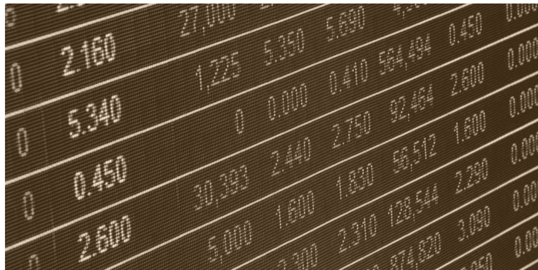
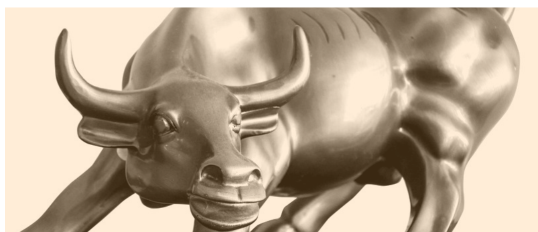
MARKET COMMENTARY

SECOND QUARTER 2017





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Second Quarter Overview

Domestic equities continued their post-U.S. presidential election rally, notching a small, single-digit advance in the second quarter of 2017. A decline in the U.S. dollar combined with some positive economic data and hope for stability in the European Union helped boost international developed stocks, which advanced more than 6%. Emerging market equities also continued to advance, posting a second quarter return of over 6% as well. Bonds rallied as the yield curve flattened. The Bloomberg Barclays U.S. Aggregate bond index ended the quarter up nearly 1½%. Some of the biggest losses were in oil, which moved into bear market territory, having fallen 9% during the quarter. Oil's decline weighed heavily on the commodity complex, with the Bloomberg Commodity Index ending the second quarter down approximately 3%.

Market Commentary

In the second quarter of 2017, the U.S. Federal Reserve (Fed) raised the target federal funds rate to 1.00% – 1.25%. While the federal funds announcement was mostly a foregone conclusion, the Fed's announcement of forward guidance on their plan to shrink their multi-trillion-dollar balance sheet came as a surprise.

Proper quantitative easing (QE) ended in October 2014 with the Fed's balance sheet at about $4.5 trillion. Since that time, the Fed has purchased securities only to replace those that have matured, in order to keep the aggregate amount of total assets unchanged. It has been expected that Fed policy would change at some point and they would stop replacing maturing bonds - or even begin selling them. This decision is of great interest to market participants because of its potential impact on interest rates, the direction and magnitude of which have great bearing on financial assets. The details of Fed balance sheet trimming will undoubtedly influence the future performance of stocks and bonds, and market volatility could follow if the Fed fails to strike the right balance.

Former Fed chair Ben Bernanke wrote earlier this year that the balance sheet should be reduced only gradually, lest the implications for the economy and financial markets turn ugly.[1] He also pointed out that the process should not begin until "the short-term interest rate is safely away from the effective lower bound." That is because if a recession were to begin with rates at a high enough level, they could be lowered to help spark economic growth. While determining whether the current level is "safely away" from the lower bound is difficult, a rate reduction from 1.00%-1.25% down to 0% seems unlikely to stave off the pains of a recession.

Former Fed Chairman Bernanke is not the only voice of caution. In mid-June, in a blog post in the *Financial Times*, former U.S. Treasury Secretary Larry Summers wrote:

> I believe that the "preemption of inflation based on the Phillips curve" paradigm within which it is operating is highly problematic. Much better would be a "shoot only when you see the whites of the eyes of inflation" paradigm of the kind I have advocated for the last several years.[2]

The Philips curve describes the expected inverse relationship between unemployment and inflation, but the old way of thinking about this relationship has been called into question in recent years. Summers suggests that a substantially less accommodative monetary policy should only be enacted when clear evidence that inflation is becoming a meaningful risk comes to light.

