

MARKET SENSE: Global Economic Stability Powering Corporate Earnings



At the midway point of 2017, our constructive view of the global economy and markets remains intact. Curiously, the broad markets have continued to drift higher, and remain near multi-year or even all-time highs in most geographies, even as the optimism about Trump fiscal and tax reform has waned. This would seem to confirm our view that the current stage of the economic cycle is broader and stronger than just a shift in political direction in the U.S. Moreover, as we concluded in our last quarterly newsletter, a delay in the implementation of President Trump's proposals could actually serve to extend the economic recovery. Thus, our base case remains that the global economy remains stable in the near term and that government policy will arrive around year-end, extending the recovery into 2018. Over the remainder of this letter we will touch on current economic data and our views on the key signs to watch for changes down the road. We also provide some of our thoughts on one of the most discussed topics in investing today – active vs. passive strategies. Before doing so, we would turn your attention to the table below with broad market measures of market performance in recent periods.

	2nd Quarter	52 Weeks
S&P 500	3.09	17.90
Dow Jones Industrial Average	3.95	22.12
MSCI EAFE (Developed International)	6.12	20.27
MSCI EM (Emerging Markets)	6.27	23.75
Bloomberg Commodity Index	-3.00	-6.50
Barclays Global Aggregate Bond Index (Global Bonds)	2.60	-2.18
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	1.45	-0.31
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	1.25	0.44
HFRI Fund of Funds Composite Index	0.21	5.84

GLOBAL ECONOMIC REVIEW

With recent stability in China and surprising (to many) growth in Europe and Japan, the global economy remains in its most synchronized period of growth since 2011. Compared to historic levels, the growth trajectory is modest, but for the intermediate term it appears stable and sustained. Though most media coverage credits the U.S. presidential election in November as the catalyst for the positive economic and market turn, we believe a broader story has been at work. Global manufacturing indexes and leading indicators turned higher in early 2016 and have continued showing improvement. Moreover, business and investor sentiment around the globe have improved greatly and are near the highs seen before the financial crisis nearly a decade ago. We are challenged to understand the link between a U.S. election and the turn in all global economies and sentiment. As long as the breadth and strength in this data continues it is hard to become overly negative on the expectations for equities and other growth assets.

The positive economic data has been progressively powering corporate earnings. It is true that global equities have produced double-digit gains since last summer, but earnings have grown even faster, meaning global equity indexes trade at slightly better values than 12 months ago. Further, earnings revisions continue to foreshadow continued improvements. At present, 72% of analyst earnings forecasts are showing positive revisions, which is near the highest levels since 2011. These trends are especially strong in Europe as the economy across the Atlantic is showing its most positive performance in a decade. Germany's economy is currently booming. In France, we believe the new President, Emmanuel Macron, is likely to push through substantial economic reform quickly following an overwhelming victory in French elections. With growth in the two largest economies in Europe, the entire continent remains on a path toward recovery, albeit one that continues to be doubted by investors.

But won't the political dysfunction in Washington, Brussels, and London derail the market at some point? In what may seem counter-intuitive, markets actually exhibit better performance when political uncertainty is high and rising. Ned Davis Research recently completed an analysis that shows the majority of market gains since 1985 have come when the Partisan Conflict Index is above average. The report speculates that the lack of policy change that occurs during periods of partisanship is a possible explanation. This observation seems to confirm the market is happiest with the status quo. As with many things though, what is good in short-term can have longer-run negative consequences. Ned Davis Research also discovered that when partisan conflict is high, economic growth is often lower. This is most directly caused by slowing capital expenditures and reduced business expectations.



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Though we remain near-term optimists, there is no hiding the fact that the current economic cycle is becoming advanced – currently it is the third longest since WWII. Various indicators are starting to show a need for increasing caution as the inevitable end to the period of economic growth draws closer. Much has been made in the U.S. of the flattening yield curve, lower auto sales, and the rise in credit card defaults by consumers. These are all signs that we are no longer in the early stages of a recovery, but they are not significant enough, on their own, to indicate broad deterioration. Further, the rest of the world is accelerating at this point, and global financial conditions remain supportive of growth.

However, there are two large macro stories that could come together in early 2018 presaging a turn in the cycle. First, we continue to expect tax and fiscal policies from the White House and Congress. Dan Clifton at Strategas (who we count as among the best in handicapping DC activity) continues to place the odds on policy change at 70%. In fairness, what they see being implemented is less than earlier predictions. But with markets now having very low expectations for any progress by Congress, tax and fiscal changes should provide upside to the economy in 2018. Clifton characterizes the likely policy package as “a pro-growth tax cut disguised as revenue neutral tax reform.” This would mean mostly a corporate tax-cut and repatriation of global corporate cash. Fiscal stimulus will help the economy and markets in the near-term but we think will bring with it more broad based fears of higher inflation and will cause the Federal Reserve to quicken its pace of rate increases. The effects of rising rates could eventually tighten financial conditions to the point of causing the next economic slowdown.

Across the Pacific, China is focused on maintaining stability ahead of the Government reorganization (19th National Congress of the Communist Party of China) later this year. However, policymakers there appear to recognize - and are starting to address - the challenges of the ever expanding debt load in the country. The pace of reform will likely pick up in 2018, and the consequences for the economy and markets there are unknown.

We will wait for market indicators to provide more clarity, but the above macro factors would imply the possibility of an economic and market cycle high – driven by changes in the U.S. and China - sometime in 2018. Watching for worsening financial conditions in the U.S. and China along with flat corporate earnings and sustained levels of investor optimism (a contrarian indicator) would cause us concern and likely lead to some portfolio repositioning.

THE ACTIVE VS. PASSIVE DEBATE

We often get asked about different investment strategies and how these are incorporated into the SignatureFD portfolio management process. Recently, the distinction between active and passive strategies has captured much of this focus. In preview, we do not believe one is a philosophically superior strategy and we recognize the positive and negative attributes of each.

First, let us define the two types of investing. Passive strategies are designed to mimic a specific index (also called benchmark) and thus do not directly take a fundamental view of the value - or lack thereof - of the underlying securities being purchased. This strategy has the advantage of being easy to understand, and typically has a lower cost as it requires limited human involvement to implement. Active strategies on the other hand are a collection of securities, designed to be somewhat different



THE DECISION REGARDING ACTIVE VS. PASSIVE IS NOT A BINARY CHOICE. THERE IS A SPECTRUM OF CHOICES THAT INVESTORS WILL MAKE REGARDING THE USE OF STRATEGIES THAT ARE VARYING DEGREES OF ACTIVE.

than an index, in hopes of outperforming or incurring less risk than the targeted index. These strategies often, though not always, utilize human judgment and decisions are based on some fundamental or quantitative methodology to express certain views of the markets, an asset class, or a specific security. The advantage of active management is the possibility of achieving superior results via security selection or risk management incorporated into the investment process.

Generically, it is our opinion that neither of these are 'bad' or 'good.' They both can serve a purpose and if utilized properly over long periods of time we believe that investor results are likely to be quite similar. But in certain market environments one or the other can appear much more attractive. We have been in that period recently for passive index funds.

The recent investment period has been characterized by a broad movement toward passive investing. This has been driven largely by technological innovation, changes in the costs and methods for trading securities, and the advent of the exchange traded fund structure in the 1990's. The result has been nearly \$1 trillion dollars of assets in the U.S. alone that have moved from active strategies to passive since the financial crisis. In typical fashion, Wall Street product development follows assets. As such, the number of indexes available for passive strategies to mimic has now exploded to more than 5,000 from just a few hundred in 2010. This means there are actually more indexes than underlying equities in the United States! Moreover, the trading of these passive strategies has also grown to the point that the majority of passive funds are now held by investors employing active strategies. The average holding period of the top 10 ETF's by asset size was 131 days, somewhat less than one-half of a year. This is probably a different holding period than most people would ascribe to a true passive investor.

