WealthHealth
Personal Wealth Management

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Market Review

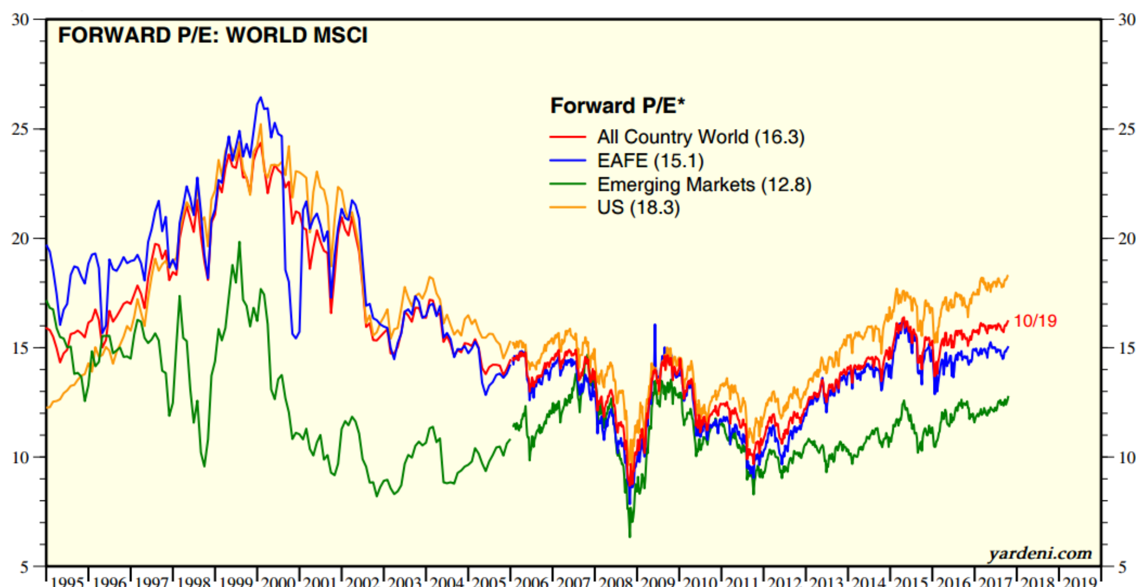
A recurring theme across the world's capital markets this year has been a persistent advancement to new all-time highs, for stocks and bonds, with apparently no regard to a growing chorus of risk. In financial parlance, this "melt up" or grind higher in stock and bond indices across the world has pushed through natural disasters, the Las Vegas tragedy, continued threats from "Rocket Man" (DPRK), domestic political failures, and international political tensions. None of these events managed to stop this advance across the globe.

Index Returns *Through 9/30/2017*

			Annualized Returns		
Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	4.48%	14.24%	18.61%	10.81%	14.22%
Russell 2000	5.67%	10.94%	20.74%	12.18%	13.79%
MSCI EAFE	5.40%	19.96%	19.10%	5.04%	8.38%
MSCI All Country World Index	5.34%	17.29%	18.77%	7.74%	10.45%
MSCI Emerging Markets Index	7.89%	27.78%	22.46%	4.90%	3.99%
Barclay Capital US Aggregate Bond	0.85%	3.14%	0.07%	2.71%	2.06%
Barclay Capital Municipals	1.06%	4.66%	0.87%	3.19%	3.01%
Bloomberg Commodity Index	2.52%	-2.87%	-0.29%	-10.41%	-10.47%
HFRI Fund of Funds Composite Index	2.35%	5.63%	6.54%	2.25%	3.86%

Emerging Markets, U.S. Large Cap Growth and International stocks especially, have shown exceptional resilience and are on track to post some of their best returns in decades. Even more incredible, the Dow Jones index is now the least volatile it has been since the last 100 years.

Looking at valuations, equity indices are not at all-time highs, but they are nearing these milestones with each passing quarter. Specifically, the forward p/e gauge looks at the stock index price in relation to its 12 month forward expected earnings, and on this metric, the US is currently viewed as being the most expensive stock market.



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: Thomson Reuters I/B/E/S.

