

## Q1 Market Commentary

### Laissez le Bon Temps Rouler !! (Let the Good Times Roll)

Global economic strength continued to gather steam in Q1 as the ongoing cyclical recovery in the US was magnified by a broader global pick-up in Europe, China, and emerging markets. While US stocks logged another quarterly gain, it was European and emerging market stocks that were the best performers.

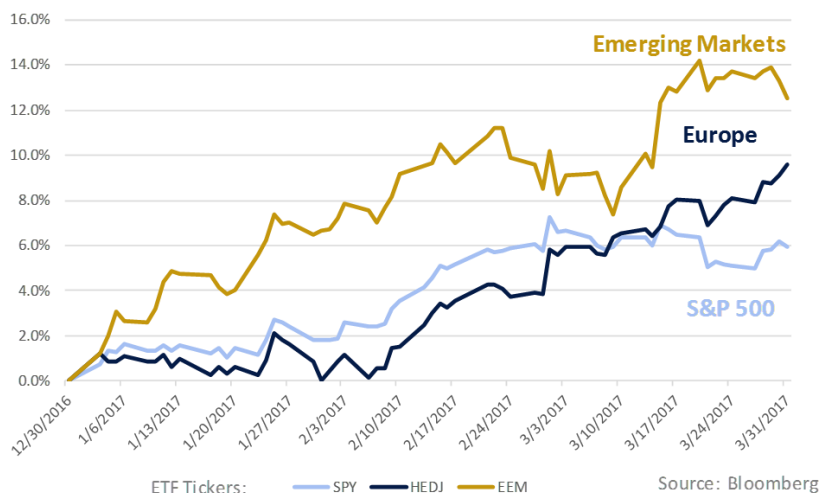
US consumer confidence hit a new 15 year high as investors propelled US stock prices and valuations to new highs on the expectation of forthcoming tax cuts, deregulation, and “big, beautiful” infrastructure spending, as promised by the Trump administration.

However, since March, the “Trump rally” has shown signs of fatigue as setbacks on both immigration and healthcare reform cast some doubt as to whether the White House will have the political support to push through Trump’s economic agenda.

Meanwhile, with US unemployment now below 5% and inflation picking up, the Fed raised interest rates another quarter point in March. The Fed promised to continue a cautious pace of tightening, setting off a two-week rally in longer-term government bonds as investors repriced the path of longer-term interest rate normalization.

Gold prices surged roughly 8% in Q1 as global political risks remain elevated. Rising populism movements in France, Germany, and elsewhere have some market participants concerned about a destabilization of the Eurozone and global trade. Notwithstanding these political risks and others, Q1 stood out as one of the least volatile quarters in decades with the S&P 500 posting a 109-day streak of not losing 1% or more in a single session. ■

#### Emerging Markets and European Stocks Outperformed the S&P 500



## Five Things You Should Know about Q1

### 1. Fed Raised Rate and Bonds Rally

The Federal Reserve raised short-term rates for the second time in three months, after which longer-term Treasury bonds rallied, perhaps signaling future growth concerns.

### 2. Consumer Confidence Remains High

The Consumer Confidence Index soared to its highest level since 2000, reflecting consumer’s attitudes to current conditions in the US.

### 3. International Stocks Outperform US

International equity markets outperform the US, with emerging markets leading the way. Divergent central bank policy, relative valuations, and global growth are likely key factors.

### 4. Gold Rallies while Oil Retreats

Gold continues its rally despite two rate increases by the Federal Reserve perhaps signaling uncertainty around future inflation. Oil sells-off (although recovers) as the market searches for equilibrium pricing.

### 5. Global Populism on the Rise

Concerns over upcoming elections in Europe, most notably France and Germany, as populist candidates continue to remain relevant. Will a repeat of Brexit and the US election unfold?

#### Asset Class ETF Total Returns: Q1 2017



Source: Bloomberg

# Market Outlook



## Market Outlook

As our Q1 review pointed out, we are currently in the sweet spot of the global economic business cycle, with strength in the US economy reinforcing economic momentum in Europe, Japan, and now the emerging markets. But markets don't necessarily rise because of good conditions. What matters is how economic conditions play out relative to the expectations reflected in asset prices. In other words, economic reality needs to exceed market expectations for assets to continue to outperform. While assets don't offer investors a tabulated list of expectations, valuation metrics help us understand just how low or lofty expectations are across various markets.

