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The Eerie Calm

At last, no looming crisis on the horizon;
Complacency reigned supreme – asset prices up, volatility down

JIMMY CHANG, CFA
Chief Investment Strategist
212-549-5218
jchang@rockco.com

Equities continued their upward march as volatility collapsed to multi-decade lows. Investors seemed unperturbed by the political circus in Washington D.C., and international stocks have become the new darlings. European equity funds were inundated with a record pace of inflows. Emerging markets continued to outperform even with Brazil's currency and stock markets selling off sharply on the news of its president being implicated in a corruption scandal. The U.S. yield curve continued to flatten and the market's implied inflation expectation drifted further south. A June rate hike by the Fed is now viewed as a foregone conclusion. China's yield curve became inverted as policymakers sought to rein in the shadow banking system. Moody's downgraded China's credit rating for the first time since 1989, prompting Chinese policymakers to actually strengthen the renminbi as a defiant response. Concerns over potentially slowing Chinese growth pressured base metal prices, and crude oil couldn't hold above $50 a barrel in spite of the Organization of Petroleum Exporting Countries' (OPEC) extension of output cuts by nine months. The U.S. Dollar slid again, but gold did not command much enthusiasm as bitcoin became all the rage. The price of a bitcoin has gone parabolic from $952 at the start of the year to as high as $2465 in late May. Lastly, in the rarefied world of contemporary art collection, the late Jean-Michel Basquiat's painting of a skull, originally bought by a couple for $19,000 in 1984, was just auctioned off by Sotheby's for a cool $110.5 million to Japanese billionaire Yusaku Maezawa. Is it irrational exuberance or the scarcity value of a deceased artist's work?

Equity Markets Indices[1]	4/30/2017 Price	5/31/2017 Price	MTD Change	YTD Change
MSCI All Country World	455	464	1.9%	9.9%
S&P 500	2384	2412	1.2%	7.7%
MSCI EAFE	1834	1890	3.1%	12.2%
Russell 2000®[2]	1400	1370	-2.2%	1.0%
NASDAQ	6048	6199	2.5%	15.1%
TOPIX	1532	1568	2.4%	3.3%
KOSPI	2205	2347	6.4%	15.8%
Emerging Markets	978	1005	2.8%	16.6%
Fixed Income				
2-Year US Treasury Note	1.26%	1.28%	2	9
10-Year US Treasury Note	2.28%	2.20%	-8	-24
BarCap US Agg Corp Sprd	1.16%	1.13%	-3	-10
BarCap US Corp HY Sprd	3.71%	3.63%	-8	-46
Currencies				
Australian (AUD/$)	1.34	1.35	-0.8%	3.2%
Brazil Real (Real/$)	3.18	3.23	-1.6%	0.9%
British Pound ($/GBP)	1.30	1.29	-0.5%	4.5%
Euro ($/Euro)	1.09	1.12	3.2%	6.9%
Japanese Yen (Yen/$)	111	111	0.6%	5.6%
Korean Won (KRW/$)	1138	1120	1.6%	7.7%
US Dollar Index (DXY)	99.05	96.92	2.2%	5.5%
Commodities				
Gold	1268	1269	0.1%	10.1%
Oil	49.3	48.3	-2.0%	-10.1%
Natural Gas, Henry Hub	3.11	3.00	-3.5%	-18.5%
Copper (cents/lb)	260	258	-0.6%	3.0%
CRB Index	182	180	-1.1%	-6.6%
Baltic Dry Index	1109	878	-20.8%	-8.6%

SOURCE: BLOOMBERG

Ten Years of Troubled Waters

John Kenneth Galbraith may not be well known to the millennials, but during the second half of the twentieth century, he was regarded as one of the greatest American liberal economists and an intellectual heir to John Maynard Keynes. He warned about corporate power, criticized the cult of consumerism, and lamented their assault on the environment. Galbraith was also a Renaissance man who excelled as an author, presidential advisor, public official, diplomat, and academic.

In 1994, at age 86, he published *A Short History of Financial Euphoria*, a book that traced speculative bubbles through the centuries and cautioned that the market's memory is "notoriously short" and that the world of finance would hail the invention of the wheel, or new financial instruments, "over and over again, often in a slightly more unstable version." A year later, Silicon Valley startup Netscape went public and ushered in the dot-com bubble, which was followed by the U.S. housing bubble a decade later. Galbraith passed away in 2006, two years shy of the Great Financial Crisis, which indeed exposed many exotic derivative products as the more unstable versions of the wheel.

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Having experienced firsthand the dot-com bubble as a tech analyst and then the subprime implosion as a portfolio manager, I've been a bit paranoid about the next potential crisis. Since this monthly publication was first distributed to clients in March 2007, much ink has been spilled chronicling the various potential financial, economic, and political landmines that could wreak havoc on markets and the real world. Over the last ten years, it seemed like there were always some potentially serious developments on the horizon, and they have resulted in quite a few strands of gray hair.

In the March 2007 issue, we wrote about the bursting of the subprime bubble evidenced in the share price collapses of subprime lenders New Century Financial and NovaStar Financial. Little did we realize at the time that it would set in motion a series of liquidity and solvency crises which eventually led to the bailout of Bear Stearns, Fannie and Freddie Mac, the collapse of Lehman Brothers, a global financial seizure and the Great Recession. Then, just as the U.S. stabilized its financial system by the fall of 2009, the European Sovereign Debt Crisis took center stage and dominated the headlines from 2010 through early 2013. When ECB President Mario Draghi's "whatever it takes" approach finally brought back some semblance of order, ex-Fed Chair Bernanke triggered the so-called Taper Tantrum in mid-2013 that roiled emerging markets. It was followed by the collapse of the commodities complex in 2014 and 2015, starting with base metals then crude oil. By early 2016, the emerging market downturn culminated with extreme fear of a disorderly Chinese devaluation to defend its shrinking foreign exchange reserves, and crude oil prices crashing below $30 a barrel. Populist backlash then dominated the rest of 2016 with Brexit and Donald Trump's electoral victory. By early 2017, investors started to worry about a far-right victory in the French presidential election.

