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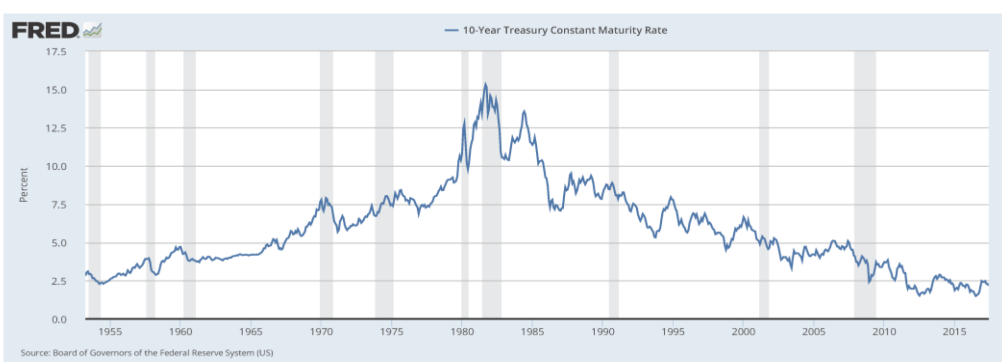
Insight

A Midsummer Night's View of The Markets

-Manchester Capital Management Strategy Group

As we adjust our pace to deal with some sultry, summer weather it seems appropriate to slow down and reflect on what the second half of the year may bring. We entered 2017 expecting that stocks could have a decent year, due in part to President Trump's "Big Three" agenda of deregulation, tax reform and infrastructure spending. Progress on his agenda has been lacking, though stocks continue to march higher thanks to better than expected earnings. We expected bonds to have a more challenging year, in anticipation of global interest rates moving higher. As we will discuss, the jury is still out on just how rapidly rates will rise as inflation expectations are more benign than they were in January.

All asset classes respond to changes in interest rates in some way, shape, or form. This is particularly accurate when rates are increasing from low levels. Simplistically, the percentage move in going from 2% to 3% rates is greater than moving from 5% to 6%. We are, therefore, more attuned to the actions of the Federal Reserve and other central banks. The Fed has signaled its intention to shrink the size of its balance sheet from $4.5 trillion (up from $900 million pre-financial crisis) by roughly 25% over the next 3 years. As bonds mature, they will not "roll over" the proceeds by buying more bonds. We may see rates rise as they step out of the market, though they are likely to pace their exit so that rates do not rise too rapidly. That said, we cannot look at the world in a vacuum. If the spread between U.S. Treasury bonds and other sovereign bonds widens then foreign buyers may be enticed to purchase Treasuries, thereby slowing the rate at which domestic yields rise. For instance, the spread between U.S. and German 10-year bonds was about 2.25% at year-end and stands at around 1.75% today. Should that spread widen again, we would expect to see more buying of Treasuries, thereby keeping yields down.



Before the era of financial repression by central banks, an old rule of thumb was the yield on a 10-year Treasury bond would approximate real GDP growth plus inflation. Today, application of that rule would suggest the 10-year should have a yield of about 3.25%, 1 point higher than the actual rate. As the Fed, the European Central Bank, the Bank of England, and the Bank of Japan are all talking about tightening policies, we believe the path of least resistance for rates is higher, depressing the total return potential of most bonds.

We have been pleasantly surprised by the performance of equities, despite the lack of a tailwind from Washington policies. While the S&P 500 returned a very strong 9.3% in the first half of the year, international markets were the true stars. The MSCI EAFE index returned 13.8% while the MSCI Emerging Markets index gained 18.4%. International markets may continue to perform well as economic growth accelerates and valuations remain attractive. Earnings for the European STOXX 600 index are forecast by Thomson Reuters to rise 17.8% in 2017 after falling -5.4% in 2016. A more stable banking environment post-election fears and Brexit vote is contributing to the stronger earnings backdrop. Emerging markets are generally rebounding as many Latin American countries are growing again after suffering recessions. U.S. equities remain fairly valued, with recent appreciation driven by positive earnings growth as opposed to further multiple expansion. Forward earnings estimates are not being revised down as much as in past years, a positive sign for second half growth. Equity market multiples historically have not been impacted by rising rates until 10-year rates reach 4%, suggesting no multiple contraction for the balance of the year.

Inflation expectations remain a wild card. Historically, an unemployment rate of 4.3% and a NFIB "Jobs Hard To Fill" reading of 34% (highest since November 2000) would correlate to wage growth of 4-5% versus 2.5% currently. If rates rise and uncertainty dissipates, we would anticipate companies increasing investments in plant, technology and people to boost productivity and thus accelerate wage growth. As the year unfolds, we will be closely monitoring inflation, believing it is the key variable to watch in gauging the future path of rates and thus the fate of all asset classes.

New to the Firm

Cory Boggs, CFA

Manchester Capital Management is excited to welcome Mr. Cory Boggs. Cory is responsible for conducting investment research and assisting with the management of client investment portfolios.

Prior to joining Manchester Capital in 2017, Cory was an Assistant Vice President at City National Bank in Los Angeles where he worked in the Private Bank as an Investment Analyst. He earned his Chartered Financial Analyst designation in 2016 and is a member of the CFA Society of Los Angeles. Cory holds a B.A. from the University of South Carolina with a concentration in Finance and Marketing.

Cory is a newlywed and enjoys hiking, golf, going to the beach, and spending time with his wife, family, and friends.