Second Quarter 2017 Financial Markets Review

- Nothing could take the shine off of risk assets during the second quarter. Limited traction with Trump's policy agenda, a circus show of allegations and Congressional hearings on Russian interference in the U.S. election, a weaker than expected U.S. economy, and a major change in the Fed's monetary policy could not derail stocks as they moved higher throughout the second quarter.
- The Federal Reserve raised the Feds Funds rate another 0.25% at its June meeting despite recent weak economic and inflation data. More importantly, the Fed gave its first public guidance on its plan to start reducing its $4 trillion balance sheet in the near future although QE withdrawal is likely to last for a considerable period of time and be very deliberate in nature.
- Stock price volatility remained at historically low levels, reflecting a high level of complacency that exists in risk assets at this time.
- The S&P 500 Index gained another 3% during the second quarter and returned just over 9% during the first half of 2017. Growth stocks lead over value stocks expanded during the second quarter as a small number of large/mega cap growth stocks represent a disproportionate share of the year to date S&P 500 Index gains lead by FAANG stocks. Small cap stocks as measured by Russell 2000 Index returned 2.5% for the second quarter but lagged large cap stocks during the first half by 4.3%.
- Non U.S. stocks benefited from improving economic growth trends outside the U.S and from a relief rally over the French election results that favored staying with the European Union. International stock returns as measured by the MSCI EAFE Index were strong, returning 6.1% for the second quarter and nearly 14% during the first half. The MSCI Emerging Markets Index continued its torrid pace during the second quarter with a 6.3% return and returning just over 18% during the first half of 2017.
- The U.S. dollar continued to weaken against major currencies during the second quarter but mostly especially against the Euro, which rallied 9% during the first half of 2017. Stronger foreign currencies provided a tailwind to international stock returns for U.S. based investors.
- Bond markets are telling a much different story than stocks. The 10-year U.S. Treasury bond yield moved lower throughout the second quarter as bond investors reacted to weaker U.S. economic data and inflationary pressures remained soft. The yield declined as low as 2.12% before ending the quarter at 2.30%, down from 2.44% at the end of March. High yield bonds benefited from a risk-on trade, returning 2.1% during the second quarter while the broad U.S. bond market as measured by the Bloomberg Barclays Aggregate Index returned 1.5%.
- Oil prices declined another 8% despite OPEC extending its production cut agreement through March 2018. Concerns over excess inventories and growing non-OPEC production including the U.S. weighed on oil prices.
- The following table shows key market benchmarks as of June 30, 2017.

	Second Quarter		2017 Year to Date		2016	
S&P 500 Index (U.S. large cap stocks)	3.1%	↑	9.3%	↑↑	12.0%	↑↑↑
Russell 2000 Index (U.S. small cap stocks)	2.5%	↑	5.0%	↑↑	21.3%	↑↑↑
MSCI EAFE Index (large cap int'l stocks)	6.1%	↑↑	13.8%	↑↑↑	1.0%	↑
MSCI EM Index (emerging markets stocks)	6.3%	↑↑	18.4%	↑↑↑	11.2%	↑↑↑
Bloomberg Barclays Aggregate Bond (invt. grade bonds)	1.5%	↑	2.4%	↑	2.7%	↑
Bloomberg Barclays High Yield (below invt. grade bonds)	2.1%	↑	4.9%	↑↑	17.1%	↑↑↑
Bloomberg Barclays Short-term Treasury (cash)	0.2%	↔	0.3%	↔	0.5%	↔
Gold	-1.0%	↓	7.9%	↑↑	8.6%	↑↑
WTI Oil	-9.0%	↓↓	-14.0%	↓↓↓	44.8%	↑↑↑
Morningstar Balanced Funds Average	2.4%	↑	6.3%	↑↑	7.3%	↑↑

Third Quarter Investment Outlook

Nothing But Net

" Over the past 20 years, the VIX volatility index has closed lower than 10 on a total of 11 days, and seven of those days were in the past month."

