1st Quarter 2017 Market Commentary – Hopes for a Cyclical Recovery Deflate

Key Benchmarks: Performance and Characteristics as of 3/31/2017

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range	
S&P 500	0.1%	6.1%	6.1%	*18.3x*	*11.4x* … *18.9x*
MSCI EAFE	2.8%	7.2%	7.2%	*15.3x*	*9.2x* … *17.8x*
MSCI Emerging	2.5%	11.4%	11.4%	*12.5x*	*7.8x* … *17.2x*

Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Barclays Aggregate	-0.1%	0.8%	0.8%	US REITs	-1.6%	2.5%	2.5%
Barclays US High Yield	-0.2%	2.7%	2.7%	GSCI Commodities	-3.9%	-5.1%	-5.1%
Morningstar Global ex US	0.2%	2.2%	2.2%	GSCI Prec Metals	-0.5%	8.9%	8.9%

Data Source: Bloomberg

Highlights:

- Global equities posted a strong quarterly return led by ex-U.S. markets as investors become increasingly comfortable with the global growth environment.
- However, U.S. equities were flat in March as investors' high expectations for fiscal stimulus and regulatory relief hit the hard reality of the D.C. political establishment.
- Fixed income had a flat March but slightly positive quarter overall. The 10-Year U.S. Treasury Yield rose up to 2.6% at one point before dropping to 2.35-2.40% over concerns that the U.S. economy is losing momentum.
- The drop in oil prices to below $50/barrel before settling just above $50 at quarter-end also weighed on commodity indices and, tangentially, the U.S. credit markets. Rising North American energy stockpiles helped drive prices lower as did perceptions of OPEC's commitment to curtail production.

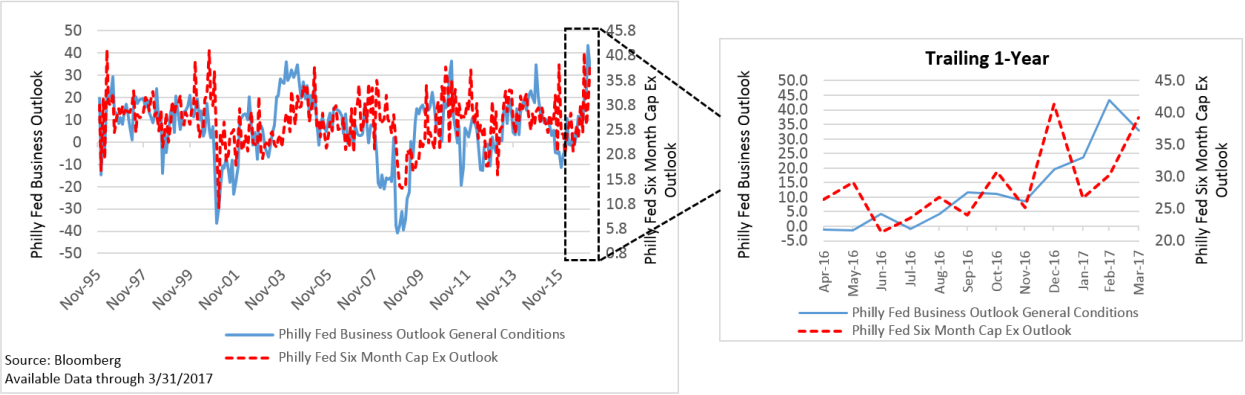
- With respect to 'soft' economic data, fixed income credit markets, such as high yield, would likely sniff out meaningful economic weakness; such weakness has not manifested itself in credit spreads so far.
- Inflation expectations remain elevated at around 2%; hence, even with reservations over the direction of this administration and commodity price weakness, the cyclical reflationary wave remains intact for now.

Investor Hopes for a Cyclical Boost Deflated by Political Realities

Rather than building on the strong performance from the prior quarter, global markets ended on a whimper as investors' high expectations for fiscal stimulus and regulatory relief hit the hard reality of Washington D.C. political machinations. In March, U.S. equities weakened when the Republican congress could not pass its own version of the American Affordable Care Act, calling into question the ability to pass meaningful tax reform and infrastructure spending promised by the Trump administration. Perhaps equity markets front-loaded too many expectations of fiscal stimulus as reality sets in that much of what had been promised won't meaningfully impact the economy until 2018.

