

This Month in the Markets

August 2017



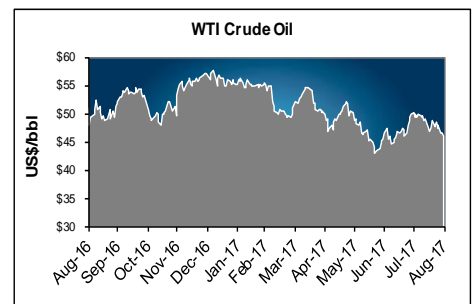
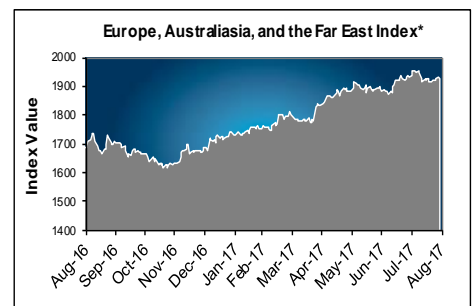
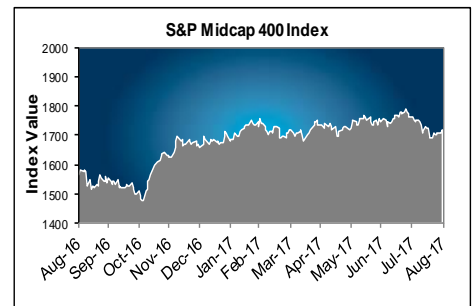
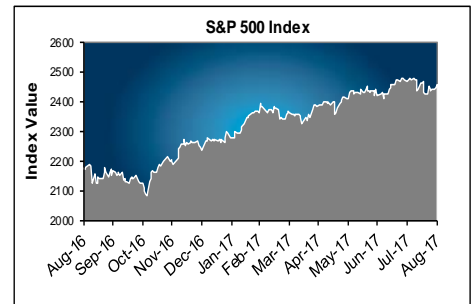
EQUITY COMMENTARY

August was a flat month for global equities. Materials, technology and utility companies were the big winners in the month returning 2.1%, 2.5% and 3.3% respectively. The materials rally was sparked with shortage fears in aluminum and strong nickel demand – both commodities surged over 11% for the month. Detractors for the month included financials, telecommunications and energy which fell 1.8%, 1.8% and 3.6% respectively. Despite the shutdowns and damage caused by hurricane Harvey to energy infrastructure, crude oil, a major input to refining, fell 5.0% for the month. Gasoline, however, surged over 14% on shortage concerns due to refining stoppages. Overall, the Morgan Stanley Composite Index (MSCI) closed flat. U.S. stocks and international stocks registered 0% returns for the month. The MSCI is up 11.9% year to date, with the S&P 500 up 10.4% and EAFE up 14.7% in U.S. dollar terms. The 4.3% outperformance of international markets, measured in dollars is mainly due to the decline in the dollar which has dropped ~9% so far this year.

The initial slide in equities for the month could mainly be attributed to geopolitical tensions regarding North Korea. The key risk in this conflict is obviously South Korea which would likely witness a retaliatory strike from North Korea if there was preemptive action taken by the U.S. In terms of the global economy, South Korea may be surprisingly large in influence. According to Bloomberg Intelligence (“BI”), “At \$1.4 trillion, South Korea’s GDP is equal to 1.9% of the global total...The picture on trade is equally stark, with South Korea accounting for 3% of the global total”.

It’s important, at this stage, to pause to reflect on what has typically transpired. The market is very fickle in regards to geopolitical events. One may want to simply review the latest effect of BREXIT, the supposed “guaranteed sell-off” that a Trump victory would bring or even the demise of the financial system during the Great Recession. It’s also worth noting that prior periods of military conflict also have mixed reactions. Ben Carlson in a post “How Markets Respond to Geopolitical Crises” from “A Wealth of Common Sense” details some interesting historic market reactions in times of geopolitical stress. To quote one more relevant example: “The Cuban Missile Crisis had the world on the brink of nuclear war in October of 1962. The confrontation lasted 13 days from Oct. 16, 1962, to Oct. 28. In that two-week period the Dow remained surprisingly calm, losing just 1.2 percent. For the remainder of that year the Dow would gain more than 10 percent.”

Given our view that crude prices will rebound from the lower end of the current range and our focus on value has lead us to add a Master Limited Partnership (“MLP”) to the portfolio. Historically MLPs have traded primarily based on their yields. This has broken down over the past 3 years since the energy crisis. MLPs are dependent primarily on volumes and are not nearly as exposed to price as the E&Ps or the integrated companies. In our analysis of the group we have come across Enterprise Product Partners (EPD). The historic spread of EPD’s dividend to the yield of the US 10 year treasury is currently at ~4.4% and is in the 94th percentile, or put another way, only 6% of the time the spread is higher than today. We believe this large valuation discount should close overtime and find comfort in collecting a 6.4% dividend as we wait.



