This Month in the Markets

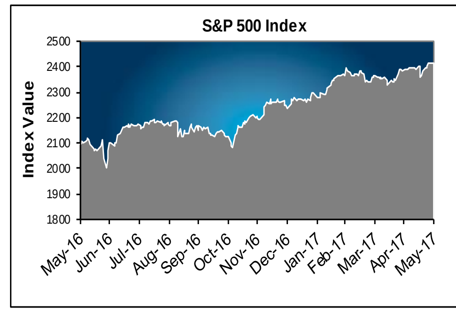
May 2017

ANCHOR
Investment Management

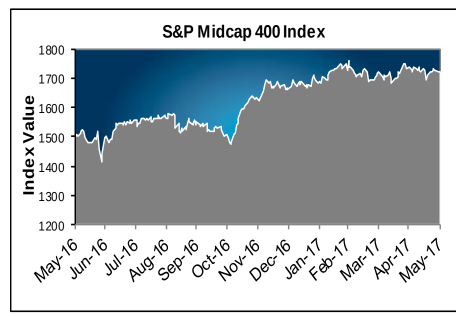
EQUITY COMMENTARY

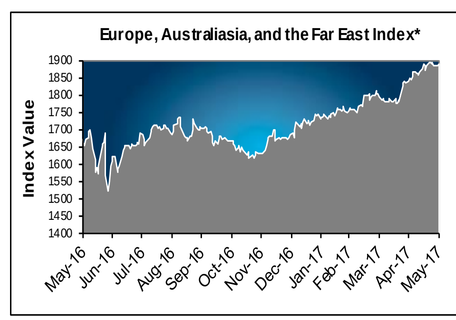
Looking Abroad

May was another strong month for global equities. Corporate earnings continued to surprise to the upside which offset continued turmoil in Washington. Utilities, technology and consumer staples companies were the big winners in the month returning 5.6%, 4.6% and 4.3% respectively. Energy, financials and materials stocks were all slightly down, dropping 1.9%, 0.8% and 0.1% respectively. Overall the Morgan Stanley Composite Index (MSCI) closed the month up 1.8%. U.S. stocks underperformed international stocks with the Standard & Poor's 500 Index (S&P 500) rising 1.2% compared to the 3.1% gain of the MSCI Europe Asia Far East Index (EAFE). Similar to April, this difference was attributable to the weakness in the U.S. dollar which fell 2.1% during the month. The MSCI is up 9.2% year to date, with the S&P 500 up 7.7% and EAFE up 12.2% in U.S. dollar terms. The 4.5% outperformance of international markets, measured in dollars is entirely due to the recent decline in the dollar which has dropped 5.2% so far this year.

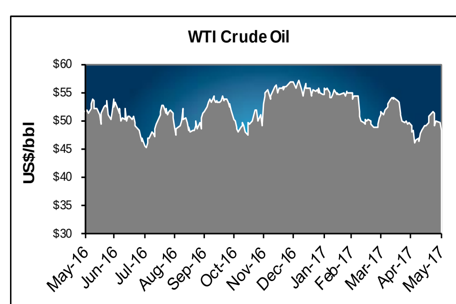


Since the markets started their recovery in 2009 we have been overweight the U.S. market versus international markets. Our reasoning was based on a few key principles. First we became more bullish on the U.S. dollar. Owning foreign stocks whose earnings were outside of dollars would be worth less in dollar terms as the dollar strengthened. Secondly on a macro level we had strong conviction that the U.S. economy would grow at a premium to Europe and Japan. All else equal, higher economic growth in the United States would translate into higher earnings growth for companies with a higher share of their revenues tied with the U.S. economy. On a more micro level we also found that in general U.S. companies offered higher returns on invested capital and are more innovative. On the other side of that, U.S. stocks were not trading at a premium to international stocks despite these tailwinds so it made sense to overweight the region where we were finding better opportunities, especially where we were not being forced to pay up for them. This call has served us well as in U.S. dollar terms over the last 8 years since the S&P 500 has outperformed the EAFE by over 130% on a total return basis, returning 207% versus the 77% return on international stocks. This discrepancy has been even larger compared to emerging market stocks which have returned just 44%.





Over the course of the last six months, however, we have been slowly reducing our overweight in the U.S. markets. While we still find U.S. companies to be more profitable and innovative overall, their significant outperformance versus international stocks over the past 8 years has led to U.S. stocks to trade at a premium to international stocks. Based on 2017 earnings, the S&P 500 now trades at 18.6 times earnings compared to the EAFE at 15.5 times earnings and emerging markets at 12.9 times earnings. So far in 2017 we have added five international stocks to the portfolio. In continental Europe we have added a media company, an oil services company and a maker of jet engines. We have also added two positions in emerging markets.



As discussed in past letters we do not believe in market timing. That is not to say that we do not look at valuation nor do we buy blindly. We focus on valuing individual businesses throughout the globe. Our current repositioning of the portfolio highlights the fact that we are beginning to find more value in international markets after the significant outperformance of the U.S. market over the past 8 years. Overall, our portfolio trades at 13.2 times 2017 earnings estimates with a return on invested capital of 9.8% compared to the MSCI at 17.3 and 5.7% respectively.

