Treading water

Markets are in a state of limbo, having started the year off strong with a string of positive economic surprises and the “Trump Bump” in play, but have leveled off as of late. The historic trend of U.S. economic data experiencing a bit of a soft patch in the first quarter has continued, too. And earlier hopes that U.S. policy changes would happen quickly under the new administration have been dashed. Global recovery and expansion are still in place, and broadly speaking, worldwide economic health continues to improve. Overall, while we’re not exactly swimming forward at Michael Phelps’ speed, we’re also not getting knocked back by a tidal wave. We’re simply treading water.

In this issue of Perspectives, we’ll share important details about the latest economic and political developments both here in the United States and around the world as well as the impact those developments have had on markets. We’ll also look more closely at why and how we recommended asset-allocation changes for some clients’ portfolios in April and explore why asset allocation is perhaps one of the most important parts of an investing strategy.
Perspectives in a flash.

Interested in what’s happening but prefer not to get into the nitty-gritty details? Here’s what you need to know about the most recent quarter and where the markets and economy stand now.

**Market perspectives.**

A more cautious outlook: Following a string of positive economic data and a “Trump Bump” that saw new record highs, markets have taken on a more cautious tone as we wait to see how quickly changes to U.S. policies will actually be put into place.

Earnings growth at home and abroad: Domestic and global companies in the United States are reporting stronger earnings. This trend is expected to continue.

Good environment for floaters: In our current economic environment, we prefer floating-rate bonds over high-yield bonds and have recommended adjustments to many client portfolios accordingly.

**Economic perspectives.**

Here Comes the Annual “soft patch”: U.S. first-quarter economic data has been relatively weak each year since 2010. 2017 looks to be no exception.

Foreign economies trending up: Economic indicators are anticipating “stable growth momentum” worldwide. Europe and emerging-market economies that had been in recession territory are experiencing particularly strong growth.

**Political perspectives.**

Last three months: Although the Republicans’ proposed replacement of the Affordable Care Act stalled and never reached a vote, President Trump has made progress on other fronts such as rolling back energy regulations and confirming Supreme Court Justice Neil Gorsuch.

Next three months: President Trump and his team are working to get new tax policy and a revised version of the American Health Care Act approved. In the meantime, infrastructure policy and revisions to Dodd-Frank take a back seat.

Domestic markets spiked at the beginning of the year but have pulled back for a variety of reasons. They are now in more of a “treading water” phase – although that’s not necessarily any reason to think that a recession is imminent. Global markets continue to grow and, given the sum of these circumstances, we’ve recommended portfolio adjustments for some clients.
Market perspectives.

A More Cautious Outlook

U.S. equity markets are enjoying a strong run. The large-cap S&P 500 and Dow Jones Industrial Average indices have now posted six consecutive quarters of positive returns. U.S. small-cap stocks ended the quarter in the black for five of the last six periods. For the broader S&P 500 index, most would classify its first-quarter climb as steady and rather boring. Only once this year has the index fallen more than 1% in a single day and larger upside swings have been infrequent. In short, volatility was unusually low through the first three-and-a-half months of the year.

“The VIX” is a phrase often tossed around by market pundits and participants. It refers to the most popular index used to track equity-market volatility. Basically, the higher the VIX, the higher expectations are for more volatile price swings. Since 1990, the average daily reading for the VIX has been 20 (for reference, the index peaked at 81 in the fall of 2008). The VIX has been below its historical average for the better part of the last four years and lower still in recent months. Since its start, the index closed below 12 an average of 21 days a year – but it’s already done that 60 times in 2017 as of May 8.¹

Yet through the early part of April, investors are starting to increase their expectations for volatility. Coming into the year, one of the bigger risks to what was then the fast-paced rise in stocks was concern over whether the new administration would put policy changes in motion as quickly as they’d hoped. Since then, markets have taken on a more cautious tone and outlook as they await the next market-moving catalyst. In fact, bullish sentiment from individual investors now sits below its historical average.²

Earnings Growth at Home and Abroad

Coming off the heels of the period of unusually low volatility, and with plenty of question marks surrounding U.S. policy changes and economic reports, market participants have recently been looking for reasons to sell rather than to buy. A strong first-quarter earnings season could flip some of that momentum back in the favor of the bulls. Numbers will likely be inflated given how dismal earnings were during the first quarter last year.

