May 2017 Market Commentary – The Death of Volatility?

Key Benchmarks: Performance and Characteristics as of 5/31/2017

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range	
S&P 500	1.2%	2.4%	8.7%	*18.6x*	*11.4x* … *18.9x*
MSCI EAFE	3.4%	6.3%	14.0%	*15.5x*	*9.2x* … *17.8x*
MSCI Emerging	2.8%	5.2%	17.3%	*12.7x*	*7.8x* … *17.2x*

Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Barclays Aggregate	1.0%	1.5%	2.4%	US REITs	-0.6%	0.4%	2.9%
Barclays US High Yield	0.8%	2.0%	4.8%	GSCI Commodities	-1.3%	-3.6%	-8.5%
Morningstar Global ex US	2.0%	3.7%	5.9%	GSCI Prec Metals	1.6%	1.0%	9.9%

Data Source: Bloomberg

Highlights:

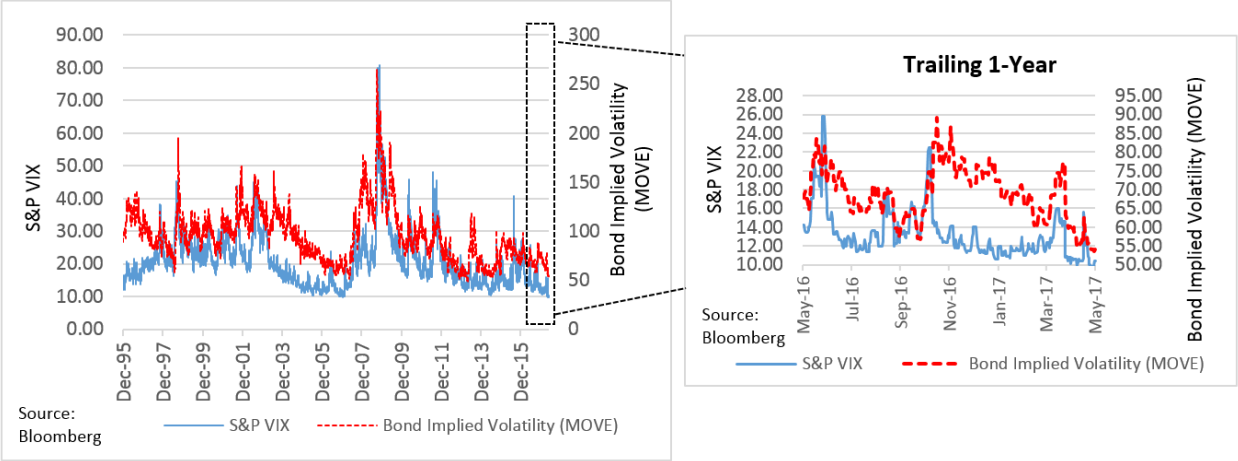
- Global equity markets put in another strong month, prompted by the outcome of the French elections with centrist/reformist Emmanuel Macron prevailing over populist candidate Jean-Marie LePen.
- Underneath the strong, stable market advance lies a curious appetite for premium growth and safety as investors move away from the cyclical recovery trade and opt for greater certainty, whether in expensive technology or in defensive sectors such as utilities and staples. All three led S&P sectors in May.
- Globally, value and small cap underperformed and emerging markets gave back some of its leadership in favor of investors' newfound love for European markets which led all major regions.
- Part of the strong performance of overseas markets came from a weakening U.S. dollar. The trade-weighted dollar index (DXY) was down just over 2% for the month.
- Fixed income markets have also rallied as credit spreads narrow reflecting a benign outlook for corporate debt service. The 10-Year Treasury Yield declined to 2.20% from 2.28% at the beginning of the month and is down from its YTD high of 2.62%.

- The 2-10 year term structure continues to flatten and forward inflation expectations have dropped below 2%. The fixed income market seems to be expressing a view that the cyclical reflationary trade is done for now as it appears more likely that fiscal initiatives will be delayed until 2018, if they occur at all.
- As implied volatility priced into equity and fixed income markets drops to new lows, the question of whether volatility is dead is grabbing more media attention. Positioning for lower volatility may appear to be crowded in the short-term, but it also reflects the new normal of low secular growth combined with heightened global central bank liquidity.
- It has been a challenging year for investment portfolios tilted towards smaller caps and value. Even portfolios built on global diversification have generally struggled in a narrowly-driven environment, whether large cap growth or single regions like Europe. For now, sentiment continues to favor a growth/defensive style of investing, but the macro environment is still supportive of broader market participation.

