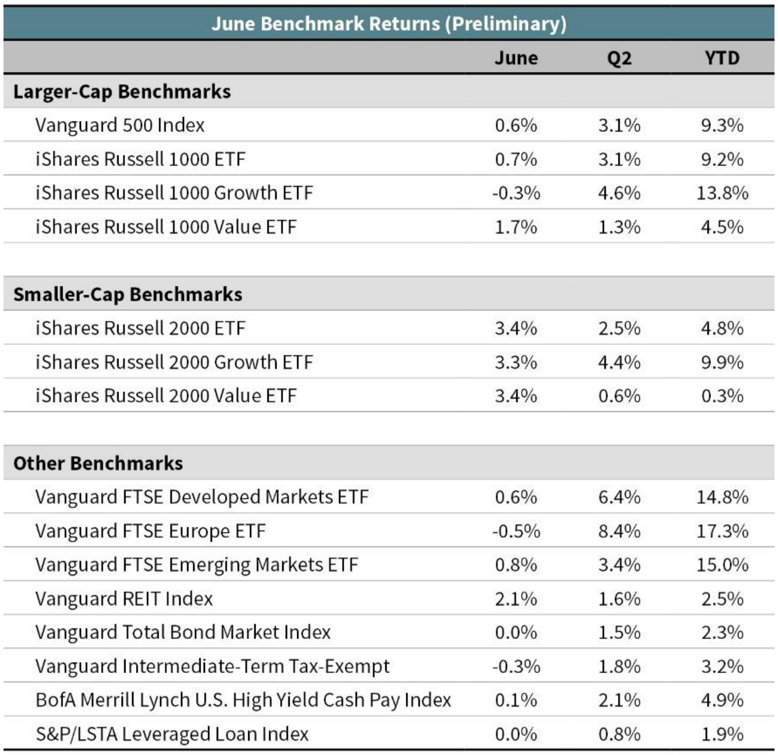
MSA
MAIN STREET ADVISORS, LLC
410-840-9200 www.mainstadvisors.com July, 2017

Market Commentary – Second Quarter 2017

Market Recap

The second quarter proved to be another very strong period for global stock markets. Larger-cap U.S. stocks (Vanguard 500 Index) gained 3.1%, developed international stocks (Vanguard Developed Markets ETF) rose 6.4%, European stocks (Vanguard FTSE Europe ETF) jumped 8.4%, and emerging-market stocks (Vanguard Emerging Markets ETF) rose by 3.4%. First half 2017 stock performance was even stronger. Larger-cap U.S. stocks surged 9.3%, while international indexes were each up in the mid-teens. In a reversal of May's sector trends, U.S. financial stocks rallied in June on strong results from the Federal Reserve's "stress tests" plus more positive sentiment given rising interest rates, while technology shares declined. Commodities prices and energy stocks remain a weak spot amid a global rally in risky assets. Oil prices fell 14% during the quarter and nearly 20% for the first half of 2017 on fears that production will continue to outstrip demand. With proper analysis, we continue to believe oil demand will not be dramatically changed any time soon, whether by renewable energy or electric cars.



June Benchmark Returns (Preliminary)

	June	Q2	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	0.6%	3.1%	9.3%
iShares Russell 1000 ETF	0.7%	3.1%	9.2%
iShares Russell 1000 Growth ETF	-0.3%	4.6%	13.8%
iShares Russell 1000 Value ETF	1.7%	1.3%	4.5%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	3.4%	2.5%	4.8%
iShares Russell 2000 Growth ETF	3.3%	4.4%	9.9%
iShares Russell 2000 Value ETF	3.4%	0.6%	0.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	0.6%	6.4%	14.8%
Vanguard FTSE Europe ETF	-0.5%	8.4%	17.3%
Vanguard FTSE Emerging Markets ETF	0.8%	3.4%	15.0%
Vanguard REIT Index	2.1%	1.6%	2.5%
Vanguard Total Bond Market Index	0.0%	1.5%	2.3%
Vanguard Intermediate-Term Tax-Exempt	-0.3%	1.8%	3.2%
BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.1%	2.1%	4.9%
S&P/LSTA Leveraged Loan Index	0.0%	0.8%	1.9%

Core bonds (Vanguard Total Bond Market Index) also delivered solid returns, rising 1.5% for the quarter. (Higher bond prices correspond to lower bond yields.) The yield curve "flattened" considerably, with the difference between the 10-year and 2-year Treasury yields ending the quarter at close to a post-2008 low. This implies the bond market sees less inflation risk than widely believed; the continued low level of the thirty-year Treasury bond, at under 3% (think about that!), also indicates a lower-for-longer inflation outlook by the bond market.

