Quarterly Newsletter

First Quarter Review: The Shape of Things

Stock markets around the world rallied in the second quarter. The S&P 500 set a succession of new highs from May into the second half of June. But it would be mistaken to ascribe this performance to a simple continuation of the trend earlier in the year. Recall that the so-called reflation trade, premised on the idea that the new administration in Washington would unleash a torrent of growth via tax reform and infrastructure spend, petered out in February when investors' hopes crashed into legislative reality. Financials and materials companies faltered. The mega cap tech platforms -- Apple, Google, Facebook, Amazon and the like -- took the leadership helm for no particular reason other than that money needed to go somewhere, so why not go with the companies that currently dominate the fastest growing segments of the economy? Then, in early June, those high flying tech names also got dumped in a surprisingly sudden exodus. The market kept going up, but in a largely leaderless way devoid of an overarching theme. Prices stalled out below the record highs and traded largely flat as the quarter ended.

Meanwhile the bond market had its own set of ups and downs. One of the big themes of the year to date has been the different messages being sent by stocks and bonds: giddiness on the one hand, and caution on the other. Bond yields remained low for most of the second quarter, reflecting a sentiment that the lackluster growth in consumer prices and workers' wages is not temporary (as the Fed has argued) but rather part of a more structural change in the economy. Suddenly, though, yields jumped in the waning days of the quarter on the heels of comments by European Central Bank chief Mario Draghi suggesting (or so it was interpreted, anyway) that a tapering may be looming in the ECB's bond buying program. Some observers claim a paradigm shift towards higher rates is at hand. Others demur, recalling the "taper tantrum" of 2013 when investors, prematurely, jumped the gun on similar musings by then-Fed head Ben Bernanke.

The key question in our minds, looking ahead to the rest of the year, is whether the shape of things as they have been – the flat shape of the bond yield curve and the almost linear upward shape of the stock market – is likely to be the shape of things to come…or not.

Second Quarter Outlook: Here (May) Be Dragons

Volatility in 2017 thus far has been a bit like the dragons of the fabled Seven Kingdoms of Westeros in the early episodes of the hit TV epic "Game of Thrones." The fact that they hadn't been seen for a long, long time didn't mean that they no longer existed (as some unfortunate bad apples in said kingdoms were to find out in subsequent episodes). Will fire-breathing volatility come crashing back into our lives just as we are dialing into the latest GoT season on HBO this month? That remains to be seen, but there are plausible reasons, in our opinion, as to why the VIX volatility index may feature more prominently in the months to come.

There are arguably three words that succinctly sum up why volatility has been so subdued for so long: "central bank put." This is investor-speak for the willingness of central banks around the world -- amply demonstrated time and again over the last nine years -- to prop up risk asset markets whenever things get dicey. Why has the stock market been able to shrug off literally everything over this time -- from lackluster growth to geopolitical crises to plunging oil prices -- with nothing more than a small handful of V-shaped pullbacks and recoveries? Because investors believe the central bankers have their back. "Don't fight the Fed" would have been the most sage advice an investor could have used from 2009 to the present.

But there are signs of a shift in this thinking. The Fed's determination to raise rates in June, with the possibility of another hike in September, says less about the urgency of inflation (very low) than it does about the Fed trying to wrest control back from those complacent markets. Draghi's comments a couple weeks ago, referred to above, can be seen in the same light. We don't know if the central bankers actually intend to take the "put" off the table, or indeed if they would have the stomach to see it through should markets react negatively. But even injecting an element of uncertainty into the assumption of central bank support could be enough to unleash the dragons of the VIX. We would not be surprised to see one of those famous summer squalls suddenly rise out of the calm seas.

Based on our assessment of the macroeconomy today, though, we would expect any such squall to be relatively brief in its intensity -- and we find it hard to believe that central banks would actually follow through on any attempt to stow the GBY (Greenspan-Bernanke-Yellen) put away in a lockbox.

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