Economic & Market Commentary

Complacency has taken hold of the U.S. equity and bond markets this year. The trends established in the first quarter continued into the second, with the S&P 500 adding 3% to its earlier 6% increase, ending the six months with a gain of 9.3%. Likewise, bonds added to their earlier performance to produce a small positive return, in spite of the Federal Reserve's June rate increase, with signals of more to come. Rarely have both the stock and bond markets been more expensive, yet stable, as they have in the first six months of 2017. The complacency was underscored by the low volatility of the equity market and the compression of credit spreads across bonds. The largest decline in stocks year to date (minus 3%), is the smallest in more than two decades. The character of the stock market was also a continuation of the first quarter. Growth and large cap were dominant once again. In terms of sectors, the reversal of last year's "Trump Trade" continued, particularly in the first two months of the year and again in May. Healthcare, parts of Technology and Consumer Discretionary had a strong quarter and six months. Financials had a weak start to the year, but have come back strongly at the end of the second quarter. Energy, which was the top performer last year, is the poorest this year – largely following the price of oil. Global equity markets have also performed well, and the U.S. ranks about in the middle of those monitored by the Wall Street Journal.

One other characteristic of the current equity market demands note: that is the outsized impact a handful of stocks is having on aggregate performance. This refers to a small portion of the Technology sector – the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google). These five issues have grown close to an 11% weighting in the S&P 500. (The Technology sector in total has a 23% weighting in the Index, compared to its prior peak of 29% in 1999). It is estimated that the performance of these five issues accounted for almost half of the year to date gain in the S&P 500. Client portfolios utilizing our All-Cap Advantage and Dividend Value equity strategies own Apple, while Alphabet (f/k/a Google) is held in All-Cap, as these stocks are reasonably priced in relationship to their respective earnings and cash flow. However, the other three companies have a combined market value of $1 trillion, but produced just under $14 billion of annualized earnings or a capitalization rate of 71x earnings – very richly priced stocks, even taking into consideration their rapid growth rates.

We have written previously about the issue of passive management (Index Funds, ETFs), and the impact it has on the equity markets. It continues and deserves further comment. Morningstar estimated that $340 billion flowed out of U.S. based actively managed funds in 2016, while $500 billion flowed into passively managed funds. Merrill Lynch recently wrote that the percentage of U.S. domiciled equity funds that are passively managed has risen from 19% in 2009 to 37% today. Merrill refers to this phenomenon as the "ETF-ization" of U.S. stocks, which they say erodes the liquidity of the market, and causes valuations to become distorted. We all know that passive investing is done by rote, with little attention paid to the economic factors that are central to any investing calculus. The reason you make an investment is to get a return on (and of) your money that is competitive with what you could earn elsewhere. That return is a function of the price paid and earnings, or payments, generated by the asset. For equities, earnings are what are generated by the economics of the business: revenues earned, margins on those revenues, asset turnover (revenues generated by the assets employed), and leverage (amount of debt used to finance the assets). The result is a residual amount left to cover dividends and other demands on capital. These economic factors are calculable and should be the focus of any thoughtful approach to investing. Price paid also has some grounding in economic fundamentals. That is to say, the price one pays for an asset providing an income stream should be dependent on the rate of return the investor expects, and that can be received from other alternatives. Price can also be a function of psychological factors that are largely unquantifiable and subject to fashion or fad. The tendency to apply an unjustifiable capitalization rate can have an outsized impact on the return earned over time. Passive investing does not take into account these economic realities. Carried to its extreme, passive investing should create massive inefficiencies, which could be capitalized on by a more fundamentally-based approach. Furthermore, there is a counterintuitive aspect to it. As a stock's price increases (often distorted by the flow into the passive model), it's weighting in the model increases, which creates more buying. The reverse happens if a stock declines in value. This seems contrary to what we've all been taught as rational investors – which is to "buy low and sell high."

So there are clear flaws to a passive approach, yet it certainly has gained increased favor in recent years. Is there a logical end to this trend? It could go on for some time, as it has in Japan where passive management is about twice the concentration as here. Some have said that what is needed to correct the trend is a good bear market, where the rote investors come up short. This calls to mind the concept of "portfolio insurance," which ended unpleasantly several decades ago. It is interesting that the granddaddy of passive investing – Vanguard (which owns almost 7% of the S&P 500 today) is working on a new actively managed offering. As committed active managers, we take these as positive signs, realizing that we will continue to have frequent, and sometimes lengthy distortions along the way.

