MID-QUARTER UPDATE – AUGUST 2017

The markets continued to grind higher into the third quarter and have performed well year to date. The S&P 500 benchmark has advanced just under 12%, as of this writing. Foreign markets have been even stronger, and the MSCI-EAFE developed foreign equity index is up nearly 18% for the year, a welcome change after lagging the S&P 500 the past four years in a row and seven of the past eight years. A deeper look under the hood shows that the majority of this year's outperformance came from currency appreciation versus the dollar. Measured in local currencies, the MSCI-EAFE index is up about 7%, which is actually less than the S&P 500 in local currency terms.

The primary reasons for foreign currencies appreciating relative to the US dollar are shifting inflation, economic growth, and interest rate expectations. After rallying nearly 5% following the election, the dollar is now off more than 9% from its post election high, which makes 2017 (so far) the worst year-to-date move for the US dollar since 1986. As we have detailed in past newsletters and quarterly market summaries, the Trump "Reflation Trade" has been unwinding as the expected stimulus, tax cuts, and reduced regulation have not materialized, and expectations of future policy implementation have been declining daily. Conversely, foreign central banks have signaled less accommodative market policy coming in the latter part of the year, and Europe and China have made overtures toward reigning in non-performing loans to pursue policies of better allocation of capital. We expect fiscal policy, or lack thereof, out of Washington to be a key factor in determining the state of the market during the second half of this year.

From a fundamental perspective the global economy continues to firm. Manufacturer surveys, such as the ISM manufacturing index, have been solid and are consistent with economic growth in the 2%-3% range. The most recent employment report can be interpreted as slightly stronger than expectations, squaring with the theme of a tight economy. Corporate earnings were again healthy this past quarter, as well. Bespoke Research reported that 63.2% of companies beat their earnings expectations, and perhaps even more importantly, 63% beat on harder to manipulate revenue estimates. As we move through the third quarter, the incremental surprises continue to be to the upside despite the lack of fiscal stimulus from Washington, DC. To continue on this trajectory, it would seem that the Fed should have little reason not to raise interest rates another quarter percent later this year and begin to reduce their balance sheet perhaps as soon as September. If tax cuts, decreased regulation, or fiscal stimulus ever come to fruition then we would anticipate higher inflation expectations, which could mean additional response by the Fed in normalizing its monetary policy.

While the market's resiliency in the absence of any expected stimulus is encouraging, it needs to be weighed against high asset prices and low volatility, since the Fed is moving toward a normal interest rate policy while other central banks begin the process. What was a 50 mph tailwind of monetary stimulus to asset prices across the globe as central banks accumulated $15 trillion of assets has become a 5 mph headwind, as the Fed is about to start reducing its holdings and others are slowing this pace of purchases. There is now an upward bias toward borrowing costs, and we expect it is going to become incrementally harder for markets to continue to set new highs.

At this point it seems there is a very large amount of optimism built into the markets. The CBOE Volatility Index (VIX) hit its lowest reading ever recorded (data series back to 1990) in July. This "fear gauge" attempts to price implied volatility in options markets, and is indicating the lowest level of expected volatility ever. Perhaps there is a good reason for this – there is no volatility in the markets to reflect. No major stock market has declined 5% this year, which is a very rare feat. Investors have responded, and according to the latest AAII survey, individual investors have the lowest allocation to cash in their investment portfolios since 2000 and are among the most invested they have been in financial markets since 1988 according to SentimenTrader. At the same time the markets are showing some signs of weakening internals. The Russell 2000 Small Cap index, which traditionally does quite well when markets are healthy, has already begun a decline and has crossed below important moving averages, while large cap indices continues to eek out new highs. According to WMInsights the broad S&P 1500 (which includes the S&P 500, the Mid Cap 400, and Small Cap 600) recorded an all time high recently; however nearly 50% of all the stocks in the index were at least 10% below their 52 week highs, which means that the market leadership is narrowing and fewer stocks are participating in the broad base advancement. The numbers continue to improve at the headline level, but beneath the surface there is some weakness that should be noted.

Few people that I have talked to trust the long term viability of this market without some sort of correction or at least an increase in volatility, and most have concerns over valuations for both stocks and bonds as well as for the political climate and shift in global monetary policy. Yet it has not paid to bet against this market or sit on the sidelines and not participate. We continue to monitor the fundamental and technical measures of this market and economy in order to best position client accounts. We consider the incredible low volatility levels experienced this year to be somewhat of an aberration and expect, and even welcome, volatility in the second part of this year as a normal part of a healthy market.

All the best,

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