HIGHTOWER
WESTCHESTER

Q2 2017 Market Commentary

Global equity markets advanced in the second quarter ("Q2") with the MSCI World returning 4.2% (in U.S. dollars). A strong corporate earnings season and generally positive economic data supported gains, while political risk waned in Europe.

U.S. equities witnessed gains despite some mixed economic data and political uncertainty over the ability of the new U.S. administration to push through its fiscally expansive policies. The S&P 500 recorded a total return of 3.1% over the quarter[1].

Growth and large-cap stocks continued to outpace other U.S. equity categories in the second quarter due to their exposure to the improving international economic backdrop. Large cap equities outperformed small and mid-caps over the period, with the Russell 2500 and Russell 2000 recording respective total returns of 2.1% and 2.5%[1]. Healthcare, industrials and financials were among the top performing sectors, while consumer staples, energy and telecommunication services underperformed. Sector performance was varied, though mostly positive, with only energy and telecommunication services experiencing outright declines due to falling crude oil prices and price competition, respectively.

The continued outperformance of several technology stocks has raised concerns that the market has become overly dependent on a small number of stocks. While the breadth of companies driving S&P 500 price returns was somewhat narrow in Q2, this level was not far below the historical median breadth during rising markets. Corporate earnings are still inflecting positively in 2017, and while potential pro-growth policies could boost top-line growth in 2018, margins will likely remain under pressure, suggesting more modest earnings growth ahead. U.S. large-cap valuations are higher than their long-term historical average, but valuations are a more meaningful indicator of long-term future returns, and are therefore more of a headwind for the secular outlook than the cyclical one.

With that said, the advance in U.S. equities was in despite of some mixed economic data, while the Federal Reserve ("Fed") looked through disappointing inflation readings and further tightened monetary policy. At the June meeting of the Federal Open Market Committee, the U.S. central bank raised base rates by 0.25% and set out detailed plans to reduce its balance sheet. A number of forward-looking activity indicators failed to build on the highs they achieved in the first quarter, including those tracking the health of the manufacturing and consumer sectors. However, official consumer spending data remained resilient, adding to hopes the U.S. economy would bounce back in the second quarter following somewhat muted GDP growth in the first quarter of the year.

Political uncertainty remained an important feature in the market as President Trump dismissed the FBI director James Comey. This raised doubts over the ability of the administration to push its fiscally expansive policies and also weighed on the dollar. The dollar was further negatively impacted amid rising expectations that central banks in other major developed economies are also preparing to tighten monetary policy.

International stocks and global assets posted strong gains for a second quarter in a row. A weaker dollar in Q2 boosted returns in most developed and emerging markets. Both developed and emerging markets equities benefited as international corporate earnings accelerated into positive territory, following several years of profit recession. Eurozone equities advanced in the second quarter with the MSCI EAFE index returning 1.8%[1]. Gains were capped by worries the European Central Bank could start to tighten policy.

1 FactSet financial data and analytics. www.factset.com

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Although reduced political risk, a positive economic backdrop and improved corporate earnings all helped to support share prices.

Political risk abroad was the focal point for investors in the early part of the quarter as the French presidential elections approached. However, centrist and pro-EU candidate Emmanuel Macron won a convincing victory and his new party also won a significant proportion of seats in the legislative elections. Markets responded positively to this news as it should enable him to push through his reform agenda and reduce the risk of a eurozone break-up. However, the final week of the quarter saw a pullback after upbeat remarks by European Central Bank President Mario Draghi were interpreted to mean that economic stimulus measures could soon be withdrawn. Attractive valuations are favorable for international equities with P/E ratios for most equity markets lower than those in the U.S. and the U.S. dollar remains at the upper end of historical ranges versus major currencies.