*MSCI EAFE Index

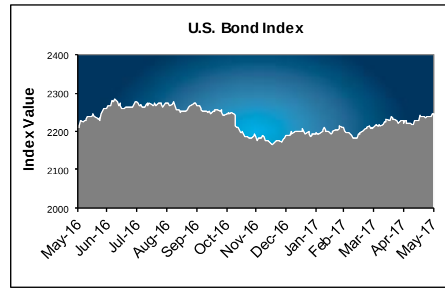
FIXED INCOME COMMENTARY

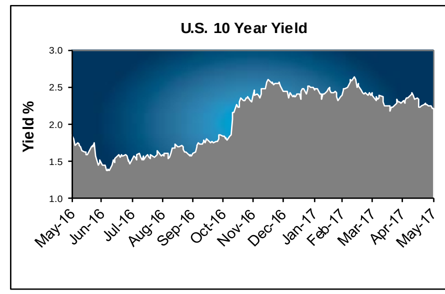
Growth Rebound

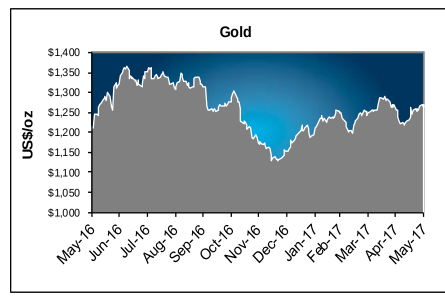
Asset price volatility has remained remarkably low. The Merrill Lynch Option Volatility Estimate MOVE Index, which measures bond market volatility, has hit a record low level in May. The same is true for the Chicago Board Options Exchange SPX Volatility Index (VIX), which reflects future stock price fluctuations, and is only a smidgen away from an all-time low. Tame asset price volatility has benefited credit products, which have outperformed government bonds by a wide margin so far this year. The best fixed income asset class has been preferred securities with a return of 8.4% year-to-date. On the foreign exchange side, the U.S. dollar has remained under pressure and has lost ground versus its peers. The euro performed especially well with a 3.2% monthly return after the "mainstream" candidate in the French election won convincingly and consequently dealt a blow to the populist movement in Europe.

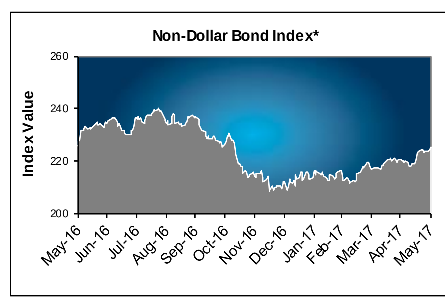
After the end of a successful earnings season the focus has shifted to macroeconomic developments. It is interesting to note that the U.S. dollar has erased the gains since Donald Trump's electoral victory, suggesting that all the hope of fiscal stimulus, deregulation and tax reform have been priced out of the market. The president's failure to find consensus with Congress on major reforms has not shown up in the forward looking data yet. However, after a measly first quarter GDP report, the next three months are forecast to post a strong rebound in economic activity. An estimate by the Federal Reserve Bank of Atlanta – which takes into account all the recent data releases – sees second quarter GDP to rise to 3.8% (quarterly annualized). Indeed, the U.S. economy is expected to grow at an above-trend pace over the remainder of the year since durable goods orders are rising, business capital expenditure intentions have surged, building permits are trending higher and consumer confidence is strong. These forecasts will be reflected in higher short-term interest rates soon. The Federal Reserve (Fed) is expected to lift the target fed funds rate by another 25 basis points (bps) at its upcoming meeting in June. Although this is not fully priced into the market yet, recent commentaries by Fed governors indicate that investors should expect a further increase later in the year as well, most likely at the September or December meeting. After a total of three 25 bps interest rate hikes, the Fed can be expected to be on hold for a while and start the process of unwinding its massive USD 4.5 trillion balance sheet. So far, the central bank has reinvested interest payments and maturities of its government and mortgage bond investments but first discussions have started about how to reduce the holdings over time. Initial indications are for the Fed to pursue a very gradual approach and the balance sheet can be expected to be half of its current size in about five years.

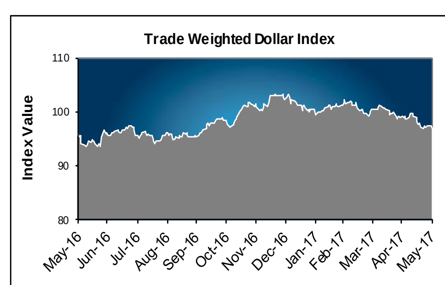
In May, the U.S. dollar was only able to outperform the British pound and the Australian dollar while underperforming all other G10 currencies. The euro has now become the best major currency with a year-to-date performance of 6.7%. This has occurred thanks to a loss of momentum in populism in Europe and slightly better growth expectations. However, the recent rally is in disconnect with the outlook for real interest rates, which are one of the most significant drivers of a currency pair in the short run. It is likely that this difference will keep rising in favor of the dollar since the Fed will continue with its monetary tightening agenda while the European Central Bank (ECB) is at least two years away from lifting interest rates. The unemployment rate in the Eurozone remains elevated, inflation has remained below the 2% target and fiscal policy is relatively tight – all factors which argue for continued monetary accommodation.











*Merrill Lynch Global Broad Market, Ex US Dollar Index