And yet, the calm, as manifested in low measures of volatility across global markets, was briefly interrupted during the last few days of June. Global stock and bond investors were rattled by comments from the heads of the European Central Bank and the Bank of England suggesting they may be considering the potential end to bond buying policies designed to stimulate markets and a move to raise interest rates, respectively. They were further jolted by Fed Chair Janet Yellen's statement that "by standard metrics, some asset valuations look high." In response, bond yields quickly spiked higher, while currency markets saw large swings. Nevertheless, at quarter-end, the S&P 500 was only about 1% below its all-time high.

Economic and corporate fundamentals largely still look solid, and investors expect the second quarter earnings season to demonstrate a continuation of the strong growth trends exhibited so far in 2017. Consequently, we continue to view exogenous risks—from central banks and geopolitics—as posing the most likely near-term threats to markets.

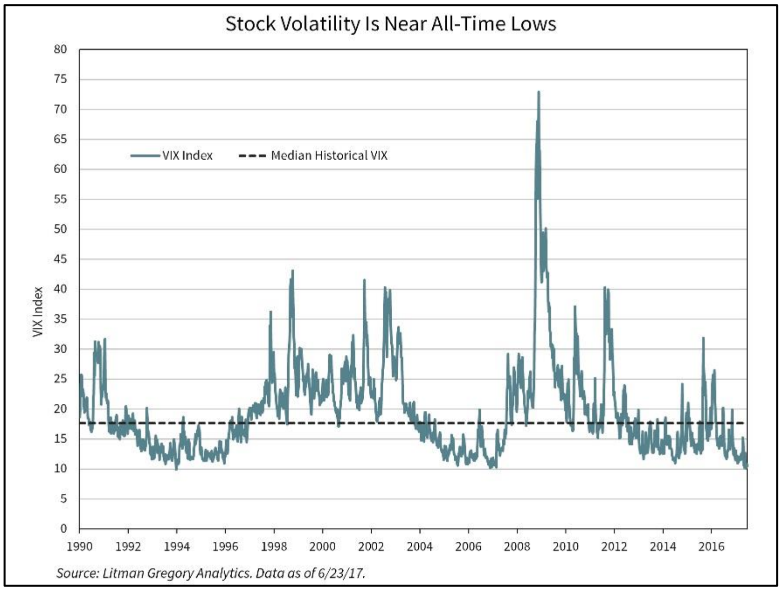
Investment Environment

As we look back over the past quarter and first half of the year, a few things stand out:

(1) Overall stock market volatility remained extremely low, despite significant domestic political uncertainty and unsettling global and geopolitical events.
(2) Both risky assets (stocks) and defensive assets (core bonds) performed very well.
(3) The period was marked by some significant market trend reversals from the previous year.

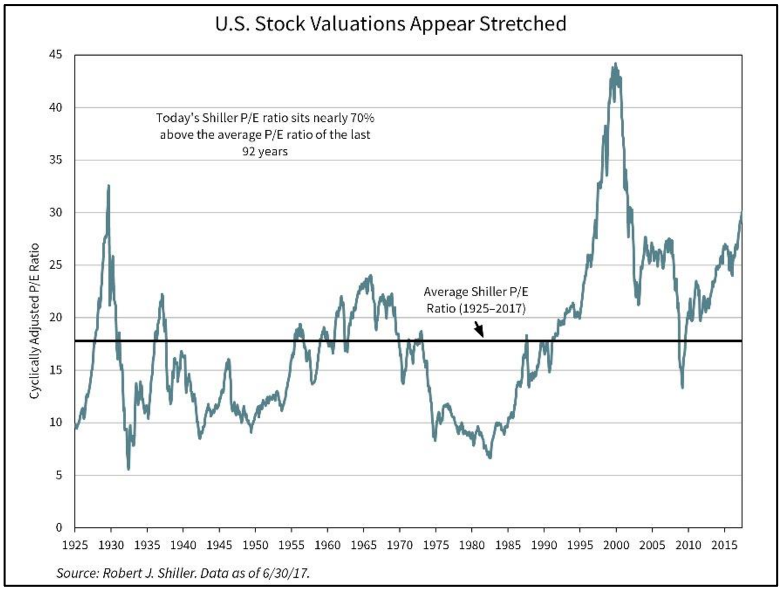
The widely followed VIX index—an indicator of the S&P 500's expected 30-day volatility, fell to a 23-year low in early May. It remained at its lowest ever recorded percentile as the second quarter drew to a close. What's more, the S&P 500's *actual* realized volatility has fallen to among its lowest levels in the past *fifty* years, according to a recent Goldman Sachs report, while the S&P 500 Index continued to hit all-time highs this year.

