Crosscurrents

The stock market continued its steady advance through the second quarter with the S&P 500, NASDAQ Composite and Dow Jones Industrial Average rising 8.24%, 14.07% and 8.03% respectively year-to-date. With the S&P 500 hovering near 2450, a scant 2% from our 2500 year-end target, we are compelled to evaluate the extent to which stocks may be overextended, reexamine the underlying fundamentals and consider potential cracks in the market's seemingly invincible armor.

Consensus earnings estimates for the S&P 500 now rest at $131.47 for 2017 and $147.10 for 2018, implying P/E multiples of 18.6x for calendar 2017 and a more reasonable 16.7x for calendar 2018 estimates. With the yield on the U.S. 10-year Treasury seemingly unable to penetrate the still-paltry 2.4% threshold, the stock market does not appear especially rich or cheap. At best, the overall market represents fair value.

The fact that the market is rising is indicative of an economy that remains on solid footing and earnings growth that has accelerated in recent months. Jumping by 15.3%, first-quarter earnings advanced at the fastest clip since 2011 and second-quarter earnings are similarly expected to increase by low double-digits. Both manufacturing and service activity are indicating further GDP expansion, the labor market is strong, housing prices remain firm and economies worldwide are enjoying synchronized global growth. Emerging markets are leading the global growth parade and even the likes of Europe and Japan are joining the party. With foreign economic recoveries surpassing only moderate U.S. GDP, the dollar has suffered its worst two-quarter decline since 2011, having dropped 5.6% during the first half of the year. This significant drop in the dollar, as opposed to strengthening economic fundamentals, has been the primary driver behind the big leap in U.S. corporate earnings. Those companies that obtain a majority of revenues overseas have enjoyed recent earnings growth double that of solely domestic companies. Just as we have refrained from turning negative on otherwise healthy businesses simply because their earnings were adjusted lower by currency fluctuations, we are not overly enthusiastic today by the favorable impact of a weakening greenback on our wonderful stable of leading global franchises.

It is peculiar that interest rates have remained persistently low even as the Federal Reserve continues its gradual pace to remove accommodation. After hiking rates 25 basis points in June to a range between 1% and 1.25%, the Fed's third such hike in as many quarters, the Federal Reserve is now poised to start shrinking its massive $4.5 trillion balance sheet in the coming months. The unwinding process is intended to be slow and methodical and the Fed hopes for the process to run "quietly in the background". Instead of reinvesting proceeds of maturing U.S. Treasuries and mortgage-backed securities as it has done since 2014, the Fed will reduce its holdings every month by allowing a predetermined amount of bonds to simply fall off the balance sheet at maturity. The telegraphed plan is to start by allowing $6 billion in Treasuries and $4 billion in mortgage-backed bonds to mature without reinvestment and gradually increase this amount each quarter until the pace ultimately reaches a maximum of $30 billion a month for Treasuries and $20 billion a month for mortgages. It is now expected that the Fed will commence this contraction of its balance sheet by September and will then wait until December to consider whether to resume its path of gradual rate hikes.

Some analysts remain puzzled by the Fed's intentions in the wake of inflation that refuses to meet the Fed's 2% target. In May, the Fed's preferred inflation gauge slowed to a muted annualized gain of 1.4%, down from 1.8% in February. Fed Chairwoman Janet Yellen cited declining prices for wireless service plans and prescription drugs as temporary factors responsible for this deceleration in inflation. As cited in our recent white paper ("Incoming! Rates, Retirement and Reaching for Yield"), there are secular forces behind such subdued inflation that include aging demographics, excessive government debt, global sourcing of labor, increasing use of machines instead of people and disruptive advanced technology, the collective impact of which seem to go far beyond that of cellular data and drug pricing. Market participants will be laser-focused on forthcoming inflation data to gauge the Fed's ability to follow through with such an unprecedented unwind of its massive balance sheet. With inflation diminished and interest rates stubbornly low, the Fed will be walking a tightrope in the coming months and it remains to be seen whether the "Great Unwind" will run quietly in the background as hoped for. We would prefer that inflation and interest rates move higher in tandem due to a stronger economy, not due to rising concerns over central bank accommodation.

Other crosscurrents that influence a more cautious stance include the following:

- Corporate debt, steadily rising since the Great Recession as companies increasingly issued debt for buybacks, dividends and acquisitions, has climbed just north of 45% of GDP, levels last seen just before the past two recessions.

- Margin debt on the New York Stock Exchange reached an all-time high $539 billion in May, up 20% year over year and up 300% since the March 2009 low.

- The average investor's allocation to stocks has risen from 25% in 2008 to more than 40% today. There have only been two periods since World War II (the go-go 1960s and dot-com bubble of the late 1990s) where allocation to equities has been higher.

- It remains unclear whether Trump's fiscal reform measures, especially tax reform, will be able to make it through Congress as we had hoped.