As of May 5, FactSet Research Systems estimated that earnings for S&P 500 companies would grow 13.5% year-over-year.³ The final growth number is likely to be higher still. Evercore ISI states the average surprise in growth between aggregate earnings estimates and actual operating earnings per share is +3.6% for all non-recessionary-influenced quarters. Combine the current estimates with the average upside surprise, and we are looking at earnings growth that could be well into the double-digits and could be the strongest in more than five years.

That earnings growth isn’t isolated to U.S. stock markets. In fact, the outlook for near-term earnings growth looks even more favorable overseas. Recent data from Eaton Vance and FactSet estimate earnings growth over the next 12 months at +16.5% for the MSCI Emerging Markets and Europe indices. That compares to +10.5% estimates for the S&P 500 using the same source. The forward-looking earnings outlook helped foreign equities outperform domestic stocks during the first quarter – a somewhat
rare occurrence during this post-Great Recession bull market. The international developed-market MSCI EAFE index beat the S&P 500 for the quarter. This has only happened a third of the time (11 out of 33 quarters) since 2009. This recent run is the exact opposite of what we saw in the mid-2000s when international stocks dominated U.S. stocks. From 2003-2008, the MSCI EAFE beat the S&P 500 in 19 of 24 quarters.

The favorable earnings outlook overseas is one reason why we recommended portfolio reallocations in April. One of those recommendations was to increase our international equity holdings in many client accounts. Another reason for this move is that we’re continuing to see divergence in monetary policy. In the United States, the Federal Reserve (Fed) is tightening – and abroad, the European Central Bank, Bank of Japan and People’s Bank of China all continue ultra-accommodative policies. More factors included the quick positive turnaround in some of the economic data (which we will hit on later) and more attractive valuations.

**Major central bank total assets**

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**SOURCE:** Financial Engines, Federal Reserve, Bank of Japan, European Central Bank

**Good Environment for Floaters**

While other central banks around the globe continue to expand their balance sheets, the Fed leveled theirs off a few years back and it has remained flat since. Minutes from the March FOMC (Federal Open Market Committee) meeting addressed the “normalization” of its $4.5 trillion balance sheet for the first time. Although it seems unlikely that any action (most likely to mean no longer reinvesting interest income rather than outright sales) in that area will come before year-end or early next year. Besides that, the March rate hike kept up the projected pace of three increases for 2017 and seemed to put aside the days of the “one and done” annual rate hike.

We think the overall economic environment remains one in which default rates may remain low from a historical perspective. Given where yields are now, we continue to favor taking credit risk, i.e., investing in corporate bonds rather than government securities. The current landscape seems to be a solid environment for using floating-rate bonds, an area to which we have increased exposure in many client accounts over the past year. Recent data from J.P. Morgan Asset Management looked at fixed-income sector performance and the impact of a +1% rise in interest rate. Of the 12 bond sectors represented, only three would see positive total returns given an upward shift in yields: convertible bonds, high-yield bonds and floating-rate bonds.

Floating-rate bonds cover two bases when it comes to fixed-income investing. First, they are issued by corporations and provide additional yield over government bonds. Also, the income they produce adjusts as rates increase, making them less sensitive to rising rates.

They aren’t without risks, however. The main one is their issuer becoming unable to meet its interest obligations. We should add what we are doing to mitigate those
risks. In that respect, floating-rate bonds are like high-yield bonds. Despite this similarity, there are some key differences. We summarized below the reasons why we currently prefer floating-rate bonds over high-yield bonds and have recommended reallocating many client portfolios to be more heavily invested in them:

- Compared to high-yield bonds, floating-rate securities offer similar yields with lower sensitivity to interest-rate changes.
- Floating-rate bonds tend to have lower correlation to equities and other bond sectors. This can equate to more diversification benefits.
- Floating-rate bonds are higher up in the capital structure (the “food chain” of who gets paid what and when by debt issuers) compared to high-yield bonds.