The complacency mentioned earlier is also worth further discussion. After all, a 9% gain in the S&P with no volatility in the first six months is surprising – it's a good year's work. The head of wealth management at a major advisory firm was recently quoted in the Wall Street Journal saying: "if the only thing we have to worry about is North Korea, there isn't anything serious to worry about… How does it get any better than this?" Investors have become jaded by all that has transpired in the last 8 months. They've seen the travails of the president and his administration, lived through European election fears, renewed Brexit concerns, Russian election tampering, North Korea nuclear antics, Syrian involvement, more Middle-East turmoil, etc., etc. and not had a catastrophe. They assume we will continue unimpeded on an upward path. It seems hope has triumphed and risks have been cast aside. Yet they still lurk and should be visible to most observers. We've discussed most of these in the past, so there is no need to repeat the laundry list. Brexit is still up in the air, but other "Eurosceptic" fears can be put aside for the time being. However, with North Korea, China, Russia and the Middle East, there is enough on the table to create destabilizing events.

The global economy does not, at this time, present a high degree of risk. The developed economies look to be on an accelerating path, and central banks are accommodative. The general feeling is that we are in a globally synchronized expansion for the first time in many years. Despite a weak first quarter, the U.S. economy is grinding along at a subpar 2% rate of real growth, as it has been for several years. The U.S. expansion has reached eight years, which is the third longest in the postwar era. There are no signs of recession on the near term horizon, and there are enough tailwinds to expect at least a continuation of the current pace for a while longer:

- U.S. consumers (most of the source of recent growth) look good both from a balance sheet and income point of view.
- Housing should be a swing factor, as starts head back toward an expected 1.7 million units.
- If fiscal policy becomes more clearly defined, capital expenditures should increase as well.

On top of this is the administration's fiscal program, which could be beneficial to growth and allow the current anemic pace to increase. Of course, this is the wild card. We have talked before about the prospects and problems facing the passage of the administration's policies. Progress to date has been disappointingly slow and confrontational, which dampens optimism going forward. Perhaps a bigger fundamental question facing investors now relates to current financial conditions and policies of the Federal Reserve Board. Both interest rates and liquidity have been excessively accommodative for a number of years, which has been the fuel powering the performance of financial assets. Merrill Lynch estimates that central banks around the globe have pumped out $1.5 trillion of liquidity so far this year, all of which is searching for return. We know the Fed's stated policy is to normalize (increase) interest rates. With the 10 year Treasury yielding about 2.35% currently, there is ample room to increase rates without damage, as long as the motivating force is improved economic performance and not rapidly increasing inflation (there are no signs of this currently). The Fed has recently added a policy statement that they will soon begin a program to reduce their bloated $4.2 trillion balance sheet. The expansion of their balance sheet over the past 6-7 years has provided much of the excess liquidity, which has fueled financial asset performance. A reversal of this process is potentially problematic. Much depends on the mechanics of the Fed's process and the timetable involved. We don't have a crystal ball on the program, but it does represent an added risk.

In spite of the above, the equanimity of the financial markets noted last quarter has continued. We are surprised, and have been wrong, regarding our expectation of increased volatility. However, we are not ready to capitulate, as we fully expect the road to be bumpy in the second half. Corporate profits were good in the first quarter, in fact the best in several years. We're starting second quarter reporting season now, and expectations are for another strong showing. Yearly estimates have moved up reflecting these expectations. The U.S. market is valued at 18x-19x current year and 2018 estimated normalized earnings. If a generous tax and repatriation bill is passed and earnings flow through occurred, valuation would be closer to 17x. None of these valuation levels could be called cheap, and in fact reflect a high degree of investor optimism. It would not be surprising to have volatility return with little or no gain in performance for the next several months. As before, we like the way clients' portfolios are currently positioned and have no reason to make strategic changes. We also like the fact that we have some liquidity in reserve to take advantage of any volatility that may occur.

Fixed Income Review

Bonds overall rose modestly during the 2nd quarter, with the Bloomberg Barclays Aggregate Index returning 1.45% for the quarter and 2.27% year to date, while the shorter duration Bloomberg Barclays 1-5 Year Government/Credit Index returned 0.56% during the quarter and 1.14% for the year. Corporate bond credits have continued to strengthen and we have over weighted the Financials sector, where companies have made tremendous improvements to their balance sheets and can benefit from rising interest rates. Municipal bonds performed well, returning 1.96% this quarter and 3.50% so far this year in the Bloomberg Barclays Municipal Bond Index, rebounding from lackluster performance in the fourth quarter of 2016.

