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Unfazed Investors and Markets Enjoy the Summer Vacation Season
July 2017

Dear Client:

U.S. Equity Market

Markets are composed of various types of investment vehicles ranging from macro focused to stock price momentum for fundamental investors; however, macroeconomic factors are the ultimate driver of portfolio outcomes. Macroeconomic developments form the roadways over which capital markets ride. If you drive over rough streets, the economic potholes may disrupt investor portfolios. Lately, the markets have been gliding on fresh asphalt, and investors have enjoyed an unbelievably super-smooth ride. Volatility in markets has been almost non-existent, as the VIX, a measure of stock market volatility, has been tranquil for months and is at a nearly 50-year low point. Having completed the first half of the year, the stock market has uncharacteristically had only one minor decline. It appears that markets are simply mirroring the lack of volatility in global output and ignoring the political rancor in Washington, North Korea, the UK, and elsewhere, as Global GDP chugs along. Investors who believe in the primacy of economics can simply point to global growth as an explanation for extraordinarily low market volatility. While this low growth environment persists, investors probably will continue to get a pretty smooth ride in capital markets…until they don't!

This calm and smooth ride has come amid investors' efforts to digest the prospects of tighter policies by central banks in developed markets (including the Federal Reserve), the unsettled public policy at home and across the globe, potentially contentious domestic politics, and elevated geopolitical risk. In the US, there remains no resolution to a looming federal budget crisis, the revamping of healthcare system, or budget and pension stalemates affecting several states. In June, the Federal Funds Rate, which covers overnight loans between banks, was raised 0.25% to a range of 1.00% to 1.25%, with the Fed indicating that another rate hike was still on the table for 2017. The market was not buying it; according to pricing in fed funds futures contracts, the probability that the June hike would be followed by another increase this year dropped to about 28% from 48%.

In a separate statement, the Fed spelled out the details of its plan to shrink its $4.5 trillion balance sheet (amassed to stem the financial bleeding of the Great Recession) by rolling off a fixed amount of assets on a monthly basis. The initial cap will be set at $10 billion a month: $6 billion from Treasuries and $4 billion from mortgage-backed securities (MBS). The caps will increase every three months by $6 billion for Treasuries and $4 billion for MBS until they reach $30 billion and $20 billion, respectively.

Officials didn’t reveal the exact timing of when the process will begin this year; how long this process will continue; and how large will the portfolio be when the process is finished. The Fed also expects to keep raising interest rates at a “gradual” pace if economic data play out in line with forecasts.

With the French election behind us and the unexpected drubbing that Prime minster Theresa May received in her efforts to expand her political power in the UK, anti-establishment sentiments appear to be receding at the ballot box. We will face a German election in the fall that should help to confirm the trend. Despite all this political turmoil and financial modifications, the markets have remained resilient.

Second Quarter Review

In the second quarter of 2017, the broad US equity market (as measured by the MSCI USA IMI Index) rose 3.0%, and the large-cap focused S&P 500® Index rose 3.1%. Large capitalization stocks fared better than smaller cap stocks did, and growth-oriented stocks outpaced their value-oriented brethren across the market capitalization spectrum. Of the 11 economic sectors within the S&P 500 Index (which serves as a proxy for the equity market), the Health Care, Industrials, and Financials sectors posted the strongest gains. In contrast, two sectors had losses for the quarter: Telecommunication Services and Energy. As of June 30, the S&P 500 has gained 10% for the year. Its worst peak-to-trough drop this year has been 2.8%. If it finishes 2017 that way, it would be the second-smallest decline in a calendar year over the past 60 years, according to LPL Financial, an independent brokerage and investment firm. The smallest decline occurred in 1995 when the index suffered only a 2.5% fall. It surged 34% that year. History suggests the stretch of calm won’t last. The S&P 500 has avoided declines of 5% or more in just five of the past 60 years, according to LPL. *I would not expect the market to end 2017 up by 34% as current company fundamentals; capital flows and Fed policy do not mirror the environment that fostered those extraordinary gains*.

Emerging Markets and International Stocks

Foreign and emerging market stocks have had a strong first half of the year. International developed equity markets, as measured by the MSCI EAFE Index (net of taxes), gained 6.1%. Emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), gained 6.3%. Almost all of the macroeconomic and event risks that had circled around foreign stocks since the beginning of the year appear to have been resolved in the market’s favor. Three examples support this conclusion. First, investors had worried that the US dollar would rise rapidly in the face of dollar-friendly policies from Washington, such as personal and corporate tax cuts, repatriation of foreign earning, and infrastructure building. However, the US dollar has not rallied, and all the promised dollar-friendly policies are now in political limbo. Second, investors had seemed apprehensive about the French election, and we ended up getting a relatively market-friendly result.

