2.64
Barclay's U.S. Aggregate Credit Index	1.46	**8.91**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.04	6.05
Barclay's Municipal Bond Index	0.76	**5.20**
Macro Measures		
Gold	3.69	**14.80**
Crude Oil	-6.22	-12.08
CBOE Volatility Index	3.12	**-24.57**
USD Dollar Index	**-0.21**	**-9.33**

Current Theme – Nothing to See Here, All is Well, Please Move Along…

Market Refuses to Price in Any Risk Scenario Even When Presented with Nuclear Missiles, Historic Hurricanes and Potential Government Shut-Downs

And the band played on. As the market was swirling with news of nuclear threats, deadly destructive storms and a completely futile U.S. Congress with its back to the wall, the stock market of course…went up. In fact it's now been going up consistently for the last year and a half.

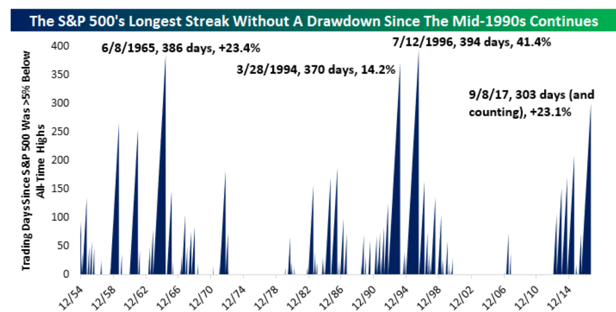
S&P 500 Positive Returns in 17 out Last 18 Months



Source: Bloomberg

As the chart above illustrates, on a total return basis which includes both share price changes and dividends, the S&P 500 has climbed higher in 17 of the last 18 months. A remarkable feat only matched during the heyday of the 1990's bull run from December 1994 until January 1996. Another parallel to the relentless bull of the 1990's is the lack of anything even close to a significant decline in prices.

S&P 500 Now Over 300 Days without a 5% Pullback



Source: Bespoke Investment Group

As the chart at the bottom of the previous column points out, the S&P 500 has now gone 303 days without a drawdown of 5 percent. This type of extended tranquility has only occurred three times before: 1965, 1994, and 1996. As we have said in the past, there is nothing magical about the number of days, but it is noteworthy, and in fact insightful when we look at past periods with similar characteristics. One key attribute that absolutely needs to be acknowledged is the one highlighted below.

Equal Weighted Index Falling Sharply – Narrow Markets

Source: Andrew Thrasher; StockCharts.com

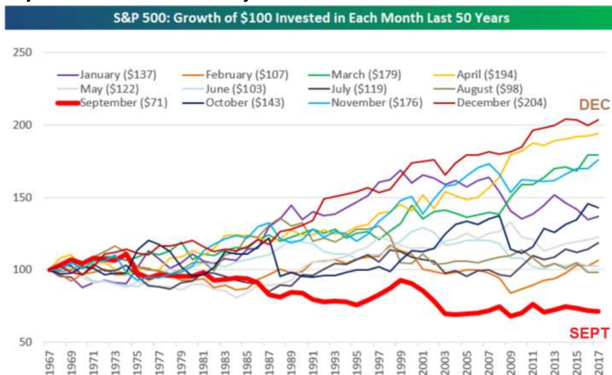
The equal weighted return of the S&P 500, where the returns of all stocks are measured with the same weight, has continued to trend downward while the broader index continues to climb to new highs. We have used this chart in our previous letters, but the fact that the indicator deteriorated noticeably in September signifies that the condition is getting worse, i.e., only a handful of stocks are doing well (and thus gaining more and more assets) while the "average" stock moves sideways or even declines. Fine, you might say, I more or less believe you but show me.

