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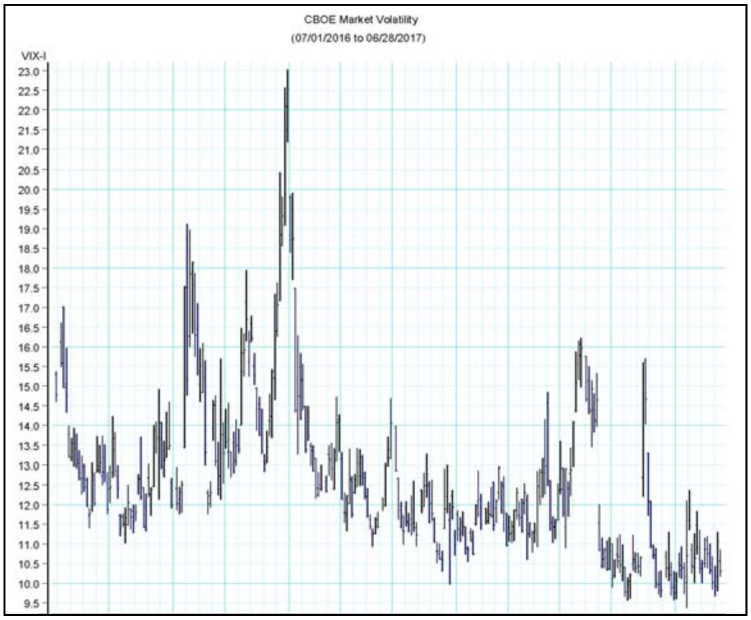
Market Review & Update

SUMMER 2017

Welcome to Summer! Don't let the chilly rain dampen your enthusiasm… We arrive at mid-year 2017 in an almost placid state of market volatility that has lasted over a year.



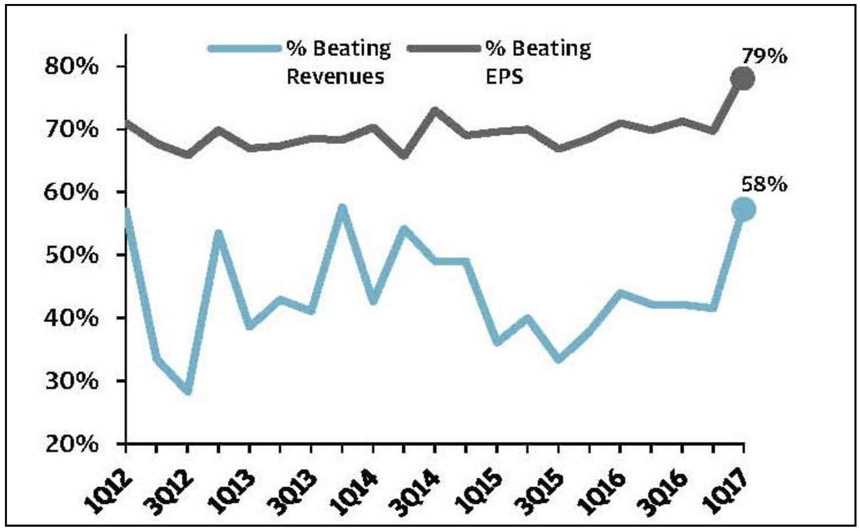
Source: Telemet

Given what we all witnessed in the election cycle, post-election Washington and in the media the very last thing most of us would have anticipated is that the VIX volatility index would have essentially parked in single digits, on a downward trajectory for 18 months. The markets have seemed to develop a media callous. This has been to the benefit of investors both here and abroad. High, or at least decent returns, in a low volatility environment that has even been kind to bonds, supported by rising corporate earnings and a relatively easy, "data dependent" Fed have been primarily responsible for this calm. Historically, years which enjoyed a similarly stable first half saw a continuation till year end.

We have also entered the 8th year of this economic cycle. It is now one of the longest in history. We have previously noted that it is also the weakest recovery in history. For that reason there has been an understandable focus on the promise of corporate tax cuts, foreign earnings repatriation and a decrease in onerous regulation. Those changes would manifest in an increased level of aggregate demand, a constructive version of stimulus. We have never witnessed fiscal stimulus arriving this late in an economic cycle, so there is no wealth of experience that can divine the exact nature of its impact. We'll go with good for now. We'll also recognize that these changes would come from Washington, so we will try to keep expectations in perspective, as this is the same town that vested us with a downgrade of credit for the US Treasury. So, let's forget about Washington for the moment and instead focus on the real underlying factors that have been pushing markets to new highs, and perhaps volatility to new lows.

