Quarterly Market Outlook

February 2018

All Green in 2017

The fourth quarter was a continuation of what we saw through the course of 2017 – positive returns across all asset classes. This was primarily driven by continued easy monetary policy, weak inflation and a coordinated pickup in global growth. This market "sweet spot" may not be sustainable as there will be increasing pressure on central banks to tighten monetary policy going forward.

Monetary Tightening

We are now transitioning from an environment of monetary easing to monetary tightening. Both the U.S. Federal Reserve (current Fed Funds 1.25-1.50%) and the Bank of England (current Policy Rate 0.50%) raised interest rates during the fourth quarter. The move by the BOE was the first increase in policy rates in more than 10 years. The European Central Bank has begun tapering their bond purchases in 2018, while the Fed expects at least 3 additional rate hikes this year. Despite these moves and a set of conditions that generally support more tightening (strong global growth, increasing inflation pressures), very little tightening is priced into markets.

U.S. Tax Cuts

The Trump administration and Republican-led congress achieved their first legislative victory in December by passing a comprehensive tax overhaul. The most prominent features of the plan were a permanent cut in the corporate tax rate from 35% to 21% and temporary cuts in income tax rates for most Americans. We anticipate that the plan should add roughly 0.5% in GDP over the coming year.

Late Cycle Pressures

We are now 9 years into the current expansion, which is the third longest on record.[1] Typically at this point in the cycle, when unemployment is low and the economy is running above potential, we start to see inflation pressures emerge, requiring that central banks tighten monetary policy. This environment tends to favor inflation hedges like commodities, but is more challenging for traditional stocks and bonds which face rising interest rates and pressures on margins.

Good News is Bad News

Measures of global growth continue to be positive, with little concern for a recession in the near term. Unfortunately for markets, good news can be bad news for asset pricing, as it often leads to more expectations of Fed tightening. The February market sell-off, triggered by a positive employment report, was an example of this. The sensitivity to monetary policy is exaggerated in this cycle as interest rates and volatility have been suppressed to historically low levels by global central banks.

[1] Source: https://www.cnbc.com/2017/05/08/goldman-says-u-s-economy-may-be-slowly-growing-into-the-longest-expansion-in-history.html.

Market Inflection Point?

Equity volatility reached its lowest point in recorded history during the fourth quarter as asset markets continued to rally.[2] Until the first week of February, there appeared to be little sensitivity to these initial tightening steps. This is a dangerous setup as asset market valuations are at historical highs, predicated on a continued low interest rate environment. Even a moderate repricing of risk and/or interest rates can have a large negative impact on returns given the long duration nature of most assets.

European Growth

Over the course of 2017, we saw continued improvement in the European economy on the back of aggressive stimulus and several defeats of nationalist/anti-EU parties on the continent. This has led to a significant reallocation of global investment flows into Eurozone. Despite the pickup in growth, inflation remains below the Central Bank's targets, so any reduction in stimulus is likely to be very gradual.

Emerging Markets Outperformance

The MSCI Emerging Market Equity Index was up over 37% in 2017 relative to a 22% return for developed market equities, resulting in a second straight year of outperformance.[3] The conditions in emerging markets are much more favorable than we see in the developed world, with increasing growth rates and significant room for monetary easing, making it likely that emerging market equities will continue their outperformance. Note that emerging markets continue to be a very risky asset class, so we believe an overweight makes sense but only in the context of a well diversified portfolio.

Uncorrelated Alternatives

Given the backdrop of historically high valuations across most assets and rising risk, our focus continues to be on finding uncorrelated alternatives such as market neutral active managers, healthcare royalties or reinsurance, which are not dependent on rising asset markets to generate returns. Such strategies can offer compelling returns while minimizing the sensitivity to an inevitable market correction.

[2] Source: St. Louis Federal Reserve. https://fred.stlouisfed.org/series/VIXCLS.
[3] Source: Bloomberg.

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