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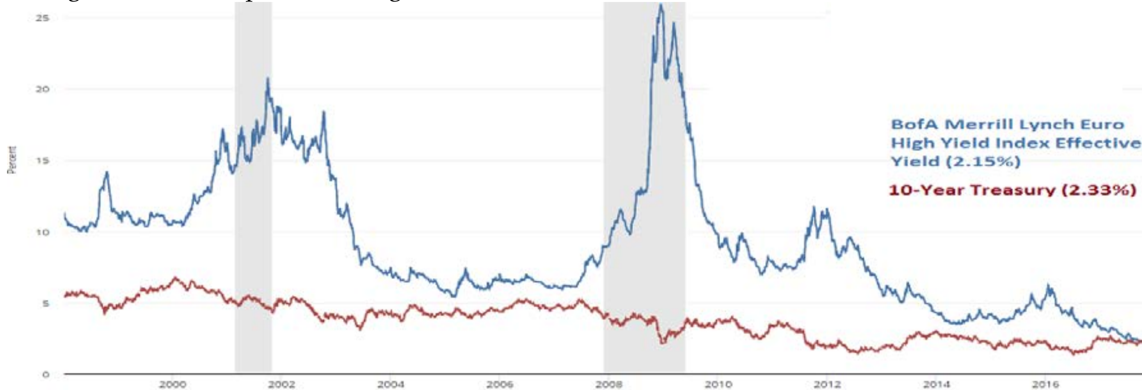
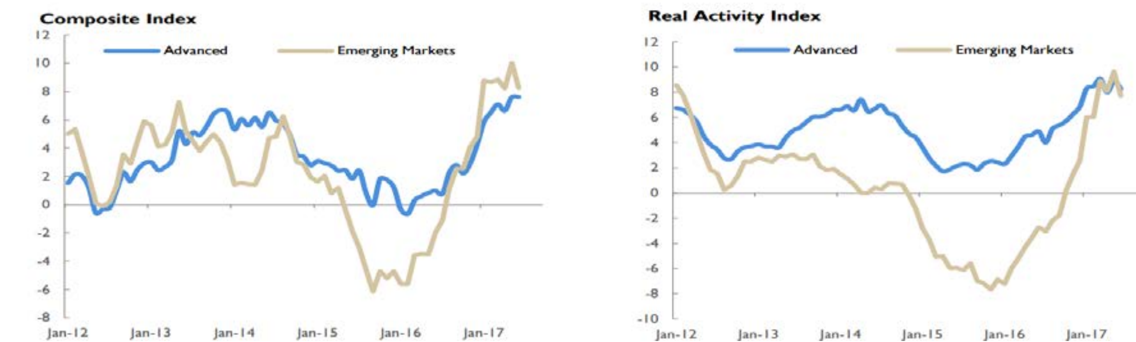
Bond markets continued to show mixed returns as a rush to riskier US and International debt created a sizeable disparity between high and low-quality bond returns. Emerging Market debt issuance benefited tremendously from these trends as EM borrowing costs dropped to all-time lows. As this trend continued, a startling phenomenon developed over the last few weeks (as shown in the chart below). For the first time ever, European Junk Bonds (low credit quality) paid a lower yield than the US 10 Year Treasury (considered the safest quality in the world). Normally, higher credit quality equates to a lower yield, as investors are comfortable with taking a smaller coupon knowing there is little-to-no chance of default.



