



## Geopolitical Risks Increase While Global Equities Keep Rising April 2017

Dear Client:

### First Quarter Review



Equity markets tend to pause or correct when the Federal Reserve Bank (the Fed) raises rates three times in succession... hence, the stock market maxim "Three Steps and a Stumble." Technically, in March, the Fed raised rates for the third time since it began an extended tightening cycle in December 2015. Yet, thus far, the market reaction to the Fed's moves has led to a series of yawns. There has been virtually no volatility and, while the S&P 500 Index recently broke

a long string of successive days without a 1% move, the overall mood has been calm. *Barron's* reported that we had not seen fewer 1% moves in either direction since 1995.

Besides the impact of the Fed's recent moves to tighten its unprecedented ultra-loose money policy, there are several events on the horizon that may have a significant impact on the capital markets and cause concern for investors. These include unsettling domestic public policies in the U.S. and across the globe, as well as potentially contentious foreign policy initiatives among nations, all of which will elevate geopolitical uncertainty and amplify risk. Over the next quarter, I will be mindful of three issues that may trigger market events.

First, the expiration of the current budget resolution that funds the federal government poses the threat of disorder and chaos. As most of us remember, the last two times congressional ideology collided with fiscal responsibility led to a 16-day government shutdown in 2013 and the threat of a furlough in 2014. As a result, the markets faltered, the economy suffered, and the prices of some basic necessities skyrocketed. Once again, the world is waiting to see how Congress and the President will govern the globe's largest economy by approving a federal budget.

Second, U.S. missile strikes in Syria and surprisingly hawkish language directed towards the North Korean regime reminded citizens and investors of the unpredictable nature of the current administration in Washington DC. While no one wants a violent conclusion to any of these conflicts, the looming threat can trigger irrational market reactions (which can become opportunities for long-term investors).



Finally, those important global elections in France and Germany that I have been discussing over the last two quarters are on now on the immediate horizon with the Part I of the French election just completed. Some uneasiness will remain until both outcomes are certain. During this period of waiting, I anticipate that the markets may react swiftly to the changing political climate, as we saw equities soar in the days after the French election.

## U.S. Equity Market

Despite of all of these concerns, markets have remained resilient, *climbing a wall of worry*. Optimism has carried over from the U.S election last year. In the first quarter of 2017, the broad U.S. equity market (as measured by the Russell 3000<sup>®</sup> Index) rose 5.7%, and the large-cap focused S&P 500<sup>®</sup> Index rose 6.1%. Large- and mid-capitalization stocks fared better than small-cap stocks did. Growth-



oriented stocks outpaced value-oriented stocks across all market capitalizations. Of the 11 economic sectors within the S&P 500 Index (which provides a proxy for the equity market), one sector posted a double-digit gain: Information Technology, led by the surging FANG stocks of Facebook, Amazon, Netflix, and Google. The Consumer Discretionary and Health Care sectors also had relatively strong gains. In contrast, two sectors had losses for the quarter: Energy and Telecommunication Services. The S&P 500 market is presently trading at about 18 times prospective earnings which is at a 13-year high. While this multiple is supported by data like strong retail sales, a low unemployment rate, high confidence in business prospects, and positive consumer sentiment, as well as increasing top-line revenue growth among many other positive metrics, some of these measures feed off each other and may not be fully supported by economic reality. Heightened optimism can help inspire periods of market performance that exceed fundamentals.

## Emerging Markets and International Stocks

During the first quarter, most investors and analysts scaled back their expectations for a major shift in U.S. trade policy. This change fueled a rebound in non-U.S. equity markets (especially emerging markets), reversing the trends that weighed on non-U.S. markets in the months after the November U.S. presidential election. As an example, we saw that the new administration no longer considered China to be a potential currency manipulator, and perhaps there will not be a border adjustment tax on imported goods.



Emerging market equities, reflected in the performance of the MSCI Emerging Markets Index (net of taxes), outpaced developed markets in the first quarter, increasing by 11.5%. On a country basis, Poland, India, and Korea posted the strongest gains, with double digit increases. Conversely, Russia, Greece, and Hungary posted the biggest losses.

Critically, emerging market fundamentals are beginning to shift in a more positive direction; emerging market growth appears to be steadying, and inflation pressures are stabilizing. International developed markets stocks, as measured by the MSCI EAFE Index (net of taxes), gained 7.3%. On a country basis, Spain, Singapore, and Hong Kong posted the strongest performance with double-digit gains, while Norway, New Zealand, and Canada lagged with weak, but positive, results.