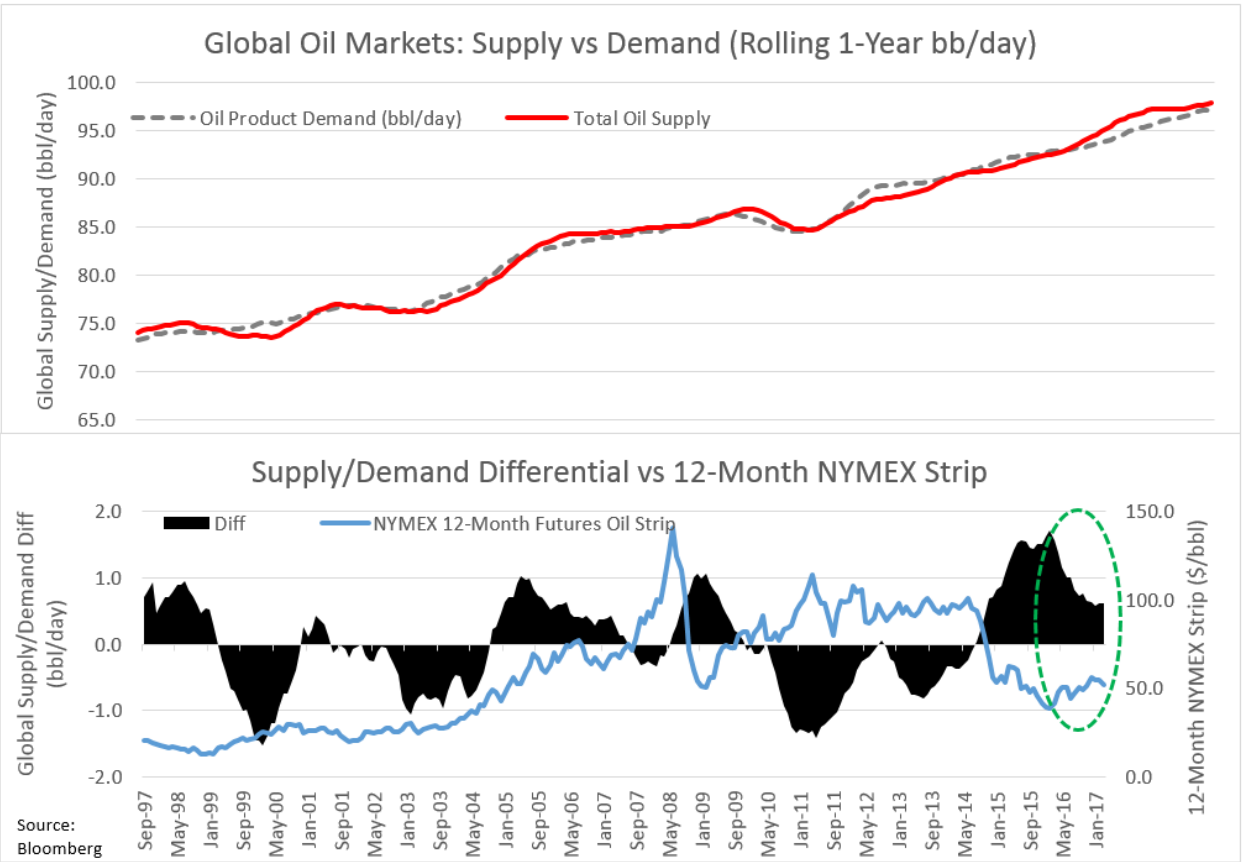
Yet animal spirits remain alive and well within the business community as the global economy continues to ride the crest of the cyclical reflationary wave that started last summer. Business sentiment indicators such as those tracked by the Philadelphia Federal Reserve continue to paint a positive picture for near-term capital spending (Exhibits 1). And despite the setback in reforming health care, Treasury Secretary Steven Mnuchin reiterated the administration's commitment to introduce "comprehensive" tax reform by August.

Exhibit 1: Philadelphia Federal Surveys – Animal Spirits Brewing Within the Business Community



The pullback in oil prices from a recent high of $54/barrel down to a low of $47 before rebounding to $50 also weighed on investor sentiment as North American producers have taken advantage of last year's oil price rebound to fire up production resulting in a near-term glut of inventory. And the cost curve for North American energy extraction keeps dropping with the advent of new technologies (i.e. fracking 2.0). The supply/demand picture appears to have stabilized (Exhibit 2) as the energy markets will likely be influenced by 1) OPEC production targets and 2) end-user demand reflected in gasoline and distillate inventories.

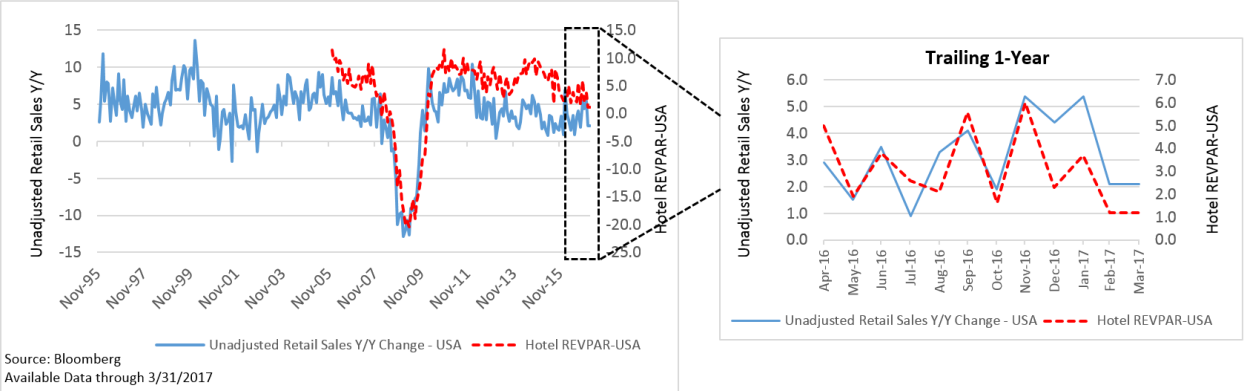
Exhibit 2: Demand/Supply Gap Puts a Ceiling on Further Oil Price Run-Ups



Beyond the come-back-to-reality over Trump policy expectations, investors have expressed nervousness over near-term soft economic data reflected in declining retail sales (Exhibit 3) and a collapse in commercial bank

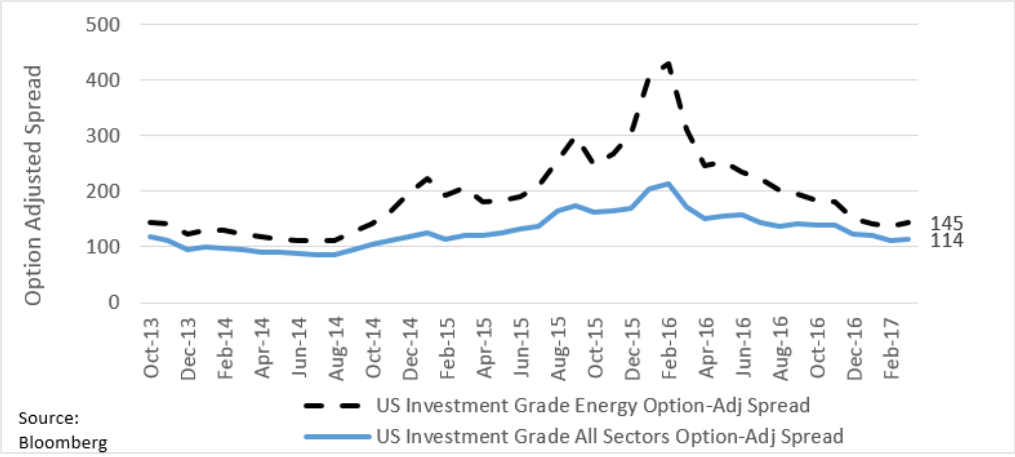
lending. With respect to the latter, Goldman Sachs commented that they believe much of this weakness stems from the energy sector contraction in 2015, and that commercial loan activity should recover based on forward sentiment indicators reflected in regional Federal Reserve surveys and the ISM.

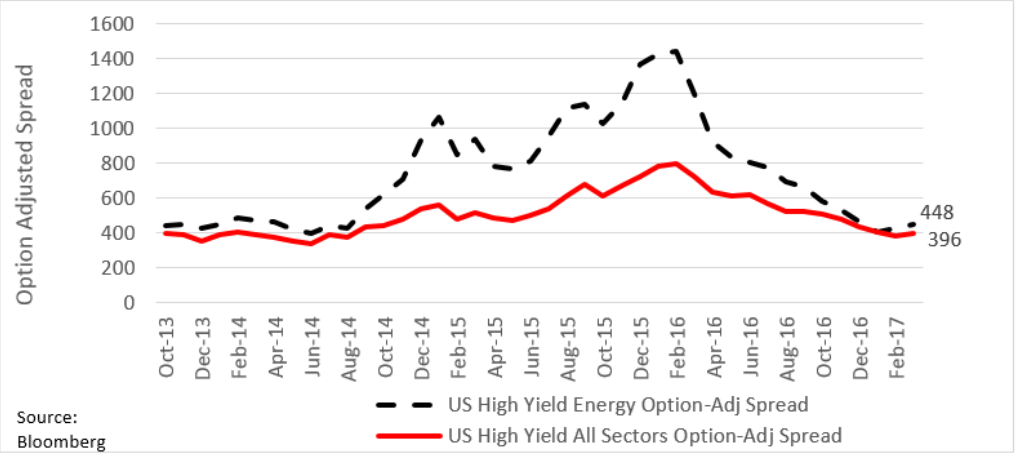
Exhibit 3 – Retail Sales and Hotel Revenue Point to a Softening Trend



In addition, the fixed income credit markets, traditional canary in the coal mines, typically sniff out meaningful economic weakness; such weakness has not manifested itself in credit spreads so far (Exhibit 4).