- Marko Kolanovic – JP Morgan Head of Macro Quant and Derivatives Strategy

" If you put your effort and concentration into playing to your potential, to be the best that you can be, I don't care what the scoreboard says at the end of the game, in my book we're gonna be winners. "

- Coach Norman Dale - Hoosiers

As a former basketball player with a good shooters touch, a favorite hoops vernacular of mine was "nothing but net". This saying defined when a player's jump shot was so accurate that the basketball never touched the rim and hit nothing but net going through the hoop. Swish!! There is nothing more esthetically pleasing in sports (especially in slow motion replay) than to see a hoopster launch a beautiful jump shot and watch the arc of the ball as it sails through the air and hits nothing but net at the end. If that shot also happens to be a buzzer beater and the crowd erupts, that's as good as it gets in the game of basketball. They call it March Madness for a reason.

Basketball is the ultimate team sport. It's five players working the ball around to get it to the player who will provide the best chance for the team to score whereas baseball is a pitcher versus batter in a mano-y-mano duel that often determines the outcome of a game. Accurate shooting can be a streaky thing except for hardcore shooters like Pete Maravich, Jerry West, Larry Bird, or Stephen Curry (Wardell Stephen Curry II). Successful scoring in basketball is highly dependent upon the confidence of the shooter. When a hoops player gets the hot hand and is making mostly every shot they put up, the goal of the team is to keep feeding the hot hand so the team can win. During timeouts, the head coach will setup a play to free up the player with the hot hand in order to give them the best opportunity to keep working their magic touch. Coach Norman Dale in the movie Hoosiers did exactly that to free up his best shooter Jimmy Chitwood to make the final shot to win the Indiana State Championship with a buzzer beater.

With few exceptions, risk assets having been hitting nothing but net and have had the hot shooting hand, generating positive returns for seven straight quarters. Even after a double-digit returns during 2016, stocks have made a continual march higher during the first half of 2017 and with barely any downside volatility to be found. The stock market today is like the Golden State Warriors present dominance of the NBA. Golden State was tough enough before but adding Kevin Durant last season would be the equivalent of Facebook merging with Google and taking over the Internet.

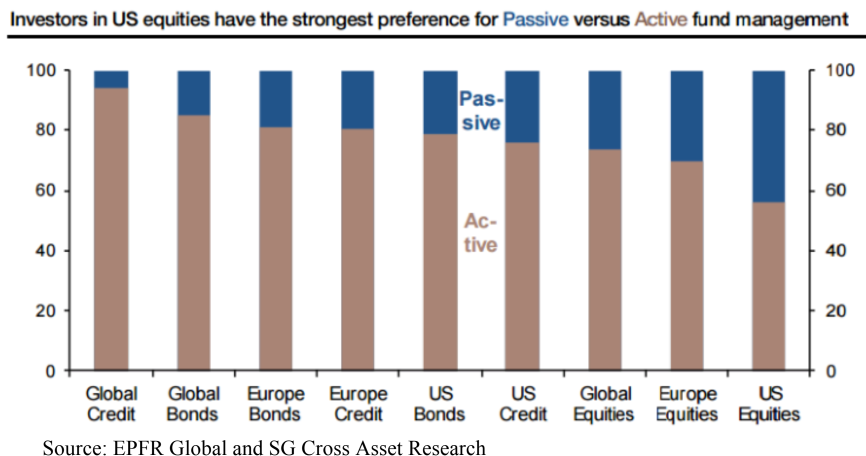
If the stock market were a basketball player, it would be considered a streaky shooter. It can get real hot and when that happens you want to keep feeding it the ball to keep scoring for your team (the Nothing But Net Worths). But when a player gets cold and starts shooting bricks (poorly aimed shots that clang off the rim or air balls that miss the basket completely), you want it sitting on the bench (riding the pine) until it gets its shooting confidence back.

When will the stock market's current hot shooting streak come to an end? A majority of investors don't believe it will and they keep feeding the ball to U.S. stocks in hopes of keeping the hot shooting streak alive. While basketball has a shot clock and set amount time per game, the stock market has neither so investors rarely worry about losing because the clock will run out on them. Rather, they often ride the hot hand much longer than they should and often lose sight of other evidence to suggest it may be time to sit the hot shooter on the bench and put in a better defensive player to protect the lead. A rabid hoops fan, like an overly bullish investor, may never recognize when that critical point in the game has been reached but a veteran coach like Norman Dale would plan ahead and react accordingly.

