July 31st, 2017

Looking for opportunities…

The price action within U.S. equity markets has been much more unbalanced than the major averages would suggest over the last couple weeks. Take the last six days for example where Boeing, arguably the most successful manufacturing company in the U.S. today, has been up for six straight sessions (appreciating almost +16%) and since it's the largest component in the price weighted Dow Jones Industrial Average, it has been responsible for more than 95% of the rise in the index over this span. This recent advance has sent the Dow to new all-time highs for sure, but the advance is a bit misleading relative to what has transpired in other major indices. For instance, the Small Cap Russell 2000 index (a much broader subset of the overall stock market) has declined for four straight sessions to the tune of -2%, the Dow Jones Transportation Index has dropped more than 500 points (falling more than -5.5%) since mid-July, and the S&P 500 has flat-lined around this 2,470 level since July 19th (closing within an 8-point level of 2,469 – 2,477 on an index that is valued at more than $20 trillion...hmm).

Nevertheless, this has been the modus operandi for the U.S. equity markets all year long – bend but don't break in what has been a consistent evolution of an abundance of capital rotating from sector to sector. If this remains the case then perhaps investors are starting to see the initial stages of a rotation from Growth to Value as the leaders of the Growth stocks (FANG – Facebook, Amazon, Netflix, and Google) have all reported results with most reacting as a "sell the news" event. Not that their results weren't the envy of any management team's ambitions for their shareholders from a growth standpoint, but perhaps investors are starting to flinch at what have become lofty valuation metrics, even in a world of historically high valuations across the entire stock market complex.

If this is truly a change of leadership that ends up having some legs it will surely be a welcomed development for investors that still adhere to fundamental relationships and a value oriented framework. In a U.S. equity market that remains in the upper echelon of historical valuation levels, the sectors that stand to benefit most play into a second half mean reversion and catch up investment theme

(Energy, Materials, Financials, and Healthcare).

Speaking of the oil market, WTI crude is sneaking up on the $50 level (pushing over this level in overnight trading on Sunday) and spiked higher by +9% in what was its best weekly price gain since December. I am by no means under the illusion that all is well in the Energy sector, a sector I still see as one of the poster-children of a misallocation of cheap money that epitomizes this cycle, but perhaps the comments last week from Shell CEO Ben van Beurden that crude will remain "lower forever" most aptly characterizes the worst of this sector's angst is upon us.

What's more is that the supply side of the oil equation is starting to look a bit more constructive for the oil price as the Saudi's reshuffle their strategy to focus on restricting exports and the U.S. inventory data is beginning to recede – last week's U.S. inventory data showed that crude stockpiles fell by a much larger level than was expected (7.2 million barrels) and this marked the fourth consecutive week of declines. Also of note is that while the Baker Hughes rig count numbers continue to show gains, the rate of new rigs being added has substantially leveled off.

It's also interesting to see the rally underway in the metals complex with copper rallying more than 5% over the last two weeks to its highest level in more than two years. Iron ore has also been firm with the latest catalyst perhaps being the solid (while slightly softer than expected) manufacturing PMI data out of China – NBS manufacturing PMI slipped to 51.4 for July (expectations for 51.5) with both the key new orders and production sub-indices retreating. Nevertheless, Chinese data continuing to hold steady is a critical element for investors constructive on emerging markets and the commodity complex.

Another tailwind for the industrial metals complex (and this one comes with a very long runway) is the continued execution on China's "One Belt One Road" project. This will be perhaps the greatest infrastructure project the world has even seen (estimated to cost between $3 - $7 trillion when all is said and done) and while it will take many years before its ultimate completion – it is underway and will put a lot of demand on the world's resource complex before it's completed. Keep in mind that this project will be sure to experience some fits and starts and will likely coincide with the ups and downs of several economic cycles, so investors looking to invest around this theme don't need to do it all at once, as there are sure to be plenty of opportunities in the years to come that may provide better points to add to existing exposures or implement initial positions. Other beneficiaries of this initiative will be the many Frontier Markets that will be connected through OBOR as China attempts to reclaim the economic and financial supremacy it held centuries ago.

