Quarterly Newsletter

First Quarter Review: A Surge and a Nothingburger

While animal spirits were out on a rampage in the final weeks of 2016, some skeptical voices could be heard from the sidelines. This is all an illusion, the skeptics would say, observing that even the most politically savvy operators would have trouble pushing three giant, far-reaching political agendas – taxes, healthcare and infrastructure – through our nation's legislative sausage factory, let alone a team of political novices. The bulls were having none of it. Cooler heads will prevail after Inauguration Day, riposted the skeptics. The bulls were still having none of it. By March 1, the S&P 500 had leapt by 5.1 percent, bringing the index's cumulative gain since last year's election to a whopping 12 percent. Trading in February provided a nice illustration of the "pain trade," where investors who for whatever reason sit out the first act or two of a bull run feel the pressure and jump in, hoping to grab at least a taste of the profits before the music runs out.

That was the surge. The nothingburger was the last month of the quarter, when some of those earlier skeptical observations appeared to be well-grounded. The new administration's first legislative outing ended poorly for both the executive and the legislative branches as the attempt to repeal and replace the Affordable Care Act – something the Republicans in opposition had been promising since it became law – failed to muster the votes. For "Trump trade" investors the issue was not so much the merits, or lack thereof, of Paul Ryan's failed American Healthcare Act. It was, rather, a reminder that comprehensive legislation is indeed hard, even with only one party in power. While the overall stock market waxed and waned over the last month of the quarter it is worth noting that the industry sectors that were the Trump trade's biggest winners last year – financials, industrials, materials and energy – have been the worst-performing thus far in 2017.

The bond market may have given a hint earlier in the quarter that the equity rally was on somewhat shakier ground than appeared. The 10-year Treasury yield, after surging in the immediate aftermath of the election last year, has had a very subdued go of it since then. The yield stood at 2.45 percent just after New Year, down from a December peak of 2.6 percent, and traded mostly flat even as rates on the 2-year note, a more direct proxy for monetary policy, rose sharply when the Fed signaled it would raise rates in mid-March. Brisk demand for intermediate Treasuries – the ultimate safe-haven asset – stood in contrast to the risk-on temperature of the stock market. That, in turn, may signal a continuation in the current equity market pause.

Second Quarter Outlook: Complexity and Volatility

If the lesson from the first quarter is that governing and decision making are tough in a highly complex world, that lesson has yet to be found in another corner of the market: volatility. While the price to earnings (P/E) ratio of the S&P 500 is higher than it has been in more than 13 years, the CBOE VIX index – the market's so-called "fear gauge" – is close to the lowest levels it has ever been at since launching in 1990. Analysts look at the P/E to VIX ratio as an indicator of expensiveness adjusted for risk, and on that basis the market is more overpriced than it has been since the height of the Internet bubble at the end of the 1990s. By another measure – the Cyclically Adjusted Price Earnings (CAPE) ratio of Yale economist Robert Shiller – the market has only ever been more expensive than today on two occasions: the months leading to the Great Crash of 1929, and (again) the nosebleed levels of the dot-com mania. Not surprisingly, investors are keeping a close eye on the first quarter earnings season as it gets underway this week. While earnings growth trends have improved substantially since the sequence of six negative quarters in 2015-16, expectations remain tempered by global demand trends and the strength of the US dollar (which generally has a depressive effect on earnings). And certain sectors – notably traditional consumer retail – appear to be facing some genuinely existential challenges.

While we do see potential for a return to volatility levels we think would be commensurate with the complexity of global factors at play, we also see continuing evidence of a generally positive global macroeconomic story. Here in the US we are at 4.5 percent unemployment, while consumer prices are just above or below (depending on your preferred measure) the Fed's target of 2 percent. The economic picture looks brighter in Europe than it has any time since the recession (risks related to Brexit and the fate of the single currency notwithstanding), Japan is not awash in negative headlines and China for the time being appears to be holding itself together. There is scant evidence of a looming recession in any major region; on the contrary, the trend continues to weigh towards growth. We do not see the case today for any significant reweighting away from equities, given our current strategic positioning. In the absence of significant changes to the overall economic narrative, we would view any sudden market pullback as more a buying opportunity than an alarm bell. That being said, there are plenty of factors in the current environment that will continue to bear close scrutiny.