February 6, 2018

What Happened in the Markets?

- The S&P 500 rose 46 points, or 1.7% today, to close at 2,695. This is the 4th 1% or larger move that has happened in the past week. Today's move pushes the S&P 500 back into positive territory for the year, up close to 1%. The Nasdaq Composite rose 2.1%, while the Dow Jones Industrial Average rose 2.3%.
- Today's move appeared to be a relief rally following yesterday's 4.1% move lower. US equity markets were volatile with the S&P 500 fluctuating around 100 points, or close to 4% throughout the day. While the market opened slightly lower, it quickly recovered and was led higher by the Technology, Materials, and Consumer Discretionary sectors. Utilities and Real Estate lagged, finishing in the red.
- Treasury yields remain in focus, with the 10-year Treasury finishing the day 9 basis points higher at 2.80%. The US Dollar Index also finished the day higher for the 3rd consecutive day.
- The VIX, a measure of implied volatility in the equity market, remains elevated at 30, though below yesterday's reading of 37. This comes after 2017, where the VIX hit historic lows, spending most of the year in single digits.

Catalysts for Market Move

The S&P 500 rose 1.7% today in what appeared to be a relief rally following yesterday's 4.1% move lower. Yesterday's move lower appeared to focus on last Friday's January nonfarm payrolls report, which showed average hourly earnings surprised to the upside, growing at 2.9% year-over-year. This wage pressure potentially indicates higher inflation, which would impact both interest rates and Federal Reserve policy. Technical pressures also likely exacerbated the magnitude of yesterday's move; the equity market surge in January had led to extended positioning levels, some of which were likely worked off in recent sessions. We would stress that the sharp sell-off over the past few days appears largely sentiment and positioning driven rather than a deterioration in fundamentals as economic and earnings data remains strong.

With 275 S&P 500 companies having reported so far in the 4Q 2017 earnings season, S&P 500 companies have in aggregate beaten top-line revenue estimates by 1.1% and bottom-line EPS estimates by 3.8%. This has translated into year-over-year revenue growth of 8.9% and EPS growth of 15.1%. The impacts of tax reform continue to be in focus as companies announce their plans around repatriated cash, which has included increasing wages, one-time bonuses, charitable donations, and investment in jobs and manufacturing.

The Global Investment Committee's Current Outlook

The GIC continues to recommend equities over fixed income given their constructive view on accelerating global economic and earnings growth, supportive financial conditions, the potential for global fiscal stimulus and cheap relative valuations. Individual and institutional investor sentiment and positioning for US equities is getting much more optimistic and may have entered the "Euphoric Stage" the GIC called for a year ago—the more speculative and lower quality part of this rally. As a result, the GIC is not as bullish on stocks as they were last year at this time. They expect a more normal year in terms of total return and volatility as the Fed potentially surprises to the upside on the back of higher growth and inflation, earnings dispersion increases, and as Washington moves from policy back to politics with mid-term elections. The GIC prefers a barbell of positioning within equity portfolios—consider deep cyclical stocks, Financials and reasonably priced growth stocks. They expect high valuation and ultra-defensive/low-volatility strategies to underperform as global growth and pro-cyclical company earnings potentially surprise to the upside. They think Japan still offers an attractive opportunity for both stock picking and beta plays levered to global recovery, and they forecast a strengthening/flat yen, and therefore, removed their currency hedge for Japanese equity positions in early January. Within fixed income, they recommend US-only positioning with no exposure to high yield and some TIPS as inflation expectations recover further with a stable/weaker dollar, potentially rising oil prices and a tighter labor market. The GIC remains underweight longer maturities and other interest rate-sensitive assets like REITs where there are also some signs of credit risk. They believe oil prices could surprise on the upside this year and maintain exposure via energy stocks and MLPs. Lastly, the GIC believes interest rates are likely to rise as inflation and growth expectations improve, but then fall again in the second half, leaving high-quality fixed income investments with low, but potentially positive returns for 2018. There may be a better time to add to duration later in the first half of 2018, in their view.

Market data provided by Bloomberg.

Dow Jones Industrial Average (DJIA): A price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

NASDAQ Composite Index: A broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

US Trade-Weighted Dollar Index: A weighted average of the foreign exchange value of the US dollar against a subset of the broad index currencies that circulate widely outside the US.

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International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk, exploration risk and interest rate risk.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

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