Towerpoint Wealth

OCTOBER 2017 MARKET COMMENTARY

Runnin' Down a Dream

The "Goldilocks" regime we described earlier remains solidly in place – global economic growth (especially in manufacturing), strong corporate earnings and revenues, raging equity markets, low interest rates, and an almost frightening level of market complacency. As measured by the VIX, market volatility has not traded above 20 since November of 2016 (coinciding with the election of Donald Trump), and currently trades just above 10 (in comparison to an historical average in the high teens to low twenties).

Keep in mind that, since November of 2016, we've witnessed the Fed raise rates three times (and strongly suggest a fourth in December), announce an implicit monetary tightening policy as it looks to unwind its balance sheet, Trump's unexpected election, three hurricanes, multiple acts of horrific global terror, an independence vote in Catalonia that could reignite nationalist sentiment across Europe, and the transfer (well, more like retention) of national leadership in China. But nothing seems capable of knocking the markets off their steady climb upward.

As we are all aware, nothing is ever completely stable in a world where Donald Trump is President, but even he seems to be taking the safe path with his announcement of selecting long-time Fed Governor Jerome Powell to replace Janet Yellen as Fed Chair.

The markets would probably like to have seen Yellen reappointed, as Fed policy under her leadership has been positive (to say the least) for the markets. But Powell is seen as someone likely to continue the "low and slow" direction of the Yellen Fed.

There was some concern that Mario Draghi would announce at the end of October a tapering of the European quantitative easing program, but even that announcement landed with a soft thud as the market interpreted it as very gradual and "lower for longer".

Inflation remains disconcertingly low, and there is some uncertainty of the wisdom of raising rates into a non-inflationary regime. Likewise, the complete lack of volatility and the corresponding level of investor complacency it suggests gives us pause.

The markets will correct at some point, and there is at least the possibility of significant investor over-reaction when it does (especially in the face of the explosion in passive investment vehicles, where any exiting of the market would be largely indiscriminate at the individual security level).

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

- The global economy remains solidly positive right now:
    - The US revised its Q2 GDP growth rate downward from 3.1% to 2.6%, and lowered estimates for Q3 down to 2.4% from 2.7%; GDP growth estimates for all of 2017 remains 2.3% (source: The Wall Street Journal);
    - Both the US manufacturing and services sectors remain well in expansionary mode – after hitting a level higher than 60 in September (the highest in thirteen years) the ISM Manufacturing index dropped back down more recently (the hurricanes played a transitory role) to around 58-59, while the Non-Manufacturing index remains around that same 58-59 range. Any reading above 50 represents an expansionary environment;
    - As we discussed last month, inflation remains a question mark – both the "headline" and "core" (which excludes the volatile food and energy sectors) inflation numbers remain below the Fed target

of 2%. There remains a strong consensus that the Fed wants to (and almost certainly will) raise rates again in December, and the announced unwinding of the Fed balance sheet certainly represents an implicit tightening of Fed policy. But tightening monetary policy in the absence of inflation is somewhat contradictory, which is why some are concerned about these moves slowing down or stopping the ongoing economic expansion.

- ➢ More than 325 of the S&P 500 firms have now reported revenues and earnings for Q3 and, as anticipated, it was a very good quarter. Through October, earnings are up 7.8% year-over-year and revenues are up 6.5% year-over-year. Equally as important, fully 75% of firms beat their EPS expectations while 65.7% of firms beat their revenue projections. Both of those "beat rates" are higher than historical averages. We've written many times before that the revenue growth is especially positive, as longer-term actual top-line growth begins to compete again with the financial engineering (stock buybacks and dividend payouts) that drove so much of the EPS growth in the past few years. In fact, earnings are growing despite a notable drop off in financial engineering over the past 1-2 quarters (Source: Zachs Earnings Report);

