CAPITAL STRATEGIES
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Financial Markets Commentary 2nd Quarter 2017

Summary

U.S. stocks rose for the seventh consecutive quarter. The S&P 500 stock index added another 3.09%, bringing its year-to-date gain up to 9.34%. Mid and small cap stocks lagged large caps again this past quarter, rising just 1.97% and 1.71% respectively.[1] Investors have preferred the relative stability of larger companies this year over the growth potential of smaller firms as prospects for infrastructure spending and tax reform have lessened considerably. Technology has been the strongest industry so far this year, while energy has been the weakest.

Foreign stocks performed very well in the second quarter as growth accelerated (especially in Europe) at the same time that the dollar fell against most major currencies. This enabled dollar-based investors to gain another 7%+ in European stocks and another 8%+ in Asia (ex-Japan) stocks.[2] The only part of the world that disappointed over the last three months was Latin America (1.74%), where Brazil was again enveloped in a corruption scandal. Emerging markets as a whole still gained 6.12%, led by Chinese internet stocks.

Bonds almost had a fantastic quarter, but remarks by the head of the European Central Bank on June 27 stopped the rally in its tracks. Yields on the 10 year U.S. Treasury Note fell from 2.39% to 2.12% in the first 86 days of the quarter, producing a price gain of over three percent. After Mario Draghi's remarks warning the bond market that the ECB was going to taper its bond buying, yields surged to 2.30%. This cut the return for the full quarter to 1.45%[3]. Global, municipal, and high yield corporate debt gained modestly more than that, but short term bonds and inflation-protected bonds did quite a bit worse. Investors do not seem to be afraid of inflation right now, but they are *really* dismissive about credit risk.

We have written before about how the market has been drifting up each quarter not so much on signs of economic strength but on the continued decrease in fear. The

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[1] Source: S&P Dow Jones Dashboard: U.S. Mid and small cap stocks as measured by the S&P 600 and S&P 400, respectively.
[2] MSCI Europe Index net return in US dollars; MSCI Asia ex-Japan net return in US dollars. MSCI is also the source for Latin American and emerging market returns in the next two sentences.
[3] Barclays US Aggregate Bond Index in US dollars, per Morningstar

less volatility the market expects from stocks (or any other asset class), the more of it's investors are willing to hold. Behavioral finance calls this phenomenon Recency Bias. As volatility continued to decline, investors were willing to up their U.S. stock holdings modestly last quarter. The real change was in Europe and emerging markets where the volatility decline was much more dramatic, leading to large inflows into those areas.

Activity

When the big picture (as far as the stocks and bonds markets are concerned) does not change, we do not do very much. Our activities tend to be limited to monitoring performance and replacing underachieving funds with alternatives that are more in step with current trends. This past quarter that usually involved replacing funds with a defensive bias (such as Low Volatility ETFs) with alternatives that are better able to take advantage of a rising market. At the margin we increased international stock exposure by one to three percent, nothing major. Europe looks a lot better than it did three months ago economically and politically, but Latin America has been moving in the other direction.

Outlook

As long as the economy grows at a 1% to 2.5% annual rate, the stock market is in its comfort zone. In that type of economic environment stock prices tend to move higher no matter how expensive they are to start with, because it's assumed corporate profits will also grow. If growth slows to less than 1%, the market worries about profits such that only companies thought to be recession resistant –consumer staples, utilities, and select internet companies – will hold up. On the other hand, if the economy grows faster than 2.5% the market tends to worry that the Federal Reserve will reign in liquidity to prevent inflation from breaking out. Financial services, energy, transportation, and materials stocks can still do fairly well with GDP above 2.5%, but most other industries do not. We are carefully watching bond yields and central bank policy statements for signs that we might be moving out of the market's comfort zone. We know this will happen at some point, but it just doesn't seem like that time is close at hand.

Commentary – Piggies!