**Comparing yield and interest-rate sensitivity**

![Comparison of yield and interest-rate sensitivity](chart)

**SOURCE:** Financial Engines, Morningstar Direct
Here comes the annual “Soft Patch”

“The more things change, the more they stay the same.” It’s a fitting description of the U.S. economy in the early part of each year of this latest recovery. Since 2010, real (inflation-adjusted) gross domestic product (GDP) growth in the United States has averaged +1.0% during the first quarter. The average real GDP growth for the remaining three quarters comes in at +2.5%. The advanced estimates from the Bureau of Economic Analysis show another slow first-quarter of economic growth, with the inflation-adjusted annualized growth rate coming in at just +0.7%.4

Economic data released over the past few weeks, in particular manufacturing PMIs and retail sales figures, has backed up the notion of another Q1 slowdown. The Citigroup Economic Surprise Index tracks the level of data points coming in above consensus expectations. This index had sustained an elevated reading through the first few months of 2017. With weaker data coming in through the April and the economic picture becoming much more mixed as of late, the economic surprise index moved back below the neutral level.5

The recent wave of disappointing data is surprising for two reasons. First, we haven’t had much in the way of bad news as of late. Second, we saw a large improvement in sentiment following the election with a gap now between the “hard” and “soft” economic data. The soft data (surveys, general sentiment and confidence polling) shot up following the election and currently remains at or near post-election highs. For example, March saw the Conference Board’s Consumer Confidence Index move to its highest level since 2000 and the percentage increase in the National Federation of Independent Business’s Small Business Optimism Index held near multi-decade highs.

Soft data remains elevated

The recent hard economic data (which includes measures such as inflation numbers, retail sales figures and new residential housing starts) tells a different story. This leads to questioning whether the gap between hard and soft data will be filled and if so, with which type of data.

Citing research from Nomura, the Wall Street Journal recently indicated we may be in for good fortunes ahead as “hard data tend to lag soft by eight months or so.” This means the increased economic activity brought about by improved business and consumer sentiment wouldn’t show itself in hard-data releases until this summer. That puts investors in a “wait and see” mode – still treading water – before we can really tell how the economy is trending in the short term.

Foreign Economies Trending Up

The Organization for Economic Co-Operation (OECD) publishes regular updates on leading economic indicators for the global economy and individual regions. Globally, the OECD's indicators are anticipating “stable growth momentum.” This improvement covers...
several different regions and many economic data points. It's helping to drive the improved earnings growth outlook, which was a key factor in our decision to recommend an increase to international equity holdings in many client accounts.

Europe is experiencing solid growth as it continues its long post-Great Recession economic recovery. Recent OECD data showed that of the major regions tracked, the Euro Area had the highest reading compared to its long-term average. In the manufacturing sector, the Eurozone's purchasing managers' index (PMI) moved up to 56.7 – a 71-month high. Other than Greece, every country saw its manufacturing output expand. Germany and Italy, in particular, are sitting at recent highs.

Failing to push healthcare reform through Congress put a damper on the U.S. equity rally. Any delay in policy changes may be seen as an improvement for foreign economics. For one, the outlook for protectionist trade policies that could negatively impact foreign exporters has dimmed. This change, coupled with a decline in U.S. dollar strength, has led to solid improvements in emerging-market economies that had been in recession territory (such as Brazil, Mexico, India and Russia).

Global manufacturing PMI heat map

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SOURCE: Financial Engines, Markit

The manufacturing sector isn’t the only economic area seeing improvement in Europe. Industrial production is rising and the regional index has moved above that of the United States. Also, retail sales have risen above levels last seen before the 2011-2012 European debt crisis. The Eurozone unemployment rate peaked at 13.1% back in July 2013. It has steadily dropped to its current level of 9.5% (which is still above its pre-recession peak, giving it room for improvement).
Political perspectives.

Below is a sampling of recent conversation on Washington policy. Content is provided by Hedgeye Potomac Research, which provides Washington policy analysis to institutional investors and private equity firms. Hedgeye Potomac Research’s actionable, predictive and non-consensus analysis of federal legislative activities and regulatory policies helps clients determine Washington’s impact on highly regulated industry sectors including health care, defense, finance, technology and telecommunications.

**Last Three Months**

The latest controversy to come out of Washington, D.C., happened on May 9 when President Trump dismissed FBI Director James Comey. The full rationale behind and implications of this move will play out over the coming weeks and months - although what we do know is that it’s just the latest jolt in President Trump’s jam-packed first months in the Oval Office.

After initially failing to reach a floor vote, Republicans revised, reintroduced and passed the American Health Care Act (ACHA). It remains to be seen what the Senate will do, however - there’s already discussion that the bill the Senate ultimately passes will be significantly different from the House’s version.