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Beyond observing tighter monetary policy, some have suggested that the Fed's concern about market volatility following policy changes is not as great now as it seems to have been in recent years. From the "Greenspan put" to subsequent words and actions attributed to a host of central bankers, many examples suggest monetary policy has at least indirectly been deployed to limit market volatility; however, those days may be in the past. From one of his recent "Epsilon Theory" letters, Ben Hunt argues:

> Today the Fed is looking for excuses to tighten monetary policy, not excuses to weaken. So long as the unemployment rate is on the cusp of "instability" (the word Janet Yellen used recently to describe it), that's the only thing that really matters to the Fed. Every other data point, including a market sell-off or a flat yield curve or a bad CPI number—data points that used to be front and center in Fed thinking—is now in the backseat.[3]

Hunt suggests this is partly because Yellen does not expect to be Fed chair after February, and that President Trump plans to make wholesale changes, potentially resulting in a far more dovish composition. Thus, firm and proactive policies can seemingly bolster a reputation when a Fed chair or governor plans to be job hunting in just a few months.

Additionally, Hunt sees wage inflation pressures as a particular emphasis for the Fed. Despite a stubbornly low core PCE—the Fed's stated preferred rate of inflation—the Fed has an interest in moving rates higher. Faster-than-previously-expected balance sheet shrinkage is one possible avenue to enact such change.

For several years, the Fed has overstated the expected rate of interest rate normalization relative to actual policy decisions, although it seems as though the wind may have shifted. Similar to the onset of a summer storm, a wind shift in rate policy may precede stormy conditions for markets.

Equities

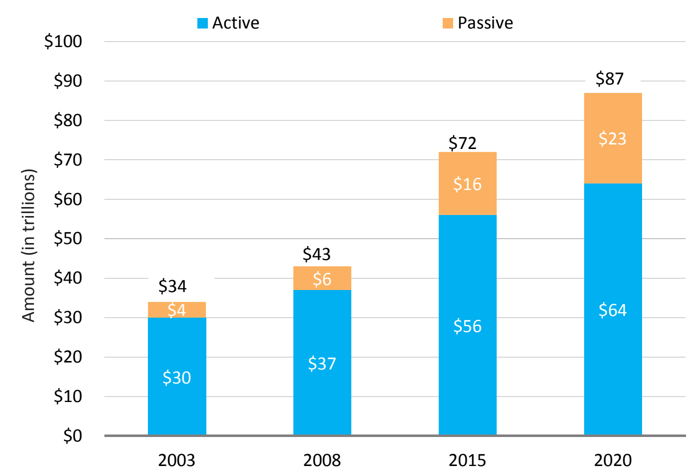
Equity investments in a wide variety of markets across the globe ended the second quarter in positive territory. U. S. stocks continued their rally, and international investments enjoyed a strong quarter in part due to weakness of the U.S. dollar.

One contributor to the equity markets' run has been a seemingly insatiable desire for passively constructed equity allocations.

Based upon recent and projected trends illustrated in the chart, it is expected that by 2020, global equity assets under management will rise by 21% from 2015, whereas the amount held in passive investments will jump by 43%. A number of similar observations support the idea that an incomprehensibly large amount of assets is flowing into passive equity investments, which is having a meaningful impact on the market as a whole.

Theoretically, if an investor sends $1,000,000 to Vanguard to invest in their Institutional Index Fund (VINIX), that money is invested pro rata into equities on a market-cap weighted basis as defined by the index's construction

GLOBAL AUM—ACTIVE VERSUS PASSIVE



Sources: Greenwich Associates 2016, BCG Global Asset Management 2016

methodology.[4] Should someone else send Vanguard $1,000,000 to invest in VINIX, their money will be invested the exact same way. On a very large scale, this activity provides demand for all stocks in the market, especially the largest stocks, providing a ballast to what might otherwise be larger fluctuations.

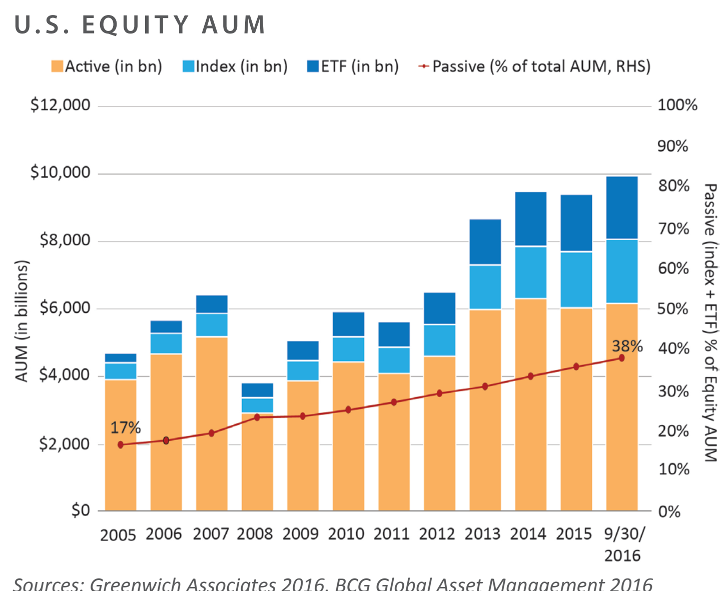
The growth in passive investing partly explains the low volatility markets have been experiencing; however, this is not to suggest a stock market decline may be right around the corner. FEG commentaries from prior quarters have explained that a low volatility environment does not always suddenly reverse and shoot higher for no reason other than volatility happens to be well below average. Some interesting data points on volatility as measured by the CBOE Volatility Index, or "VIX" are worth repeating from last quarter's note:

> The VIX represents the market's expectation of volatility over the next 30 days based upon the pricing of S&P 500 Index options. Data on the VIX goes back to 1990. The average level has been 19.7. The VIX ended the second quarter at 11.22, but recently spent time even lower. Levels at 12 or below have occurred 8.2% of the time since 1990, so we can say that recent activity has been fairly rare. That said, sub-12 levels don't exactly portend market doom. Specifically, the average one-year return of the S&P 500 after the VIX posts a below-12 reading has been 9.9% since 1990, which is actually better than the 8.9% average return over that same period, and likely reflects the momentum of recently strong markets getting stronger.[5]

A bearish signal from a low-level VIX is delectably tempting because the opposite signal is so strong. VIX readings above 30 occur about as frequently as those below 12 (8.6% of the time); however, they are far more instructive. The average 1-year return following a VIX reading above 30 has been over 20%.

This relates to passive equity investing because, as described in a Goldman Sachs paper from earlier this year, passive now accounts for nearly 40% of total U.S. equity assets under management—more than twice the number in 2005.[6] This is partially because active management has been out of favor, predictably underperforming during the QE-fueled meteoric rise in equity indices. History shows that funds tend to flow to areas that have been performing well, albeit sometimes at the exact wrong time.

The increase is also a result of fee pressure, which has been levied on all parts of the investment universe. Certainly hedge funds have been feeling the pinch, but some active long-only equity and fixed income mandates have been forced to lower fees as well.



Sources: Greenwich Associates 2016, BCG Global Asset Management 2016

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Considering the level of enormity illustrated here, it is natural to wonder what can go wrong. Zerohedge.com posted an excerpt from a note written by Eric Peters, CIO of One River Asset Management, spelling out one plausible bad ending:

> There is no such thing as price discovery in index investing. And there will be no price discovery on the downside either. The stocks that have been blindly bought on the way up will be blindly sold. When these markets do finally have a correction there will be no bid for many of these stocks.[7]

"Price discovery" is the process whereby an investment changes price until supply and demand are in balance. The point here is that with passive strategies having achieved a more significant position in the marketplace, future declines could prove more volatile than they have historically.

FEG is not predicting an impending stock market decline, although a correction at some point over the next 12 to 18 months would come as no great surprise. No one can predict short-term moves in the stock market—a point that is absurdly obvious yet bears repeating. This lack of predictability highlights the merits of diversification, both within the equity subset of investment portfolios and at the higher levels.

As far as primary areas of focus, FEG continues to believe in the long-term prospects offered by emerging markets and is still finding occasions for clients to access private equity opportunities with specialized managers and niche specialties.

Fixed Income

Many areas of fixed income enjoyed positive returns during the second quarter. High yield was particularly strong, advancing on sustained positive economic news. Long duration U.S. Treasuries also rallied as the yield curve flattened. The yield curve, as represented by the 2-10 spread, is now nearly as flat as it has been in years. This yield curve flattening comes in conjunction with declining inflation expectations.

While FEG recognizes the Fed's desire to "normalize" rates in order to reload one of their most trusted weapons against recessions (i.e., the ability lower rates and have it actually make a difference) it is not likely that rates will skyrocket higher in the near future, as the continual lack of inflation does not justify a meteoric rate hike.

Therefore, if the landscape for fixed income remains one where we believe rates are low and perhaps slowly grinding higher, the need for differentiated sources of yield becomes ever more acute. One area in which investors may find those desired yields is private credit.