Passive versus Active

A sign that the hot shooting streak for U.S. stocks may be coming to an end is the rapid growth of indexation and Exchange Traded Fund (ETFs) assets. The combination of these two categories is captured under the broad category called passive investments. Passive investments own a group of stocks that fit the definition of the index or ETF category whose returns it is designed to replicate or capture. The most popular and longest tenured passive investment vehicle is the S&P 500 Index, which holds the 500 largest stocks in the U.S. stock market as defined by market capitalization.

Passive investments are growing rapidly, much to the detriment of actively managed investment strategies that employ the vast majority of investment professionals in the investment management industry. The following chart shows how passive investing is becoming a larger portion of the investable asset world across every major asset class. This trend is especially true in U.S. equities, where passive products now comprise 42% of all assets under management. It is projected that by 2022, the market share of passive investing will exceed active management in the U.S. stock market. 91% of all investors say they use or have considered using ETFs in their investment portfolios.

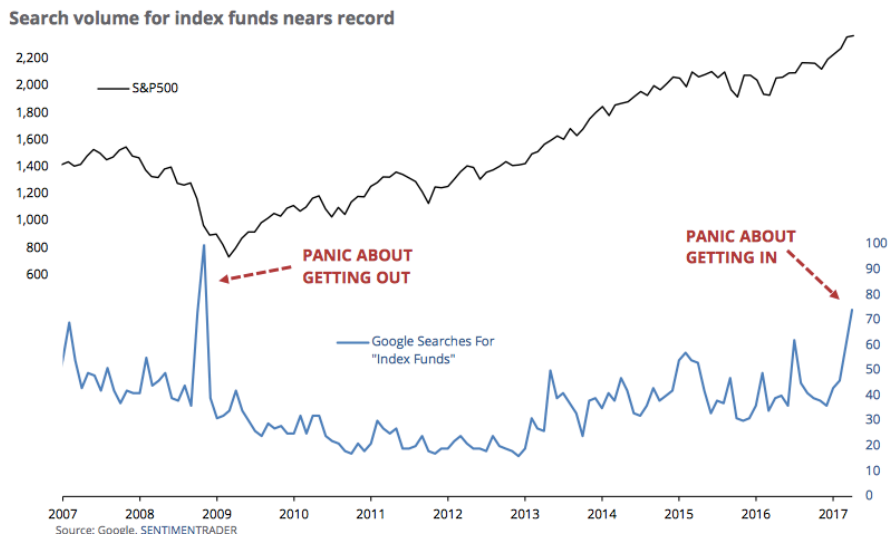


Source: EPFR Global and SG Cross Asset Research

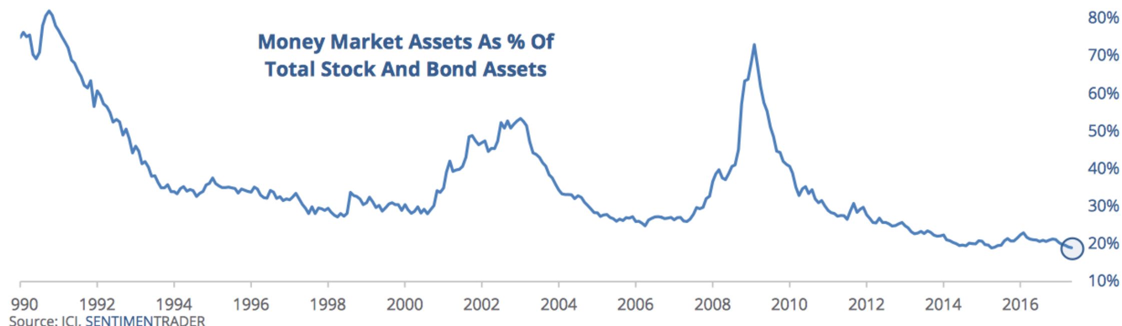
It used to be that passive investing's main attributes were low cost and broad diversification and that is still true of many of the broad market index fund products. However, with the advent of ETFs, low cost is often now a secondary consideration and the goal is to provide more narrow stock exposure to an investor, which is leading to a proliferation of ridiculous ETF product offerings whose only purpose is to make money for the ETF issuer. In the way that the 3-point shot in basketball has ruined the game of basketball in terms of reducing the importance (and beauty) of passing and play making, ETFs are ruining the investment game in terms of massive over issuance in very questionable market niches. Quincy Jones, the famous music producer of two of the greatest albums in music history, Michael Jackson's "Off

