Market Pulse Report

June 2017

SUMMARY

Worrying can often be a waste of energy, though when harnessed properly can help prepare for a variety of outcomes. And while there are plenty of things to be concerned about with regards to stocks, they are for now outweighed by improved earnings and a solid economic outlook.

What, Me Worry?

Photo by Nathan Rupert, San Diego, CA

Many of you may recall the old fictitious *Mad* magazine character, Alfred E. Neuman, whose catchphrase line "What, me worry?" made light of the need to dwell on anything. The motto and the image of the gap-toothed grinning kid projected a devil-may-care attitude of someone who maintains a sense of humor when everything around him is going up in flames. But in real life, most folks find plenty to fret about. And an anticipation of problems—big or small, real or imagined—can often lead to counterproductive anxiety and a clouding of judgement.

That's not to say that worrying is not sometimes beneficial, particularly when it comes to investing. Equity bull markets are often referred to as "climbing a wall of worry"—there is almost always something to be concerned about, be it geopolitics, recessions, inflation, interest rates, or other matters. But during strong uptrends, stocks have a tendency to surmount all obstacles. How do stocks pull off this feat? One possible explanation is that various apprehensions and uncertainties cause cautious investors to keep a reserve of cash on the sidelines. However, when fears subside (and most of the time, nightmare scenarios do not actualize), those investors usually put some of their dry powder back to work in the markets. In other words, ongoing worries supply the stock market with an ample reserve of fresh funds to be invested. Collective worrying thus helps fend off bubbles—it is typically not until things get too frothy, with masses of euphoric performance-chasing investors with nary a care in the world, that stock markets run into big trouble.

So What Has Us Worried? Plenty of things. That's not to say we have a negative outlook (either from a macro economic standpoint or specifically with regards to equities). In fact, we see plenty of positives out there (such as renewed earnings growth, a solid labor market, and improved consumer spending) and generally have a relatively sanguine view of the investing landscape. But it is a good idea to keep an eye on various trepidations and to be prepared for how to handle unpleasant situations which may come to pass. Here are some of the areas of risk our Research Strategy Group and Investment Committee are thinking about:

- **U.S. equity valuations**, which are relatively high from a historical perspective.
  - *Why worry:* Elevated valuations tend to make the market more vulnerable to changes in sentiment and can magnify any downturns. Empirical evidence is quite conclusive that "buying cheap" leads to better forward returns than does "buying dear".
  - *Mitigating factor:* Valuations have not proven to be a precise timing mechanism. While the implications for longer-term returns are somewhat gloomy, in the near-term investors may continue to drive prices higher on the prospects of continued earnings and profit growth. Furthermore, even if the outlook is muted, investors have few traditional options for generating returns comparable to those of stocks.
  - *What to do about it:* Tilt towards cheaper overseas equities (which may have more room to run) and look to less conventional investment strategies less dependent upon market beta. With that said do not abandon U.S. stocks.
- **Political instability** and reversal of the "Trump trade".
  - *Why worry:* Market-friendly agenda items such as tax reform, infrastructure spending, and deregulation may not come to fruition after already being priced into the market. If their expectation has driven stocks higher since the election, it seems logical that their dismissal (and further budget quarrels) could lead to lower prices.
  - *Mitigating factor:* Political wrangling is not unprecedented. Sustained economic and earnings growth are the true linchpins for a continuation of the current bull market, and they are showing improvement irrespective of political issues or uncertain fiscal policy changes.
  - *What to do about it:* Focus on fundamentals, not political noise.
- **The Federal Reserve** continues to tighten, with another quarter rate hike likely in June and an unwinding of its massive balance sheet expected to commence later this year.
  - *Why worry:* Many bull markets and economic expansions die at the hands of the Fed, or more specifically, overly-restrictive monetary policy.
  - *Mitigating factor:* Given improvements in the labor market, the Fed's normalization of interest rate policy appears justified and markets appear comfortable with the gradual pace of rate hikes. Meanwhile, rates remain relatively low from a historical perspective and monetary policy is far from overly-restrictive (on average, it takes about five years from the time of the first rate hike before a recession hits).
  - *What to do about it:* Stay invested while waiting out the normalization process. Core bond positions (which have a subpar return outlook) should be tilted towards credit risk alternatives and shorter-duration instruments.