The Death of Volatility? (Or Waiting for Something to Happen)

'Is Volatility dead?' seems to occupy much of the financial headlines (apart from Trump, what else is there to prognosticate on?). Some novel theories have been put forward such as how the accelerated adoption of Twitter has led to a decline in investors' attention spans causing them to behave more like deer in the headlights (because they fear the spread of fake news on social media) rather than react to market moving events (although the brief spike in volatility in reaction to veiled accusations of obstruction of justice charges against the Trump administration would seem to belie this theory). As volatility gauges reach 1-year lows (Exhibit 1), investors are finding it difficult to reconcile these low levels with an investment environment they regard as the "most unpredictable" ever (according to a UBS survey of wealth managers). Of course, the "surge in passive as opposed to active investment strategies" as well as the "trillions of liquidity provided by the world's central banks through their quantitative easing programs" are more likely suspects, but the social media theory does hold some intuitive appeal.

Exhibit 1 – Smooth Road Ahead for Equities and Fixed Income



Regardless, lower volatility may be great for investors (despite their angst) but it can wreack havoc on those who profit from uncertainty. On the last day of the month, both J.P. Morgan and Bank of America warned investors that second quarter trading results were tracking below expectations, dragging down the major money centers. Now granted, the year-over-year comparisons are tough given that the world was facing the Brexit decision last June, but the low levels of volatility have prompted concerns over heightened investor complacency. Narrow credit spreads, lack of currency volatility, minor geopolitical disruptions, and the increased popularity of risk parity strategies (reflexivity?) confirm an environment where the best strategy is to do nothing, much to the chagrin of those who make money from investors doing something.

Yet, it's hard not to think that some amount of complacency has seeped into the pricing of risk:

"If you look at implied volatility, it is at or near one-year lows across every asset class and nearly every region" we track, said Mandy Xu, a derivatives strategist at Credit Suisse. "Investors are pricing in zero risk in the near term."

One can also draw parallels to what Alan Greenspan warned back in 2005:

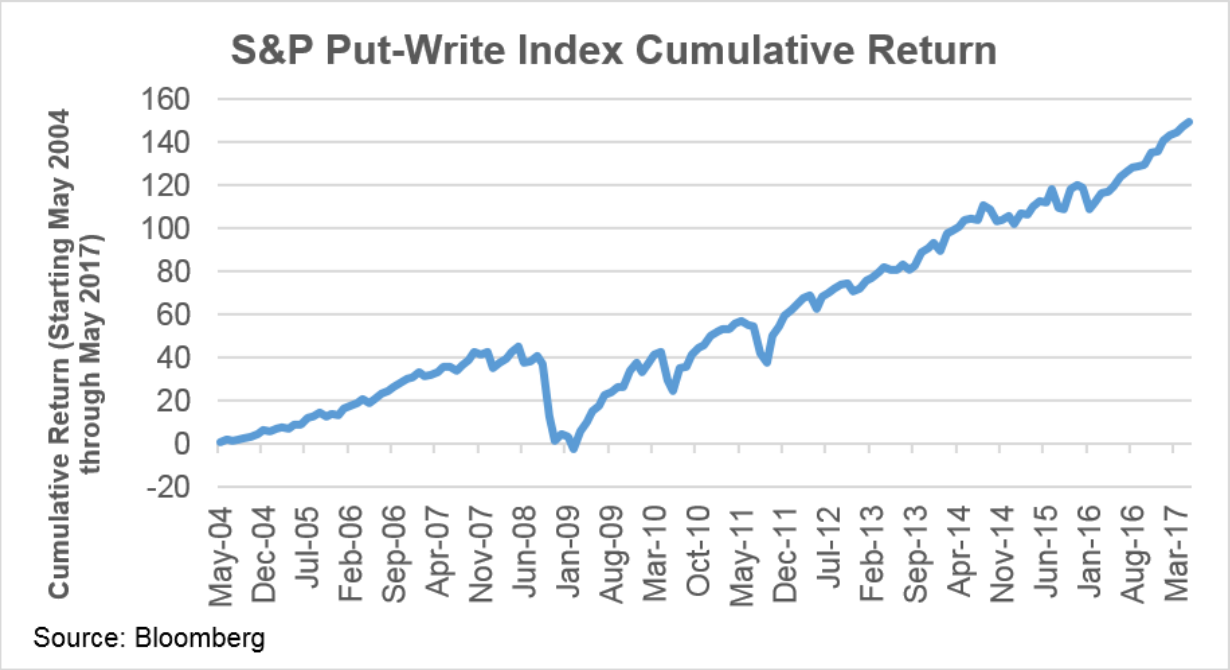
"Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums. (Emphasis Ours)"

