“An investment in knowledge always pays the best interest”
(Benjamin Franklin)

[Nigel Tufnel]: "You see, most blokes will be playing at 10. You’re on 10, all the way up, all the way up...Where can you go from there? Nowhere. What we do, is if we need that extra push over the cliff...Eleven. One louder."

[Marty DiBergi]: "Why don’t you just make 10 louder and make 10 be the top number, and make that a little louder?"

[Nigel (after taking a moment to let this sink in)]: "These go to 11."

This scene from the classic spoof “Rockumentary” This is Spinal Tap is a fitting analogy for the markets today. The global economy continues to expand, corporate revenues and earnings are solid and, despite frothy valuations, the stock market continues to chug up “to 11” and beyond.

There is a certain level of complacency to the market that gives us pause, as if there is nothing that could stop the relentless rise. A reading of 20% or lower on the VIX, a commonly used metric of stock market volatility, is generally considered to indicate a fairly quiescent market. With the exception of a few daily spikes, the VIX has generally traded below 15% for the past six months, and in the 10% -- 11% range for much of the past month. That strikes us as almost too quiet.

President Trump continues to have good days and bad days, but parts of his agenda (healthcare reform, tax reform) have at least begun to slog their way through Congress. We think it unlikely that anything significant will make it back to his desk for signature before late this year, and more likely not until next year.

Trump continues to rescind or overturn certain Executive Orders that were issued under the previous administration – a process that does not require Congressional approval. Most of the rescissions (regarding, for example, oil pipelines or prohibitive regulations) have generally been viewed as business friendly.

He faced fierce criticism, though, from both Democrats and many business leaders when he
announced recently that the US would pull out of the Paris Climate Accord (which he could do unilaterally because Barack Obama never submitted the Accord to the Senate to have it ratified as a treaty, which would then have been binding).

Although Trump’s agenda continues to be slowed by universal opposition from Democrats and the by-design glacial pace of legislative protocols, as long as the market continues to believe things are moving, it will most likely remain both patient and optimistic.

As investors, we do not attempt to time the markets and tend to take a long-term strategic approach. Neither do we give much credence to most market “maxims”, such as “Sell in May and Go Away.” But at current market levels and with the onset of the summer trading doldrums soon upon us, we would not argue too strenuously if investors chose to take some profit off the table and wait for further developments.

It has been a fairly common occurrence over the past few years for the markets to see a spike in volatility (and associated drawdowns) as traders return from the beach in September and October, and we will not be surprised if that happens again this year, especially if it appears that pending legislation has slowed even further or perhaps even failed. That seems to us the most likely event that could cause this market to correct. In the meantime, enjoy it while it lasts.

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 positive and trending in the right direction:

  - The current “Blue Chip Consensus” estimate for US Q2 GDP growth is a strong 3.0%, and after some recent economic releases, the Atlanta Federal Reserve’s “GDPNow” forecast is a robust 4%. Both manufacturing and non-manufacturing indicators remain strongly in expansionary modes.
  - The US yield curve continues flatten as short-term rates rise (partially due to a baked in assumption that the Fed will raise rates in June) and the long-end of the yield curve continues to fall, driven by indicators of weakening inflation and (perhaps) some concerns about how late we are in the economic cycle. With less than 1% separating the 2-year rate from the 10-year rate, the US yield curve is as flat as it has been since the fall of last year, just before the “Trump Bump” following the election. We stated then that we anticipated that rates would retrace, and that seems to be the case for now.
  - The US economy has been technically out of recession since mid-2009, and it is highly unusual to avoid a recession over any given 10-year market cycle. So a recession is coming, but seemingly not for a while.
  - Wages in the US are increasing slowly but still not keeping up with employment growth as a “skills gap” persists – small companies in particular are actively seeking to hire but cannot find enough qualified workers.
  - Essentially all companies in the S&P 500 have now reported Q1 performance, and the results are solid. According to the Zachs Earnings Trend Report, reported earnings
(through May 31st), for Q1 2017 in the US are up 13.5% year-over-year (YoY), with a ~72.6% “beat rate” (i.e., earnings were better than estimates). Reported revenues are up 7.2% YoY, representing a 65.2% “beat rate”. It is decidedly positive to see the revenue beat rate, which had been below historical averages for quite some time heading into 2017. Companies continue to engage in financial engineering to drive earnings growth, and the expectations are that earnings growth may have peaked for the time being, but the first quarter also saw decided upticks in two key factors – revenue improvement and capital investment.