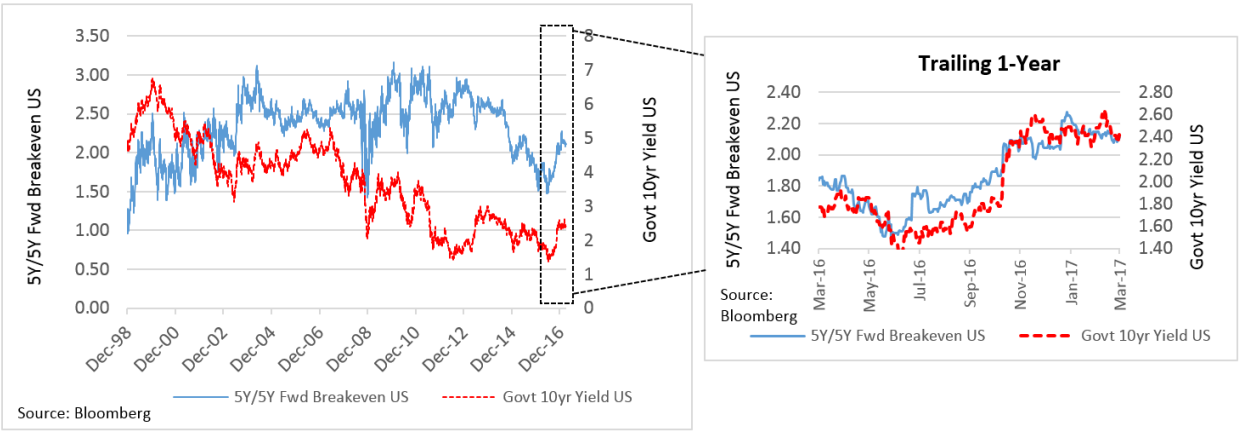
Exhibit 4 – Credit Spreads Widen but Financial Conditions Remain Loose





Inflation expectations also remain elevated at around 2% (Exhibit 5) despite the flattening of the yield curve with the 10-Year Treasury Yield dropping below 2.4% from a high of 2.6%. Even with reservations over the direction of this administration and commodity price weakness, the cyclical reflationary wave remains intact for now.

Exhibit 5 – Inflation Expectations Remain Above 2%

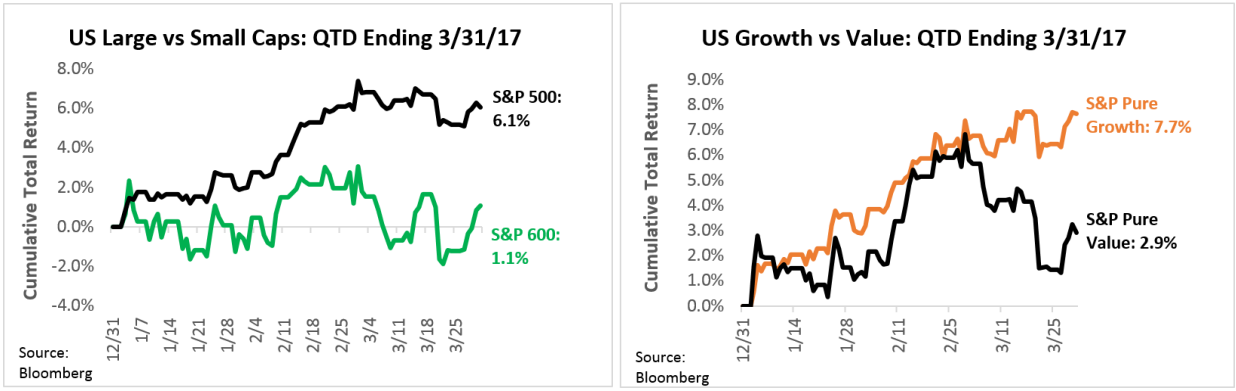


1Q2017 Can Be Summarized as the 'Trump Trades that Were Supposed to Work but Didn't'

Credit for this subhead goes to the Wall Street Journal that summarized the 'Trump' trades that haven't worked out this year. Here is a list of some of those trades in addition to some other ones not mentioned in the WSJ article:

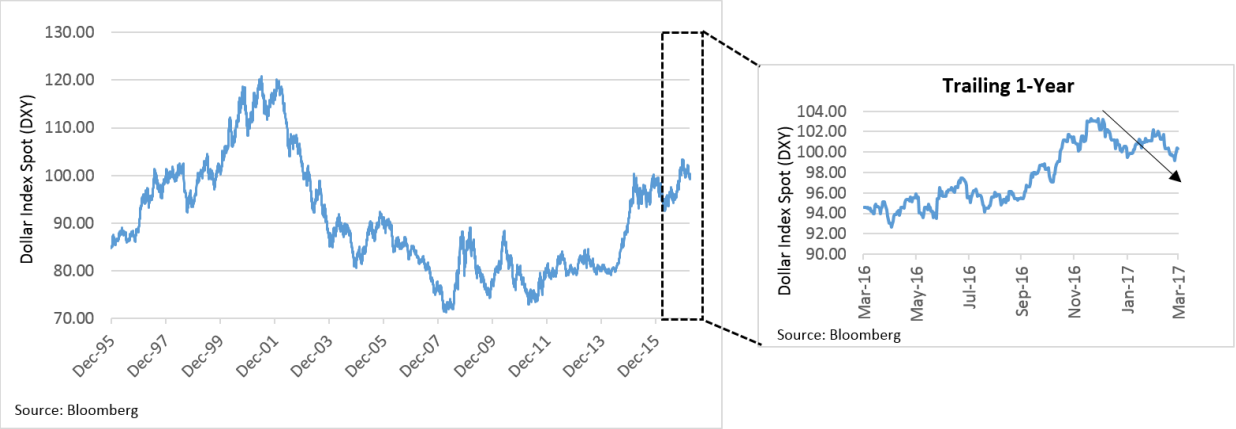
- U.S. small cap has underperformed large cap (Exhibit 6a)
- U.S. growth has outperformed value (Exhibit 6b)

Exhibit 6a-b – U.S. Narrowly Driven by Large Growth



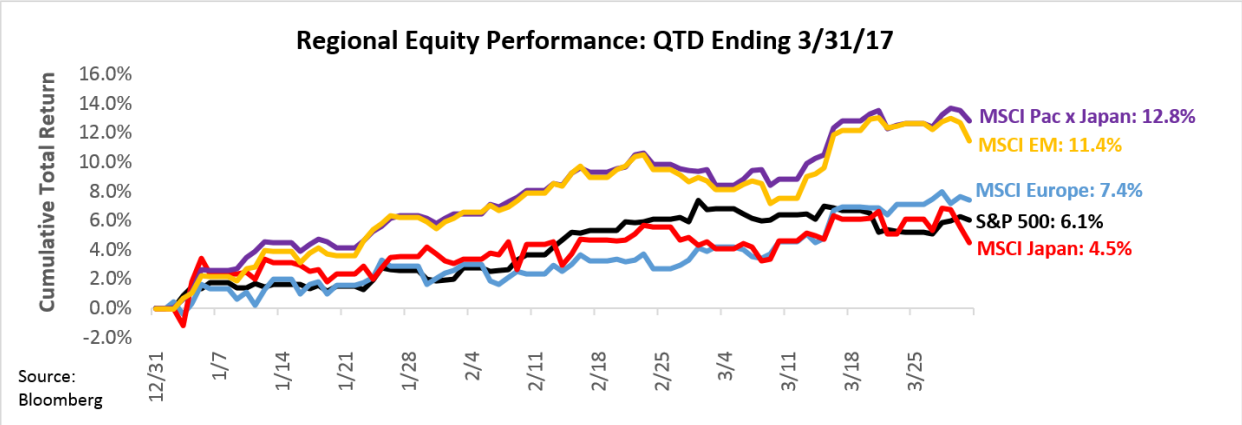
- The U.S. dollar has underperformed on a trade-weighted basis (Exhibit 7)

Exhibit 7 – U.S. Dollar Has Weakened Against Trade-Weighted Basket



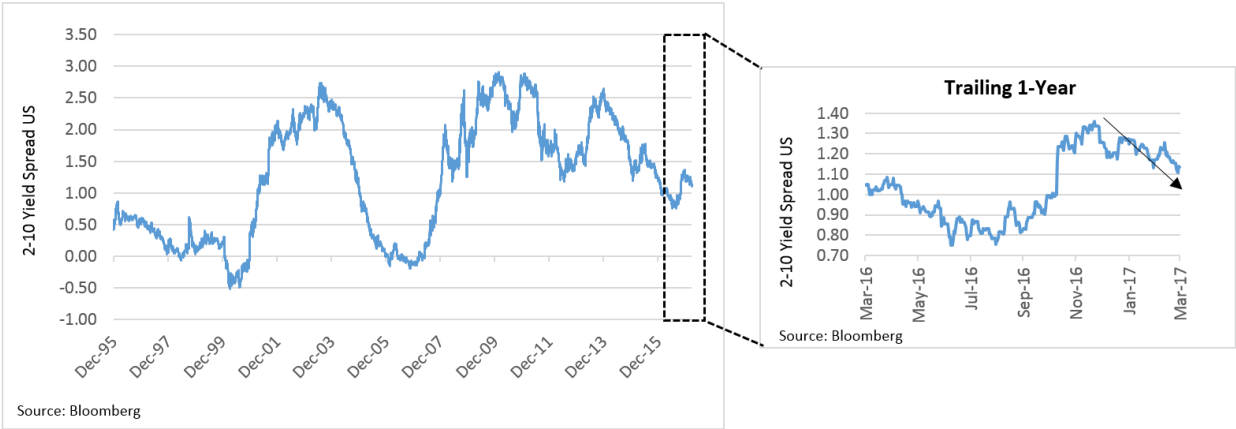
- Emerging markets have outperformed all other regions (Exhibit 8). In addition, Europe, faced with its own populist revolts, was supposed to have underperformed as a region but outperformed the U.S.