Alan Greenspan made this remark in the backdrop of a growing wealth-to-income ratio amidst a growing stability of the world economy (obvious well before the 2008 Financial Crisis) even though today's environment lacks ingredients present in the mid-2000s such as productivity growth and increased globalization. Regardless, one can read frequent debates over whether today's stability will beget tomorrow's volatility or whether today's stability is justified in the current macro environment (your views more likely shaded by your political leanings; probably more so than with any past White House administration).

Over the longer run, investors have been rewarded for underwriting insurance against downside risk as opposed to buying protection against downside risk. Exhibit 2 shows the performance of the S&P Put-Write Index which tracks a strategy that sells fully collateralized near-term put options on the S&P 500. Despite the risk of large drawdowns stemming from market sell-offs, the strategy performs well over the long run as the strategy can offset these large drawdowns by taking advantage of higher option premiums following the sell-offs. This past year has witnessed an especially smooth ride. Today's low risk environment has shrunk those premiums, so

underwriting downside protection today may resemble picking up nickels in front of a steamroller. But such strategies remain popular as the market expects the low risk environment to continue for the foreseeable future.

Exhibit 2 – Underwriting Market Downside Risk Has Been Rewarding



Momentum Runs but Risk Appetite Shows Signs of Buckling

It's becoming a challenge to discern what to make of the contradictory signals coming out of the markets. Supporting equity risk appetite, we see the following:

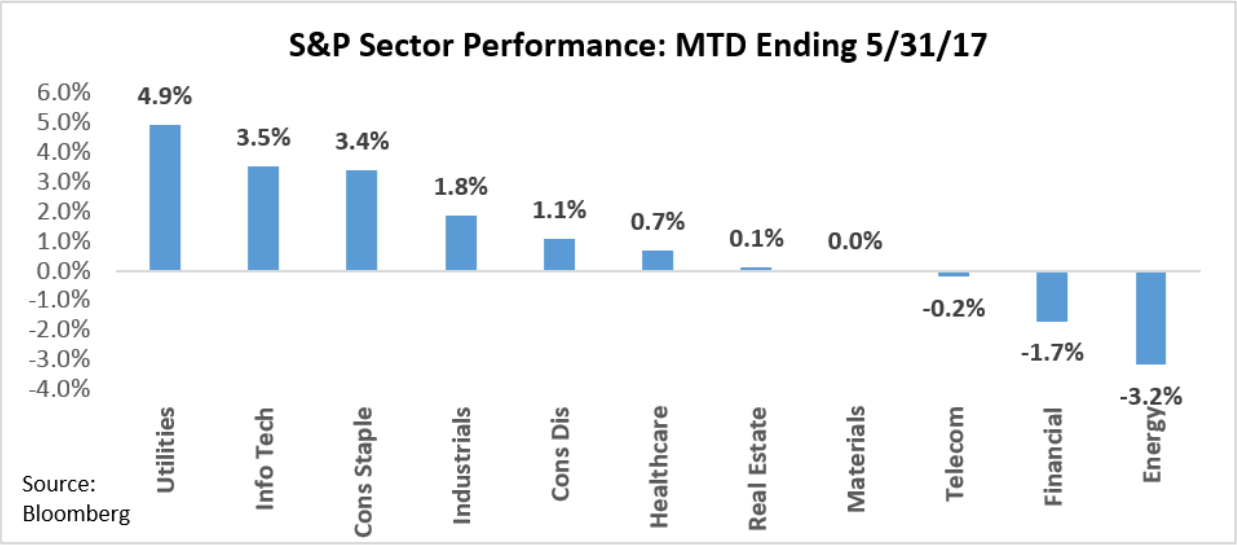
1) Historically low levels of implied volatility in equities (VIX) and fixed income (MOVE).
2) Narrow corporate credit spreads versus U.S. Treasuries.
3) Broadening of the equity rally to overseas markets, particularly Europe, which had been in a malaise since the 2010 sovereign debt crisis.
4) S&P 500 operating margins remain resilient which helps fuel higher earnings growth in a recovering revenue growth environment.
5) Strong U.S., Japan, and European business sentiment.