Source: Federal Reserve, Wealth Health Investment Research

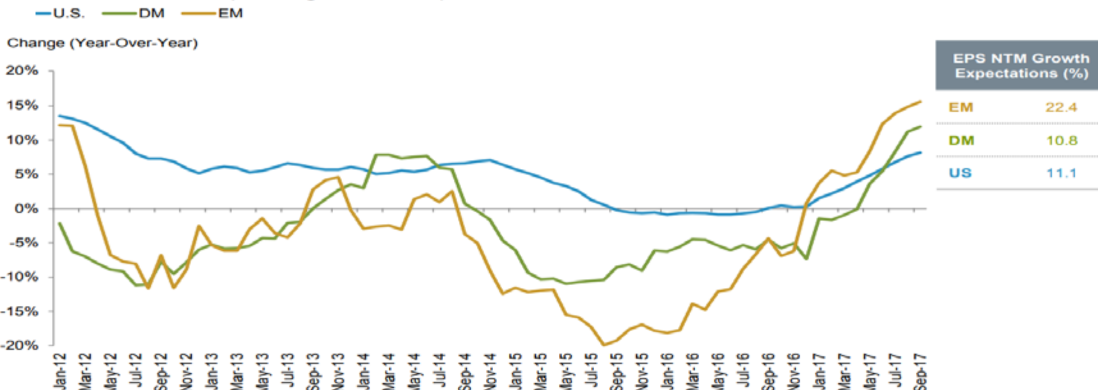
Broad Look

Looking at various gauges of economic activity, there is a clear trend developing of global synchronized growth. The last time this type of synchronicity occurred was in the late 90's and mid 2000's.



Source: The Brookings Institution

Corporate earnings confirm this trend with earnings showing a similar pattern in rebounding from the 2015 lows, although the momentum has been slowing.



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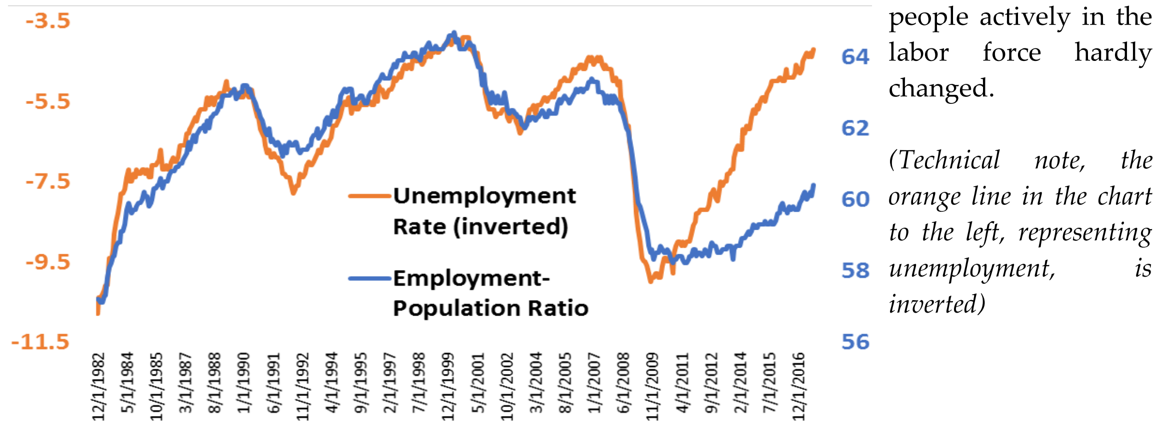
The most likely leading cause of this impressive turnaround in global growth is the world Central Banks working in tandem to further stimulate economic expansion. Equally important in this pursuit of artificial demand was China's central bank and its easing of accessibility to private credit. This leads to more economic activity such as construction and consumer spending which inevitably requires China to spend hundreds of billions on imported goods. So far in 2017 alone, about $2 trillion of new currency was created by central banks and introduced into the capital markets. This new money lowered corporate borrowing costs and broadened access to capital across world. This was evidenced by a serial defaulter like Argentina being able to issue 100-year bonds at 7.9% and 3.5x oversubscribed (meaning the country borrowed 3 times more than it originally planned as investors rushed in to lend money to Argentina).

On the employment side, while it is encouraging that the current unemployment rate is at multi decade lows, it's somewhat worrying that wage growth is still lackluster. The most likely explanation for this phenomenon is the growing number of people out of the labor force. As seen on the chart below, unemployment levels dropped to historic lows, while the amount of people actively in the labor force hardly changed.

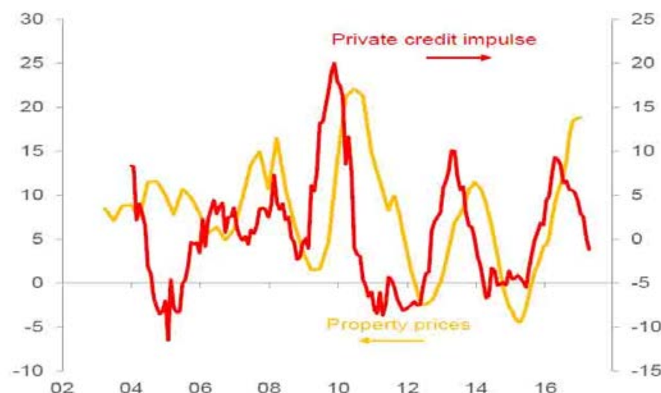


(Technical note, the orange line in the chart to the left, representing unemployment, is inverted)

