2017 Second Quarter Review of the Markets

Index	2nd Qtr Return	YTD Return
S&P 500	3.09%	9.34%
MSCI ACWI Ex USA	5.78%	14.10%
Barclay’s Bond Index	1.45%	2.27%
Consumer Price Index	0.02%	0.40%

Investment Commentary

Stock and bond indices increased further during the second quarter of 2017. Non-U.S. stocks continued to outperform U.S. stocks. The MSCI ACWI Ex USA, a broad based international index, returned 5.8% for the quarter. Domestic stocks also showed positive performance as the S&P 500 increased 3.1%. Smaller stocks trailed larger stocks again in the U.S., returning only 2.5% for the quarter. Globally, emerging market stocks and small cap international stocks were the strongest performers – each returned over 6% for the quarter.

Fixed income markets benefited from both decreasing interest rates and lower cost of borrowing relative to Treasuries for both investment grade and non-investment grade corporate borrowers. The yield on the 10 year U.S. Treasury note fell 0.09% over the quarter to 2.31%. The Bloomberg Barclays U.S. Aggregate Bond Index increased 1.5%.

At the beginning of the second quarter, the U.S. Federal Reserve announced that they would begin allowing their balance sheet of bonds to decrease in size. Investors may recall that the mechanism by which the Fed helped stimulate the economy after the financial crisis involved purchasing substantial amounts of U.S. Treasury and mortgage bonds from the market (also known as “Quantitative Easing”). The increase in demand drove up the price of bonds, making interest rates lower (thereby increasing the incentive to borrow) and injecting liquidity into a liquidity-starved economy.

As the bonds made interest and maturity payments, the Fed used those proceeds to purchase similar bonds, thereby holding the value of bonds on the balance sheet steady.

When the Fed begins to unwind its balance sheet, rather than selling the bonds back into the market, they will cease reinvesting 100% of the coupon and principal payments that their bond portfolio generates. The idea is that the absence of such a large purchaser will reduce the overall demand for bonds which could allow yields to increase to a more “normal” level.

Economic Outlook

The unwinding of the Fed’s balance sheet described above will be a critical part of the continued recovery. We do not expect the reduction of repurchases to materially impact economic activity. The decision to reinvest interest payments should be viewed as a decision to make a new loan to the U.S. government and mortgage borrowers. In the absence of the Fed making that loan, we believe the economy is healthy enough for other lenders to pick up their slack and continue to extend credit.

The question then becomes, “Are investors so yield-starved that not even the Fed can reduce overall demand for bonds?” As the Fed increases its federal funds rate and lifts the front end of the yield curve, we could end up with an even flatter yield curve than we already have (meaning the difference in yield between short term bonds and long term bonds is very low and could drop further). Far more problematic would be if demand for intermediate term bonds remained so strong that their yields stayed low enough for yields on short term bonds to be higher than long term bonds. This is known as an inverted yield curve which historically has been a clear harbinger of recession.

Our view is that continued normalization of monetary policy by the central bank is not only prudent, but necessary. The Fed continues to be wary of making policy missteps and has become ultrasensitive to creating any sort of instability in markets. We are of the mindset that increasing interest rates (specifically for intermediate and long term bonds) is the optimal outcome. Among the more important measures to monitor are possible increases in the domestic unemployment rate from what are currently very low levels.

Investment Strategy

We believe that we have properly positioned client portfolios for a wide variety of potential outcomes and are not comfortable taking higher than normal levels of risk. While we do not think a major bear market is imminent, we have grown wary of the lack of skepticism that markets are currently demonstrating. We expect that at some point – just don't ask us when – a correction will hit somewhere, and we are well positioned at the current moment to take advantage of volatility where and when it presents itself. In the meantime, neutral weight exposure to risk assets means that clients will continue to participate in positive markets to the degree that their current risk profile calls for market exposure. As always, we encourage clients to communicate with us if they feel that their overall risk tolerance may have changed.

One of the benefits of the Fed hiking short term rates is that the opportunity cost of holding cash and cash equivalents (short term bonds, more specifically) has fallen meaningfully from several years ago when short term bonds were yielding close to zero. By the end of the second quarter, the difference in yield between a 30 year Treasury bond and a 5 year Treasury bond was less than 1%. Considering a 30 year Treasury bond has more than 4 times the sensitivity to interest rates (or "duration") as a 5 year Treasury, it is difficult to justify so much more risk for so little incremental return. In our view, intermediate and long term Treasury bonds provide value to portfolios as insurance against negative economic outcomes (they will likely be amongst the best performing assets should the yield curve invert and the economy enter into a recession).

After many years of poor relative performance, international stocks continue to do well. In our view, there is still room to run for international stocks and, after such a long period of U.S. equity outperformance, it is likely that they will continue to take the lead in terms of relative equity market performance. Relative valuations continue to be supportive of international stocks, and ultimately economic conditions broadly speaking still have more room to improve from current levels abroad.

Finally, we continue to be very wary of higher yielding securities. Whether high yield ("junk") bonds, higher quality corporate bonds, or high-dividend paying stocks, investors have bid up higher yielding assets to prices at which we are uncomfortable buying. After taking advantage of volatility in junk bonds in early 2016, we have continued to reduce exposure across client portfolios by selling into market strength.

Much of the uncertainty of the global economy we experienced throughout 2016 seems to have abated. Equity markets and fixed income markets have diverged and seem to be signaling very different things at this point. Looking at interest rates throughout the course of the year, one may draw the conclusion that the economy is troubled. However, looking through the stock market lens, one would likely draw a very different conclusion. We will only know in hindsight which conclusion is correct, but we feel that client portfolios are positioned for any outcome.