This Month in the Markets

October 2017

EQUITY COMMENTARY

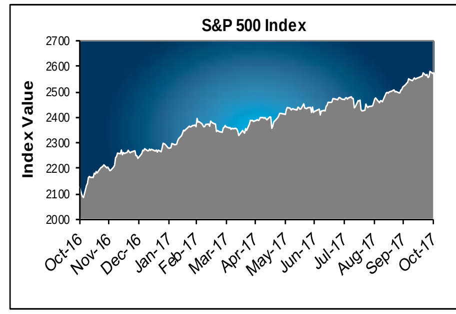
Shift in Tides

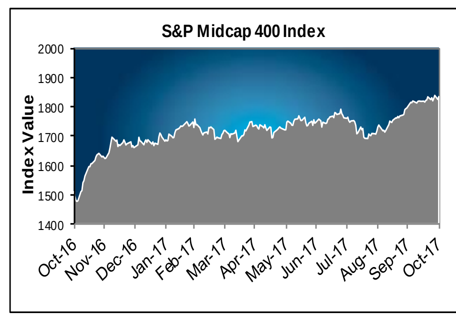
The equity market rally continued in October with the Morgan Stanley World Index climbing 1.8%. Materials, technology and utilities were the big winners in the month returning 3.1%, 7.1% and 2.7% respectively. Technology benefited from strong earnings reports from major players and commodities gained 2.1% which helped spur gains in the materials sector. Detractors for the month included healthcare and telecommunications which fell 1.3% and 3.4% respectively. U.S. stocks and international stocks registered 4.2% and 3.7% returns for the month. The MSCI is now up 16.3% year to date, with the S&P 500 up 15% and EAFE up 18.9% in U.S. dollar terms. The 3.9% outperformance of international markets, measured in dollars is mainly due to the decline in the dollar which has dropped about 7% so far this year.

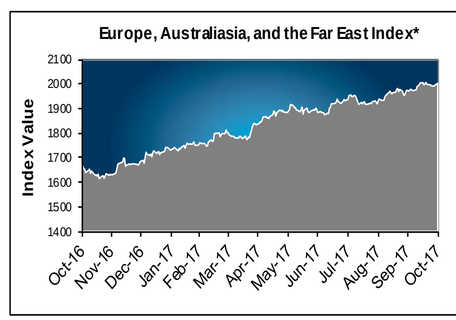
Despite relatively high valuations, investors do not appear to be spooked. Earnings season has begun for the third quarter and companies in the S&P 500 are currently registering beats at a very high rate as well earnings growth of around 7%. This is partially due to the fact that we are witnessing a global synchronized recovery that is driving some very positive macroeconomic factors such as a surging Global Manufacturing Purchasing Manager's index, very low unemployment rates and ramping consumer sentiment. Japan, the best performing equity index with a gain of 5.4% in October, was buoyed by incumbent Japanese Prime Minister Shinzo Abe's snap election majority victory. Prime Minister Abe has promised to help improve Japan's human capital and increase labor participation with a series of investments.

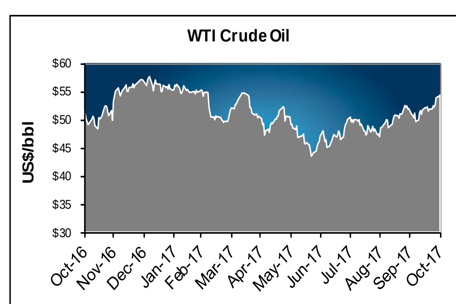
So far this year the MSCI World Growth Index has returned 21.1% while the MSCI World Value Index has risen by only about half this amount at 11.0%. Being naturally contrarian in nature this has tilted our search more into areas that offer deep discounts to the market given our belief of an eventual resurgence in value based strategies and opportunities. It is rare to see these indexes deviate so much historically. In fact, the last time in the last 10 years that one strategy outperformed the other by more than 10% was in 2016. In this case value handily thumped growth – value returning 15.1% vs. the 4.4% return from growth. As we are seeing in 2017 this is quickly reversing.

Given our view that the lag in value will revert to the mean and will rebound from its underperformance we have added a company which reflects what we belief to be a discounted valuation. Babcock International Group PLC ("BAB") is an engineering services company involved in managing complex assets used in the defense industry and civil customers. Its work entails managing a wide series of essential equipment for government bodies and private customers in the UK and internationally. We believe that the market is incorrectly lumping BAB in with the troubles seen across the broader UK outsourcing companies. We do not believe the market is correctly noting that BAB operates in markets that include high barriers to entry and a great deal of technical expertise. At only about nine times 2018 earnings estimates with a dividend yield near ten year highs, we find the material discount to the market's current 18x earnings multiple and the companies historic average multiple very compelling. Furthermore we note that BAB has as solid order book, organic revenue growth of about 5% and a rebid win rate of over 90%.