The U.S. stock market's calm ascendance seems to fly in the face of ongoing political uncertainty and geopolitical tumult, including tensions with North Korea, the ongoing crisis in Syria, terrorist attacks in Europe, cyberattacks in the United States, and widening investigations of President Trump as well as members of his administration and election campaign staff. Each day seems to bring a new headline concerning something else to worry about.


Stock Volatility Is Near All-Time Lows

Source: Litman Gregory Analytics. Data as of 6/23/17.

Why are the financial markets so calm and why do stocks continue to go up? Do markets reflect a dangerous complacency in the face of so many risks and unknowns? We have two responses. First, yes, U.S. stock investors probably are too complacent now. We see this reflected not just in the extremely low market volatility, but also in high stock market valuations (e.g., price-to-earnings multiples), which implicitly discount a very rosy economic scenario. Based on our analysis of valuations and longer-term earnings fundamentals—even putting aside any near-term political/geopolitical risks—U.S. stocks present unattractive expected returns over our five-year tactical investment horizon, evaluated across the macroeconomic scenarios we think are most likely to play out. In that sense, we think the high level of complacency leaves stocks particularly vulnerable to a negative surprise. Valuation risk is high and offers no margin of safety in the event the optimistic scenario currently baked into valuations doesn't play out.


U.S. Stock Valuations Appear Stretched

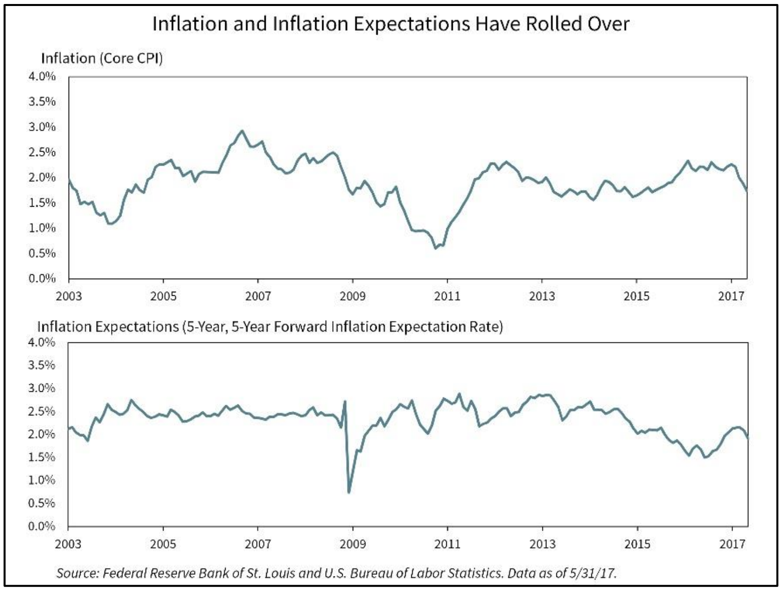
Source: Robert J. Shiller. Data as of 6/30/17.

That said, maintaining a degree of equanimity is a valuable attribute of successful long-term investors. Global risks *always* exist and unexpected events inevitably happen, causing markets to fall no matter their valuation. The world and financial markets have faced numerous negative shocks over the decades, but the broad economic impacts have ultimately proved transitory. Over the long term, financial assets are priced and valued based on their underlying economic fundamentals—yields, earnings, growth—not on transitory macro events or who occupies the White House. Therefore, we believe it is beneficial for investors not to react to every domestic political development or geopolitical event with the urge to sell their stocks nor get overly excited and jump into the market on some piece of news they view positively. We don't think refraining from such short-term trades is complacency—*if* the choice is supported by a sound decision-making framework. Having a disciplined investment process and a focus on the long term are essential to best achieve your financial objectives.