While I'm finding myself becoming more intrigued by the possible scenario of reflation or even commodity inflation confronting markets and the economy in the second half of the year, this enthusiasm for a potential investment opportunity is superseded by the cautious outlook I continue to retain on the economy. Additionally, the rally in the broad commodity baskets could very much end up being more about the U.S. dollar declining nearly 10% this year to a 14-month low, years of capacity being shelved from companies during what is now a commodity depression that began back in 2012, and less about any sustained meaningful increase in demand.

However, the two parts of the commodity space I'm finding some interesting opportunities in (outside of the contrarian view I have on energy) is the agricultural space and precious metals. In the agricultural space, I think some select fertilizer companies look interesting and in precious metals I continue to think there are a growing list of reasons why investors should hold an allocation to gold.

Gold very well may be a 'pet rock' or a metal that is impossible to quantitatively value, but whether it is deemed as an alternative currency, a hedge, a store of value, or a means of commerce, it has proven itself over the years as providing diversification and a positive performance attribute to an investment portfolio.

GOLD % ANNUAL CHANGE

	USD	AUD	CAD	CNY	EUR	INR	JPY	CHF	GBP
2001	2.5%	12.4%	8.9%	2.5%	8.6%	5.9%	17.9%	5.6%	5.2%
2002	24.8%	13.2%	23.1%	24.8%	5.8%	23.7%	12.6%	3.9%	12.7%
2003	19.4%	-10.9%	-1.5%	19.4%	-0.6%	13.9%	7.7%	7.0%	7.6%
2004	5.5%	1.7%	-2.3%	5.5%	-1.9%	0.5%	1.0%	-3.0%	-1.7%
2005	17.9%	25.6%	14.0%	15.0%	34.9%	22.1%	35.3%	35.9%	31.3%
2006	23.2%	14.5%	23.5%	19.2%	10.6%	21.0%	24.5%	14.4%	8.3%
2007	30.9%	18.0%	12.1%	22.4%	18.4%	16.6%	22.9%	21.7%	29.2%
2008	5.8%	31.8%	29.2%	-1.2%	10.5%	30.7%	-14.1%	0.1%	43.9%
2009	24.4%	-2.6%	7.3%	24.4%	21.3%	18.9%	27.5%	19.9%	12.2%
2010	29.6%	13.7%	22.9%	25.3%	38.6%	24.5%	13.1%	17.2%	34.2%
2011	10.1%	10.4%	12.7%	5.1%	13.7%	30.8%	4.4%	10.6%	10.6%
2012	7.1%	5.2%	4.0%	5.9%	5.2%	10.5%	20.7%	4.3%	2.4%
2013	-28.3%	-16.4%	-23.2%	-30.3%	-31.1%	-19.1%	-12.9%	-30.0%	-29.6%
2014	-1.4%	7.5%	7.8%	1.0%	12.0%	0.8%	12.0%	9.8%	4.8%
2015	-10.4%	0.5%	6.7%	-6.3%	-0.2%	-6.2%	-10.0%	-9.7%	-5.3%
2016	8.1%	9.3%	5.0%	15.7%	11.7%	11.0%	5.2%	9.9%	29.1%
2017	11.9%	7.0%	12.4%	11.0%	9.7%	6.4%	4.4%	9.4%	7.8%
AVG	11.3%	9.9%	9.8%	8.4%	12.0%	14.3%	12.2%	9.2%	13.2%
10 YRS	242.0%	259.2%	278.6%	189.9%	302.0%	368.6%	283.6%	212.9%	315.0%

Furthermore, the technical setup continues to improve with the charts suggesting the yellow metal is set to take another shot at eclipsing the $1,300 level that has been key resistance for some time now. Should it break above this level and hold then it’s highly probable to think that the $1,050 levels hit in December 2015 will end up being the lows of this cycle.

Not to mention gold potentially being a nice hedge to the increasing level of geopolitical risks around the world: Congress just passed a new round of sanctions against Russia (without Europe’s support) to which Russia is already responding by ordering the reduction of U.S. diplomatic ties, the honeymoon period ending between U.S. / China relations following Trump’s visit with President Xi Jinping at Mar a Lago earlier this year and the growing frustration from U.S. leaders on China’s lack of cooperation with North Korea. As for North Korea, their latest missile launch has raised the specter that they may actually be capable of reaching the west coast of the U.S.