*MSCI EAFE Index

FIXED INCOME COMMENTARY

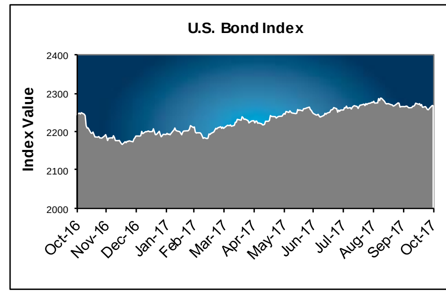
Firing on all Cylinders

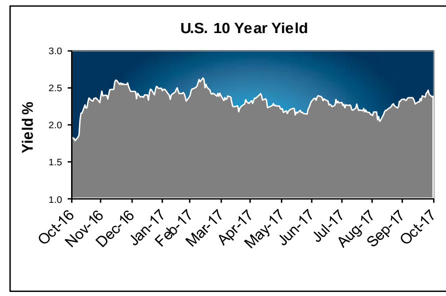
The performance of fixed income securities was mostly flat in October while the U.S. dollar appreciated versus all G10 currencies. The tragic shooting in Las Vegas, devastating hurricanes in the Caribbean and Florida, North Korea and secession attempts by Catalonia from Spain did not nudge the rate and foreign exchange markets by much. The underlying global growth is firing on all cylinders according to the Organisation for Economic Co-operation and Development (OECD). The think tank estimates that all 46 of the economies that it tracks will see positive growth this year, the first time this has happened since 2002.

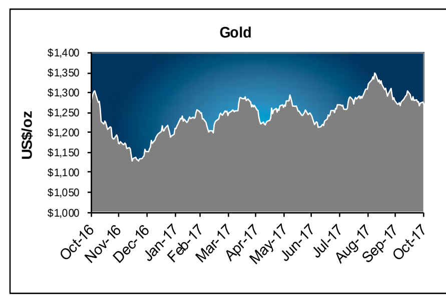
In addition to the OECD, the International Monetary Fund (IMF) lifted its outlook for the global economy from 3.5% to 3.6% for this year. While growth upgrades have been rare since the last recession, the IMF also warned about the lingering risks and that there is no time for complacency. One of the central issues is that not everybody has participated in the upswing. Inflation often remains below target with weak wage growth and the outlook beyond this year is rather subdued. If one wanted to take an ultra-long view, estimates for population and workforce growth are a concern and have already lowered the potential for developed economies. The United Nations estimates that global working-age population growth will be negative from the mid-2020s on. Initially, the negative trend will stem from developed economies but by 2030 even the emerging markets are expected to post declining workforce growth. For China, for example, this rather dire outlook means that 400 Million people will leave the workforce by the end of the century. With slowing or declining population trends, global demand from the consumer will be negatively impacted and the contribution to growth will have to come from somewhere else. There is always the chance that productivity enhancements will take over and consequently support global growth.

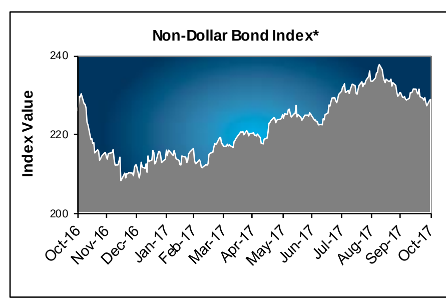
Shifting back to a shorter time horizon, economic data has remained upbeat. In the U.S., the hurricanes have led to a little dent in the data but by the end of October there were already signs that the downturn was short-lived. Indeed, after a brief rise the filings for unemployment benefits in the U.S. dropped to the lowest level since 1973 as hurricane-affected workers continued to return to their jobs. The bounce can be expected in the monthly non-farm payrolls number in November and December as well. The labor market has been supported by very favorable financial conditions in the U.S. They usually lead growth by around six to nine month, implying the growth rate could potentially exceed 3% next year (the last time this happened was in 2005) and could take the unemployment rate below the 2008 low of 3.8%. Despite the robust employment market, wage and consumer price inflation have been fairly modest. The good news is that there have been some moderate improvements lately and that contained inflation readings have kept monetary policy supportive globally. The recent healing of the U.S. economy has led to a more hawkish stance of the central bank and expectations for another 25 basis point interest rate hike in December rose to over 80%. Higher short-term rates led to a further flattening of the yield curve since long-dated bond yields did not increase as much as shorter-dated ones. Such development can be seen as an indication that market participants do not trust the economic upswing and foresee that higher interest rates will keep inflation modest. The flattening yield curve is also a warning shot to the U.S. central bank (Fed). Since the Fed does not want to choke off the moderate growth environment they will tread carefully with future interest rate hikes.

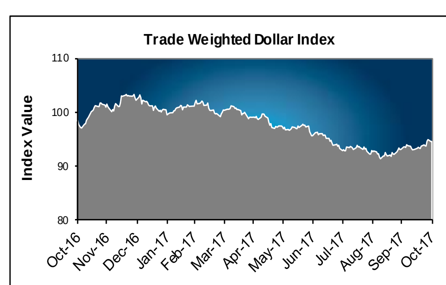
After a mediocre year for the U.S. dollar the month of October showed some stabilization in the greenback. The potential for tax reforms in the U.S. and the possibility that President Trump may choose a more hawkish chairman for the Board of Governors of the Federal Reserve brought back some life into the U.S. dollar.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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