Private credit encompasses a variety of investments, including private senior loans and mezzanine finance.
Private senior loans are senior secured debt. Like public senior loans, private senior loans sit on the top of the corporate capital structure, meaning that they are the first to be repaid in a bankruptcy situation. Beneath private senior loans in the corporate capital structure is often a tranche of mezzanine debt followed by private equity. Mezzanine debt is used to fill a void in a company's capital structure, which usually falls between equity and senior secured debt, i.e., bank debt.

Private debt fundamentals remain mixed but stable, with unlevered net returns for senior and mezzanine remaining in a range from 6% to 12%. When compared with the 10-year U.S. Treasury barely above 2%, some investors will likely find private credit yields compelling.

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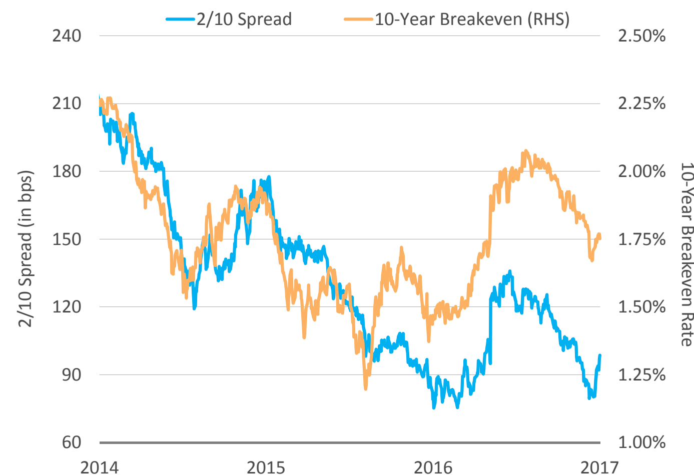
Real Assets

An allocation to real assets caries a dual mandate: total return to help support capital appreciation and protection against the ravages of inflation. In recent years, the second mandate has been all but irrelevant; more recently, inflation expectations that firmed slightly in 2016 have reversed course lower in dramatic fashion over the past few months.



Declining realized inflation has also coincided with a strong downward move in inflation expectations. For example, the 10-year breakeven reached 1.6% in late June, the weakest print since mid-October 2016. Slumping inflation expectations may complicate the need for a significantly higher federal funds rate, as additional tightening would likely apply further downward pressure to already weak inflationary sentiment.

This is a frightening thought given that the Fed seems intent on normalizing rates and has begun providing guidance on balance sheet reduction. Could we soon be considering the risk of deflation? What is truly frightening is the self-fulfilling nature that deflation can have—fear-induced cash hoarding only makes the deflation problem worse. Also, given where rates are now, it seems unlikely the Fed would be capable of stopping deflation if it started; moreover, an always dysfunctional Washington seems unwilling to bring meaningful fiscal policy to bear that might help avoid a deflationary problem before it even starts.

Historically, commodities and certain other types of real assets have been expected to hedge against inflation, but the prospects for meaningful bouts of inflation in the near future appear slim at best. The steep recent drop in oil prices has coincided with collapsing inflation expectations. We continue to favor master limited partnerships (MLPs) in the real assets space, not for inflation protection, but because they continue to offer a solid yield, are attractively priced, and have long-term growth potential. Further, we believe opportunities to access private real asset managers with a demonstrated ability to add value and access to information should be considered.

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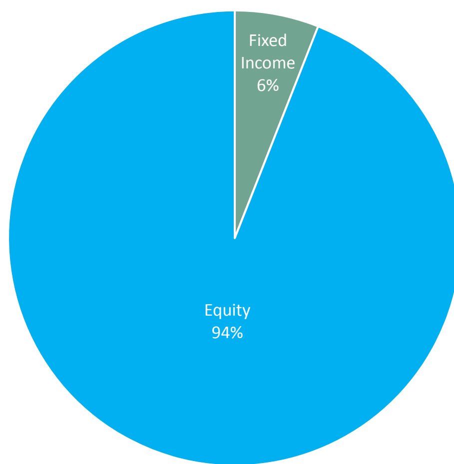
Diversifying Strategies