However, other areas of the market are exhibiting troubling signs that, perhaps, not all is well underneath the surface:

1) Narrowing market breadth as indicated by a) small caps underperforming large caps and b) rising % of S&P 500 stocks dropping to a 24-week low.
2) Declining prices in industrial commodities.
3) Flattening Treasury yield curve (10- vs 2-year Treasury yields).
4) Weakening macro indicators coming out of China.
5) Softening in global manufacturing sentiment, particularly in emerging markets.

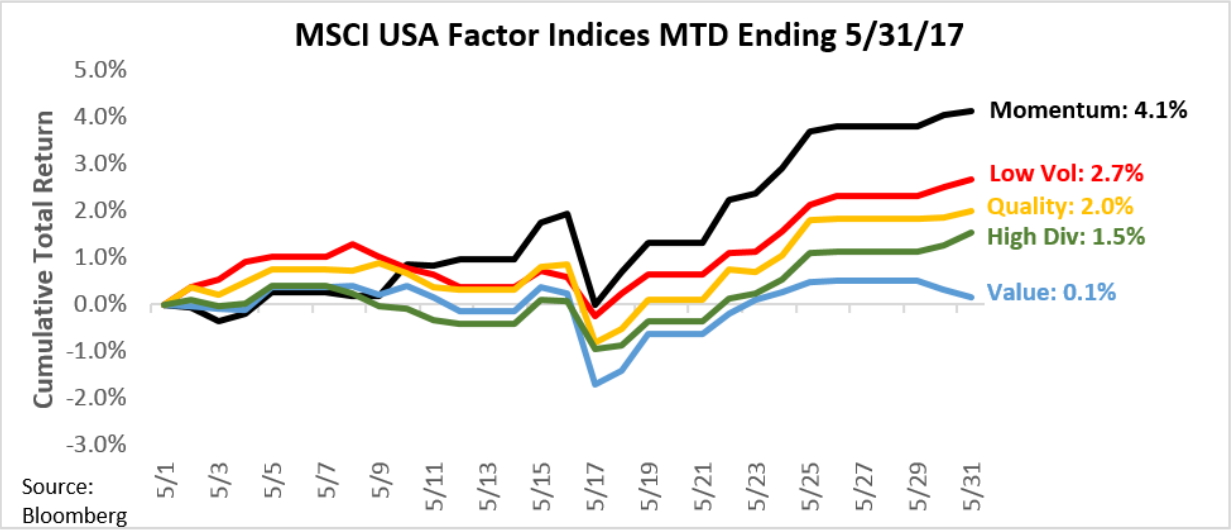
The market's efforts to reconcile these conflicting signals has manifested itself in the primary drivers of this latest market advance: strong, narrowly-driven performance of momentum and defense where investors are increasingly willing to pay a premium for perceived growth certainty versus an uncertain cyclical growth recovery. This has shown up in both equities and fixed income where investors are now willing to pay for certainty (premium growth) and safety (defensive growth, yield-sensitivity) as evidenced by this month's sector performers (Exhibit 3). A bifurcated leadership has emerged with defensive sectors such as utilities and consumer staples along with growth technology leading all other sectors.

