WealthHealth
Personal Wealth Management

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Market Review

Global equity markets continued their gains in the first quarter of 2017 with European equities leading the way. Driven in part by the rejection of anti-euro politicians in both Austria and the Netherlands, the total return on the MSCI EAFE Index was 7.2% vs 6% from the S&P 500. Even more impressive however, was the 11% total return from emerging market equities, as investors piled into the developing nations expecting greater global growth. Fixed income returns were more mixed during this quarter with the Barclay's Aggregate Bond Index returning only 0.8% while high yield returned 2.2%. Overseas, bonds were largely flat.

The chart below shows the performance of the various indexes we track for the quarter and the year.

Index Returns *Through 3/31/2017*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	6.07%	6.07%	17.17%	10.37%	13.30%
Russell 2000	2.47%	2.47%	26.22%	7.22%	12.35%
MSCI EAFE	7.25%	7.25%	11.67%	0.50%	5.83%
MSCI All Country World Index	6.80%	6.80%	15.44%	5.06%	8.55%
MSCI Emerging Markets Index	11.45%	11.45%	17.22%	1.18%	0.81%
Barclay Capital US Aggregate Bond	0.82%	0.82%	0.44%	2.68%	2.34%
Barclay Capital Municipals	1.58%	1.58%	0.15%	3.55%	3.24%
Bloomberg Commodity Index	-2.33%	-2.33%	8.71%	-13.91%	-9.54%
HFRI Fund of Funds Composite Index	2.33%	2.33%	6.17%	1.78%	3.21%

Since the election, the phrase "Trump bump" became common parlance in media after the rally in equities and exuberant expectations of increased economic growth. Although, economic data does support a continued improvement in the US outlook, a high level of uncertainty remains around President Trump's policies and the likelihood of success in implementing them. Following the failed attempt at passing a new healthcare law by Congress, worries started to mount that these expectations were perhaps overdone. Instead, fears developed that failure to pass the new healthcare reform law could be a harbinger of future Congressional gridlock. Consequently, it now seems possible that other plans such as overhauling the tax code or reducing regulation and most importantly, repatriating the $2 trillion plus in offshore corporate assets could also be delayed, diminished or derailed. Notably, a portion of future expected earnings are reliant upon lower taxes while, concurrently, expected future stock prices are reliant upon repatriation.

Outside of the US, we see more attractive valuations and the improving growth backdrop as broadly supportive of equities. In Europe, we continue to believe that the European recovery story is gathering momentum. Initially supported by the European Central Bank's (ECB) loose policy and a weak euro, along with bank balance sheet restructuring now largely over, we view the recovery as increasingly self-sustainable.

Despite the recent Austrian and Dutch election results, geopolitical risks remain elevated ahead of core-European elections in France and Germany taking place this year. We see these risks as having the potential to increase volatility even though consensus estimates that these risks are already priced in.

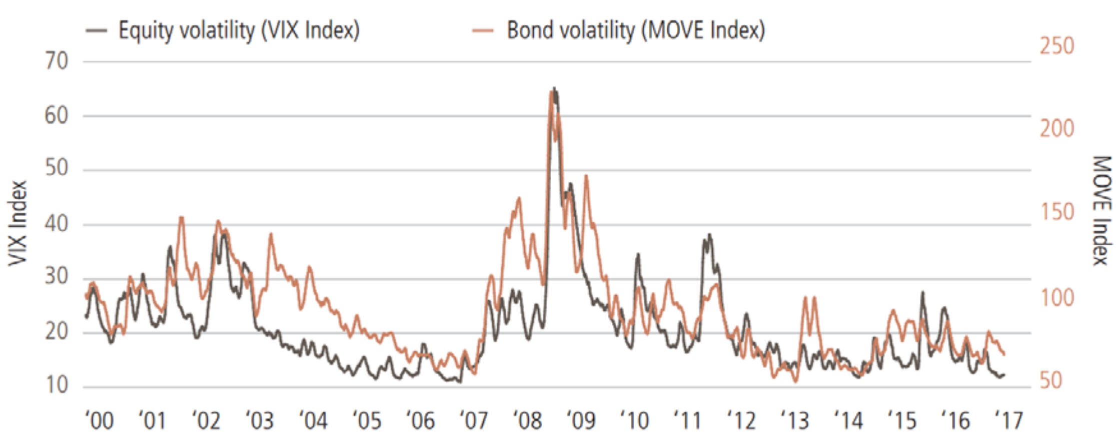
In addition, we continue to monitor structural deflationary forces, including aging populations, as posing pressure on yields and stock index levels.