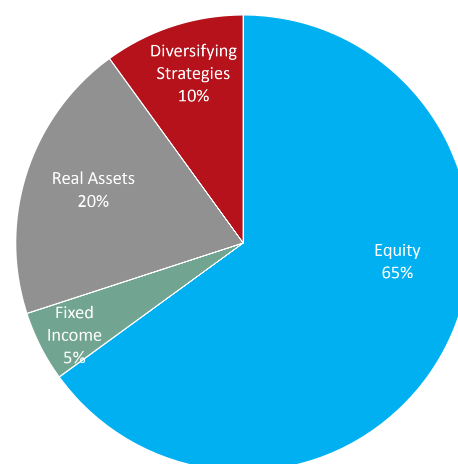
The diversifying strategies (DS) category includes the most active of active managers, a breed that has lately endured assault. An egregiously inappropriate comparison made by many during a market rally—the underperformance relative to the S&P 500 endured by many DS managers now more than 8 years into the post-financial-crisis bull market in stocks—has led some to abandon the strategies; however, FEG remains confident in the use of diversifying strategies.

One might expect that a traditional 60/40 portfolio would exhibit modest risk, but it is subject to immense equity risk exposure. A full 94% of the risk endured by a 60/40 blend comes from equities and the unpredictable drawdowns they occasionally endure. By contrast, a well-diversified portfolio of stocks, bonds, real assets and diversifying strategies garners just 65% of its risk from stocks.

RISK OF A 60/40 PORTFOLIO



RISK OF A DIVERSIFIED PORTFOLIO



Source: FEG.
Diversifying Strategies is a blend of 40% HFRI Event Driven, 20% HFRI Macro, and 40% HFRI Relative Value Indices. The 60/40 and Diversified Portfolios are represented by the index within each asset class. The results do not necessarily represent the actual asset allocation of any client or investor portfolio and may not reflect the impact that material economic and market factors might have had on investment decisions. Investment results achieved by actual client accounts may differ from the results portrayed. Diversification or asset allocation does not assure or guarantee better performance and cannot eliminate risk of investment loss. Investments cannot be made directly in an index. No representation is being made that any fund or account will or is likely to achieve profits or losses similar to those shown herein. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently realized by any particular trading program. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. Hypothetical performance results are presented for illustrative purposes only. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in achieving the returns have been stated or fully considered. Changes in the assumptions may have a material impact on the hypothetical returns presented.

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It is also worth noting that during the 20 worst global stock market drawdowns since 1990, diversifying strategies protected capital more effectively in each of them compared to equities alone. During these stock market declines, the average loss was 9.7% for the MSCI All Country World index, while Diversifying Strategies declined only 1.8%, on average.

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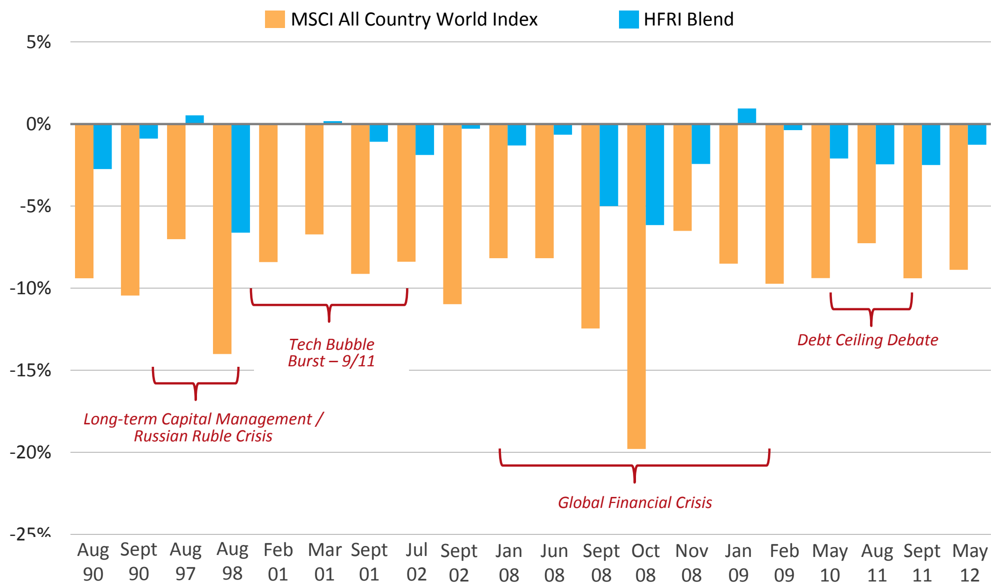
PERFORMANCE DURING WORST 20 MONTHS
JANUARY 1990–DECEMBER 2016