Forget health care, though – Trump is notching up his energy wins and he’s doing it without Congress. Trump received the State Department recommendation to issue the Presidential Permit for the Keystone Pipeline and signed the permit with the CEO of TransCanada in the Oval Office. Up next is the rollback of the Obama carbon regulations. On April 24, President Trump signed an executive order directing the Environmental Protection Agency (EPA) to take action to reverse the Clean Power Plan, which signals the end of the Obama-initiated policy to decarbonize the U.S. economy. The EPA had only started with the power sector but had plans to move on with carbon regulations for other sectors, including the auto industry, airlines and others. Since President Obama established these policies via executive orders and agency rulemaking, they’re reversed by President Trump through the same executive branch actions.

Supreme Court Justice Neil Gorsuch received his confirmation vote before the Easter Recess even as Senate Minority Leader Chuck Schumer whipped over 40 votes necessary to filibuster the Gorsuch nomination. That brought the game of chicken with Majority Leader Mitch McConnell over the “nuclear option” to a head – changing the Senate rules so that only a simple majority was required to confirm him instead of 60 “yes” votes. McConnell, who is a disciple of Senate rules, has said that he didn’t want to use the nuclear option, but Democrats left him no choice – and the slippery slope both parties have been on for the past decade leaves only legislation as the last support for the filibuster.

**Next Three Months**

President Trump has started rewriting his tax plan. The latest iteration has Trump proposing to cut taxes to help rural and industrialized parts of the country, where a stretch of his major supporters live. The president has not signed off on Ways and Means Chairman Kevin Brady’s proposal, which would include the controversial border-adjustment tax. There is also a third plan circulating on the Hill that would cut the corporate tax rate while getting rid of a lot of the payroll tax. With Trump starting over and many ideas/plans under consideration on both ends of Pennsylvania Avenue, the White House is coming around to the fact that the Treasury Secretary’s goal of having it done by the August Congressional recess is looking even bleaker – especially considering that the review process allows both Republicans and Democrats to weigh in on the final bill.
Republicans are trying a new way to get the ACA repealed and replaced. They have created the Patient and State Stability Fund that would allow states to use their share of the $100 billion fund to help out insurers and subsidize the high cost of the chronically ill. Republicans have been working on this fund since before the election and have slowly been adding money to address major sticking points such as maternity care and substance-use-disorder treatment. Conservatives and moderates are still sparring over other parts of the AHCA, but the Stability Fund is one area on which both sides agree.

Republicans came into the new Congress with an aggressive agenda that is now causing a logjam. Wall Street reform was oft-mentioned by Trump during the campaign. With Congress failing to pass health care and trying to move forward with tax reform and infrastructure, Dodd-Frank keeps getting pushed back. Now, reform of the seven-year-old law likely won't see the light of day until the summer. The House remains confident they will have no issue getting it done. But the Senate might be another story.

Secretary of State Rex Tillerson slammed the Iran deal even while confirming that Iran has remained compliant and the Administration is going to review whether the lifting of sanctions was in the country’s national security interests. The review will be a joint effort with Congress and could mean the end of the “worst deal ever negotiated.” This could spell bad news for some American companies that have jumped at the chance to invest in Iran.
Putting it all together.

The U.S. equity bull market that began in March 2009 celebrated its eighth birthday this year. U.S. indices – both large- and small-cap – put up fresh all-time highs in March. Given where we’ve come from and where we are now, people often ask us, “When is the next correction coming?” Since the beginning of March, the S&P 500 has been treading water as investors digest a delay in pro-growth policy changes and a flare-up in geopolitical tensions involving Syria and North Korea. Markets are waving other red flags worth monitoring as well. These include the “three-steps-and-a-stumble rule” about FOMC rate hikes at three consecutive meetings, the increase in global short rates and U.S. equity valuations above their historical averages. While we are paying close attention to these conditions and watching the recent string of weaker economic data, we believe that plenty of positive data points counter-balance the negatives.

The global economy is still expanding and the markets are still in a longer-term bullish uptrend until proven otherwise. Market corrections are a normal (and outside of the past few years, relatively frequent) occurrence. Any pullback doesn’t mean a crash may be around the corner. The weight of economic evidence indicates that the risk of recession remains low and nowhere near the projections for at least the next 12-18 months. Likewise, full-on bear markets are rare outside of recessions. Bull markets don’t end because they’ve gone on for a long time.

Finally, asset allocation, or how the money in your portfolio is invested among different asset classes, is a critical part of any investing strategy. Monitoring individual asset-class performance is key. Far more important is balancing the degree to which you’re exposed to each class in any given environment – and having the ability to make allocation changes when circumstances call for it.
References and disclaimers.