Exhibit 8 – Ex-U.S. Markets Outperform U.S.



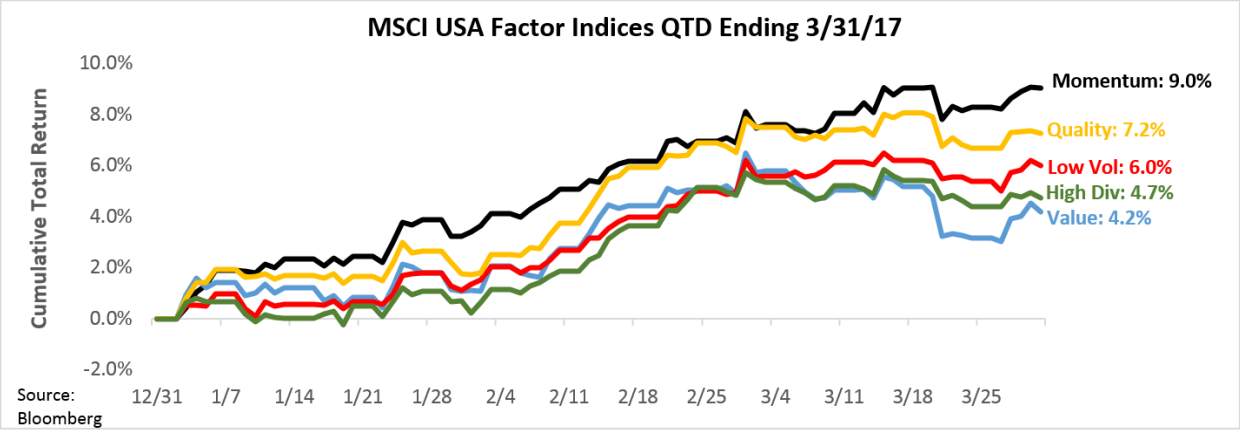
- The 2-10 Year yield curve is flattening in reaction to perceived administration failures and weakening macro conditions (Exhibit 9). Wasn't the 10-Year Treasury Yield supposed to spike to 3% on the heels of a hotter economy brought on by fiscal stimulus?

Exhibit 9 – Yield Curve Flattening Portends a Softer Environment Ahead



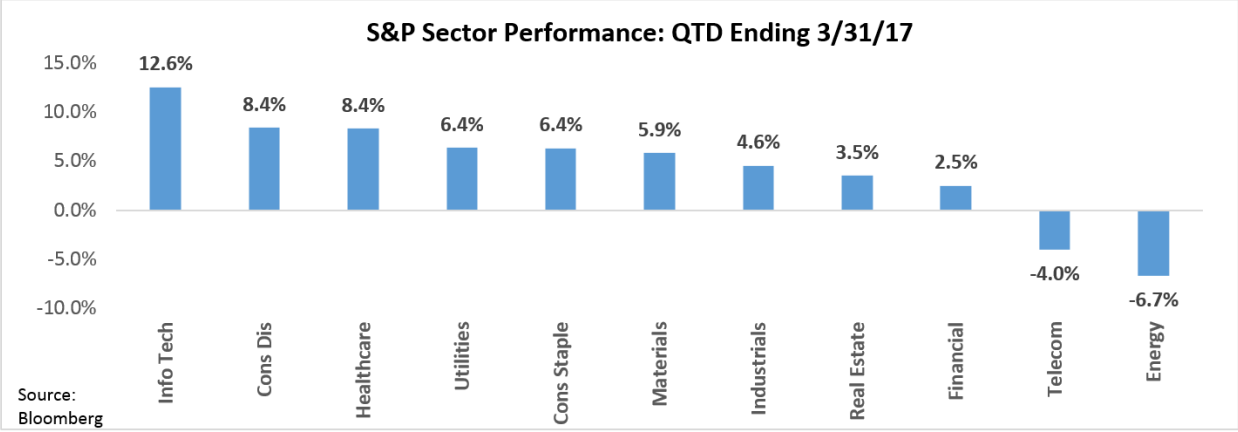
Considering this Bizarro world where expectations got flipped on their head, investors flocked to 'certainty' by opting for success (momentum) and high quality (Exhibit 10). If investors are unsure what will succeed tomorrow, buy what has been successful more recently.

Exhibit 10 – Investors Flock to Momentum and High Quality



1Q2017 was driven by a narrow group of large growth stocks and sectors (Exhibit 11), led by technology and health care. Trump was supposed to usher in a new era of small cap and value outperformance (an environment supportive of traditional active management), but so far it has only produced more uncertainty and a narrow-driven market as investors pay up for what they perceive as scarce growth opportunities. The Trump trade has been sidelined for now but could re-emerge if Trump's legislative agenda regains its footing.

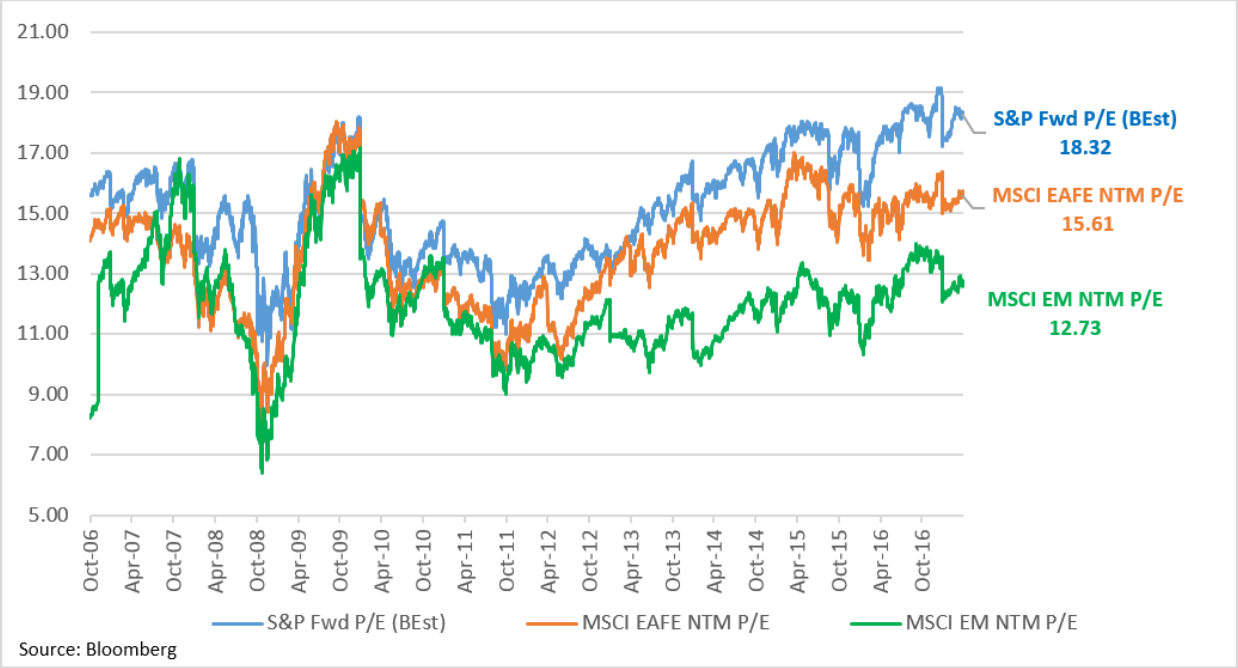
Exhibit 11 – Technology Dominates Sector Performers in 1Q2017



Overpaying for Insurance (i.e. Downside Protection)?

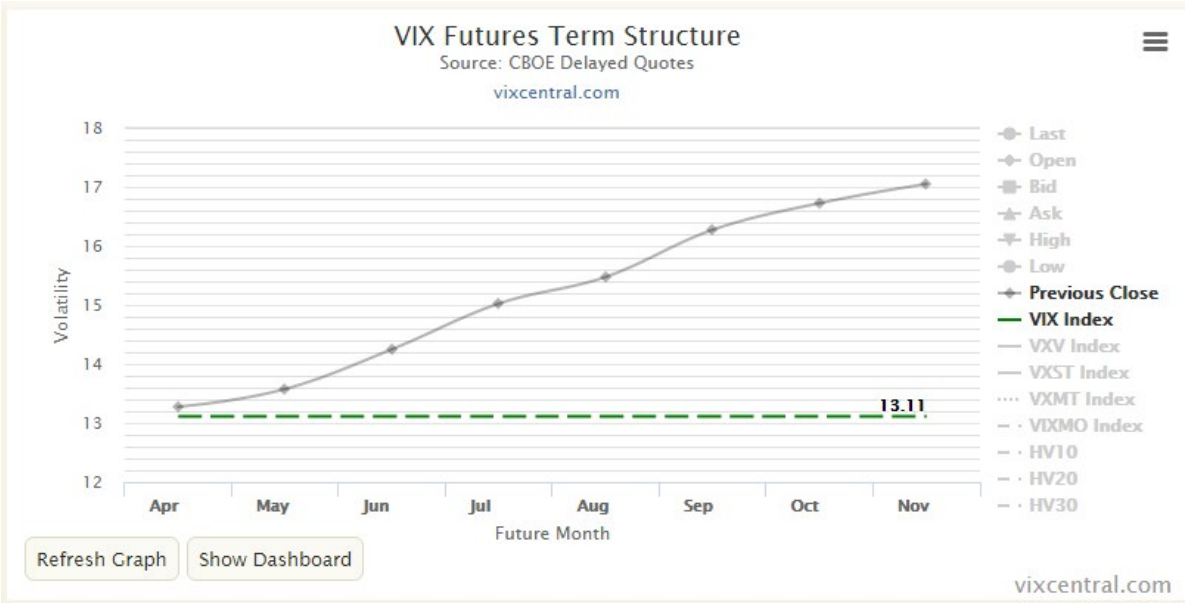
Investors have grown increasingly wary of equity investing as equity market valuations have gotten further stretched (Exhibit 12).