During the 2nd quarter, U.S. Treasury yields rose between 6-26 basis points for shorter maturities (3 years and less) and fell between 3-17 basis points for longer maturities (4 years and greater). The rise in shorter term rates was not unexpected as the Federal Reserve increased its Federal Funds target rate by 25bps in June, following an equivalent rate hike earlier this year in March. The decrease in longer-term rates reflects the markets' diminished expectation for inflation and economic growth, due to the delays in enacting the proposed tax reform and increased infrastructure spending programs announced by the president.

A slightly disappointing May jobs report that showed an increase of 138,000 jobs called into question whether the Federal Reserve would raise rates at the June meeting, but the Federal Reserve has stated its desire to normalize rates by raising them on a more regular, periodic basis, assuming no significant changes to the key economic indicators including employment, inflation and economic growth. The Fed's decision to go ahead with the June rate hike was subsequently supported by the June jobs report, which showed a higher than expected 222,000 jobs were added. Despite continued mixed economic data, the Federal Reserve remains on target for the three rate increases it projected for 2017, with the next rate increase either in September or December. There is a 42% probability of getting the 3rd rate hike by the end of this year, based on Fed Funds Futures.

Importantly, the Federal Reserve has discussed for the first time the possibility of shrinking its balance sheet by reducing the amount of money it reinvests in new securities from maturing Treasury and mortgage-backed securities it holds. Chair Janet Yellen confirmed in her July testimony to Congress that the Fed intends to start the process later this year. The Federal Reserve currently holds over $4.2 trillion in Treasury and mortgage-backed securities that it acquired during the Quantitative Easing programs following the Financial Crisis in 2008-2009. The Federal Reserve wants to unwind its balance sheet extremely cautiously to avoid undoing the measured steps it has taken since starting to raise rates in December 2015. Yellen also noted that the Fed does not see its balance sheet as a tool for implementing monetary policy and will use a gradual and predictable process for reducing its balance sheet to attempt to avoid disrupting the bond market and interest rates. If the Fed does start the process in September, we believe they will forgo a rate hike then and hold off any interest rate adjustments until December.

The Fed faces some tough decisions because there are several economic indicators that would argue against further raising rates this year. The Fed's favored measure of inflation has decelerated for three straight months and after peaking at 2.1% in February, it has slowed to 1.4% as of May, although Chair Janet Yellen has stated she believes the retreat in price pressures is likely temporary. In addition, real GDP growth has been modest with 1.4% growth in the first quarter this year, which was lower than 2.1% GDP growth in the fourth quarter of 2016 (although the first quarter growth is typically a weaker quarter). Furthermore, wage growth has remained relatively low, with wages increasing just 2.50% in the past year. Also, retail sales have been weaker than expected following a soft first quarter with Adjusted Retail and Food Services Sales decreasing by 0.25% in May. However, it should be noted that lower prices may have played a role in the weaker sales, as the figures are not adjusted for changes in inflation.

At the same time, Janet Yellen has recently mentioned concern about elevated asset prices and low Treasury yields, noting in June that asset valuations were “somewhat rich.” Fed Vice Chair Stanley Fischer also noted that the rise in valuation pressures pointed to not only improving economic outlook but also “…signs that risk appetite had increased as well.” Despite the four Fed Funds rate hikes since December 2015, the current levels of Treasury yields, credit spreads and stock prices would typically be associated with loosening financial conditions, rather than tightening financial conditions. These new and recent comments surrounding asset prices by Janet Yellen and other Federal Reserve officials suggests part of the motive for the Fed to continue on its path for its tightening cycle, while pricing pressure and wage growth have remained minimal. The Federal Reserve seems intent on avoiding the excessive run-up in asset prices during the dot-com and housing bubbles, as well as the subsequent bursting of those bubbles.

Janet Yellen stated in June that the Fed was not targeting specific financial conditions with its monetary policy; however, New York Fed President Bill Dudley did comment that tighter financial conditions are “sort of the purpose of tightening monetary policy.” The key point is that while the Fed remains accommodative, they are concerned about monetary conditions being accommodative for longer than necessary and leading to excessive asset prices, just as they were about providing the financial conditions needed for the economic recovery following the financial crisis. They absolutely do not want to be behind the inflation curve, where they would need to accelerate rate hikes and have to play “catch up” to combat pricing pressures.

Our clients’ portfolios primarily contain short and intermediate-term bonds to lessen the impact of rising interest rates on the bond portfolio values. We believe this to be prudent, given the Fed’s clearly stated desire to normalize interest rates and now especially that they have indicated that the process to unwind the Fed’s balance sheet positions will begin this year.