Quarterly Newsletter

Fourth Quarter Review: Good Old-Fashioned Window Dressing

Professional money managers are fond of their old chestnuts – tales of how the market moves to the rhythms of the seasons. How many times have you heard “sell in May, go away” or watched a sober-faced pundit explain the “January effect?” Well, sometimes the chestnuts have a ring of truth to them, and Q4 2017 was one of those times. The chestnut for the year’s last three months is typically about “window dressing” – the frenetic rush by portfolio managers to load up on whatever happens to be in favor before year-end, in an effort to reduce performance gaps and have smoother conversations with their clients come January. Sometimes the managers hold off to make sure no October surprises trip them up. Not this year. The buying kicked in after Labor Day and plowed right through to the end of the year with barely a pause for breath. The S&P 500 gained almost 7 percent over the quarter. There was nothing particularly new in the economic news cycle to drive the year-end animal spirits, so one could reasonably conclude that old-fashioned “window dressing” is as good a narrative as any.

What was true for US equities was true for many other asset classes as well. Non-US developed and emerging market debt and equities performed well, helped by another strong rally in non-dollar currencies, from the euro to the Russian ruble, in the last month of the year. The dollar, in fact, finished the year around 10 percent weaker against an index benchmark of other major currencies. The dollar’s weakness has been one of the bigger puzzles over the course of the year, starting from the major reversal in January 2017 when the greenback led other asset classes out of the misguided “reflation trade” that took shape following the presidential election. In a year when the Fed raised rates three times while Europe and Japan kept monetary stimulus moving ahead at full speed one might have expected to see a stronger dollar – instead, sentiment seemed inclined to the perception of relative strength, compared to expectations, elsewhere in the world.

One Q4 development on which many investors are keeping a watchful eye is the shape of the yield curve. In December the spread between the 10-year and the 2-year Treasury notes narrowed to about 0.55 percent, which is the flattest the curve has been since 2007. A flat yield curve can be cause for concern, as in the past it has been a harbinger of approaching recession (as was the case in 2007). That short term rates are rising is not particularly surprising, given the Fed’s stated intention to continue raising its target range on the Fed funds rate. Why intermediate and long rates have not been rising in tandem is the larger mystery. Perhaps the most convincing reason – though there are no doubt others – is the continuation of low inflation. But that answer poses another question which is front and center on our minds as 2018 gets underway: why is inflation still so low, and is this state of play due for a change? We’ll have more to say as the numbers come in.

First Quarter Outlook: More of the Same, But Edgier

We are fond of reminding our readers that while people are calendar-centric, markets treat the New Year like any other random point in time – which is to say that changes don’t always happen with the turning of the annual page. This brief year-to-date looks more like a continuation of late 2017 than anything else. A general “risk-on” sentiment continues to drive risk asset prices higher. Major developed and emerging markets, along with those here at home, are already approaching mid-single digit price gains with less than half of January in the books as we write this. We don’t have too many hard data points so far this year, but initial reads from the labor market and from wholesale prices suggest little variance from last year’s mantra of moderate growth, low inflation and a healthy labor market.

Sometimes, though, one gets a nagging sense of a mood shift. Markets were spooked for a brief time on January 10 by rumors that the Chinese central bank was planning to moderate its purchases of US Treasury securities and to source more of its foreign exchange assets from elsewhere. US bond yields jumped and equity index futures suggested a moderate pullback from recent record gains. The furor was short-lived, and the day ended without any movements of note in major asset class benchmarks. But hair-trigger responses like that to unsubstantiated rumors suggest that investors are a bit twitchy. We have also noticed that while the CBOE VIX – a volatility index often referred to as the market’s “fear gauge” – remains at near-historic lows, the internal volatility on the S&P 500 (in other words, how much intraday movement there is around the central tendency) is quite a bit higher in the past two weeks than it was late last year.

An unusually long period of time has elapsed since the market last experienced a significant pullback (nearly two years). Awareness of this no doubt accounts for some of the present edginess. We cover this subject in some depth in the Annual Outlook you are receiving as part of this year-end packet. Our shorter message here is to remind you that pullbacks happen, and they more often amount to little more than a brief squall. Better to ride out any such squall than to panic.

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