Currently US stocks are enjoying some of their highest valuation levels ever...following one of the longest bull markets ever.

**Table 1: High valuations lead to low 10-year returns**

### Starting Median P/E Ratio & 10-Year Returns

Starting Date	Starting Median P/E	10-Year Annualized Return
12/31/1989	13.9	15.28%
12/31/2000	20.6	-0.48%
12/31/2001	23.5	0.92%
12/31/2002	18.8	4.94%
2/28/2003	16.9	6.06%
12/31/2003	21.2	2.17%
12/31/2004	20.3	5.54%
12/31/2005	19.0	5.24%
12/31/2008	12.5	13.21% *
2/28/2009	11.0	16.69% *
1/31/2017	24.2	???

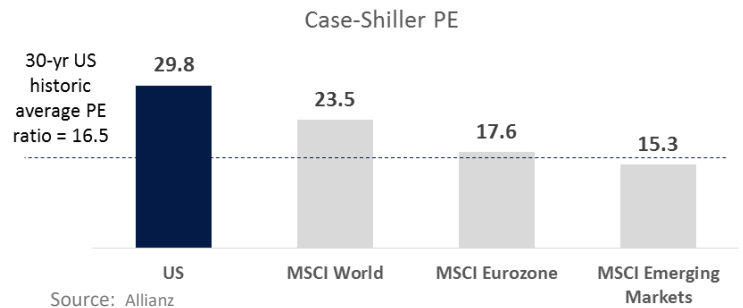
\* Less than 10 years (through December 2015)

Source: CMG Investment Research, Ned Davis Research, Worldscope

Ironically, this combination of frothy returns and frothier valuations has triggered enormous new investment flows into US stocks. Of course, high valuations don't necessarily mean a correction is imminent...or even forthcoming. What they do reliably predict are lower returns in the years to follow. As Table 1 depicts, high valuations (median P/E Ratio) are a leading indicator of low 10-year returns.

By comparison, the valuation metrics for Europe and emerging markets equities look significantly cheaper. Further, this divergence in valuation is occurring at a time when the US is actively tightening its monetary policy (i.e. tapping the brakes on growth) while other central banks (like Europe's ECB) continue to stimulate.

## US equity valuation much higher than Eurozone or Emerging Markets

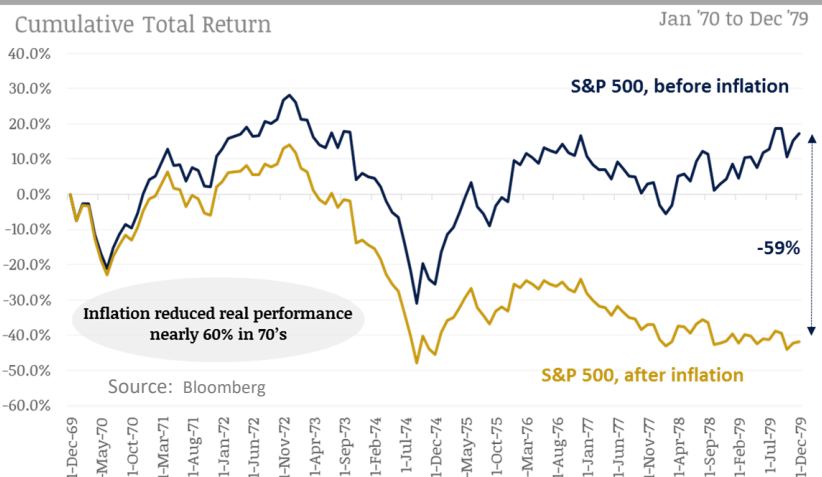


Of course, US markets still have the "Trump card". Will the Trump administration be able to set in motion their plans to stimulate higher economic growth and productivity? Clearly there is already a good bit of anticipated stimulus-driven growth priced in. While we are optimistic that some of the proposed economic stimulus plans can generate a new wave of growth, we think the risks are currently skewed to the downside. If the best case growth scenario does play out (i.e. the Trump administration successfully orchestrates a brand new growth cycle) that growth will almost certainly include a long dormant economic menace...inflation.

## The Sleeping Giant

It's been so long since US investors have experienced inflation that most don't remember or are unaware of how damaging it can be to an investment portfolio. For starters, inflation erodes the spending power of a portfolio - and spending power, particularly in retirement, is what matters most. To better assess the quiet corrosion of inflation on a portfolio, we focus on "real" or inflation-adjusted returns. We illustrate this in the chart below by contrasting nominal and real returns of US stocks in the 1970s. While not quite the "lost decade" (before inflation), in real terms, the 70's were a disaster....far worse than the 2000's. For an investor concentrated in US assets near retirement - this outcome could be catastrophic.

