MID-QUARTER UPDATE – MAY 2017

Domestic stocks had a strong first quarter but have since meandered sideways in a narrow range since early March. Stock recently set new highs earlier this week but have declined on the heals of political uncertainty bringing year-to-date returns for the S&P 500 to just under 7%. The notable feature of this market has been historically low volatility.

The CBOE Volatility Index, or VIX, dropped to 9.77 on May 8, the lowest reading since 1993! This "fear gauge" attempts to price implied volatility in options markets. Normal periods in the past would have the index hovering around 20, but those averages have been dropping since the financial crisis. Low levels do not necessarily mean danger is imminent, but a low VIX means high complacency. Put simply, if the market is not expecting any trouble in the near future then the stage could be set for a more serious market reaction than normal on adverse news. This was illustrated on May 17th when the S&P 500 declined 1.8% on political concerns. At the same time, the VIX jumped from 10 to 15, up 50% but still at the low end of its historic range. A 1.8% move would be considered more "normal" than "extreme" by typical market standards, but when complacency abounds it can rattle investors. Historically, extreme complacency and all time highs in stock prices are a dangerous combination, serving as the tinder and dead wood that can accelerate the next forest fire.

With markets higher and volatility low, the headlines would suggest that the "Trump trade" has remained in effect as 2017 has progressed. Below the surface, however, there have been shifts as the late 2016 campaign rhetoric rally has come to terms with both the timetable and trade offs of policy making. Although health care reform is headed to the Senate, and there is still some chance tax reform is coming later this year, there is plenty of room for market disappointment should the stimulative Trump agenda see a more significant or permanent delay. The markets have slowly been pricing this all year. In fact, the "Trump Trade" sectors that benefited the most post-election in 2016 (such as small caps, energy and financials) have been among the worst performers year to date in 2017. On the other hand, areas that were negative post-election have been some of the best performing year to date. The MSCI Emerging Markets Index, which was down 5% from election to year end, is up over 14% this year as trade threats have faded. The MSCI EAFE index of developed European and Asian countries was flat in the post-election period, but has had a strong 2017. This is in part because Emanuel Macron's win over Marine Le Pen in the French Presidential election reduced the threat of political risk to the euro area, at least for the time being, and has the MSCI EAFE index 10.5% higher.

Political infighting, controversies, investigations and hearings in Washington up until this point have been mostly just noise to the markets, with the most significant impact being a distraction to passing fiscal stimulus. However, the escalation of these since the firing of FBI Director James Comey has forced the markets to face the potential that Donald Trump goes beyond the tipping point to the land of no return, where his presidency becomes unsalvageable and fiscal stimulus does not happen. Approval ratings are power in Washington D.C., and if it gets to the point where everyone jumps ship, then we would be in uncharted waters, leaving fiscal stimulus dead on the side of the road for longer than the market is already anticipating, perhaps much longer.

Even as markets are weighing the chances for the tailwind of fiscal stimulus, on the monetary front the reality is that policy is becoming a headwind. Up to this point hopes for fiscal stimulus have trumped tighter monetary policy, and the market has taken rate hikes in stride thus far. The market is already pricing in two to three additional hikes later this year, beginning as soon as the June meeting in less than a month. So far it appears that the economy has easily digested the higher rates as well, but the Fed has a history of overshooting interest rate policy, restricting economic expansion in favor of protecting against inflation, and there is no reason to think at this time will be any different. As rates continue to move higher economic activity is eventually restricted, and the threat of recession begins to surface. Coming from near zero interest rates means that the runway for higher rates is probably longer than normal.

Possibly far more important and impactful than rate hikes, few people are talking about the future impact of the Fed unwinding its balance sheet during the process of reversing the Quantitative Easing (QE) programs. We have discussed for years in this newsletter and in client meetings the how QE artificially inflated asset prices (stocks, bonds, real estate, etc.) as the Fed purchased $4 trillion of bonds in order to knock down longer term interest rates. Now that the Fed is signaling that they will indeed begin unwinding these bond positions, possibly starting later this year, one has to imagine that the corresponding impact on asset prices to be negative. While there is plenty of precedent for what to expect in a rising rate environment, this is the first time we are experiencing "anti-QE" and therefore it is impossible for anyone, including the Fed, to know what to expect. The Fed unwinding its balance sheet is a necessary course of action, but the process of doing so will likely not be a pleasant one – a headwind for stock prices at the very least.

All time high stock prices accompanied by extremely low levels of complacency and price volatility do make us nervous. There is plenty to be incrementally optimistic about and we remain fully invested in our strategies, but trees do not grow straight to the sky, and we view this market with a skeptical eye.

Service Item:

- Verizon is no longer supporting email so anyone who has a Verizon.net email address has one of two options – you can keep the Verizon.net email but it will now be with AOL, or you have to create a new email address with another service. If you change your email address please let us know so we can update your information here.

All the best,

Kevin T. Grimes, CFA, CFP®
President/Chief Investment Officer

110 Turnpike Road, Suite 100 • Westborough MA 01581
Tel. (508) 366-3883 • Fax (508) 366-0999 • E-mail: advisors@grimesco.com
Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet.