This Month in the Markets

November 2017

EQUITY COMMENTARY

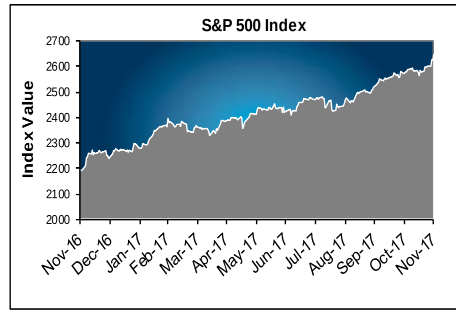
Moving Along…Nothing to see here

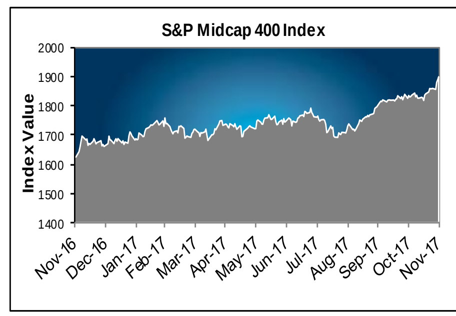
The equity market's rally continued in November after a short stall. Developed markets extended gains by 1.6% with year-to-date returns approaching 18%. The U.S. led the monthly gains with a return of 3.1% while the UK FTSE 100 stumbled due to Brexit concerns, ending down 1.8%. Emerging markets slipped by 0.8% in November but year-to-date returns are still an impressive 27.7%. Commodities posted a slight decline of 0.5% and ended the month with a year-to-date contraction of 1.2%.

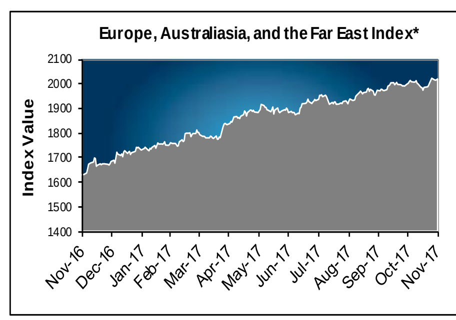
Staples were a leading sector, jumping 3.5%, as persistent negative sentiment revolving around "the death of brands" and being "Amazoned" abated and share prices have likely overly discounted these fears. Telecommunications companies also bounced after being oversold. All sectors participated in the rally during the month with Materials lagging, rising only 0.7%, reflecting the general weakness in commodities. The MSCI is now up 18.6% year-to-date, with the S&P 500 up 18.3% and EAFE up 20% in U.S. dollar terms.

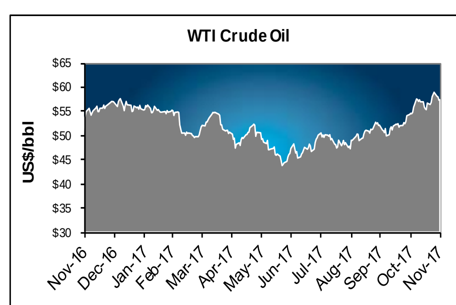
The U.S. macro picture remains promising. Manufacturing is expanding and core inflation is expected to gradually rise from the current 1.8% rate. A great deal of ink was spilled on the outcome of U.S. tax reform and it appears that a bill to lower U.S. corporate taxes may pass before Christmas. This would be a gift for the U.S. economy and corporations, helping profitability and employment. This piece of the puzzle is important as the market has almost assuredly factored in a great deal of the benefit of lower taxes already. Failure to make headway on this initiative would likely pressure equity markets (especially domestic companies). The Eurozone continues to defy skeptics as its economic momentum accelerated in the month – third quarter GDP growth was revised up to 3.5% (faster than the US growth of 3.3%). Growth and recovery is being felt throughout the Eurozone with improving conditions in France and Italy as well as sustained growth in Germany. European and Asian equities still appear, in aggregate, cheaper based on various valuation metrics and our research continues to highlight some opportunities in these geographic locations.

Bitcoin's surge of nearly 10 times this year and its further parabolic rise in November has vaulted it to front page news and caused a bit of a stir. Debate abounds as to its merits as an asset class or currency but we would caution readers on venturing into this realm. Putting aside the merits of blockchain, the distributed ledger that records bitcoin, we would suggest that cryptocurrencies are exhibiting many of the trademarks of a speculative bubble. Owners of bitcoin, for example, do not own the technology behind bitcoin. Nor does bitcoin offer any underlying claim of return such as earnings, cash flow or dividends which are useful if someone is trying to value any investment. Arguments that bitcoin should be considered a currency are questionable since it is very volatile. Governments may have difficulty supporting a currency that can be used for money laundering and to avoid taxes due to it's more anonymous and decentralized nature. These facts, of course, do not in any way suggest that bitcoin's gains cannot go further – bubbles often do defy all rational estimations. The Fear of Missing Out ("FOMO") is a compelling siren song that many are incapable of resisting. We fear many will "make" and lose fortunes because of it. Just ask the Dutch about their historic experience with tulips in the 1600s.









*MSCI EAFE Index

FIXED INCOME COMMENTARY

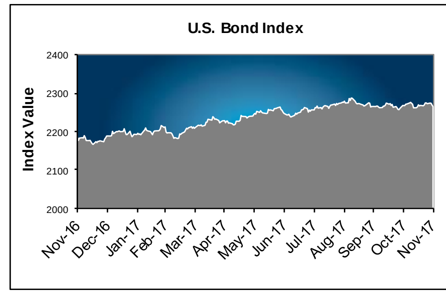
Flattening Yield Curve

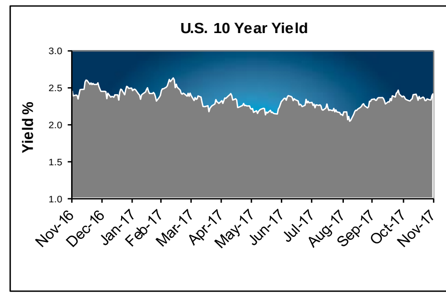
The low volatility environment continued in November. There was no major surprise regarding Donald Trump's pick for the Fed Chair. The candidate, Jerome Powell, is expected to continue Janet Yellen's monetary policy of gradual interest rate hikes and will wind down the central bank's balance sheet on a preset course. There were also no significant geopolitical events which could have rattled the markets while all eyes were on the proposed tax reforms in the U.S. The fixed income markets performed mostly flat during the month but the dollar lost some ground due to rising interest rate expectations elsewhere.

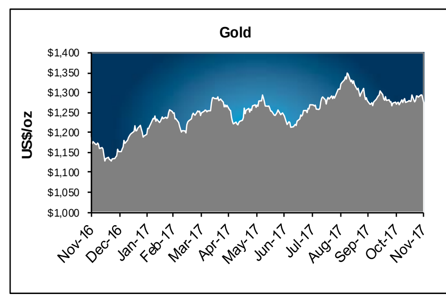
On a global basis, the International Monetary Fund (IMF) estimates that the median output gap (difference between the actual output of an economy and its potential output) for 20 advanced economies will shift from a small deficit this year to a surplus of 0.3% in 2018. This would be the first positive gap since the last decade and makes it hard to justify the maintenance of hyper-stimulatory monetary policy. In fact, the world economies remain in an unprecedented period of negative real interest rates and the balance sheets of the major central banks hold record amounts of purchased assets. The average real interest rate of the G7 economies stands at a negative 1 ¼ percentage points. Even tighter monetary policy by the U.S. central bank (Fed) will not be able to lift real rates above zero percent any time soon and consequently the very stimulatory environment can be expected to persist for now.

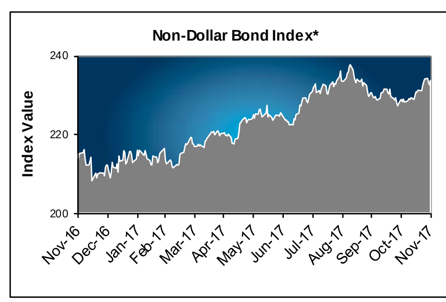
In the U.S., a key development has been the broadening of growth drivers beyond consumer spending. A broad range of indicators shows that activity has picked up steam in most areas. Core capital goods orders have increased at a solid pace, the Citi Economic Surprise Index is close to a record high and growth expectations have been driven by a dramatic easing in financial conditions and elevated consumer and business confidence. Despite two 25 basis points interest rate hikes, financial conditions are estimated to be equal to a 30 basis points cut in the target rate. The reasons for this estimate are lower long-term interest rates and contracting credit spreads. The strong economic performance in the U.S. has made it very likely that the Fed will hike by another 25 basis points in December. The outlook for next year is less clear. Since growth is expected to remain solid in the U.S. and elsewhere and inflation is forecast to pick up somewhat, the Fed intends to lift rates three times to 2 ¼ percent in 2018. This is in stark contrast to the futures market which sees the target rate at a mere 1 ¾ percent. The most interesting action is occurring in long-term bond yields which have continued to contract during the course of the year and have led to a flattening yield curve (the difference between the 10-year and 2-year bond yields). Despite an upbeat outlook by the U.S. central bank, the market has started to price in a growth slowdown and/or declining inflation rates. A flattening yield curve (the difference between the 10-year and 2-year bond yields) has often been an indicator for an economic slowdown and hence market participants pay close attention to it. The current spread of 62 basis points is at decade-low but still indicates an expansionary economy for now.

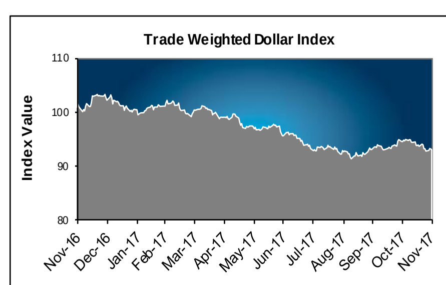
The proposed tax reforms in the U.S. are somewhat counterintuitive considering that the economies of the U.S. and most parts of the world are doing well. Nevertheless, if the yield curve indicator is correct in predicting an economic slowdown, then stimulatory fiscal policy could turn out to be well timed and prolong the ongoing economic recovery. Fiscal stimulus would also give the Fed more leeway in raising rates and hopefully lift inflation expectations close to or even above its 2% target. This would widen interest rate expectations between the U.S. and other economies since the European Central Bank is nowhere close to adjusting its target rate and conditions in Japan will most likely not warrant an end to the hyper-stimulatory policies for years to come. Rising interest rate differentials and stretched positioning indicators will benefit the U.S. dollar.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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