## U.S. Bonds



Bond markets performed relatively well in the first quarter, with all major indices and sectors posting gains. The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, rose 0.8% for the quarter. Longer-duration maturities fared better than shorter-duration maturities. Riskier sectors and debt instruments within the fixed income market fared better than less risky securities, such as U.S. government bonds. The yield on the 10-year U.S.

Treasury note ended the quarter at 2.39%, down from 2.45% at the end of 2016. The focus for much of the world regarding Fed policy has been the rise in short-term rates this year. Yet perhaps the more important event is the intentional decrease of the Fed's \$4.5 trillion balance sheet. The fivefold increase in the balance sheet from \$907 billion in 2007 to \$4.5 trillion is unprecedented in size and composition as it contains U.S treasuries, along with trillions of dollars in mortgage bonds, some of which were once owned by failed Bear Sterns and AIG and others of which were issued by the Federal Housing Administration (FHA). The unwinding of this balance sheet over the next three years – by allowing these bonds to mature and by stopping the large purchase of these types of securities from the Treasury and the FHA – will also likely increase interest rates too. This unwinding of an enormous balance sheet will be the conclusion of an experiment that the world has never seen.

The unintended consequences of these actions are completely unknowable...until they start happening. It will be very interesting to see what the mortgage market looks like – particularly for first time home buyers, step up buyers, and financial intermediaries who package loan portfolios – when the Fed is no longer the



definitively largest buyer of mortgage bonds. Will rates rise? Will the market completely disappear? Will the bond world revert to the way it existed before 2009? The next 12-15 months will tell.

## A Look Ahead

By any measure, we are in the late-cycle of the now 8+ year bull market expansion with some indications of a change in direction, including:

- a U.S. central bank that “wants to” and looks like it is changing gears,
- political leadership grappling with major challenges externally and self-created, and
- equity prices at near-record multiples.



In my view, we are facing potential serious political changes all around the globe, including here at home. All of which will have both intended and unintended consequences with impacts that have yet to be fully addressed or even contemplated. Despite these concerns, U.S. economic growth (as measured by gross domestic product [GDP]) for the fourth quarter of last year was revised up to 2.1%; consumers and businesses are buoyant and expect lower tax bills. The labor market is still running along at a good clip. Many investors eagerly look forward to policy changes in taxes, financial regulation, and health care that they expect on the horizon.

The economy appears resilient, and I know things could be a lot worse. However, I am equally skeptical. If all the policy, taxation, governmental changes initiated during this period of transition were to occur, the outcomes may not yield the bountiful upside envisioned by so many believers. I am starting to pay attention for warning signs that investor patience is beginning to run thin and that the markets are reflecting circumspection over the pace of reform in Congress.

In my view, it is hard to see any danger of a near-term recession on the horizon without some traumatic negative event(s) arising. Typically short-term unemployment indicators and payroll tax receipts, as well as housing related data, serve as the canary in the coal mine when the business cycle is starting to deteriorate. As of now, these indicators do not point to any immediate risks, and the current slow economic expansion endures. Still it is impossible not to see that, like the price of Telsa stock, investor expectations have run ahead of market fundamentals, especially in U.S. equity markets. Earnings, the inflation rate, oil prices, labor data, retail sales, and other hard data fundamentals may or may not catch up to investor enthusiasm in the short-term (1yr or less) without making a pause in stock prices. However, *inevitably over the long term, investors' sentiment and economic results must move more or less in lock-step or prices will fall.*



International equities have underperformed U.S. equity markets for nine years, and though this trend can continue in 2017 to bring the total to 10 years, but I'm very comfortable in placing a strong bet that the outperformance will not persist for 11 years. So, consider taking the following as themes for your portfolios:

- 1) begin to let equity tilt away from the US to International (buying more emerging markets based on your appetite for volatility),
- 2) use gains in US equities for liquidity needs,
- 3) consider a shift to value versus growth for new capital,
- 4) begin to emphasize small caps versus large caps,
- 5) examine energy and industrial securities,
- 6) focus on selected illiquid private investments, and
- 7) continue to seek short duration and floating rate bonds

I believe a clearly defined and repeatable investment process, active portfolio and risk management, and a commitment to your interests are paramount to help you navigate through this challenging market environment.

The arrival of spring means flowers are in bloom; trees and grass are green again; and we all start to think about reaping the rewards of winter's hard work and patience. I wish you vitality, health, and happiness in this season and years to come. Let us continue to review your financial objectives and goals, as well as your risk tolerance, unique circumstances, and time horizon, to determine whether the asset allocation we still have in place is suitable for you and your objectives. As always, I look forward to continuing to work with you toward achieving your investment goals

Appreciatively,

*Walid L. Petiri*

[Market Commentary](#)

[Market Watch](#)

[Monthly Foresight](#)

[Connect with Me on LinkedIn!](#)

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board