Does it make sense that both stock and core bond prices are higher this year? In light of the very strong returns from U.S. and global stocks this year, it may seem somewhat surprising or contradictory that defensive core bonds have also performed well. For example, the long-duration Treasury bond ETF (TLT) is up more than 6% year to date after plunging 13% in the fourth quarter of 2016. What messages are the stock and bond markets sending, and can they both be right?

Treasury bond prices typically rise when people are worried about the economy or other macro risks and put their money into safe-haven assets. While there are plenty of things to worry about in the world, that doesn't seem to be what is driving core bond prices this year, given the accompanying low volatility and strength of riskier asset classes. Rather than fears of an impending macro shock, it seems the bond market is responding largely to the recent declines in inflation and inflation expectations. For example, the core Consumer Price Index (CPI) dropped to a year-over-year rate of 1.7% in May, down from 2.3% in January. Inflation is the enemy of bondholders. So in that regard, the drop in bond yields and rising bond prices makes sense.

The equity market, on the other hand, likes neither too little inflation nor too much inflation—just as with Goldilocks and her porridge. So stock investors have had plenty of reasons to propel prices higher: Inflation is lower but still in the ballpark of the Fed's 2% target. The global economic recovery is ongoing and S&P 500 company earnings are rebounding. And global central banks, including the Fed, are not seen as becoming too aggressive in tightening monetary policy any time soon.


Inflation and Inflation Expectations Have Rolled Over

Source: Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics. Data as of 5/31/17.

On a shorter-term basis, both markets may be "right." But the current state is not sustainable for very long—something has to give. The Fed holds a big key as to how things might play out: will it tighten too much (hurting stocks but good for core bonds), too little (hurting bonds), or manage it just right (producing a continued Goldilocks scenario for the stock market, but implying higher bond yields/lower bond prices as inflation rises to the Fed's 2% target)? Nobody knows, but based on history, we wouldn't put all our chips on the last scenario, or on any single scenario. Potential changes to fiscal, tax, and regulatory policies are also big unknowns.

Investment Outlook

We think it is prudent to construct portfolios that are prepared for, and have resilience to, a range of potential outcomes. As a result, in most of our portfolios, we maintain normal-to-high exposure to core bonds (Vanguard Corporate Fixed Income, Doubleline Total Return, PIMCO Total Return, all tax-free bond funds) despite very low current yields, because of their risk-mitigating properties in the event of a recession or other shock. But given core bonds' paltry yields and unattractive longer-term (five-year) return prospects, we maintain meaningful exposure to other more flexible and opportunistic fixed-income funds (Loomis Sayles Bond, Osterweis Strategic Income, Templeton Global Bond). We've mostly exited from alternative holdings such as managed futures and gold. All of these investments should also provide some protection against rising interest rates and inflation.

On the equity side of the portfolio, we see unattractive valuations and low expected returns for the U.S. market over the next five years. Therefore, we are underweight (but by a smaller margin since last year), however we don't see any particular near-term trigger for a sharp market decline. Outside of the United States, we see strong potential for both improving earnings growth *and* higher valuations—leading to relatively attractive longer-term expected returns. We have a moderate overweight to both European and emerging-market stocks. Overall, our portfolios have lower than normal equity risk exposure but higher than normal core bond exposure, since we think neither asset class offers absolutely attractive returns relative to their respective risks. Goldilocks has had a nice run, but the bond and/or stock market bears are probably getting hungry.

A final observation: *several of the market trends and consensus market views we highlighted in our year-end 2016 commentary have reversed (again) this year*. For example,

- European stocks are beating U.S. stocks by a wide margin;

- the U.S. dollar is down (about 6%), Treasury bond prices are up/yields are down, and the yield curve has flattened;
- oil prices have plunged 20% from their recent highs (unfortunately dragging energy stocks with them);
- growth stock indexes are crushing value indexes;
- larger-caps are beating smaller caps; and
- emerging-market stocks are once again outperforming U.S. stocks after a sharp post-election plunge.

The recent market shifts only reinforce the point we made then. We don't think anyone can consistently and accurately time short-term swings in markets or inflection points in market cycles. The false belief that they can be timed often leads to performance-chasing, whipsawing in and out of markets (selling low and buying high), and ultimately disappointing investment results. What's more, it is often when "the experts" are overwhelmingly aligned on one side of a trade and the consensus is strongest that a trend will continue, that it actually has the most potential to reverse.