Smooth Sailing for Now

Interestingly, with the French presidential election now in the history books, we suddenly find ourselves, for the first time in ten years, looking out on the horizon and *not* spotting potentially destabilizing dark clouds (I had to have my glasses checked). Some may disagree by pointing to the North Korean nuclear situation as a clear and present danger, but we suspect a full-blown crisis will be averted as both President Trump and Kim Jong-Un, (the "smart cookie", quoting President Trump), have dropped hints on a willingness to talk. The German federal elections on September 24, 2017 could result in a surprise regime change, but the left-of-center Martin Schulz is unlikely to usher in a dramatic policy shift. If anything, the Social Democrats may loosen the purse string to the benefit of the Eurozone. In short, we do not see the potential for a market destabilizing election until the next Italian general election, which is to take place by May 20, 2018, though it could still be moved up to this year.

On the economic front, a synchronized global recovery has been underway. With a power transition scheduled to take place in autumn, China appears to be maintaining growth and stability for now, and its infrastructure and housing-led growth has pulled many emerging market countries along. Japan, the world's third largest economy, is currently enjoying the longest run of sustained growth in more than a decade. Even the Eurozone, the Rodney Dangerfield of the developed world, is enjoying the lowest unemployment rate in seven years, and Germany's Ifo Business Climate Index has hit record highs. Lastly, Trump's protectionist rhetoric has been more bark than bite, and the border adjusted tax seemed dead on arrival.

Corporate earnings are also rebounding nicely after roughly three years of stagnation. The S&P 500 Index's earnings per share surged about 15% year-on-year during the first quarter. While earnings growth is likely to decelerate, the Street's high-single digit growth expectations for the quarters ahead remain supportive to the positive macro narrative.

But What Could Go Wrong?

These rose-colored macro views do not mean markets will continue to appreciate unimpeded. Markets usually climb a wall of worry, and complacency often precedes nasty surprises. As a sign of the widespread complacency among equity investors, the VIX Index (a measure of market volatility) slid to 24-year lows in early May, and the cyclically-adjusted P/E ratio for the S&P 500 Index has risen to 29 times, an altitude only surpassed by the 1929 and the dot-com periods. Equities also continued to move higher with nary a concern even in the wake of the horrific Manchester bombing.

The Treasury and currency markets, however, do not appear to be on board with the stock market's rosy outlook. The U.S. Dollar Index has given up all the gains since the November election, signaling less confidence in the U.S. reflation story. Admittedly, some of the U.S. dollar weakness reflects the stronger overseas growth. That said, the greenback's weakness has coincided with a flattening U.S. yield curve, a falling 10-year U.S. Treasury bond yield, and the market's stubborn refusal to price in much of the rate hikes conveyed by the Fed's dot plot.

Equity bulls would point to the falling U.S. Treasury bond yields as justification for high equity valuations – a Goldilocks scenario. However, the combination of elevated stock valuations, low bond yields, and widespread complacency makes it difficult to find attractive investment opportunities – most asset classes are either fairly or richly valued, meaning that there is little margin of safety should something go wrong. We thought the headline of a recent sell-side report on the U.S. Agency Mortgage Backed Securities aptly portrayed the investment challenge: "Poor in Absolute Terms, Better in Relative." Experiences have taught us to be careful when one has to justify investment merit on relative terms.

While the macro outlook appears sanguine at present, there is always the risk of unforced errors and self-inflicted wounds. The so-called "Comeygate" could derail the Republican tax reform agenda. Partisan bickering may lead to a U.S. government shut-down this autumn. The window of opportunity for President Trump to get things done legislatively is also dwindling, as congressional members will be busy campaigning for the mid-term elections by this time next year. If Democrats manage to galvanize anti-Trump sentiments to flip the House in the 2018 mid-term elections, the final two years of this presidential term could descend into even deeper dysfunction and paralysis.

There are also questions on the strength of the U.S. economy in the absence of the much anticipated Trump stimulus. In light of Galbraith's prescient observation on the cult of consumerism in the U.S., the recent weakness in automobile and retail sales at a time of near full employment bears watching. Similarly, there is the concern over the sustainability of China's housing bubble and debt-fueled growth. Lastly, shouldn't policymakers be taking away the punchbowl if this synchronized global recovery really has legs?

Let's wrap up with a recent quote by Ray Dalio, the head Bridgewater Associates, the world's largest hedge fund: "Big picture, the near term looks good, the longer term scary." For now, enjoy the temporary reprieve from the world's longer-term structural challenges. ●

ROCKEFELLER
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For More Information on Rockefeller & Co:

ROCKCO.COM

insights@rockco.co

New York, NY
10 Rockefeller Plaza
3rd Floor
New York, NY 10020
212-549-5100

Washington, DC
900 17th Street NW
Suite 603
Washington, DC
20006
202-719-3000

Boston, MA
99 High Street
17th Floor
Boston, MA
02110
617-375-3300

Rockefeller Trust Company, N.A.
10 Rockefeller Plaza
3rd Floor
New York, NY 10020
212-549-5100

The Rockefeller
Trust Company (Delaware)
1201 N Market Street
Suite 1401
Wilmington, DE 19801
302-498-6000

[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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