- **Investor complacency**, as illustrated by unprecedented low volatility, soaring investor confidence, and elevated valuations, may make investors unprepared for any potential stock market corrections.
    - *Why worry:* Because when other investors stop worrying, you should. Volatility could come back with a vengeance, especially in this day and age of passive investing, algorithmic-based trading, and media-driven herd behavior. In the past, volatility often shows its head after many complacent investors take unsuitable investment risks (believing a placid environment can continue unabated).
    - *Mitigating factor:* While investor sentiment is high, we have not yet seen some of the egregious behaviors (such as a dramatic expansion of leverage/margin, introduction of new financial products, etc.) that typically accompany bubble territory. Furthermore, low volatility does not, in and of itself, beget future levels of high volatility, and the timing of volatility is impossible to predict.
    - *What to do about it:* Adhere to strategic investment plans, do not take outsized bets, and keep portfolios well-diversified. Accept that volatility and stock corrections are normal and their appearance would not necessarily signal the end of a bull market. If increased volatility is unacceptable, look to incorporate alternative solutions such as structured products to complement traditional long-only equity positions.
- **Geopolitical risks (North Korea, Syria, terrorism)** appear heightened.
    - *Why worry:* Macro surprises, including natural disasters and technology-related "flash crashes", can spur a flight out of equity markets in a risk-off scenario.
    - *Mitigating factor:* There are almost always macro risks on the table, but few are systemic in nature and have lasting effects on markets (Brexit anyone?). Regarding Europe, in light of the French election, at least some of the structural risks appear to be reduced for now.
    - *What to do about it:* Try to get a good night's sleep and not dwell on things outside of your control. Instead, focus on things within your control such as maintaining a diversified portfolio and having a long-term perspective (while being cognizant of near-term risks).
- **An economic slowdown in China** or an escalating trade war could throw markets into disarray.
    - *Why worry:* China is still transitioning to a consumer-driven economy, has massive amounts of debt (and rising interest rates), and is showing some signs of slowing (based on several recent data points missing expectations). As the second largest economy in the world (as per nominal GDP), a slowdown in China could affect not only emerging markets, but also developed regions.
    - *Mitigating factor:* We have been through a Chinese slowdown before (2015-16), and the Chinese government reacted with aggressive stimulus to reaccelerate growth and stem capital outflows. Any new market/economic downturn could be met with a similar response. At least this time around it does not appear that Chinese capital markets are in the midst of a leverage-fueled bubble.
    - *What to do about it:* View emerging market positions as long-term holdings. China may be experiencing growing pains, but emerging markets as a whole are still expected to experience economic growth well-above that of developed economies.

Unlike the character Alfred E. Neuman, we worry a lot. Many of the themes we have recently been discussing internally are somewhat distressing, and it could be easy to get dismayed. But worrying about what could possibly go wrong helps our Investment Committee make better and more-informed investment decisions. Rather than just dwell on the negative consequences of any of these risks, we attempt to put them in perspective by considering how likely they are, how portfolios might be impacted, what opportunities exist, and what actions (if any) should be taken. We strive not to let worries unnecessarily cloud our judgement or lead to unproductive transactions.

The truth is that many of the risks we have historically deliberated have come and gone without a long-term market effect. Just look back at the wall of worry this bull market has already scaled—wars, tsunamis, flash crashes, government shutdowns, an oil collapse, sovereign defaults, Brexit, and more. It is quite a wide-ranging list, and has been overcome at every turn by what matters most: corporate earnings and economic fundamentals.