At a high level, most of the market reversals we've seen this year are consistent with, if not driven by, an unwinding of the so-called Trump trade. This is shorthand for the markets' almost knee-jerk reaction (which soon became consensus) that Trump's election and the Republican sweep of Congress would herald a period of inflationary, pro-growth fiscal, tax, and regulatory policies, unleashing the U.S. economy's animal spirits. Instead, as the Trump administration has gotten bogged down in a myriad of other issues, with little progress on the economic front, confidence in that scenario has diminished. We made small changes to our portfolio positioning when Trump was elected, adding to our foreign and U.S. equities, but we highlighted the significant uncertainty around potential Trump policies. That's not to mention the highly uncertain *timing, implementation,* and *magnitude* of their *ultimate economic and financial market impacts*. Therefore, the unwinding of that narrative this year hasn't led us to make any portfolio changes.

Portfolio Performance and Recent Market Trends

Just as our portfolios' performance was impacted to varying degrees by the markets' reaction to Trump's victory last year, primarily from the bond market rout in the fourth quarter, they've experienced differing impacts so far this year. Most significantly, given our overweighting to energy stocks (-12% to -24% year-to-date), but also our positions in foreign stock markets, our portfolios have performed at an average pace compared to the strong year-to-date performances of both international and emerging markets versus U.S. stocks. These positions have also benefited from the depreciation of the U.S. dollar against the euro and emerging-market currencies, boosting the return to dollar-based investors like us who have not hedged their currency exposure.

Our positions in flexible, unconstrained bond funds have performed well this year and again added value versus the core bond index. Managers like Loomis Sayles and Osterweis, it should be remembered, perform more like stocks during periods of strong risk market performance but will not defend against sharp drawdowns nearly so well as core, high-quality bonds funds like Vanguard, PIMCO and Doubleline.

We have mostly exited from our lower-risk liquid alternative strategies and commodities like gold. While we remain on guard for any early warnings of market turbulence, and these positions serve as insurance against larger market declines, they have frustratingly been drags on our portfolios that are already a bit light on riskier equities.

Finally, our active equity managers' performance versus their respective index benchmarks has been mixed this year. This is often the case over any given shorter-term time period, and there are usually varying stock-specific drivers of performance differences across the managers given their differing investment approaches. To broadly generalize, the reversal of last year's very strong value outperformance versus growth has been detrimental to our U.S. active manager performance in aggregate, although our growth-oriented managers are crushing both the growth index and the S&P 500 this year. More positively, our active international fund managers have generally outperformed their benchmarks this year.

Given that our active managers are disciplined and focused stock pickers, our diversification across managers and investment styles pays off over the longer term. But it does come with periods of inevitable underperformance. Therefore, maintaining conviction in the *longer-term* payoff is essential. That conviction is a function of our intensive manager research and ongoing due diligence.

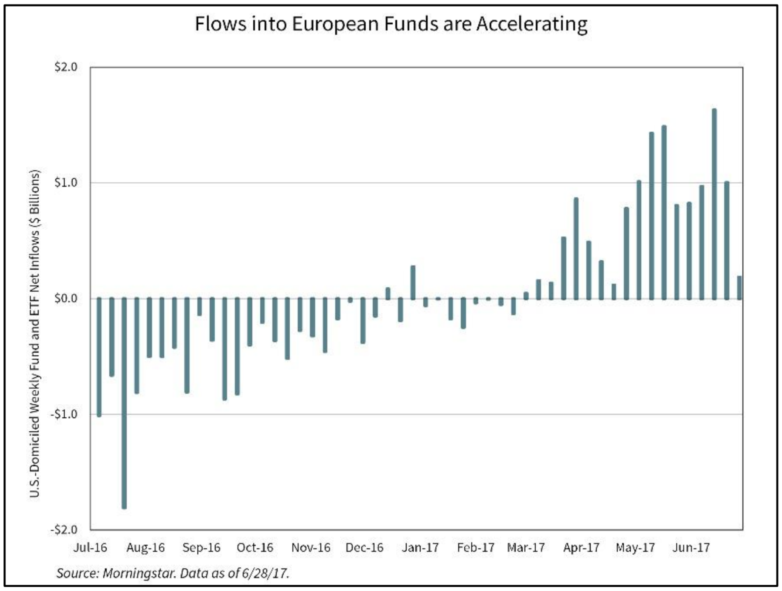
Portfolio Positioning and Outlook

Our positioning is driven by our ongoing assessment of nearer-term (12-month) downside risks, balanced against our longer-term (five-year) expected returns analysis for various asset classes and strategies, evaluated across a range of scenarios and assumptions. Given the lack of market volatility, while we added to equities by about 5% early this year, our portfolio positioning has not changed since then.

