SWBC® Investment Services

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Market Commentary

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Friday's domestic equity markets saw both the S&P 500 and NASDAQ 100 indexes mark new all-time highs, although both were slightly off of the intraday peaks recorded during yet another strong session. Thus the strong start to 2018 continues, with the S&P 500 logging its strongest start to a year since 1987, up 5.4% year to date, comfortably ahead of the start to 2017. The same can be said of the NASDAQ, which has gained 6.87%, as tech companies regained their footing after wobbling to the finish in Q4 2017. International equities have also continued to build on a strong 2017, with the MSCI EM index posting gains of 6.4% and MSCI Frontier Markets index up 6.29%. While I would not try to predict the months ahead by extrapolating results from a two week sample, but it is safe to say that investor spirits are alive and well.

Year-end allocations have shown a decisive tilt towards cyclical sectors and away from more defensive, interest rate sensitive sectors. If we look at trailing 1 month performance by the 11 GICS S&P 500 index sectors (which effectively captures the 2017 year end and 2018 start of the year portfolio shifts), we can see that Tech (+6.8%), Energy (+6.4%), Consumer Discretionary (+5.8%), and Industrials (+5.1%) have led the broad market, while the laggards have been Utilities (-3.7%), Real Estate (-3.6%), Telecom (-1.4%), against an index return of 4.3%. If we look back at the same period one year ago (December 19th 2016–January 19th 2017), the S&P 500 generated a 0.05% return, with the leaders being Real Estate +2.72% and Utilities +2.45%.

While different post-election factors were driving allocation decisions a year ago, the change in the direction of allocations between the two periods is noteworthy and reflects a substantial shift in sentiment about the prospects for the global economy. I don't blame investors for this shift in sentiment, since this is arguably the strongest and broadest period of global economic growth since the mid 1990's. The chart below illustrates how global equity markets are being driven by the acceleration in global PMI (see chart below.) In addition, we have the recent passage of US tax reform, which will stimulate after-tax earnings and boost incentives for an increase in capital investment.

It is still too early in the current season to have a view on how things are playing out, but the breadth of strong global data that tend to track corporate performance suggest that activity increased in virtually all geographic locations in recent months. In my view, this justifies taking a pro-cyclical stance that embraces a broad allocation to cyclical equities. While the demand side picks up, one potential risk for the months ahead are shortages of supplies and labor. This seems particularly true for commodities, where the recent bear market from 2011 to 2016 led to a substantial reduction in global production capacity. The fact that China is deliberately shutting down much of its own capacity while the US is looking to turn on the fiscal spigots should support the commodity complex, which bottomed in early 2016 and has been moving steadily higher (see chart below.)

Credit conditions in both investment grade and high yield continue to remain supportive for risk assets. Despite fears of a government shutdown, investor appetite for the riskiest debt has continued unabated, with more than $8B pricing in the last week and $15B year to date (+2% YoY). Credit spreads, which measure the additional compensation that investors demand for credit risk, have continued to compress and are near the lowest levels since the “Great Recession”, with speculative grade earning an additional 319 bps and investment grade commanding a 97 bps risk premium over treasuries. While equity valuations have been discussed ad nauseam, the asymmetric return potential for high yield bonds warrants discussion. According to Bloomberg Intelligence, over $400B of high yield bonds trade at a premium to their next call prices, with nearly $239B of that rated B or lower. This has resulted in record low convexity for high yield bonds, currently -0.3105. Convexity measures the relationship between bond prices and bond yields. When bonds exhibit negative convexity, they become less sensitive to further spread compression and more sensitive to spread widening. Given the current set up in high yield, increases in bond prices will be much harder to come by while the risk of losses is higher if credit conditions deteriorate. While this does not appear to be a risk in the near term, it is important to understand what you own and the risks that go with it.

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