Not to pile on, and not all of these should be considered as negatives for the U.S. as they are part and parcel of the responsibility that comes with being the world's sole super-power, being the world's reserve currency, and a nation that now is confronting structural economic and social challenges of our own – but having to impose sanctions on Venezuela, while very well the appropriate action, comes at an inopportune time when coupled with the growing threat of protectionist policies this administration has espoused since the election. This heightens how one should view the recent action by Japan (a large U.S. ally) to boost beef tariffs – is this nothing more than a one-off issue, a tit-for-tat, or the gradual proliferation of nationalism around the globe?

Not to mention the tension being created in the EU as issues in Poland and Turkey threaten the modest healing underway in the region. Add to this the unknown of the U.K. and are they going to exit the EU or not? France and Emmanuel Macron appeared to be flying high following his victory a short few months ago, but it now looks as though his agenda is being side tracked as his poll numbers hit post-election lows.

The bottom line is that it's hard to look around the world today and not see heightened uncertainty everywhere.

Add to this, and let's call it what it is, the agenda of the Trump administration is in total disarray: repeal and replace is dead, tax reform is up next, but with the recent news that the Border Adjustment Tax (BAT) is off the table and with no revenue from the failure to repeal and replace the ACA then the highly touted "Yuuge" tax cuts are impossible without blowing a huge hole in the deficit.

Perhaps that is what the currency markets have been sniffing out all along and why the dollar has gone straight down since the House fumbled with passing healthcare reform. Now Trump seems to be redirecting blame at Congress and creating friction with his finger pointing over the weekend with a legislating body that will dictate his fate far more than he perhaps is aware. It looks as though the GOP ranks are digging in their heels and readying themselves as a body to start pushing back at the White House.

Who knows where we go from here, as with each passing day I tire of the reality show playing out on a global stage in this administration, but my hope remains for the good of the country that perhaps we are hitting rock-bottom and there is nowhere to go but up from here. Peggy Noonan from the Wall St. Journal (not 'fake news' and not a liberal periodical by any means) had this to say last week:

> *"Meanwhile, the whole world is watching, a world that contains predators. How could they not be seeing this weakness, confusion and chaos and thinking it's a good time to cause some trouble?"*

Let's turn the page back to where we started this commentary and that was with trying to identify opportunities in an investment universe that is perhaps the richest valuation-wise across the broadest array of asset classes in history. And while there are investment themes and opportunities that can be taken advantage of in this environment, investors should remind themselves every day that no one has ever seen an investment landscape like we are in today.

What I'm getting at is that the entire construct of global capital markets in the post-Global Financial Crisis era has come on the back of the most unprecedented and experimental monetary policy in history, full stop. While asset prices across the board continue to hover near all-time highs, no one has any idea if they can remain at these levels without the continued support of excessive monetary policy. In addition to all-time high asset prices we have record low interest rates, record high levels of debt (government, corporate, and household), and the weakest economic expansion in history.

To put it another way, and this is something for all investors to consider – low interest rates have had the effect of increasing debt, which is a swap of current consumption for future payment. So, current monetary policy has borrowed more from future demand than at any time in history, and if capital markets discount the future then stock valuations should theoretically be selling at a discount to historical valuation levels – not near the highest levels in history.

Let me reiterate the caution I've had about asset prices for more than a year now: knowing these imbalances exist does very little in telling an investor when a bad outcome could occur, but they tell a prudent / disciplined investor all they need to know about the vulnerability that is present. So, while all investors should continue to seek out investment opportunities that they deem offer a favorable risk / reward tradeoff, no investor should be under the illusion that current price and valuation levels are definite. They've never been sustained in the history of capital markets, and that isn't to say that they can't be this time, but the probabilities are not in an investor’s favor.

So investors should continue to move forward, but with caution. While not an absolute, but investors should just consider that central banks are more openly discussing (understandably, discussing is not acting upon…) starting the unwind of eight years of monetary policy that targeted raising asset prices to the levels they are today. Is it naïve to think that this will not have an impact in the opposite direction? Me thinks so, but we’ll never know until they start to remove the punch bowl, and we’re not there yet.

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