- The Eurozone Q3 2017 GDP growth came in at 2.5% (annualized) well ahead of the 2.1% consensus expectations and the strongest quarter since Q1 of 2011; the consensus estimates for Q4 are also 2.5% (source: TradingEconomics):
  - ➢ GDP and manufacturing are expanding across the Eurozone, with the Markit manufacturing index hitting almost 58.6 in October – the highest reading in 80 months; the services index also remains in solidly expansionary mode (Source: IHS Markit);
  - ➢ Unemployment has fallen to 8.9%, an 8-year low, and annualized inflation through October fell to 1.4%. Although ECB President Mario Draghi did announce his long-awaited "tapering" statement about quantitative easing in the Eurozone, his comments were considered dovish and well within the "lower for longer" category. He faces the same dilemma as Janet Yellen (now Jerome Powell) and the Fed with respect to tightening monetary conditions in a non-inflationary environment (and thereby running the risk of stifling the still moderate economic recovery);
  - ➢ Japan's Q2 GDP was a positive 2.5% (annualized), and represented the sixth straight quarter of positive GDP growth. The consensus estimates for Q3 and Q4 GDP growth rates are 2.6% and 2.4%, respectively (source: TradingEconomics);
  - ➢ China's (official) growth rate for Q3 was roughly stable at 6.8%, down slightly from previous quarters and (official) estimates for Q3 are 7.1%. The PBoC continues to slowly push up rates in an attempt to control massive debt build up and highly speculative real estate prices. President Xi Jinping took unprecedented power in the newly unveiled Chinese Leadership Team, cementing his hold on the country's political and economic future.

The Towerpoint Wealth Economic & Market Outlook

The global economy is growing. Manufacturing in particular is expansionary in most major regions of the world. Oil and commodity prices have risen or stabilized over the past 2-3 months in response. Inflation remains lower than expected or desired, though some analysts believe that there are "hidden" inflationary pressures (e.g., wage growth) that have the potential to disrupt the current highly complacent environment. The "Goldilocks" economic regime ("It's just right!") seems firmly in place, barring a highly unexpected exogenous event.

Donald Trump's decision to appoint Jerome Powell as the next Fed Chair should be welcomed by the markets. He consistently supported Yellen's policies over the years, and his appointment will likely be viewed as a continuation of the Fed's current approach.

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The Catalonian independence question in Spain and the recent and horrific terrorist attack in New York City are reminders that the world can be an unstable place, with unforeseen economic consequences. But until and unless such exogenous events occur, the global economy seems poised to maintain its positive growth.

On the investment side we maintain our general market forecast:

- The global macro-economic environment remains constructive, though still somewhat modest by historical standards;
- Global inflation and global interest rates generally remain low, with little upward pressure on either, despite the Fed's desire to tighten and "normalize" interest rates;
- There has been some policy movement with respect to tax reform; we remain of the opinion that not much will happen in what remains of 2017 and that any legislation passed in 2018 will likely be "weaker" than initially anticipated;
- Despite very solid earnings and revenue growth, low rates, and a somewhat disconcerting lack of volatility, equities (especially US large cap stocks) still look expensive to us, but it is hard to identify any particular obstacle to at least a modest continuation of the ongoing rally, perhaps for the next 1-2 quarters;
- Valuations are relatively more attractive in small cap, EAFE, and EM stocks. The US dollar trend is the wild card for US investors (continued weakening will help non-US returns) – we are of the opinion that the year-long slide in the US dollar is nearing its bottom;
- The US yield curve remains flat as the market prices in a further increase in short-term rates and low inflation and lower growth in the longer term. We do not anticipate the yield curve to invert;
- At these rates and credit spreads, the public credit markets still look very expensive to us. Though spreads have contracted in the private markets as well, we still think there are better alternatives there for investors who can access them and handle the lower level of liquidity;
- As we anticipated, it is shaping up to be a better year for alternative investments, both hedge funds and liquid alternatives, though we remain more optimistic about hedge funds than liquid alternatives because of fewer liquidity and leverage constraints;
- While we are generally constructive on the global economy and overall market performance, the public markets are not cheap and we still expect mid-to-high single digit performance for globally diversified portfolios over a full market cycle.

So, as we review the economic and market landscape, we see many good and positive things – a growing economy, solid earnings, low inflation, and low interest rates. We assign a fairly low probability to that regime not continuing through the remainder of this year, but we do see potential issues that we should not ignore. It is times like these when we frequently witness many investors "*runnin' down the dream*" as they "*put the pedal down, to make some time*" because they are convinced that "*something good is waitin' down this road*" and they seek to "*pick up whatever is mine*". In our experience, often times that is a good time to start looking for the off-ramp, or at least opening up the Waze app to find the best route to where we want to go.

Warm Regards,

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President

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