The Wall" and "Thriller", recently announced he has agreed to lend his name to an ETF that will focus on owning the stocks of companies in the music and entertainment sector called the Quincy Jones Streaming Music, Media & Entertainment ETF. There are now even Biblical ETFs (no doubt holding water and ark manufacturer stocks). Boy, that is really exciting stuff. Sound like a market top?

Investor obsession with index funds and ETFs and the returns they are generating (or missing out on) is reaching a peak, as the next chart of Google search words indicates.

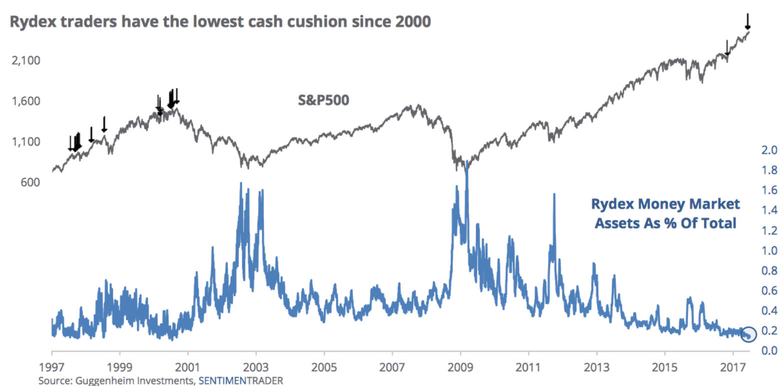


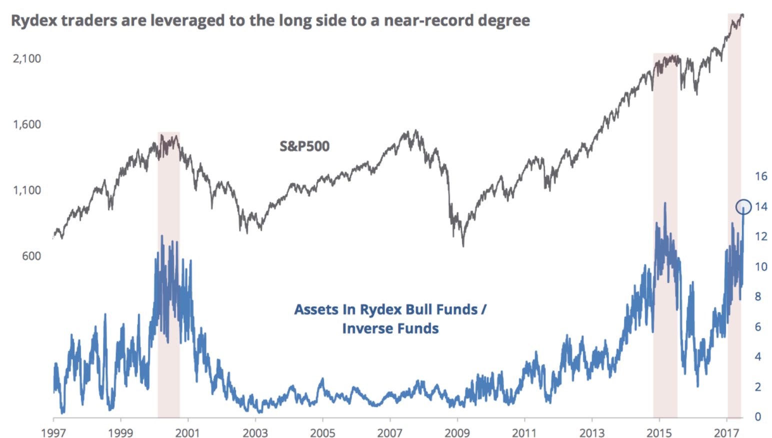
Money flows are another good indicator of how investors are overplaying the hot shooting hand and extending the stock market's upside move. The next chart shows how money market assets as a percent of total stock and bond assets are reaching a new all-time low. It is an indicator that investors are chasing the returns of stocks and bonds and have one of the lowest cash cushions of cash over the past 27 years. Of course, the extreme low interest rate policies (ZIRP, NIRP) of global central banks, which has basically made owning any kind of cash-like investment worthless, is the main factor behind this trend since 2008 and has pushed many investors out into bonds and stocks in order to capture higher returns.