Exhibit 12 – Global Markets at Elevated Valuations



With volatility measures, such as the VIX, at depressed levels, getting downside protection in the form of buying put options or investing in VIX futures may seem attractive. However, investors seeking to hedge their downside exposure by investing in VIX futures must monitor the 'volatility term premium' reflected in the steepness of the VIX curve (Exhibit 13), where investors in VIX futures 'pay up' for protection for periods further out from the present.

Exhibit 13 – Investors Pay Up to Hedge Risk Beyond the Present Period



Source: vixcentral.com. As of 3/31/2017.

Specifically, investors in VIX futures pay a roll-down cost as the more expensive later-dated futures roll down to less expensive spot prices which must then be reinvested back into higher cost later-dated futures in order to maintain the hedge against downside losses. Barring a significant volatility-driven event, the roll-down produces negative returns over time, which represents the cost of maintaining the hedge.

Except during extreme periods of stress, the VIX term structure typically trades at a steep level, or contango, reflecting this volatility term premium. It's one of the costs of paying for downside insurance, akin to paying for downside 'tail' risk in the form of catastrophe insurance for property/casualty. Since the typical investor's utility function for accepting risk tends to be asymmetric (i.e. high risk aversion towards downside tail losses), issuers of downside protection, whether P&C insurance carriers or hedge funds that short the VIX, know they can charge a higher premium than what would be warranted if investors were to exhibit risk-neutral behavior rather than risk aversion. Should a downside event occur resulting in tail losses, insurance companies and hedge funds, assuming both possess sufficient capital levels, can absorb the losses while also taking advantage of the spike in premiums that typically follow the downside event. Issuers of downside risk protection profit on this asymmetric desire of investors wanting that full upside capture while protecting themselves on the downside.

Another way of seeing this overcharge for downside protection is the volatility risk premium ("VRP"), measured as the difference between the implied volatility priced into an option versus the realized volatility of the underlying asset, explored by AQR Capital which recently published "Embracing Downside Risk" in the Winter 2017 edition of the Journal of Alternative Investments. The paper explores the nature of the long-run returns of the S&P 500 Index by splitting the index into its upside and downside components and then building portfolios to reflect each one by purchasing and selling identical call options while holding the S&P 500.

In a risk-neutral setting, the expected returns of the long and short call positions should be "proportional to their equity betas" or no discernable difference in returns once accounting for market exposure. However, the asymmetric behavior of investors, who desire upside participation while limiting downside losses, "leads to demand for options" with the option price reflecting this demand. This demand drives the VRP where the implied volatility priced into the options is higher than the realized volatility of the underlying asset class those options are tied to. Based on their empirical work, the authors conclude that "nearly all of the S&P 500 Index's return may be attributed to its covered call component" or the insurance premium portion for taking on downside risk. In addition, the long call position "contributes little reward" while still contributing 41% of the underlying market risk.

By isolating the VRP from historical market returns, AQR observes that 'downside' risk provides "the main source of long-run rewards in equities and other asset classes" and that "long-term investors may be better off embracing the downside because hedging it would remove much, if not all, of the long-term returns." (Emphasis Ours) Again, this is due to the asymmetric risk behavior exhibited by the typical investor: strong demand for upside participation but little tolerance for downside losses.

Is this pricing irrational? Not necessarily, because as stated above, this is the cost demanded by option sellers for their willingness to take on downside losses that the investor is unwilling to bear. Investing in equities is risky; hence, the concept of the equity risk premium for compensating investors willing to assume this risk over a long enough time horizon. But as AQR observes, "this compensation is asymmetric, reflecting investor preferences" for upside capture with little downside loss. In other words, those who earn the long-term equity risk premium are capturing it from those who are unwilling to bear the downside losses but who still try to capture all the upside.

Are there smarter, more cost-effective ways of achieving this elusive goal of maximizing upside capture / mitigating downside losses? Admittedly, this is out of our wheelhouse, but AQR's paper does reemphasize the importance of disciplined, strategic investing for those desiring to capture long-term risk premiums.

Disclosure:

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