MARKET
PERSPECTIVES

STC Investment Committee

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October

Markets struggled in October as investors began to shift concern from deflation and falling commodity prices to an expectation of increasing inflation and higher interest rates independent of the election outcome. The realization that central banks had reached the limits of excessive monetary accommodation was reinforced by strong economic numbers. While Treasuries declined 1% and global equities declined 1.7%, the magnitude of transition was seen in the 2.8% decline for the world government bond index - the most in two years (international bonds fell 4.6%).

Domestic equities underperformed, returning -2.2%, as a Federal Reserve Board (Fed) interest-rate increase appeared more likely after the release of third quarter Gross Domestic Product (GDP) at 2.9% annualized. The technology sector was weak, growth stocks lagged value stocks and small-cap stocks fell 5%. Financials were the only sector in the black (modestly), with health care falling 7% on heightened Clinton election odds. Interest-sensitive real estate investment trusts and master limited partnerships fell 5%,

International stocks fell 1.6% and reflected a similar capitalization and sector pattern, with value stocks outperforming growth stocks by almost 5% and small-cap stocks falling more than 3%. International developed equities (EAFE) fell 2.0%, dragged down by United Kingdom's 5% loss on "hard" Brexit fears. In the eurozone, peripheral markets rose despite the European Central Bank (ECB) not extending its quantitative easing program. No doubt the ECB took notice that: the U.K. GDP beat expectations; Germany had the highest inflation level in two years; and eurozone manufacturing levels hit a multi-year high. Japan followed suit. As its central bank took no action, markets rose 2% on expanding manufacturing and higher interest rates (while deflation fear declined).

Emerging markets managed modestly positive returns, with Latin America gaining 10% as Brazil's central bank announced the first rate cuts in four years, signaling the start of a virtuous cycle of falling inflation and rates. The Mexican peso rallied with shifting U.S. election odds. Despite a positive 6.7% GDP number, China stocks fell 2% on concerns over higher rates.

The U.S. bond market weakness (that first started in the longer maturity issues in September) broadened in October with 10-year Treasury yields up 24 basis points. Credit markets were mixed as investment-grade-corporate debt fell 0.8%. However, high-yield debt gained 0.4%, as tighter spreads offset higher rates. The real damage was overseas, particularly in Europe. While Japanese bonds fell 4%, many eurozone bonds declined 7%, with longer-term U.K. bonds plunging 12%. Emerging-market debt also was weak on the higher Treasury yields and stronger dollar. The dollar strengthened 2% with growing odds of a December rate increase. Commodities were slightly lower, with oil spiking before falling back to end down 3% as OPEC failed to agree on a plan to cut production.

November

While the Trump victory and the Republican control of Congress are typically credited with reigniting growth and inflation expectations, these green-shoots were already apparent this summer. They spread from the long-dated bonds to the broader bond market in October and became a full-fledged bond rout post-election. The election turbo-charged pre-existing trends only reinforced over the month by continued firm economic releases and a surprise OPEC agreement. Economic uncertainty retreated toward more normal levels, as more measured political rhetoric and the strong equity rally quelled tail-risk concerns.

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Both headlines and markets were U.S. centric. The dollar gained 3% or more against most currencies, while U.S. stocks spiked 4.5% as the international equity index fell 2.4%. Domestic investors were animated by the prospects of tax cuts, infrastructure spending and deregulation, with the latter particularly in the financial sector. There was a remarkable divergence across and within asset classes as the market quickly discriminated between investments that will benefit from such new policies versus those supported by artificially low rates. Small-cap domestic value stocks rallied 13%, while at the other extreme, carnage in the fixed income markets was widespread, with longer-term Treasuries down 8%.

Within the U.S. equity market, value and small capitalization factors won out, with small-cap value outperforming large-cap growth stocks by 11%. There was an equally pronounced sector divergence, with financials up 14% and bond-substitute defensives such as consumer staples, utilities, and real estate falling around 4%.

Developed international equities fell 2.1% on eurozone weakness and Japan. Despite Chancellor Angela Merkel seeking a fourth term, Europe fell 2% with Germany and peripheral Europe weak. While Japan eased 2.4% in dollar terms, many overseas investors are currency hedged and enjoyed the 6% local market return as third quarter GDP came in at 2.2%, well ahead of expectations (and the 1.6% U.S. rate).