Rydex Funds is an ETF provider that offers extreme (highly leveraged) ETFs to investors. If you believe stocks are going higher and would consider buy the S&P 500 Index fund, why not instead buy an ETF that will give you 2X or 3X the return of the S&P 500 Index for the same dollar of investment and make double or triple your money? Because of the nature of what Rydex funds offer, day traders or other risk biased investors often gravitate towards these types of ETFs and analyzing the underlying data of the asset flows in these types of ETFs can provide insight into the current bias of the stock market.

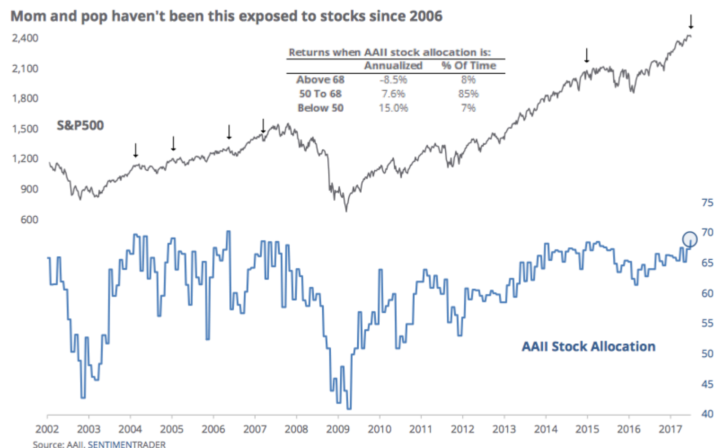
The next chart shows how cash levels of Rydex ETF traders are now near their lowest levels of the past 20 years. The chart below it shows how long biased (believe stocks are going up) Rydex ETF asset flows relative to short biased (believe stocks are going down, aka inverse ETFs) ETF assets are hitting peak levels of the past 20 years. It's important to understand that when leveraged ETFs designed to deliver positive stock market performance receive cash inflows, it exacerbates the upside effect of stock market movements. The opposite is also true. One of the important and less well known risks of the growth of passive U.S. stock investments (including leveraged ETFs) as shown in the chart on page 3 is that when the hot shooting streak for stocks ends, the investors owning passive investments including leveraged ETFs will liquidate and move into cash or inverse ETFs and the downside movement for stocks will be more dramatic and faster than most traditional investors can comprehend.





Source: Guggenheim Investments, SentimentTrader

It's not just the professional investors who are enamored with stocks. The next chart shows that mom and pop investors have not been as heavily overweight stocks since 2006. When the level of bullishness towards stocks hits these high levels, future returns from stocks have been quite poor.