Source: Federal Reserve, Wealth Health Investment Research

Looking Ahead

As the developed markets enter the later stages of the business cycle, all eyes are on the Central Banks and their planned "balance sheet reduction", which is basically another way of saying quantitative tightening or put another way, taking money out of capital markets by way of selling securities, not buying. China is already seeing a clamping down on private credit creation as an overheated real estate market threatens the economy. This creates risks worth watching as 70% of Chinese household wealth is in real estate (it is 33% in the US). In addition, China's central bank governor Zhou Xiaochuan, just recently warned that China could soon see an increase in volatility as credit creation is reduced.



Source: Citi

A key turning point will be in early 2019 when world central banks will start to withdraw currency from capital markets. Between now and then, over $2 trillion of currency accomodation will go away with a shift into negative territory taking place in 2019.

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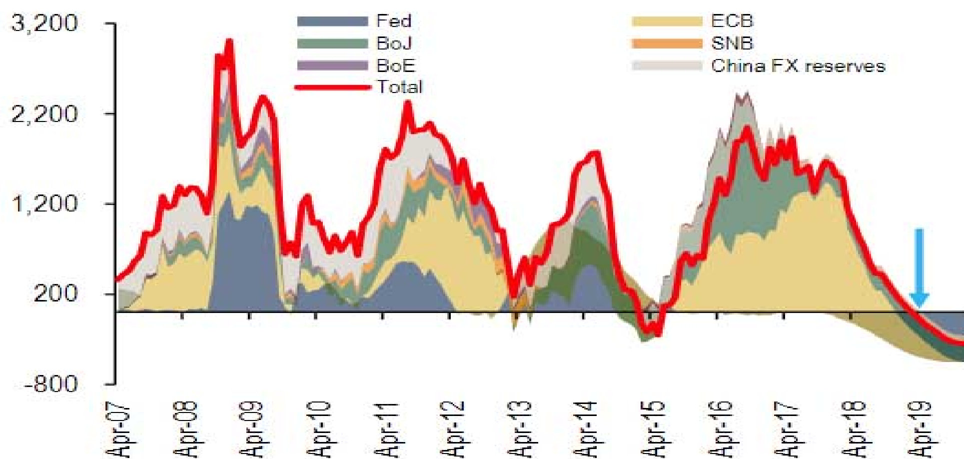
Seen below is a planned central bank reduction in asset purchases. The red line represents the total effect of all buying and selling by the major central banks. As the red line breaks the X axis in late 2018 / early 2019, we could see an increase in volatility, as currency is withdrawn from the system for the very first time in over 10 years (on a *sustained* basis).

Chart 1: Early 19 is when global YoY "QE" turns negative (12m changes in balance sheets, in $bn)



Source: BofA Merrill Lynch Global Research. Bloomberg.

(Technical note: each point on the red line represents the cumulative total sum of all buying and selling for the previous 12 months)

In Summary

In aggregate, the global economic story seems to be stable and muddling along. Exogenous risk factors such as North Korea's missile program or votes for independence in Spain seem unable to hamper global stability. While this is encouraging it also provides the potential for investors to be lulled into a false sense of security. Evidence of complacency and excessive risk taking continues to accumulate. And while overall recession risks remain low, they are increasing. And given next year's end to the largest monetary experiment in history, an increase in volatility is not out of the realm of possibilities. Couple that with talks of a new trade war between the US and China, political gridlock in Congress and a rise in protectionism, one should warrant a cautious approach and a tapering of expectations.

Overall, we would not be surprised if risk assets continued to do well, driving valuations to new highs and volatility to new lows. And while positive surprises are certainly possible, and we could get pro-business tax reform passed through congress, we cannot manage your assets based solely on possibilities, we must also weigh them by their probabilities. It is at this time that we look to re-evaluate your portfolio allocations and make changes where necessary based on your specific risk tolerance and cash flow needs.