From a big picture perspective, we think the odds favor a continuation of the ongoing mild global economic recovery we've witnessed so far this year. That should be broadly supportive of riskier assets, such as stocks and corporate credit. In particular, we believe there is still more room to run regarding the outperformance of foreign stocks given their superior valuations and earnings growth potential versus the U.S market. Even with their strong performance so far this year, our longer-term return expectations still materially favor Europe and emerging markets compared to the United States.

Those markets are also seeing increasingly positive investor sentiment and strong cash inflows. More than $12 billion has flooded into U.S.-domiciled European stock funds and ETFs this year, reversing 13 consecutive months of net outflows prior to that. Year-to-date inflows into emerging-market stock funds are close to $30 billion.

Momentum seems to be shifting in favor of foreign stocks. We are seeing more and more Wall Street strategists recommend an overweight to European and emerging-market stocks: a position we have held for a while. This can feed on itself in a virtuous cycle—as more money flows into these asset classes, it can boost prices and returns, attracting yet more inflows and driving prices higher.


Flows into European Funds are Accelerating

Source: Morningstar. Data as of 6/28/17.

Our base case scenario should also be beneficial for our non-core fixed-income funds. That doesn't mean there won't be market volatility in response to day-to-day news flow and unexpected events whether negative or positive. Central bank policy, as usual, could trigger volatility. European and Japanese central banks seem set to retain their highly accommodative monetary policies. But in the United States, the Fed is signaling it intends to continue gradually hiking rates—once more this year and three times next year. That contrasts with market expectations, as reflected in the federal funds futures market, for just one or two more rate hikes over that period.

Will the Fed inject unexpected volatility into markets? In past years, the Fed's actions have repeatedly converged to meet market expectations, with a less aggressive rate hiking path than it originally forecast for itself. The Fed is likely more hawkish at this point in the economic cycle with unemployment down to 4.3% coupled with its expectation that wage, and ultimately, inflationary pressures will emerge. This creates uncertainty and the risk that the Fed will tighten more than the economy and markets can handle. Economist David Rosenberg writes, "If the Fed does what it says it's going to do, the yield curve will invert sometime next year, with a recession all but an inevitability."

An inverted Treasury yield curve has preceded all seven previous U.S. recessions. But, with global central bank bond purchases still depressing longer-maturity bond yields, this cycle may be different from prior ones. The Bank Credit Analyst, whose macroeconomic research we respect, sees the risk of a U.S. recession sometime in 2019, after a final burst of growth over the next year. And this being macroeconomics, there are intelligent counter arguments that the Fed is more likely to fall behind the curve or already has, in tightening monetary policy, meaning a period of higher-than-expected inflation and interest rates will ensue.

Conclusion

We don't expect a recession in the near term, but we remain alert to and positioned to meet the high level of uncertainty that characterizes both global financial markets and global economies – which can't seem to reach higher, previously normal growth rates – and the current geopolitical environment. We maintain exposure to assets – core bonds in particular, as well as defensive equities like utilities and energy – that should generate positive returns or at least smaller declines in the event of a recession and a bear market in stocks. Our defensive positions in liquid alternatives and gold, while mostly abandoned, still have allowed us a window into so-called portfolio insurance and what to be watching for when markets stumble. We manage *your money*; if you would like to review or consult with us about lower-risk alternative strategies, say the word. The vast amount of money chased into riskier assets, due to globally ultra-low interest rates for many years, is truly astounding. At the same time, governments of all stripes are debt-laden, making them more vulnerable to future financial and economic shocks than ten years ago. So yes, it is easy to see a benignly, overpriced stock market and still-low interest rates and just shrug. But if the sun now rises in the west and sets in the east, the weather may still be similar but how do we now measure it?

—Main Street Advisors, LLC / Litman Gregory Research Team (July 13, 2017)