Exhibit 3 – Investors Flock to Premium Growth and Safety



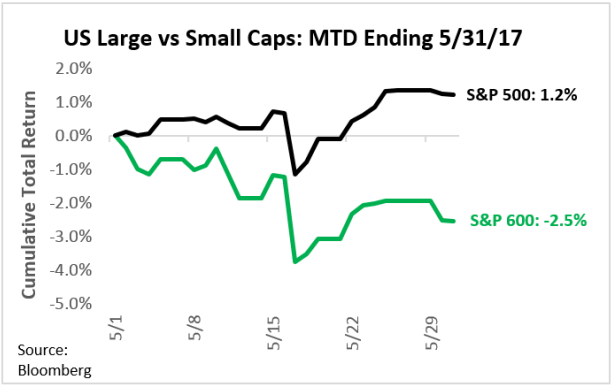
Low volatility style is outperforming all other major styles (outside of momentum) contrary to expectations that defensive strategies should not prosper in a risk-complacent environment (Exhibit 4). Why pay up for low volatility when protection against volatility is not being afforded a high premium? However, given the rate sensitivity of low volatility strategies, low volatility's outperformance should not come as a surprise given the drop in long-term interest rates. In the end, this may all just reflect an exercise in fence sitting as the current go-to strategy is to stick with 'certainty' and 'defense' until more clarity emerges concerning the cyclical outlook.

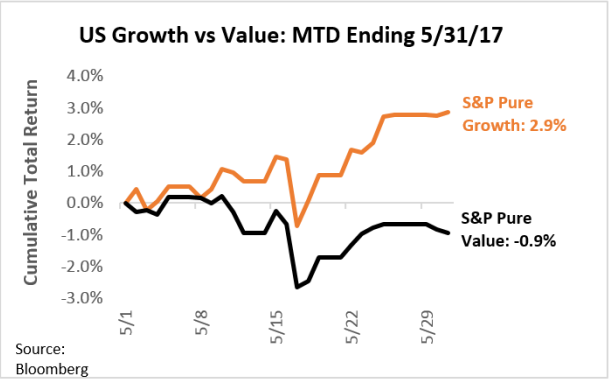
Exhibit 4 – Momentum Running Ahead Followed by Low Volatility



This investor posturing also shows up in the dominance of U.S. large cap growth to the detriment of small caps and value (Exhibits 5a and 5b). Globally, small caps fared better as MSCI EAFE Small Cap returned 3.69% versus 3.67% for MSCI EAFE, although MSCI Emerging Market Small Cap Index return of 0.69% lagged the 2.96% return for MSCI Emerging Markets. Value style of investing is also underperforming globally as MSCI All Country World Index ex-U.S. Value return of 2.08% lagged the 4.45% return of MSCI All Country World Index ex-U.S. Growth.

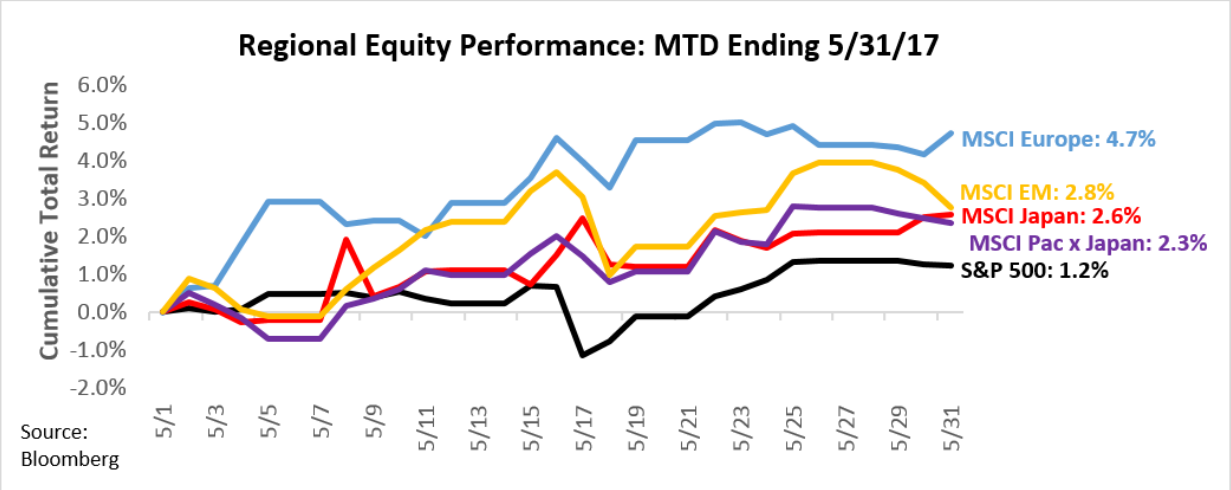
Exhibits 5a and 5b: U.S. Large Growth Continuing Its Dominance