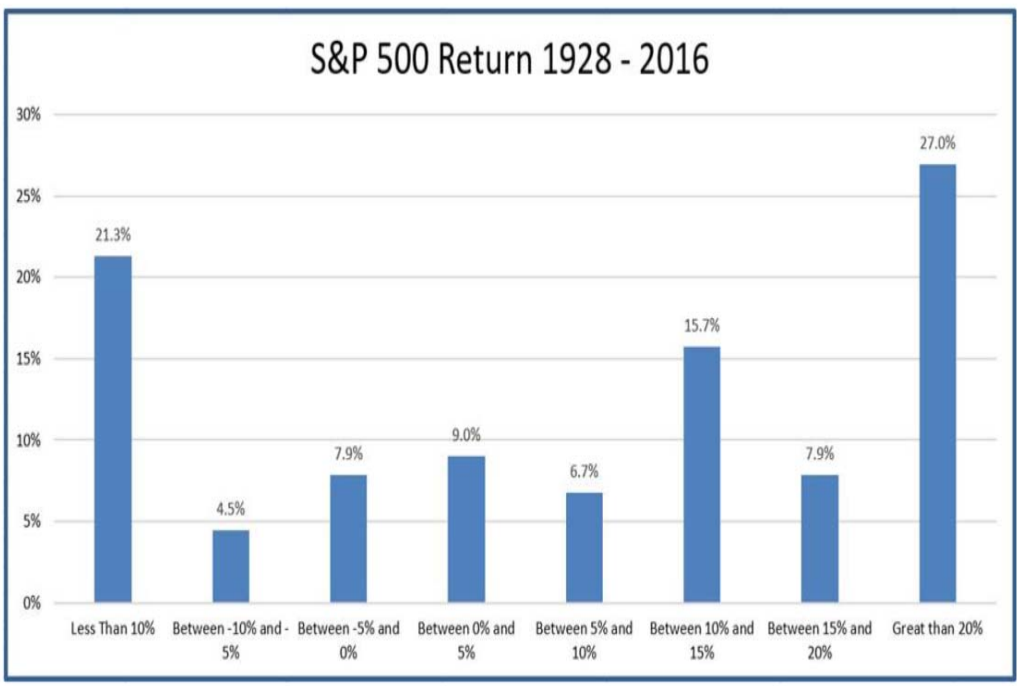
At the risk of saying this too often, let's restate that, ultimately, the markets are guided by fundamentals. And the fundamentals have been pretty good, to say the least. Let's review. We have had a recent announcement out of China that they would revive some significant investment in infrastructure. When that occurred a few years back we saw robust global demand for construction commodities which benefitted many important economies around the world. That will impact forward earnings. We have just completed an earnings season in the US. To say that it was good would be an understatement. Analysts had predicted a rise of more than 9%, and actual earnings came in up more than 15%. Additionally, earnings in the Euro zone also moved higher at a rate exceeding 20%. This gives us an opportunity to talk about analysts, the predictability of metrics and how to use their data. Analysts represent a discreet group of experts tasked with focusing on a handful of companies within their assigned industry. They focus like lasers on every small action of each company, visiting their sites, interviewing their supply chains and running sophisticated mathematical algorithms. And yet, their detailed predictions came in with a 40% error factor. A typical analyst report contains a story about the company, an exhaustive slew of metrics and a conclusion based thereupon. The history of accuracy guides us toward paying close attention to the story, slightly less attention to the metrics and ignoring the conclusion completely. If it was a science, the algorithms could result in optimal performance. This earnings quarter gave requisite credence to the fact that it's going to be some time until a program will be capable of accurately scoring market victories.

% of Companies Beating Revenue and EPS Estimates



Source: Standard and Poor's, Factset, JP Morgan Asset Management

We entered this earnings period with a quite high level of consumer confidence, albeit a level that has yet to manifest in an equally robust increase in consumer spending. Labor markets have likewise improved a bit. And, perhaps most notably, we have completed the 8th year of growth in capital spending. While the level of growth may not be astounding, it is growth nevertheless. So a good earnings period should have been no surprise. Following fundamentals, strong earnings delivered new highs for the indices. The S&P 500 returned a bit over 9% by mid-year. If we take a look at historical market returns, full year returns most rarely stay in this "average" zone. Full year returns between 5 and 10% occur less than 7% of the time, so it would be entirely consistent with history to expect more, or less, to occur by the new year. The next quarter of earnings reports, due to begin in a few weeks, will give us a fairly strong clue as to the direction this will take. As we have mentioned recently, action or inaction from Washington on the various tax and regulatory items that could provide interim stimulus could provide sources of volatility beyond fundamentals, but the earnings period will tell us where the tide will ultimately take us.



Source: CNBC

Enjoy the Summer, we'll talk to you soon…