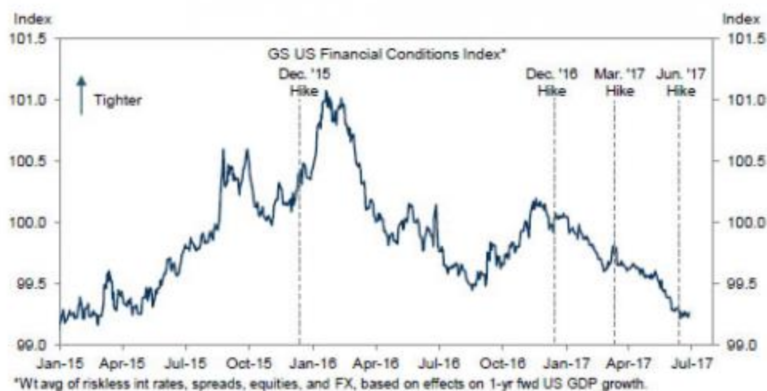


What Excess Liquidity Has Meant to Risk Assets

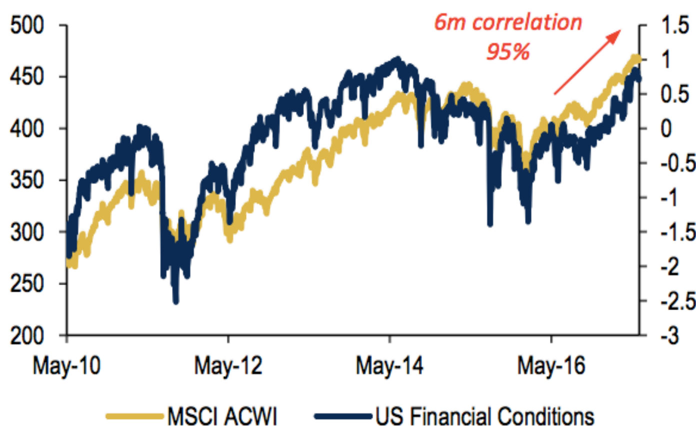
Liquidity is the point guard that keeps passing the ball to the player with the hot shooting hand: risk assets. When central banks unleashed Quantitative Easing in 2008, it started a tsunami of artificial liquidity being injected into global financial markets and is a key reason why risk assets have surged over the past nine years. Initially, the global central bank liquidity injections were intended to offset the highly damaging effects of the collapse of many financial players during that 2007-2009 window. However, QE morphed into attempts by global central banks to juice economic growth. As these various attempts more or less failed, central banks have kept pushing the liquidity envelope even further. The chart below shows the cumulative growth of the balance sheets of the Fed, Bank of Japan, and European Central Bank from 1990 to today. The right side of this chart shows how there has been a rapid and significant uptick in central bank liquidity over the past three years. In 2017 alone, central banks have injected $1.5 trillion of additional liquidity into global economies. Has this excessive liquidity support elevated the level of global economic growth? Definitely not, but it has had one other notable effect. This excess liquidity has found its way into global financial markets and risk assets and helped to drive U.S. stocks to all time highs.

Source: Bloomberg, Macro Tourist

The Goldman Sachs Financial Conditions Index is shown in the next chart and shows financial conditions from 2015 through today. Starting in mid 2015, financial conditions started to tighten. As conditions tightened, risk assets struggled. 2015 was a tough year to make any returns with the S&P 500 Index returning just over 1% and bonds barely in positive territory too. Difficult conditions persisted until February 2016 when the stock market suffered a sizable decline of over 10% during the first six weeks of the year before bottoming in early February. Since then, financial conditions have eased and with it the performance of risk assets has recovered strongly with the S&P 500 Index up over 13% during 2016 and up another 9% during the first half of 2017. The easy financial conditions environment is happening despite the fact that the Fed has raised short-term interest rates four times during this window starting in December 2015.



The next chart shows how the changes in U.S. financial conditions have been highly correlated to the movement of global stock markets since 2010.



The performance of risk assets such as stocks is now clearer in the context of how financial conditions have acted over this time period. However, easy financial conditions and the excess liquidity environment are likely peaking and should head back towards tightening mode due to the fact that the Fed is about to engage in the process of reducing its $4 trillion balance sheet. While the balance sheet wind down process is likely to be deliberate and take many years, on the margin it will take excess liquidity out of the financial markets and make it harder for risk assets to perform well.

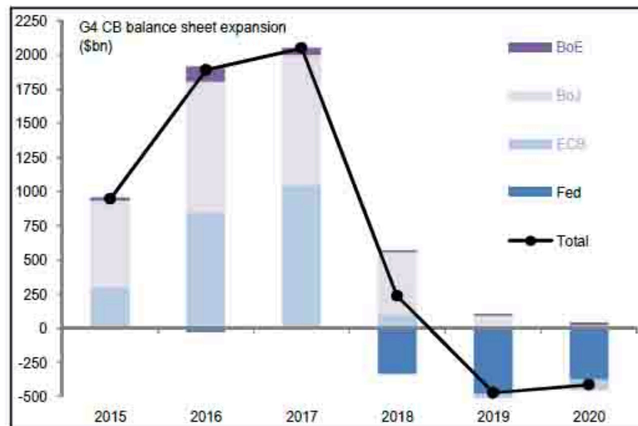
The Proverbial Elephant in the Room

In the complicated world of investing, even in normal times it can be intimidating, confusing, confounding, and head scratching all at once to the Average Joe investor. Since 2008 when global central banks stepped into the chasm created by the Global Financial Crisis (GFC), even seasoned and experienced investment professionals have struggled to understand the ramifications of this new world order. Nothing like the GFC had ever occurred in anyone's lifetime and the policy reactions of global central banks to the GFC have been unprecedented in nature. Global central banks and their extreme policies over the past nine years have been a key contributor to the rise of risk assets and global stock markets everywhere. However, just as the U.S. Federal Reserve lead the rest of the world's global central banks in implementing extreme monetary policy measures, it is now leading the move to withdraw these same extreme policy measures.