Top Ten Names +25.3% YTD - Rest of Market Only +4.2%

Source: FundStrat; Bloomberg

Research firm FundStrat put together a great chart this month doing just that. As the previous chart clearly demonstrates, the market leaders (FB, AMZN, AAPL, GOOGL, MSFT, etc.) are up over 25 percent so far this year while the "average" stock is only up about 4 percent. And this trend has consistently compounded throughout the year, with the leaders outpacing all others during every month with the exception of June. A legitimate pushback question might be "Why is this bad exactly?" It's not in and of itself other than the fact that most portfolios simply won't be able to match the returns of the highfliers. What's more important is why its happening and what's next. The why part makes sense. The U.S. is in the late stages of an economic expansion. After eight years of growth the only areas of faster growth remaining tend to be large cap tech. These companies also tend to generate a large portion of the revenues overseas. Growth outside of the U.S. is solid now and the weaker dollar helps to boost the profits of these companies. As a result, more money chases these names, particularly passive investments which blindly buy more of the largest Index names. As such, the process is somewhat self-fulfilling. The "what's next" question is less clear. Referencing back to the Bull market runs of the 1960's and 1990's, following the low volatility periods of up-trending markets, the S&P 500 Growth Index (a proxy for the Top Ten we see today) fell by a third six months before the recession hit in 2001 and then proceeded to tumbled another third before bottoming in mid-2002. This echoes the pattern seen in the 1960's as well. (*Wall Street Journal*). What usually tips the scales is a deteriorating economic environment. And as we have discussed in past Insights, we do see some troubling signs across markets and indicators.

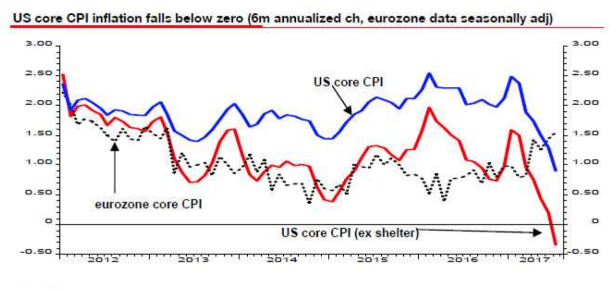
September Consistently Weak Over Past 50 Years



Source: Bespoke Investment Group

Now, if you were looking for a place to plant your "Trouble Ahead" flag, September would be a good place to start. Consider the chart at the bottom of the previous column. Bespoke Investment Group has created a novel way to show the month's historical weakness. If you had invested $100 in the market only during the month of September for the last 50 years you have a grand total of…$71 dollars. By contrast if you did the same exercise, but this time only invested in the month of December, you would have $204. Again, historical patterns alone are not enough to upset current trends, but concerning data points abound. Essentially, it boils down to the idea that the market is starting to realize that actions of the Federal Reserve have failed to produce real results. Consider the following chart.

Consumer Price Index (inflation) Falling Sharply in 2017



Source: Societe Generale

As strategist Albert Edwards points out, U.S. inflation (in contrast to Europe) has been in sharp decline during 2017. While declining inflation might seem like a good thing at first glance, what's really going on here is a lack of inertia to push prices higher. What that means for the average person is that wages are not increasing despite what has been a consistently solid labor market with a low unemployment rate.

Real Compensation Has Fallen for Third Straight Quarter

Source: Zerohedge

So there are jobs available, but employees are moving backwards in terms of their compensation. This is a real concern given the following.

"Velocity" of Money Continues Relentless Decline

Source: St Louis FRED

In basic terms, liquidity is injected into the system by the Fed which hopefully boosts the frequency, or "velocity", at which customers use the money for goods and services. As you can see it just isn't working. The market is keenly aware of this and expectations of a continued period of low growth are being reflected in several areas. Most glaringly, as inflation data continues to deteriorate with no end in sight, the market has priced in a zero percent chance of an interest rate hike this month, and in fact, only two more rate hike over the next *three* years.