We cover these details to make a simple point. The decision regarding active vs. passive is not a binary choice. There is a spectrum of choices that investors will make regarding the use of strategies that are varying degrees of active. At SignatureFD, to reiterate, we utilize strategies all along this spectrum. In practice, we run many client portfolios that are biased toward passive and others that currently happen to include a majority of active managers. But even in the passive portfolios we will often incorporate a few active strategies and in portfolios predominately invested in active strategies typically include 20-40% of holdings in passive oriented holdings.

When targeting a specific area of the market (for example a specific asset class or geographic focus) we typically narrow the scope of investments to at least one passive and one active. This allows us to compare and contrast the two for total expenses, long-term performance and risk, and the ability of us to easily trade the position. When choosing index oriented funds (especially ETFs) we look in detail at the index being tracked, the costs of the fund (both direct and indirect), and the size and liquidity of the fund. For active management holdings we look for consistency in strategy and results and our conviction level in the portfolio manager's ability to continue to achieve superior results net of the

cost differential to a passive alternative. The market structure of a particular asset class also impacts our decision whether to invest in active or passive. Large, efficient markets (e.g. large-cap U.S. equities) tend to offer fewer opportunities for an active manager to capitalize on, thus requiring more skill. In contrast, we believe the market for securities like international REITs and managed futures are less efficient and present managers with the chance to outperform. Some markets, like legacy mortgage securities, have no investable index funds and require active management.

Finally, we want to avoid the temptation to try and project when one approach may outperform the other. As with most alternatives in investing, trying to time when one strategy or the other is going to be in fashion is not productive. Many factors go into these trends and forecasting these shifts consistently seems difficult, if not impossible to us.

PORTFOLIO POSITIONING

Overall portfolio positioning remains little changed from the previous quarter. We believe equities continue to be the most attractive asset class. Though valuations continue to look elevated, this is probably a problem for a future date. Fixed income has provided some diversification benefits of late, but long-term return potential appears capped. Alternative investments are helpful in balancing portfolio return versus risk, but remain frustrating with inconsistent results across strategies.

At a high level, total equity exposures were little changed across most portfolios in the just completed quarter. However, we made some modest shifts around the edges. During the quarter we initiated in client portfolios a position in oilfield services equities funded by trimming Japanese equities and MLPs. We remain positive on both Japan and MLPs, but felt the energy underperformance provided a good entry point. Energy sector equities have experienced their worst start to a year ever relative to the S&P 500 even though the YTD decline in crude oil prices has been less than in prior periods of energy weakness.

Additionally, international REITs remain an attractive asset class, we believe, due to wider than normal spreads relative to global interest rate benchmarks, their positive correlation to inflation, and diversification benefits. We recently made a shift in most client holdings of international REITs, swapping out a passive ETF in favor of an actively managed mutual fund. As mentioned earlier, we believe the international real estate universe is inefficient enough for an active manager to add value through geographic allocation and security selection, especially as returns from different property types have begun to show wider dispersion.

There were no changes to alternatives exposure during the quarter. We conducted an in-depth review of our allocation to managed futures and ultimately reaffirmed our belief in the strategy. As previously discussed, we have a positive outlook for both the domestic and international economic environment but recognize that valuations are higher than average in both equity and fixed income markets. As such we believe an allocation to uncorrelated assets, especially during market declines, is appropriate and expect managed futures are still able to serve that role.

Fixed Income remains an area of intense debate among investors. We stand closer to the inflationary rather than disinflationary camp given falling unemployment and a reasonably strong global economy

and are positioned accordingly through REITs, inflation-focused securities, and low duration bonds. While our low duration positioning leaves us less exposed to the negative effects of interest rate increases (which we expect) it does reduce the diversification benefits bonds provide in an economic slowdown. While such a deceleration is not our base case we believe the odds of one happening are higher now than that Fed has increased the pace of interest rate hikes.

Though our overall views have matched well with recent market activity in recent quarters, we remain aware that the winds of change seem to be starting to rustle. As always, we are open to new information or changes in the behavior of various asset classes. As the French philosopher, Voltaire, was credited with saying, “doubt is not a pleasant condition, but certainty is absurd.” Thank you for your ongoing support of SignatureFD and the confidence you have placed in our team.

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