Perhaps our greatest concern lies in the accelerating proliferation of Exchange Traded Funds (ETFs) as a means to gain equity exposure. ETFs offer passive exposure both to whole markets and sectors through index ETFs and specific swaths of the "active" market through so-called "smart beta" ETFs. After pouring $506 billion into ETFs in 2016, investors have steered $400 billion to these funds during this year's first half. There are now more than 1,800 listed ETFs with roughly $3 trillion under management. Of this total, 1,300 ETFs valued at $2.3 trillion are linked to stocks, 300 ETFs worth $500 billion are tied to the bond market and the balance of 200 ETFs at $200 billion are exposed to "volatility control" VIX-related products. Approximately $50 billion of the ETF universe utilize leverage. Almost all of the funds invested in ETFs have piled in since the end of the 2008-09 financial crisis, thus only knowing one of the longest bull market stretches in history. Because of the popularity of ETFs, passive investing strategies now represent 37% of all U.S. fund assets and own nearly 6% of the U.S. stock market.

So why the concern? As money pours in, passive funds must buy securities in the same proportion as the underlying index *without any regard for fundamentals or valuation*. With indices dominated by market-cap-weighted strategies, price-insensitive ETF investors are essentially loading up on the highest valued stocks just as the market is reaching new all-time highs. In this way, ETF investing is akin to momentum investing where investors attempt to capitalize on the continuance of existing market trends. The problem for momentum investors occurs when the tide invariably turns. Jim Grant, the founder of Grant's Interest Rate Observer, estimates that price-insensitive buyers (including ETFs, global central banks and indexed mutual funds) represent more than $21 trillion of assets. It would seem clear that this sizable pool has had profound impact on the rising tide for both stocks and bonds. Because the impact of such price-insensitive investing is so new and has all occurred during a great bull market for both stocks and bonds, it remains unclear what will happen with ETF investors during the next downturn.

Passive investors have enjoyed the elevator ride up as the indices march higher, but they will also obtain 100% of the downside when the markets inevitably turn south. In approximating the composition of an index as precisely as possible, ETF managers do not have the option to hold cash, cash which might otherwise reduce the impact of a precipitous decline and also afford tactical resources to buy stocks at bargain prices. When momentum eventually reverses course in favor of more value-oriented strategies, it is probable that ETF investor sentiment will also reverse course, causing additional selling pressure as ETF shares and the underlying stocks they represent are dumped into a declining market.

Next, it is unclear how the mechanics of ETF portfolio construction will fare during a pronounced market decline. Leading ETF purveyor iShares by Blackrock explains the creation and redemption of ETFs as follows: "The important difference between an ETF and a stock is, that unlike a stock, an ETF is openended. Creation and redemption of units is facilitated by market makers who interact with the fund in large blocks of units. This mechanism facilitates the primary market in ETFs, and works through the in-kind transfer of a basket of securities to (or from) the fund. Thus if there is net buying of an ETF, more units are created to meet that demand. Similarly, if there is net selling, units are redeemed. Units are created or redeemed at the full net asset value per unit. Thus, analysis of trading activity in an ETF needs to be viewed in the context of the liquidity of the underlying securities that it holds." Indeed.

Last year, an amazing 37% of volume on the New York Stock Exchange occurred in the final 30 minutes of trading because this is when ETFs must adjust their holdings to remain in line with the index. Vanguard founder Jack Bogle recently observed that ETF impact in stock trading "has reached mammoth proportions". The dollar volume of trading in the 100 largest ETFs reached $13 trillion during 2016. While this volume closely approximates the dollar volume of trading in the shares of the 100 largest stocks, the market cap of those ETFs was just $1.6 trillion compared with $12.8 trillion for the 100 largest stocks. This resulted in annualized turnover of 120% for stocks and nearly 880% for ETFs. Bogle warns that the ramifications of this rapid trading and turnover in ETFs "have yet to be fully examined". A wide scale investigation by the Securities and Exchange Commission into the ETF industry and the potential for ETF-exacerbated volatility remains ongoing.

Meanwhile, volatility has all but vanished from the stock market. The average 0.3% daily swing during the second quarter was the lowest in more than 50 years. A strong case can be made that low market volatility is a direct function of low economic volatility as the annualized change in U.S GDP form quarter to quarter has reached an all-time low over the last three years. Reduced economic volatility can be attributed to the primary importance of the steadier service sector over manufacturing, more predictable government spending, real time inventory and supply chain management and increased government regulation over banks in the wake of the Great Recession. In addition, aging demographics and mounting government debt have served as self-enforcing roadblocks to more rapid growth, further reducing the propensity for heightened economic volatility. While diminished economic volatility may prevail, it would be naïve to expect that market volatility has been vanquished.

As you will read in our secondary article on *Scarcity and the Importance of Dividend Growth*, we are confident that OVIM portfolios are well positioned for volatility that may arise in the coming months. And unlike the ETF manager, we are hedged not only by our dividend growth strategy but also by the protection of bonds and the availability of ample cash reserves. While we are admittedly cautious, dare we say hopeful, that the market is due for a correction, we also realize the propensity for a continued lull from the lack of volatility to call in the sirens of market euphoria. You should expect us to take additional precautionary measures should that contingency play itself out.