Weekly Market Flash

The Turkeys of 2017

November 22, 2017

In this holiday-shortened week, our thoughts easily start to drift towards all the delicious, rich food we will be ingesting between now and early January when we wake up with newfound determination to go out and conquer the next marathon, or the first triathlon, or just the first visit in months to the nearest fitness center. With these sentiments in mind, let us invoke the theme of turkeys for this week's missive. The metaphorical kind of turkey, as an easy stand in for "seemed like a good investment idea at the time, but…" Now, the year has been a generally benign one for most asset classes. But there were turkeys aplenty that caught investors off guard. Here is a random selection of three of the gems that have caught our eye over the past months.

#1: The Reflation-Infrastructure Trade

In a sense, many of the year's turkeys flow from the granddaddy of them all, the "reflation-infrastructure trade" theme that caught fire literally within minutes of Trump giving his election night victory speech. The idea behind this trade was that a new, Republican-controlled government was going to unleash a flood of new money into the world through a combination of hefty tax cuts and massive spending from both the public and private sectors on new infrastructure projects. It's fair to say that this trade caught the vast majority of the investment world by surprise, since almost nobody expected the Republicans to capture the White House (their victories in the House and Senate were rather more predictable). But the trade dominated the last two months of 2016, with the key beneficiaries being financial institutions (net interest margins!), resource and industrial companies (lots of new projects!), the dollar and intermediate-long interest rates (because, reflation!).

The trade wasn't a turkey for anyone who took a wager on it from November 9 through New Year's Day and then sold out. But the fundamental rationale for the trade, which was never strong to begin with, proved wildly off base. Core inflation never breached, let alone smashed through, the Fed's 2 percent target level. A year later, low inflation continues to exist right alongside 4 percent unemployment. In fairness, nobody including the Fed's Board of Governors knows with assurance why this is so. As for infrastructure, anyone who has paid any attention at all to Washington politics for the last couple decades would understand that public infrastructure spending has never been a priority item on Republican policy agendas. As for taxes – again, a passing knowledge of GOP politics would lead one to conclude that, yes, tax cuts would certainly be up for legislative action, but complex, actual tax reform that broadened the base (i.e. killing off corporate loopholes) while lowering statutory rates might be a bridge too far for a party beset by fractious differences among its own members, let alone those across the political aisle.

In any event, most elements of this trade, led by the US dollar, had fizzled out by late winter. Periodically talk of the reflation trade recurs, mostly because financial news anchors love to say "the Trump trade is back!" while grinning foolishly into the camera. Caveat emptor.

#2 The Return of Volatility

The twin surprises of 2016 – the Brexit vote in Britain and the US presidential election – set the stage for much chatter about the political land mines in store for the year ahead. Mostly the prognosticators looked to Europe, where the springtime calendar included potentially explosive elections in the Netherlands and France, to be followed in early fall with the German contest. Then there were the ever-present concerns about central banks weaning dependent investors off the easy QE money, a hard economic landing in China, the possibility of trade wars with an ascendant hyper-nationalist contingent in the White House and even the possibility of actual wars as tensions ratcheted between the US and North Korea.

All these events – and many more besides – had their various days of reckoning. Each day came and went with asset price volatility barely budging from all-time lows. The CBOE VIX index, a measure of volatility dubbed the "fear gauge" by investors, had fallen below a level of 10 (the lower the VIX, the less risk) only a handful of times between its launch in 1990 and 2016. The index has closed below 10 a grand total of 40 times in the year 2017 to date, making this the "safest" year by the VIX measure in 27 years. Meanwhile the intraday volatility of the S&P 500 index is lower this year than any time since 1963. Anyone long VIX risk – and for defensible reasons! – will be ruing that bet.

Interestingly, the European election with potentially the most far-reaching consequences for 2018 may well be the one deemed the safest bet – Germany. Chancellor Angela Merkel's CDU/CSU party came first in the elections two months ago, but has since failed to secure a governing coalition with other representative parties. Political discord in Europe's most stable power could signal much uncertainty ahead. So far, though, markets are as relaxed as ever.

#3 Another Bad Year for Emerging Markets

We finish out our gallery of turkeys with a look at emerging markets, a surprise 2017 darling. Now, the success of emerging market (both equities and debt) is in a way the flip side of that reflation-infrastructure trade. But we believe this to be a useful morality tale on the perils of asset allocation assumptions. Let's consider the following. As portfolio managers were making their 2017 asset allocation decisions, late last year, two things about emerging markets were known to them.

First, the asset class had performed dismally, on a relative basis, for several years. While the S&P 500 went on a tear in 2012 and never looked back, EM equities had a very bumpy ride up and down, but mostly down. US large cap stocks passed their earlier historical highs in 2013, but emerging markets remained well shy of theirs in both dollar and local currency terms (they finally regained the high ground in local currency, but not dollar terms in 2017). In fact, on a risk-adjusted basis EM equities have produced negative value relative to blue chip US stocks on an annual average basis over the past 30 years. Any quantitative asset allocation model based on some variation of modern portfolio theory would have recommended deep underweights, or zero allocation, to emerging markets.

The second thing portfolio managers knew in December 2016 was that emerging markets were getting pummeled by the reflation-infrastructure trade. What reason would there have been to make a large allocation to this asset class? Well, to be sure, there are enough contrarians in the world who, at any given time, will put their chips on asset class X because asset class X has been out of favor for a while. Some managers did that, and were amply rewarded. But – and here is the key point – that decision boils down to a single variable: luck. Asset price trends will almost always exhibit mean reversion over time. But pinpointing the time – getting that inflexion point right – is a matter of luck. Emerging markets did well in 2017. They may well do so again in 2018 – or they may not. But questions about the long-term underperformance of this asset class are not answered by a single year's outcome.

There will be much at stake in 2018. As always, we and our fellow practitioners in this industry will be diligently at work over the next several weeks to try and figure out how to be positioned for 2018 and beyond. Meanwhile we leave you with this sentiment: may the turkeys be on your dinner table, and not in your portfolios. Happy Thanksgiving!

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