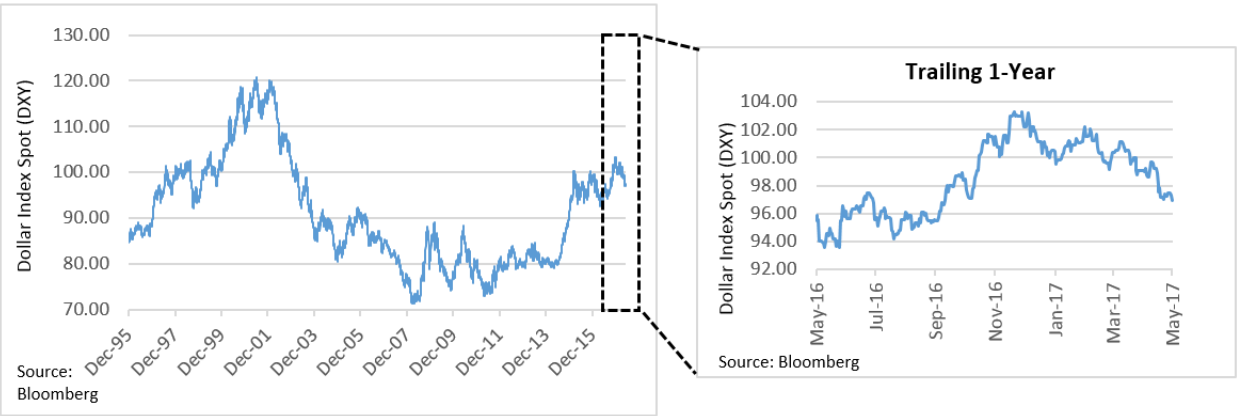
Equity sentiment has clearly shifted towards U.S. large caps and Europe following the French elections (Exhibit 6). The European Central Bank remains committed to its quantitative easing program as inflation appears to have peaked which will give more flexibility to the central bank even if growth conditions continue to improve.

Exhibit 6: Europe Leads All Major Regions in May Largely Driven by Euro Strength



In addition, one driver of ex-U.S. outperformance has been the weakening U.S. dollar as the trade-weighted dollar index dropped 2.2%, breaching pre-election levels from past November (Exhibit 7). Currency investors seem to be looking beyond the U.S. Federal Reserve's communication of three rate hikes this year as they anticipate a slower growth environment that would preclude further rate tightening. Indeed, some Fed officials have communicated that they believe the U.S. is close to reaching a neutral rate level which would imply lower long-term rates despite the current Fed tightening cycle. In recent inflation releases, Federal Reserve governor Lael Brainard commented that this softening could lead the Fed to "reassess the appropriate path of policy." Despite a strong employment picture, inflation appears to have peaked following the initial recovery in oil prices. A benign inflationary environment would give the Fed more room on setting rate policy but could also help support the risk appetite driving pricing in growth equities and fixed income.

Exhibit 7: U.S. Dollar Weakens to Pre-Election Levels



A Summer to Remember (for Growth Momentum)

What does this all mean? The stars are aligning for the growth investment style to continue its dominance. Despite the strong YTD run, U.S. momentum does not look that expensive relative to its own history, as well as, the broader market. According to iShares, MTUM is not much more expensive versus the S&P 500 (as proxied by IVV). Value style of investing is clearly out of favor until some clarity emerges on fiscal policy initiatives, as well

as, tangible signs of a broad-based cyclical recovery (especially one that is inflationary). Small cap may see a recovery as this year's underperformance has narrowed its valuation gap versus large caps. And the momentum in fixed income seems to point towards lower yields from current levels (maybe the 10-year Treasury drops to 2% during the summer) but also narrow credit spreads, so this would favor long duration credit-sensitive exposures.

Value investors take upon the burden of exercising patience, but styles will cycle in and out of favor. Over the long run, this patience has been historically rewarded with higher returns for taking on risks beyond the market itself. However, over the short term, this environment may produce more pain for value investors.

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