Market rallies tend to last as long as credit remains cheap and easily available. This allows companies to borrow at rates they can easily repay. Speculators tend to make, or increase, bullish bets because their expected rates of return are far above the cost of borrowing. By expanding its balance sheet to unprecedented levels, the US Federal Reserve has done an excellent job of providing the economy with enough cheap credit to fuel an economic expansion that has lasted over eight years. By

keeping the economy in a modest 1.0% to 2.5% annualized growth channel, the Fed has helped the U.S. stock market post gains not justified by corporate earnings. As a result the market has re-entered valuation territory last seen in the late 1990s. Apparently, our collective confidence that the Fed can continue to keep us in this "Goldilocks" environment remains intact. We now run the risk that investors are over-confident in the Fed at the same time the Fed may be looking to reduce their impact on markets.

As most of us know, the U.S. Federal Reserve took radical steps in 2009 to bring the country out of a deep recession. The most significant step they took was to expand the national balance sheet by buying much of the debt they issued. This had the effect of lowering interest rates, since they reduced bond supply while demand was unaffected. Many expected that this would produce inflation, so gold soared between 2009 and 2011. Other world central banks (save Japan) chose to fight recession by cutting spending. By 2012, the results were clear – the American economy was recovering without any significant upturn in inflation, while austerity brought the Europeans to the brink of economic ruin. As the American experiment was acknowledged to be a success, the European Central Bank began to follow our lead, and gold plunged. To this day our economy has continued on its low growth, low inflation path, while other developed economies appear to be in the earlier stages of their economic turnarounds.

Unfortunately, one of the side effects of the Fed's success is that investors now have a high degree of confidence that they need not fear inflation or recession. Greed is replacing fear. Speculative activity is again at high levels. And once again the financial services industry is creating complicated and risky speculative vehicles such as inverse volatility ETFs[4]. This doesn't necessarily mean the market is headed for a correction but it suggests, if history is any indication, that we are probably in the later innings of this particular game.

The increase in speculative activity has not gone unnoticed. Central bankers here and in Europe have recently cited the desire to "normalize" interest rates. They do not explicitly say that they are trying to curb speculation, but in the absence of inflation that is the most logical explanation. Reigning in overly generous liquidity conditions may well be prudent, but it is not financial markets friendly[5]. It involves reducing credit available to banks (and by extension investors), and that means lower bond and stock prices.

The Federal Reserve and eventually other central banks have the task of gradually normalizing their impact on financial markets and economic activity. This means that at some future point central banks will once again allow markets to determine where

[4] In essence, a derivative vehicle that allows one to bet against volatility. It (XIV) is up over 95% this year as this is written.

[5] At least in the short term. If it helps us avoid a speculative crash, it will have been very friendly in the long term.

interest rates ought to be. They want the path to normalization to be as smooth as possible so as not to create a market panic (remember, both bonds and stock prices are elevated due to their actions). This is going to be a delicate task, so expect the management of market expectations to involve them seeming hawkish one week and dovish the next. If you are beginning to feel like investors are being "herded" more or less like livestock, you are catching on. In other words, "farm pigs" have eaten considerably better over the last few years than the wild boars that have fought the Fed. However when credit conditions finally begin to tighten, the farm is going to be a lot less pleasant place to be.

One of the most important things to understand about modern economic systems is that stability tends to lead to instability, and vice versa[6]. Too much stability for too long and we get complacent. This breeds overconfidence that leads to speculation and eventually financial excesses. All of this builds until we finally reach a breaking point (known to economists as a Minsky moment). The financial conditions that allowed stocks and bonds to perform so well are <u>ever-so-gradually</u> being reversed by central bankers, who know the markets have become dependent on their generosity. They would strongly prefer not to trigger a crash, but market greed might make that impossible. The economy is currently in no danger of breaking out of its comfort zone, but a stock market that goes up every week might create destabilizing conditions nonetheless. We are maintaining our stock weightings for now, yet we are becoming somewhat uneasy. After all, there is an old market saying, "Pigs get fat; hogs get slaughtered".

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[6] This insight, the Financial Instability Hypothesis, is credited to Hyman Minsky who published a paper on it in 1992.