Quarterly Newsletter

Third Quarter Review: The Second Rotation of 2017

A study of price movements in the S&P 500 over the course of 2017 reveals two major directional trends bookending an otherwise gentle upward drift. In February, the market turned away from the so-called “reflation trade” that favored financials and resource companies after the 2016 election, and went big into mega-cap tech stocks. Then, in mid-late September, that old reflation trade once again caught the fancy of the investor class. Back into fashion came the financials and energy companies and old-line industrials. These two rotations are instructive, and offer a clear illustration of what we commonly refer to as TINA – There Is No Alternative. The idea behind TINA is that there isn’t much new under the sun: the global economy is in a synchronized mode of slow, low-inflation growth, while corporate profits make steady gains and labor markets are mostly healthy. Money has to go somewhere. Rather than selling off – we haven’t seen a pullback of any significance in US stocks for nearly two years – the money just rotates into and out of sectors, often for no readily apparent reason.

Not that the TINA syndrome is limited to stocks. Fixed income asset classes, industrial and precious metals commodities and real estate have all had ample opportunity to count their blessings this year. Bond yields have stayed low, with the 10 year Treasury yield remaining below 2.5 percent for all but a brief period back in the first quarter. Yield spreads between higher-risk bonds and risk-free benchmarks are tighter than they have been for more than five years. The spread between Baa corporate bonds and Treasuries is barely 2 percent. Copper, an industrial metal widely viewed as a growth proxy, is up more than 20%. All this has been good news for investors with prudently diversified portfolios, but it has elicited some concern from monetary policymakers about the potential for a bubble involving multiple asset classes. Keeping the bubble at bay is likely driving at least part of the Fed’s calculus in seeking to continue gradually raising rates.

The other major third quarter story was the surge in foreign currencies versus the US dollar. The euro, the pound sterling and a host of emerging market currencies went gangbusters against the greenback, arguably for a variety of reasons involving both relative growth prospects and geopolitical tensions (geopolitics still have an effect on currencies, though demonstrably little impact on equities). This trend reversed a bit in late September, mostly (it would seem) due to the resurrection of the above-mentioned reflation trade in US assets following the announcement of a possible framework of sorts for tax reform. But unless something truly meaningful emerges from the shallow optics of fiscal policy discussions in Washington, the dollar may face further headwinds.

Fourth Quarter Outlook: A High Bar for “Black Swans”

The fourth quarter is less than two weeks old as we write this, and there is always the opportunity for surprises at this time of year. That being said, though, there is very little evidence to suggest the potential for a major reversal in asset price trends. In many arenas (political and otherwise) 2017 has been a volatile year, but the capital markets have been able to shrug off pretty much everything that has been thrown at them. Pullbacks have been brief, shallow and infrequent, notably due to the “buy the dip” mentality that has a firm hold on investors’ proclivities. Economic data suggest that growth will likely continue in both developed and key emerging economies. In the absence of genuine recessionary concerns, the catalyst for a significant correction would have to be the actualization of one or more of the various risk factors that always lie dormant under the surface. “Black swan” is the popular parlance for such risk factors, defined as events, the shape, timing and magnitude of which cannot be predicted or quantified ahead of time.

As we have seen, though, the bar is high indeed for a black swan to have meaningful impact on a market firmly rooted in expectations for more good times ahead. This high bar is not unique to our current environment; in the past, fearsome manifestations ranging from the Cuban Missile Crisis to political assassinations to foreign wars have mostly failed to profoundly shake up asset prices. However, it is worth noting that market volatility has rarely been as low as it is now. The CBOE VIX index – a popular gauge of risk sentiment, has averaged lower in 2017 (lower meaning less risky) than in any of its previous 27 years of existence. Either we are living in age of structurally reduced risk expectations, or we should expect another bout of volatility to surface sooner or later.

In our view, the best approach to investing as we head towards the end of 2017, and into another year with its own store of surprises, is the time-honored discipline of diversification. It’s not a time to panic and start building up cash defenses, nor is it a time to throw caution to the wind and chase returns from unlikely sources (long term Ukrainian bonds, anyone?). We believe that a portfolio positioned for growth but with a healthy mix of assets to mitigate risk and supply dependable income streams – not radically different from that which has worked this year – is a sound way to get ready for the year ahead.

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