Market Commentary

Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the next crisis hits – **Hyman Minsky**

Stocks and other risk assets continued to perform as the S&P 500 ended the mid-year point with a gain of 9.3%. The top contributing stocks were Apple, Amazon.com, Facebook and Microsoft, which together accounted for about two percentage points of the return. Energy and Telecom were the only losing sectors within the S&P 500. Technology and Healthcare – laggards in 2016 – were the winners. Smaller cap stocks underperformed and lower quality stocks outperformed. Foreign stocks rallied, with developed markets outside the US returning 13.8% and emerging markets up 18.4% (as represented by the MSCI EAFE and MSCI Emerging Market Index, respectively).

While investors have not been rewarded for diversifying their equity exposure outside the US over the past several years, improved economic growth and lower valuations for foreign stocks offer a better outlook than for US stocks. Our analysis, based on current valuations and potential earnings growth, gives stocks in developed countries outside the US a 200-300 basis point annualized return advantage over the next seven years. Emerging markets could provide a 400 basis point return advantage if these economies are able to sustain growth over this period. The forward P/E on the MSCI EAFE index was 14.8 on June 30, compared to 17.5 for the S&P 500. The EAFE's dividend yield of 3.1% compared to 2.0% for the US index. The MSCI Emerging Markets Index traded at 12.2 times forward earnings at June 30. While the US economy is late in its economic cycle, Europe and the emerging markets are recovering from the slowdown that began in 2012, giving profits in these regions greater room to grow.

MLPs and other midstream energy stocks suffered along with the rest of the energy industry despite delivering strong financial results and growing their payouts to investors. A reasonable fear existed back in 2015 that low oil prices might lead to reduced drilling activity and pipeline volumes, justifying some of the price declines for assets that transport and store crude. However, the current decline in crude prices stems from the prolific production of US shale formations. Crude production this year will meet and possibly exceed the peak levels of 2015. About 70% of MLP assets transport, process and store natural gas. The production of the natural gas continues to grow, driven by the retirement of coal and nuclear power plants, its use as a petrochemical feedstock and liquefied natural gas (LNG) exports. Despite the bullish outlook, many investors have simply grown tired of the sector and outflows continue. Given the current distribution yield of around 7% and potential for mid to high single digit distribution growth, we believe MLPs currently offer the highest potential return of any segment of the publicly traded US market.

Market volatility – the amount by which the stock market fluctuates on a daily basis - fell below the all-time lows reached in 2006 before the Financial Crisis. This low volatility led to poor performance for several defensive alternative strategies, notably managed futures. While volatility will return at some point, history suggests that the current low volatility environment may persist for another couple of years. We believe it still makes sense to allocate to non-correlated investments that can provide something of a hedge when volatility returns.

The longest period of economic expansion without a recession in US history was the ten year period from March 1991 to March 2001. The recession following the 2008 Financial Crisis ended in June 2009, giving this expansion two more years before it potentially becomes the longest on record. With unemployment at 4.7% and leading indicators such as manufacturing new orders, new building permits and consumer confidence all supporting continued economic growth, the near-term risks of a recession remain low. However, risks are beginning to accumulate in the economy. Debt levels of businesses outside the financial sector now exceed levels in 2007, the last year of economic growth before the 2008 Financial Crisis. Driven by the decline in mortgage debt, total consumer debt levels relative to the size of the economy have fallen since 2007. However, credit card debt, auto loans and student loans increased by 13%, masked by the much larger size of the mortgage market. Increased debt levels are also apparent within the S&P 500 where median Debt / EBITDA and Debt / Capital ratios have increased well above 2007 levels for companies outside of the Financials sector.

Valuations of US stocks offer little room for disappointment. The median P/E ratio of an S&P 500 company currently stands at around 23 times, a higher level than any year in recent history except for the bull market of the late 1990s. More illustrative of the dearth of cheap stocks, the bottom quartile P/E is more expensive than at any point in recent history. Despite its excesses, the 90s technology bubble offered many overlooked and inexpensive stocks in the 'old economy'. Valuations today are much more uniformly elevated. The favorite growth stocks during the late 90s tech boom traded at over 100 times forward earnings, whereas today Facebook trades at a more modest 22 times expected 2018 earnings. Apple trades at 13.5 expected 2018 earnings and Google at 19.2. While these valuations still require strong continued earnings growth, they are not irrational.

What may be irrational is the 30% increase in S&P 500 earnings per share Wall Street expects for the entire S&P 500 by the end of 2018. With profit margins already at record levels, a tightening labor market and a lack of promised tax and regulatory reform from Washington, delivering sustained earnings growth will pose a challenge. The initial 'Trump Rally' focused on banks and industrial stocks that would benefit from reduced taxation and regulation. Not surprisingly, these sectors have withered since the prospects for reform appear increasingly unlikely to emerge from the chaotic environment in Washington. Investing in disruptive technology companies makes sense late in an economic cycle when the economic tide has lifted most of the boats. While the share prices of the disruptors will likely decline during the next recession, they can at least be expected to survive, unlike the disruptees.

While this benign market environment can easily continue for several more years, current valuations and the inevitability of a future recession make for a difficult return environment over the next seven to ten years. With very few options, investors must focus equally on quality, growth and valuation. MLPs and emerging market stocks, having not participated in most of the recent market gains, offer the best risk /reward prospects but remain satellite investment holdings that should not represent the majority of a portfolio. Fixed income, while necessary for near-term liquidity needs, offers a return about equal to the 2% inflation rate targeted by the Fed. Given this, it makes sense to maximize diversification and have some 'dry powder' available in cash or non-correlated alternative strategies such as managed futures. Finally, maintaining near-term liquidity needs in high quality fixed income of appropriate duration remains paramount to preserving capital should volatility return to the financial markets.

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