"Zero" Chance of Rate Hike This Month – Only 2 by 2020

Source: Bloomberg

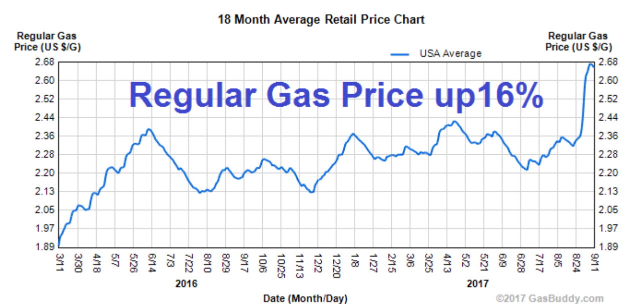
Clearly, the market does not believe that there will be any substantial growth going forward that needs to "managed" by the Fed. The yield curve shows us this. The curve is the flattest it has been since 2007 (most recent recession), compressing rapidly this year after a post election ramp, suggesting that longer term investors are worried about the economy in the future.

Yield Curve is Now Flattest Since 2007 Recession

Source: St Louis FRED; ZeroHedge

Hurricanes Harvey and Irma were unquestionably devastating tragedies, but unfortunately they also hamper the growth outlook. You may come across some stories espousing the notion that disaster recovery efforts are actually good for the economy, but it's simply not true. In the most elemental sense, Goldman Sachs believes that the estimated $120 billion in damage caused by the two storms will reduce GDP growth by a full percentage point due to disruptions in consumption, inventories, housing, and the energy sector. But the follow-on impacts to the economy are wide spread and impossible to gauge. Some effects though, can be seen immediately. Given its key role in oil and refinery industry, the shut down of Houston by Hurricane Harvey had almost an instantaneous influence on the price of gasoline, pushing prices at the pump almost 20 percent higher.

Gas Prices Shoot 16% Higher After Hurricane Harvey

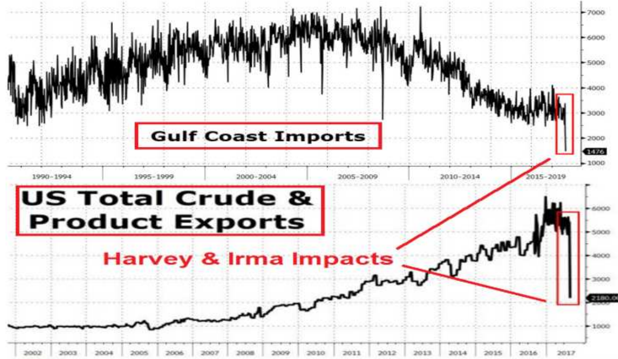


Source: Gasbuddy.com

Further, the Port of Houston is the busiest port in the United States in terms of foreign tonnage, second-busiest in the United States in terms of overall tonnage, and the thirteen-busiest in the world

(*Houston Chronicle*). A shutdown of transit in and out of the port will have unknowable impacts further down the supply chain as time goes on.

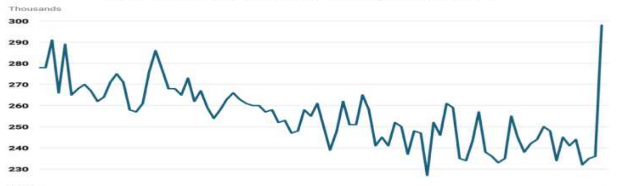
Imports and Exports Out of Houston Have Been Curtailed



Source: Zerohedge

And more directly for hurricane victims themselves, there will be no income for some time which will lead to a more dramatic steepening of joblessness.