Source: PerTrac. HFRI Blend is equal weighted HFRI Equity Hedge (Total) Index, HFRI Relative Value (Total) Index, HFRI Macro (Total) Index, and HFRI Event-Driven (Total) Index

As discussed previously, the Fed has been moving interest rates higher and has laid plans for shrinking its balance sheet. While that does not necessarily portend immediate market doom, one of the primary supports for the reflation of the U.S. stock market—quantitative easing—has been completed, and its effects are being reversed. If the U.S. economy is not yet strong enough to support tighter policy, or if one or more of a myriad of global risks manifests into an actual crisis, stocks could plummet and those investors who maintained their allocation to DS mandates may find their capital better protected than those who did not.

Most investors who deploy capital in the markets for long enough recognize that cyclicality is reality; not just for stock market performance, though that is certainly true, but for the performance of active managers as well. To that end, FEG does not believe that now is the time to reduce or eliminate diversifying strategies in general, nor that now is the time to abandon active managers with demonstrated histories of skillfully executing their craft.

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Conclusion

For the first time since beginning their historical bond-buying program following the Great Financial Crisis, the Federal Reserve has begun providing guidance on how those bonds might be divested of in years to come. Although we believe the Fed will embark upon the program with guidance and transparency in the hopes of avoiding market disruption, they also have a strong motivation to allow interest rates to ascend to a more normal level, given the current employment and price environment. Further, policy makers are considerate of their so-called “third mandate”–financial conditions–which include stock prices and bond yield spreads, and appear willing to take action in response. In fact, the minutes from the June Federal Open Market Committee (FOMC) meeting explicitly mention easing financial conditions as support for a policy rate increase, which begs the question of whether they now care less about protecting against market volatility than perhaps they once did.

Stock market performance remains strong and volatility has been low, but that alone is not cause for concern. A number of risks that could lead to a market correction are worth noting, including potential conflict in the Middle East or the Korean peninsula, as well as the ever-shaky political and sovereign debt situations in Europe, although they continue to stabilize.

Inflation remains low and is not expected to budge, due in part to technological disruptions that cross a number of different industries. Recalling how their entry contributed to the skyrocketing inflation of the 1970s, Baby Boomers exiting from the workplace serve as an additional inhibitor to inflation. The expectation of tempered inflation is one reason FEG does not anticipate that interest rates will skyrocket, which leads to a need for differentiated fixed income investments such as private debt.

More than anything, however, FEG remains stalwartly committed to the fundamental philosophies that focus our attention on the long term, require valuation criteria to drive investment decisions, ensure global diversification by sources of risk, and access skilled active managers who have the ability to add value.

There is a cyclical nature to nearly every aspect of investing. Successful investors are able to recognize this fact without recoiling and making ill-timed decisions based upon emotion rather than data. Inexpensively priced investments can remain so for extended periods and diversification can occasionally feel uncomfortable or unnecessary, but those fundamentals and others like them have helped guide investors to their goals throughout time. May we not be among those who by failing to recognize economic and market history are doomed to repeat it.

FOOTNOTES

1. Ben S. Bernanke, “Shrinking the Fed’s Balance Sheet,” Brookings.edu, January 26, 2017.
2. Lawrence Summers, “Five Reasons to Doubt Yellen and the Fed’s Wisdom,” Financial Times (blog), June 15, 2017.
3. W. Ben Hunt, PhD., “Post Fed Follow-Up,” EpsilonTheory.com, June 22, 2017.
4. As described in the fund’s prospectus available at Vanguard.com. S&P 500 index construction methodology is described at www.SPIndicies.com.
5. FEG Market Commentary, First Quarter 2017, http://www.feg.com/insights/first-quarter-2017-market-commentary
6. Steve Strongin et al., Goldman Sachs Global Market Institute, “Directors’ Dilemma: Responding to the Rise of Passive Investing,” January 9, 2017.
7. Tyler Durden, “Hedge Fund CIO: ‘Expect Enormous Losses In The Next Correction As There Is No Price Discovery In Index Investing,’” Zerohedge.com, April 9, 2017.

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