Review & Outlook

SECOND QUARTER 2017

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Review

The US stock market made steady gains in the second quarter of 2017 and market volatility is at historic lows, which we found surprising given the dour news headlines confronting investors. European markets were similarly optimistic after the elections in France and the Netherlands restored confidence in a unified EU. In the US, negative market response to growing concerns that "business friendly" Federal policies might fail to emerge are being offset by steady domestic growth and improving conditions in foreign developed and emerging markets.

Large capitalization stocks (as represented by the S&P 500 index) have continued to perform somewhat better than mid and small capitalization stocks during the second quarter. Small and mid-cap stocks caught up with large cap stocks by mid-June, but have lagged noticeably since then. Growth stocks have continued to perform much better than value stocks. This quarter, the technology sector emerged as a top performer, with technology stocks making up a significant portion of growth stocks. The biggest laggard was the energy sector, due to the steadily falling price of oil. Financials trailed at the beginning, but showed relative strength in June.

	Total Return as of 6/30/2017	
Indices[3]	Q2 2017	Trailing 12 Months
S&P 500 Index (Large Cap)	3.06%	17.9%
S&P 400 Index (Mid-Cap)	1.97%	18.57%
S&P 600 Index (Small Cap)	1.71%	22.47%
Morningstar Short-Term Bond Index	0.46%	0.32%

Outlook

Like last quarter, we see no obvious events on the horizon that would cause significant concern about either domestic or international stock markets. The election of Emmanuel Macron in France, and possibly more importantly, the defeat of far right, anti-EU Marine Le Pen, has provided confidence that stronger pro-EU, pro-Euro political sentiment is emerging. The recent election in the UK went sideways for the Conservative party, but it does not appear to be troubling for broader global growth. An ongoing issue to navigate in Europe is bank debt, with Italian bank debt being of particular note. While Mario Draghi, who happens to be an Italian, continues as President of the European Central Bank, it is likely that the current monetary policy will remain in place, doing everything possible to keep any graver financial crises at bay. While there continues to be no shortage of concern about debt buildup in China, it also appears that the Chinese government has the skill and resources to manage for now. One measure of financial stress in China is the currency level, which is tied to capital outflows. While the currency has been steadily depreciating over the past few years, it has stabilized, and even appreciated in the past months.

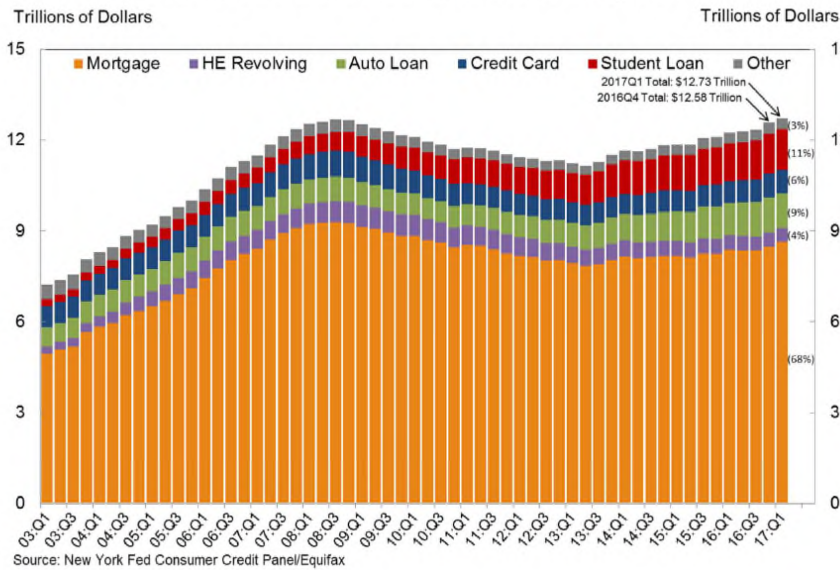
One positive change that has occurred over the past two quarters is a reversal in the appreciation of the trade weighted U.S. Dollar. This is a measure of strength of the U.S. dollar vs. a basket of currencies from major trade partners. The dollar strength hit a record high for the decade at the very end of 2016, but has been in decline ever since. One consequence of this is that domestic exporters become more competitive, and multinational companies earning foreign dollars will see exchange-related gains to revenue and earnings.

Another trend that became more pronounced in the first part of the second quarter is a decreasing longer-term interest rate, measured by the 10-year Treasury. This is somewhat troubling, as it does not support a view that the economy is strong and growing; nevertheless, it does provide some extra support for interest-sensitive industries, such as housing. The lower longer-term rates are also at odds with the Federal Reserve Bank, which raised the Fed Funds rate to 0.75% on Dec. 14th, and to 1.0% on March 15th. The 10-year Treasury was at about 2.5% at each of these hikes, but has since declined to 2.3%, a continuation of a historically low longer-term yield. While a flattening yield curve (the difference between long and short-term rates) is a potential sign of economic trouble ahead, we do not see the basis for that conclusion right now.

In Focus

In this quarter's "In Focus" section, we highlight consumer debt. As we have all experienced within the past decade, stress in the consumer debt market can carve a nasty path through the financial markets.

Given that roughly 70% of economic activity in the US is consumer driven, it is especially important to keep an eye on consumer-related debt. In general, the largest source of consumer debt is tied to housing and mortgages. The embedded table comes from a recent New York Federal Reserve report showing mortgage debt and other categories of debt, aggregated nationally.[1]



Other significant categories include home equity revolving debt, auto loans, credit card debt, and student loans. Of these loans, only one (housing) is supported by an asset that is generally appreciating. For now, real estate values seem to be in an extended phase of steady appreciation. Most recently, underwater loans are now in the black, with a positive equity position. Further, loan underwriting has tightened up since the financial crisis of 2008, requiring more up-front equity for new loans. While mortgage debt has increased steadily the past few years, the total amount of outstanding mortgage debt is less than in was in 2008. For now, our view is that mortgage debt markets are stable.

Outstanding credit card debt has remained fairly constant over the past decade. For credit card debt, the amount of balances that are 90 days or more delinquent is lower than before the financial crisis. In general, both interest rates and unemployment rates are historically low, keeping credit card debt manageable to service. Even though credit card debt is unsecured, we do not see any immediate economic trouble on the horizon.

While the amount of outstanding credit card debt has remained fairly stable, auto loan debt has been expanding, especially in the past three years. And often with increasingly easy terms for loan qualification. While auto loans can use the car as collateral, it is a depreciating asset. More importantly, 90 day plus delinquency rates for auto loans have started to increase in the past couple of years, and there are increased reports of stress showing up in this market. There are reports that banks have tightened up credit requirements for auto loans.[2] As such, we have become wary of much of the auto sector.

We are also seeing more news stories about exploding student loan debt. Borrowing for education is supposed to be a winning investment, leading to higher lifetime productivity and earnings. However, the cost-benefit calculation is more challenging when borrowing can easily exceed $100,000 for a four-year degree. Increasingly, young people are starting out their careers saddled with large monthly student loan payments. Perhaps not surprising, the delinquency level of student loan debt far exceeds any other types of consumer debt, and has been on an uptrend over the past decade. It is not clear that this will lead to a singular financial crisis event. However, as the total amount of outstanding debt grows, there will be a growing net drag on certain segments of the economy.

While we see nothing right now that would make consumer debt a prime element of our investment decisions, and we see no new domestic debt crisis on the immediate horizon, the issue has our attention. In particular, we will be keeping student loan debt on the radar.

1. Federal Reserve Bank of New York. (2017, May). Quarterly Report on Household Debt and Credit, from https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2017Q1.pdf
2. McLannahan, Ben. (2017, May 29) "Debt pile-up in US car market sparks subprime fear." Financial Times, from https://www.ft.com/content/bab49198-3f98-11e7-9d56-25f963e998b2
3. Index Return Source Data: S&P 500 Index, http://us.spindices.com/indices/equity/sp-500. S&P 400 Index, http://us.spindices.com/indices/equity/sp-400. S&P 600 Index, http://us.spindices.com/indices/equity/sp-600. Morningstar Bond Index: http://news.morningstar.com/index/indexReturn.html.

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