*MSCI EAFE Index

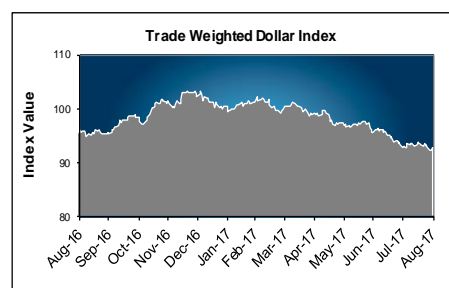
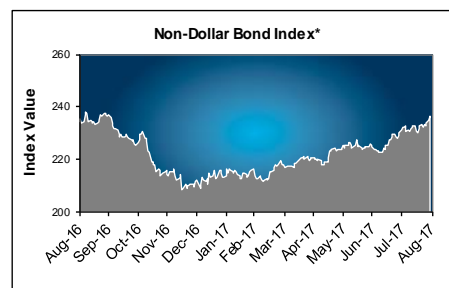
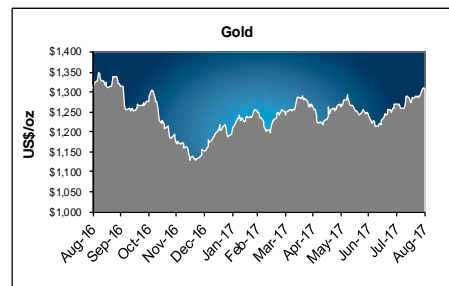
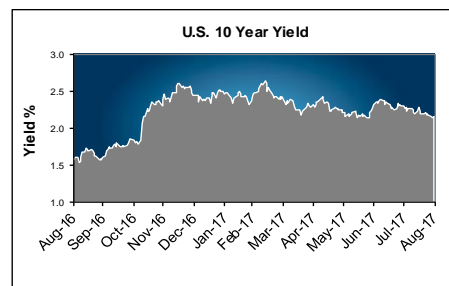
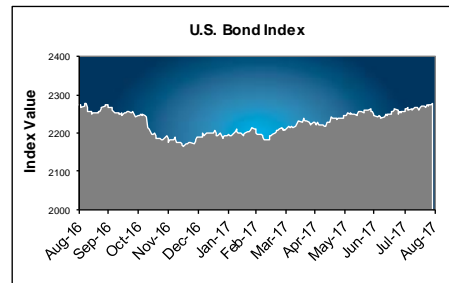
FIXED INCOME COMMENTARY

Debt Ceiling

The relative calm during the year reached a small setback in August with several events creating higher asset price volatility and a flight to safety. Although the losses in risk assets were modest in comparison to similar episodes in previous years, they were above average for this year's benign trading environment. The triggers were of geopolitical and domestic nature. North Korea stepped up its missiles tests and threatened the U.S. to detonate one close to U.S. territory Guam. Once those tensions eased, President Donald Trump sparked a big controversy after his comments about a racist rally in Virginia. Several business leaders protested his stance and distanced themselves by withdrawing from Trump's councils which eventually got dissolved due to a lack of remaining members. Finally, rising expectations that the U.S. Congress will not be able to pass a budget by the end of September and consequently not raise the debt ceiling in time in order to avoid a default of U.S. debt obligations (for the first time in history). The debt ceiling debate has come up every two years and while it has always been resolved it has created increased volatility in asset prices and a flight to safety.

The global economy has been on a strong footing this year and is expected to grow over 3% while global inflation is forecast to rise over 2%. There are several positive factors which have assisted economic growth: fiscal policies can be considered as supportive in most developed markets, financial conditions have eased remarkably in the U.S. (not so much in Europe) and rising consumer and business confidence data have pointed to improving "animal spirits". Although the U.S. economy has performed somewhat below expectations, several indicators point to an ongoing upswing. Despite higher short-term interest rates, financial conditions have actually eased since longer-term rates have come down and the U.S. dollar has weekend since the start of the year. Financial conditions have proven to be a good leading indicator for economic growth and they are indicating a strong rebound in the second half. Forward looking business surveys point to a further improvement in capital expenditures and nearly record high consumer confidence data paired with strong household balance sheets have given the consumer a significant boost. The U.S. economy is expected to receive further support once President Trump can get his tax and infrastructure reforms passed in Congress. Although monetary policy is not as accommodative as it once was it can still be considered supportive for economic growth. The target rate is at a mere 1.00% to 1.25% and longer-term interest rates have dropped ~32 basis points this year. Additionally, credit spreads have narrowed and further cheapened the funding costs for most corporations. The U.S. central bank (Fed) does not seem to be in any rush to increase interest rates by much this year but will rather focus on unwinding its massive balance sheet. It has become very likely that the Fed will make an announcement to start selling U.S. Treasury securities and mortgage-backed bonds at its meeting in September. Since this event constitutes monetary tightening by itself, further hikes in the target rate will be pushed further into the future. In fact, data from federal funds futures do not expect any further hikes until the second half of 2018.

The U.S. dollar took another hit in August with only the British pound and the New Zealand dollar faring even worse. Markets have priced out any further interest rate increases for an entire year which has impacted the greenback negatively. In addition, setbacks in getting Trump's proposed reforms written into law have weighed on interest rate and inflation expectations and propped up other currencies. Especially the European currencies have had a great run this year since the economy has gained traction and the European Central Bank may consider reducing monetary stimulus soon. However, the Brexit negotiations may induce some volatility again.



*Merrill Lynch Global Broad Market, Ex US Dollar Index

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