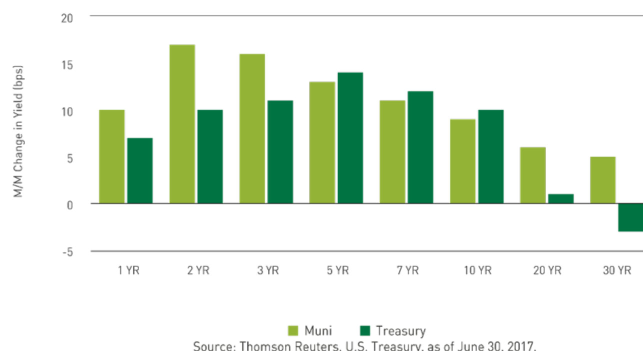
Emerging market equities were beneficiaries of a supportive global backdrop in the second quarter, in particular U.S. dollar weakness. The MSCI Emerging Markets index registered a strong gain and outperformed the MSCI World index. Further signs of improvement in global growth were positive for markets including Poland, Korea and Taiwan. Elsewhere, Turkish equities rebounded strongly with U.S. dollar weakness, domestic stimulus and a firmer outlook for exports to Europe all boosting sentiment. China also recorded a strong gain as macroeconomic data remained firm, despite measures to gradually withdraw liquidity. In contrast, Russian equities and the rouble lost value, with a sharp decline in Brent crude being the key headwind. Brazilian equities also lost value as political risk increased following corruption allegations against President Michel Temer.

On a secular basis, we expect GDP growth of emerging countries to outpace that of developed markets over the long term, providing a relatively favorable long-term backdrop for emerging-markets equity returns. The recent flattening of globalization trends could reduce the correlation between U.S. and international equities from such elevated levels, a secular shift that would likely provide greater diversification benefits for non-U.S. equities within a global portfolio.

On the fixed income front we experienced most sectors post low single-digit positive returns this quarter. Continued accommodative monetary policy, positive economic data and still subdued inflation provided a healthy backdrop for bonds over the quarter. Long bonds were the strongest-performing category, benefiting from a drop in long-term yields, while most credit-sensitive categories enjoyed a boost from the continued narrowing in credit spreads. Treasury Inflation-Protected Securities (TIPS) were the worst performer because market expectations for inflation waned. Despite a fourth policy rate hike from the Fed in Q2, bond yields moved even lower across categories the past three months. Yields remain extremely low relative to history, with high-yield corporate bonds approaching all-time lows. Credit spreads also compressed further for most categories, making all sectors expensive relative to their own histories.

In June, the municipal curve also flattened, with the front end selling off in sympathy with Treasury bonds and long-end yields rising relatively less (Figure 2). Ratios were higher in June, as municipals underperformed Treasuries. Municipal yields increased across the curve, ending the month at 1.4%, 2.0% and 2.8% for the five, 10 and 30-year maturities, respectively[2].

Figure 2: Longer Bonds Fared Relatively Better in June



Source: Thomson Reuters, U.S. Treasury, as of June 30, 2017.

2 Breckenridge Capital Advisors. (2017, July 12). June Market Commentary. Retrieved from https://www.breckinridge.com/insights/details/june-market-commentary/

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Supply in June was down 24% versus the same month in 20162. New money issuance fell by 11%, while refunding issuance declined 48%[2]. However, municipal supply was the second highest in any month yet this year. Demand remains solid as there were many oversubscribed deals in June. Aggregate inflows have reached $5.3 billion year-to-date[2].

Overall, municipal fundamentals remain stable, but there are many idiosyncratic risks, especially in the state sector. In particular, states like New Jersey, Illinois and Connecticut continue to struggle with pension and budgetary issues.

Fixed-income strategies, similar to the style that we at Hightower Westchester are akin to, with designated allocations in both high-quality bonds and higher-yielding sectors have exhibited consistent downside protection. The diversification offered by "core-plus" and "multi-sector" portfolios have delivered very strong risk-adjusted returns, despite the low-interest rate environment.

It has been a solid first half of the year for equities. Returns generally exceeded historical average full-year performance in the first half of the year. With central banks expected to remain supportive of financial markets and moderate short-term political risks, we believe that investors maintain an overweight allocation to equities over bonds with a tile from U.S. stocks to European and emerging market stocks.

As we move into the second half of the year it is important to emphasize how critical it is to maintain a diversified portfolio from a market sector (equity, fixed income, and alternatives) and geographical perspective. As valuations remain elevated, investors need to look beyond domestic equities to help reduce overall volatility and increase alpha.

To discuss this commentary further, please contact us at 914-825-8630.

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