Jobless Claims Move Dramatically Higher After Hurricanes



Source: US Employment and Training Administration via FRED

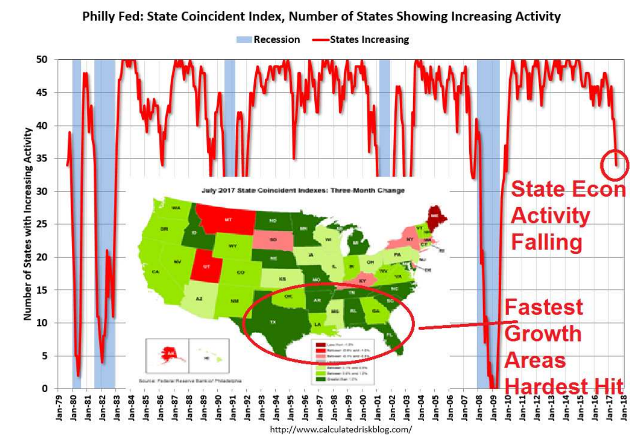
We then have the more nuanced factors that will echo through the economy. For example, Houston is a huge base of imperative chemical production for our economy. As Bloomberg writes, "Texas alone produces nearly three quarters of the country's supply of one of the most basic chemical building blocks. Ethylene is the foundation for making plastics essential to U.S. consumer and industrial goods."

Critical Houston Chemical Production Severely Impacted

Source: Bloomberg

We are also seeing analysis from groups like the Florida Fruit and Vegetable Association suggesting that a 50-70 percent crop loss in Southern Florida looks to be a realistic estimate. All this suggests that we will not know the full extent of the spiraling effects of the storms on the broader economy for quite some time. And consider the chart below.

South East Engine of Growth Will Now Be Hampered



Source: Federal Reserve Bank of Philadelphia; Calculated Risk.com

According to the Philly Fed, economic activity at the individual state level has seen a sharp decline in 2017 – and this was before the hurricanes. To make matters worse, the states that were displaying the highest rate of activity are in fact those that were the hardest hit by Harvey and Irma. Unquestionably, the negative consequences will quickly spread from just Texas and Florida, to the rest of the South East and then out to the country as a whole.

Blaine Rollins at 361 Capital painted the picture well this week when he wrote, "Imagine owning a construction company in Phoenix, Denver or Dallas and find out that half of your work crew just drove to Houston to spend the next three to five years. Or, consider your next Avis rate as 20 rental cars from every airport in the U.S. are now being loaded on a truck headed for south Texas. And insurance companies? Well they can handle one big event risk, but two might hurt the industry and impact future prices for all insurance buyers."

One last thought – the debt ceiling issue is no closer to resolution than it was last month. The short term yield curve in December is inverted pointing to a rocky Holiday period ahead.

Going Forward

Congress now has 12 weeks in session remaining in 2017 to address the following: comprehensive hurricane relief, fund the government, raise the debt limit, stabilize the ACA and CHIP, extend FFA (flood insurance) and find a solution to DACA. There simply is just not a lot of time (or frankly, the available funds) for the Holy Grail of tax reform and stimulative infrastructure spending to come to fruition anytime soon. In the meantime, we can not ignore the signals of the bond market, stretched equity valuations, international tensions, and Trump's now completely unpredictable interactions with not only other global leaders, but with leaders of his own Congress. 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 the numerous imperative issues on the horizon.

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 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 in the near future. 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.

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 and 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 its 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. 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. Although the expected trajectory of rising interest rates has declined somewhat, 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 nicely in 2017 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 in a time of policy and macro uncertainty. We have also experienced the added benefit of the commodity producing above average absolute returns with gold rising almost 15 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.

Litvak Wealth LLC ("Advisor") is a registered investment advisor. Information provided in this letter is for educational purposes only and should not be considered investment advice. Advice may only be provided after entering into an advisory agreement with Advisor. Information is at a period in time and subject to change. Past performance is not a guarantee of future results. Discussions relating to risk and diversification are for illustrative purposes only. Please contact us to discuss your specific allocations and portfolios risks. Indices discussed in this letter, such as Standard & Poor's 500 Index (S&P 500), are unmanaged, do not reflect the deduction of any fees, and cannot be invested into directly.