Market volatility trends lower

A key question permeating in markets these days is, why is volatility so low?

From a historical perspective, both implied (forward-looking) and realized (historical) volatility across assets are quite low and have been trending lower. This trend is mostly evident in equities; before March 21, the S&P 500 has not seen a daily decline of more than 1% in over 5 months, the longest run in the last 30 years. In the high yield fixed income world, there were spikes in volatility related to Brexit and the US election as expected, but these were short-lived. Volatility in other asset classes such as currency and commodities have seen similar trends. We are aware of these trends and are carefully monitoring them as we believe they are significant from a historical perspective. In addition, we are also monitoring the prospects for a sharp increase in volatility from these levels as the reason for these low volatility levels could be coming to an end.

Exhibit 1: Market volatility trends lower



Source: Bloomberg Finance, LP

Although the number of reasons to this post-financial low-volatility environment is debatable, we think there are two primary and underlying drivers: (1) the consistently positive stream of global economic data, and (2) the volatility-suppressing force of central bank asset purchase programs. With respect to the first driver, although global growth has been disappointing post-crisis, it has been unusually stable. US real GDP growth has fluctuated steadily around 2%, avoiding any exaggerated spikes or drops. Moreover, this trend cascaded into global growth as well, as those growth numbers have hovered in the 2.25% to 3.25% range since the 2011 European debt crisis. Additionally, despite some volatility in headline inflation driven by oil price fluctuations in recent years, US and global core inflation have also been quite stable.

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This brings us to what we think is the second underlying reason for the unusually low level of volatility: large-scale asset purchase programs by major central banks. G4 central banks together have expanded their balance sheets by more than $25 trillion since 2009. There has been a coordinated effort by these institutions to buy up longer-term government securities that in effect, reduced the net supply of bonds in the market. Together these institutions have also bought asset-backed or mortgage-backed securities, credit and even equities as is the case with the Japanese Central Bank (this is an extreme example of intervention whereby The Bank of Japan is now a top 10 holder in 90% of Japanese stocks). The presence of steady and price insensitive buyers of assets around the world has artificially compressed volatility to these extremely low levels.

What can drive volatility higher?

Earlier we explained that the core drivers of this low volatility environment were (1) stability in global macro data and (2) central bank purchases of public assets.

Therefore, any meaningful change in volatility would likely result from a rapid change in either of those two drivers. While there are always risks to the growth outlook, we currently do not see any imminent trends that would catalyze a sharp downturn. The globally synchronized rise in economic activity makes improvement in global growth a continued reality. What's more, despite ongoing tightening in labor markets, there is little sign that core inflation is set to accelerate, thereby forcing a sharp tightening by the US Federal Reserve or other central banks. We continue to keep a close eye on developments in trade and fiscal policy, but as of now, we do not see anything on the horizon impactful enough to meaningfully derail the stability of growth or inflation data.

The most important on our list of potential volatility aggravators, is the removal of central bank liquidity—a factor that is known to markets, but with uncertain consequences. Recently, various members of the Federal Reserve have begun to publicly discuss the gradual unwind of the Fed's balance sheet. In addition, the European Central Bank may also begin to reduce its asset purchase program at the turn of the year. Finally, and most surprising of all, there is growing public speculation that the Bank of Japan may reduce its bond buying program. Our view is that since these changes are being introduced gradually and transparently, the chances of unforeseen negative impacts should remain muted. Nonetheless, we will continue to closely monitor these historical monetary changes as they happen and adjust our outlook accordingly.

Our summarized view

While there will no doubt be surprises over the next few years, as there always are, we do not anticipate a sharp and consistent rise in volatility. Even in an environment as uncertain as this, we believe that highly telegraphed central bank actions should guide the markets during this period of decreasing central bank assistance. As such, we continue to remain cautiously optimistic on global markets going forward.