**Chart 2: Comparing S&P 500 returns in the 1970s - before and after inflation**



# Market Outlook, cont'd



## Real Returns in an Inflationary Environment

Inflationary environments are, on balance, not good for either stocks or bonds (at least not the type of bonds most investors hold in their portfolio). As a result, the traditional 60/40 portfolio (the kind most investors have in their 401k) is highly exposed to inflationary risk.

There are, of course, ways to protect your portfolio through better asset allocation. Specifically, by investing in inflation protected “real assets” like gold, commodities, real estate, timber and inflation-linked bonds (an asset class that did not exist in the 1970s).

Not surprisingly, most investors are woefully under-allocated to real assets because inflation has been so low for so long. Inflation rates have been falling steadily for nearly 35 years now

Chart 3: Comparing S&P 500 real returns - 1970's vs. 2000's



## Real Asset Returns in Inflationary Environment (1970s)

S&P 500 Index  
Real Returns  
1970-79

-35%

+37%

Real Asset Index  
Real Returns  
1970-79

Source: Almanack, Kenneth French & Bloomberg, Real Asset Index is equal weighted to GSCI Commodity Index and mining, gold and energy sector stocks.

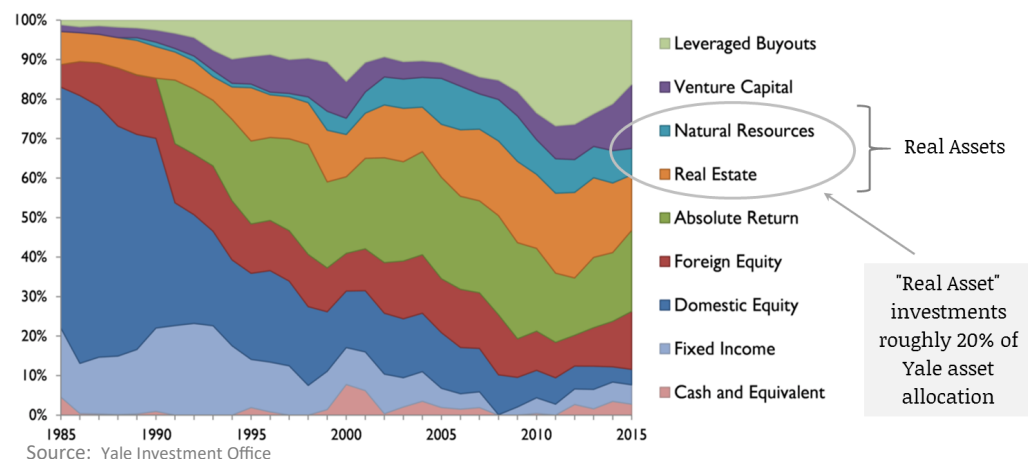
(since the 1980s) - and over the past 10 years, inflation has run at the lowest levels since the 1930s. Episodes of multi-decade long “disinflation” aren’t unusual, but they do eventually reverse. One major factor behind the low inflation levels of the past 20 years has been globalization. Global free-trade helped unlock large, low-cost labor pools in China and other emerging countries which helped keep inflation tame despite strong growth...but that may be changing. Lately, nations like the US (with Trump) are increasingly protectionist. With the inflation damping impact of globalization abating, we think the next decade runs the risk of structurally higher inflation.

## The Endowment Playbook

Endowments like Yale are among the most respected and emulated asset allocators in the world. Yale and other endowments were among the first institutional investors to start making major allocations to real assets. That is, in part, because university endowments are more keenly aware of inflation risk. Higher education inflation has tended to rise twice as fast as the normal rate of US inflation. Today, nearly 20% of Yale’s portfolio is invested in real assets.

Our concern is that most investor portfolios are essentially a single engine plane powered by US equities. We build strategies and otherwise encourage investors to consider four portfolio growth engines that include global stock, bonds, credit, and real assets. We call this “macro-risk” balanced. A portfolio that is appropriately counter-balanced with return engines that can survive either inflation or growth shocks is far more stable. After eight years of epic gains for the US market and gathering inflation risks, the opportunity to diversify away from US stocks could be ideal. ■

Yale University's asset allocation over time - real asset exposure





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