- European Q1 2017 GDP growth was roughly 0.5%, slightly better than expectations and suggestive of continued improvement, especially in manufacturing. Current estimates for Q2 GDP growth are roughly 0.4% -- not especially robust but consistently positive.
- Uncertainty remains about the nature and results of the “Brexit” negotiations, with early signals that the larger Euro-zone countries, especially France and Germany, are not inclined to negotiate “easy” terms with the UK.
- Japan’s GDP in Q1 was a positive 0.5% -- the fifth consecutive positive quarter and the strongest quarter since Q1 of 2016. The US dollar has weakened against both the yen and the euro, which puts headwinds into exports from both of those regions (while helping US exports). Nonetheless, Japan saw increases in Q1 in personal consumption, exports, and capital expenditures.
- China’s GDP growth rate, while remaining over 6%, is now consistently declining and is expected to continue to do so for the remainder of 2017 (according to Moody’s Investors Service).

- With the exception of Global Materials, the general commodity complex continues to get pounded by falling oil prices.
- As we anticipated, 2017 thus far continues to show an improved opportunity set for active managers.

The Dynasty Economic & Market Outlook:

The global economy is growing, driven by solid manufacturing expansion. Global inflation remains in check and, perhaps, is beginning to show signs of retreating (which would be troubling if it continues). We remain generally optimistic about a continued expansion of global economic activity, even if at a fairly modest pace.

On the investment side we maintain our general market forecast, with no major changes:

- Although Trump’s legislative agenda will take longer to implement than many thought, we may be beginning to see some progress. The Democrats will universally oppose him (except perhaps on infrastructure spending), so the question will be whether or not the Republicans can maintain some level of unity as the majority party – and this is not a sure thing. Any passing of major legislation is not likely to happen until late in 2017, and more likely in 2018
- The UK, European, and Japanese central banks will remain accommodative – driving increased policy divergence with the US, which almost certainly will raise rates in June (put differently, the markets are likely to react strongly if the Fed does not raise rates).
- Despite an uptick in economic data and earnings, US public equities still look expensive
to us. We remain modestly constructive for the year, though valuations in EAFE and EM stocks remain more attractive (despite very strong performances thus far in 2017). The USD trend is the wild card for US investors – a continued weakening would put a tailwind behind non-US performance for US-based investors

- We expect a “grind higher” interest rate environment, and the public credit markets still look very expensive to us. We do not expect the US yield curve to continue to flatten, unless future economic or inflation data come in worse than expected
- We think there are better opportunities in the private equity and private credit spaces for investors who can access them, though anticipated spreads to comparable public markets have fallen as investors have piled in seeking premiums. We still like the private markets, but investors need to actively manage expectations – historical premiums may not be available in the current environment
- It is shaping up to be a better year for alternative investments, and we remain more optimistic about hedge funds than liquid alternatives because of lower liquidity and leverage constraints. This optimism has been justified so far in 2017 as hedge funds at the individual fund level generally are outperforming their mutual fund brethren
- Real assets and commodities have been a disappointment this year, as falling oil prices have dragged down the whole complex. We remain generally constructive due to improving economic conditions, but are now less optimistic about the space than we were earlier in the year

The market is already complacent, and the onset of US legislative summer recesses, personal vacations, and typically low-volume trading activity in most major markets should all combine for a fairly slow summer. We try not to act on assumptions, however, and we will be watching the hard data as they come in and positioning our portfolios accordingly.

We don’t need our portfolios to “go to 11” – a louder 10 works just fine for us.

Warm Regards,

Scott Welch, CIMA®
Chief Investment Officer
Dynasty Financial Partners

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Source: Bloomberg, Data Analysis, 1/2016-Present
Source: Zephyr, Data Analysis, 1/2016 – Present
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