Given the strong dollar, emerging markets fell 4.6% as investors rotated out on concerns over protectionism, higher interest rates, and debt repayment ability. Latin America gave back October's gains, falling 11% as expectations for Brazilian rate cuts and economic growth may have been too optimistic. The Mexican peso fell 8% on protectionist concerns. Authorities in China showed their concern over the stronger dollar by decreasing legal limits on transfers abroad by 90%. Russia proved the exception, rallying 5% on higher oil prices and the tailwind of an October ratings outlook upgrade.

While global equities were mixed, rising interest rates and plunging bond prices were a global phenomenon with world government bonds falling 5%. Treasuries outperformed, but still fell 2.7%, as the curve steepened with 2-year Treasury yields up 25 basis points and 10-year yields up 53 basis points. Corporate spreads tightened slightly, but high quality bonds fell almost 3%. High yield continued to outperform on spread tightening, losing only 0.5%. Local currency emerging-market bonds fell 7%, facing the dual headwinds of rising rates and a stronger dollar.

The commodity index gained 2.5% overall, but saw strong energy prices (crude oil up 5.5% and natural gas up 10.8%) offset by an 8% decline in precious metals prices. Oil gained as OPEC secured agreements from members and non-members to cut production 1%, the first coordinated cut since 2008.

Thoughts on Portfolio Positioning

Given that bond markets have just witnessed their biggest move in the history of the Lehman/Barclay's aggregate bond index, the obvious question is, "Where will yields go from here?" The answer to that question depends on what your perspective was this summer, before the bond market collapse.

- If you subscribed to the view that inflation and growth would remain sub-par for structural reasons (demographics, disruptive technologies, excess debt overhang, populism) and that the Fed was ahead of the curve, then the recent pop in yields and the associated convergence of the market's and Fed's forecast of future rate increases would be a welcome opportunity to buy bonds on weakness, as Treasury yields have increased 60 basis points versus German yields since the election.

- In contrast, if you thought 1) the post-Brexit bond market was a bubble, 2) the Fed was intellectually bankrupt, behind the curve, and in denial about their culpability for past asset bubbles, and 3) that deflationary concerns were overdone, then this move up in yields, while significant, is only the beginning.

Treasury yields are biased higher for a number of reasons:

- With calls for infrastructure spending and reductions in personal and corporate tax rates, fiscal policy will become highly stimulative at a time when the U.S. is already at full-employment.

- Eerily mirroring President Obama's mistake of making a poorly timed macro-economic policy (the Affordable Care Act being a growth-sapping tax increase at the bottom of a recession), the hotter economy will likely foster wage-cost-induced inflation to above the 2% target level.

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- Even if the strong dollar suppresses inflation, the fiscal stimulus and pro-growth supply-side policies and rhetoric will take monetary policy off the hook as the only game in town and give the Fed the confidence to continue its rate normalization through 2017.

- The composition, leadership and philosophy at the Fed will change significantly over the next 14 months, as Chairperson Yellen steps down and two openings are filled. The incoming Fed leadership is more likely to recognize both the limitations of monetary policy and the risks of excessive accommodation. As a result the odds of significantly higher short-term rates and a shrinkage of the Fed's balance sheet are greater than the market expects.

"Making the World Great Again"? While highly debatable from a stand-alone U.S. perspective, pumping the fiscal accelerator will be welcome from a global economic perspective as the growth impetus may facilitate the normalization of interest rates, first in the U.S. and then overseas. The stronger dollar and U.S. growth will boost growth, exports, and inflation overseas. With overseas' short-term rates fixed for now, the stronger growth will steepen yield curves (thus supporting higher U.S. rates) and foster loan growth while reducing systemic risk in banking systems. The normalization of interest rates may trigger the next recession and corporate default cycle in 2019, but the continuation of debt-inducing artificially low rates would make the ultimate problem worse. U.S. protectionism presents the biggest risk as China's need for a weaker renminbi versus the dollar (to avoid appreciation against its Asian trading partners) is hard to reconcile with a President-elect who thus far seems committed to do much of what he has promised.

While the near-term economic backdrop is supportive of risk assets (but not risk-free bonds such as Treasuries), the capital market starting conditions are adverse in that valuations are so high, interest rates are still unusually low, credit spreads are unusually tight, and the U.S. equity market is significantly overvalued. By our numbers, after the continued rally into December, domestic equity valuations are so unattractive that they are approaching peak pre-global financial crisis levels. Just as we have seen that unorthodox monetary policies boosted asset prices but not the real economy, President-Elect Trump's policies are more likely to boost the economy than asset prices. Put another way, Main Street is likely to do well, but even if inflation remains subdued and protectionist policy mistakes are avoided, financial market returns are likely to disappoint as so much future potential return has already been realized in the form of high valuations.

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