Lastly, investors also were concerned about the possibility of a horrific result from Britain's exit from the European Union (stay tuned), and while we have just begun exit negotiations, so far, we have seen no indications of an impending calamity. All of the ostensible geopolitical risks, which at one time looked elevated, have not materialized into precarious conditions. Thus, foreign equities, already substantially less expensive on a multiple basis than US stocks, have had ample room to rally.

U.S. Bonds

Bond markets continued to perform relatively well in the second quarter, with almost all major indices and sectors posting gains. The broad US bond market, as measured by the Bloomberg Barclays US Aggregate Bond Index, rose 1.5% for the quarter. Longer-duration maturities fared better than shorter-duration maturities. Riskier sectors of the fixed income market, including covenant-light loans and junk bonds, fared better than less risky sectors, such as US government bonds. The yield on the 10-year US Treasury note ended the quarter at 2.31%, down from 2.39% at the end of 2016. The decline of the US dollar against most currencies continues to confound what most predicted post the US presidential election, as two-thirds of global economies are growing faster than the economy of the United States. This downward pressure is compounded by the Fed's belief that keeping inflation in check is a big driver to continue the process of raising short term rates. These factors indicate that investment dollars should be flowing out of U.S. assets into foreign countries. This trend, of course, puts further downward pressure on the dollar and drives up foreign currencies. The trend is likely to persist. Leading economic indicators suggest foreign economies will continue to do well relative to that of the U.S.

Markets can keep grinding higher and unabated, until they stop dead in their tracks as many of us may remember from the start of the dot com collapse during the summer of 2000. I am not comparing that event to what we are experiencing now, nor am I predicting a recession or major correction. Rather, I continue to see equities as the best game in town for now, and I accept that we should continue to ride it. The growing complacency and myopic outlook of so many investors raise my antenna about growing risk.

As in the past the market will give us a chance to see a real view of how misallocation of capital creates irrational or unsustainable economic activities which lead to "systemic risk. For example, a decade after the mortgage debacle, the financial industry has embraced another type of subprime debt: auto loans. And, like last time, the risks are spreading as they're bundled into securities for investors worldwide. Subprime car loans have been around for ages, and no one is suggesting they'll unleash the next crisis. But since the Great Recession, business has exploded. In 2009, $2.5 billion of new subprime auto bonds were sold. In 2016, $26 billion was, topping average pre-crisis levels, according to Wells Fargo & Co.

An interesting, perhaps anecdotal, trend that I am following is related to mergers and acquisition activity. While the CEOs of America's biggest companies continue to profess confidence in the economy, the new policy agenda, and the US consumer, there is a dearth of major deal flow in the markets. Merger and acquisition activity is the ultimate barometer of CEO confidence, in the same way that purchasing a home is indicative of individual confidence about the present and future economic situation. As reported in the NY Times by Andrew Ross Sorkin – the numbers tell the story. So far this year, the number and size of deals are at their lowest levels since 2013. Total deal making in the United States in the first quarter was off nearly 40% from its peak during the same period in 2015, according to S&P Global Market Intelligence. And yet, the Business Roundtable, which conducts a survey of chief executives, said its confidence index "jumped 19.1 points, from 74.2 in the fourth quarter of last year to 93.3 in the current quarter," well above the historical average of 79.8.

A Look Ahead

2017 is only a little more than half over, and plenty can change in the back half of the year. But the last time equity markets went this deep into a year without all three of these benchmark indexes – the S&P 500, MSCI Europe, and MSCI Asia-Pacific ex-Japan – suffering significant pullbacks (defined as at least a 5% decline off recent highs) was nearly a quarter-century ago, in 1993, according to The Wall Street Journal's Market Data Group. All three finished that year with sharp gains. The three major stock-market benchmarks in the US, Europe, and Asia have avoided pullbacks this year and seem to be defying indicators that could foreshadow a decline. Never in at least the past 30 years have all three indexes—the S&P 500, MSCI Europe and MSCI Asia-Pacific ex-Japan—gone a calendar year without falling at some point by at least 5%.

Given these insights, my portfolio thoughts from my first quarter 2017 letter remain intact, so consider allowing your overall equity exposure to hold at portfolio allocation targets. I would recommend the following portfolio actions:

1) let equity holdings tilt away from US to International (start buying emerging markets)
2) use gains in equities for liquidity needs
3) rotate to value versus growth,
4) tilt to small caps versus large caps,
5) shift to energy and industrial securities,
6) move toward selected illiquid private investments, and
7) rotate to 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 challenging market environments.

I hope you and your families are enjoying a healthy, happy, and safe summer. At mid-year, if you have questions or concerns about your investments or your long-term strategy, or if you would like to discuss the challenges and opportunities that the current market may present for your specific situation, let's review and discuss your portfolio and investment strategy. As always, I look forward to continuing to work with you toward achieving your investment goals

Appreciatively,

Walid L. Petiri

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