At the last Fed meeting in June, Chairwoman Janet Yellen announced the Fed's intention to start reducing its $4 trillion dollar balance sheet as part of its plan to start normalizing Fed policy over time. Undoubtedly, other global central banks are making plans to do the same as noted in recent public comments by European Central Bank head Mario Draghi. Given that the cumulative liquidity stimulus of global central banks over the past decade is in the trillions of dollars, the reversal of some of this extreme liquidity from global financial markets is likely to produce some degree of indigestion in the years ahead for both stocks and bonds. Think of it this way. Just like the massive growth of central bank balance sheets pumped unprecedented amounts of liquidity into financial markets and caused risk assets to rise, the decline of central bank balance sheets will produce some degree of the opposite effect, depending on how quickly central banks go about this extremely delicate task and depending on how global GDP growth and investors reacts as the process unfolds.

The next chart shows the balance sheet profile of the four major central banks (US, UK, Europe, Japan) from 2015 to 2017 and with projections from J.P. Morgan Research on how their balance sheets may contract from 2018 to 2020. As global investors have grown accustomed to central banks being the helicopter parent over past 10 years, they may find it very difficult to adapt and adjust to surviving on their own (Ain't it fun, living in the real world? - Paramore) as central banks move to the sidelines and begin the delicate liquidity withdrawal process.

Figure 3: A "QE cliff" will occur at the end of 2017 as G4 Central Banks scale down or reverse their balance sheet expansions
Projections based on JPM estimates



Source: J.P. Morgan.

Who's Right? Stocks or Bonds?

While risk assets continue to move higher and stock market volatility bounces along all-time low levels, the bond market is whistling a different tune and called a timeout to sub in its better defensive players. The next chart shows the yield curve spread (10-year U.S. Treasury bond yield minus the 2-year U.S. Treasury bond yield) over the past year. Longer maturity bonds are much more sensitive to inflation and U.S. economic growth trends while shorter maturity bonds are much more sensitive to Federal Reserve interest rate policy changes.

The yield curve spread started to widen in November 2016 when Trump was elected. Longer maturity bond yields started to rise as investors expected Trump's pro growth policy agenda to juice economic growth and inflation.   This view peaked right towards the end of 2016 with the yield spread near 1.35%. Since then, longer maturity bond yields have declined as economic data has been weak and Trump's pro growth policy agenda is stuck in the mud. At the same time, the Fed has raised short-term interest rates three times since Trump was elected, most recently at the June 14th meeting. This has caused the short end of the U.S. Treasury curve to move higher. As longer maturity bond yields declined, and shorter maturity bond yields headed higher, the yield curve spread has narrowed substantially, hitting a recent low of 0.8% until a quarter-end pop moved it back up to 0.93%. A flattening yield curve (long yields decline, short yields rise) is historically a sign of a slowing economy. The bond market is saying the complete opposite of the stock market. Bond investors think the economic outlook is weakening and are playing defense while stock investors are still feeding the ball to their hot shooter who keeps hitting nothing but net with every shot.

Summary

Investors with high stock market exposure are enjoying watching the Run-N-Gun highlight reels on CNBC every night, confident that stocks will keep hitting nothing but net while bond investors have called a timeout and their coach is putting in the Four Corner offense to run out the clock for the win. As long as stock investors remain confident in their hot shooter, the Federal Reserve, and the Fed remains confident in its own shot, then there is no telling how long this hot shooting streak for stocks will last. The Ws are piling up and everyone feels confident that the team will raise another banner to the rafters for 2017. However, any coach worth their salt will have a plan already in place for when the Fed's hot shooting streak comes to an end and the bricks and air balls start flying.

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