July 2017

On Thursday stocks suffered another Z-score "shock day", the most recent, which we covered in our May 2017 letter, occurring on May 17th. The 1-Day Z-score compares the day's change in the S&P 500 to the average daily change over the past year, in this case. Thursday's decline was -3 standard deviations from normal. As previously shared and contrary to popular belief, "shock days" tend to be short- term buying opportunities. From Friday's The Finance 202:

Without anything in the way of legislative wins to tout, President Trump has demanded credit instead for a surging stock market. How much he deserves remains a point of debate.

But credit cuts both ways. **And after markets swooned yesterday over intensifying concern with the North Korea crisis, this much is also clear: The president has been at least partially responsible for the two biggest stock sell-offs of the summer**. The Dow lost 204.69 points, or .9 percent, on Thursday, after Trump doubled-down on inflammatory rhetoric aimed at North Korean dictator Kim Jong Un. (Responding to criticism of his pledge to bring "fire and fury" on North Korea if its regime continues leveling threats, Trump issued a new one: “Frankly, the people who were questioning that statement — was it too tough? Maybe it wasn’t tough enough,” Trump said, adding “things will happen to them like they never thought possible" if the country attacks the U.S. or its allies.)

The New York Times’s Landon Thomas Jr. reports on the market response:

After a record-breaking run of buoyant market behavior, investors appeared unnerved on Thursday by a series of provocative remarks by President Trump and increasing tensions with North Korea.

The tech-heavy Nasdaq 100 index closed the day down 2.13 percent, and the broader Standard & Poor’s 500-stock index fell by 1.45 percent as investors sold out of such high-flying stocks as Amazon, Facebook and Netflix. It was the sharpest daily decline in the benchmark S&P 500 since May 17.

On May 17, the market had its worst day in eight months — with the Dow shedding 373 points for a 1.8 percent decline — on the shock of Trump firing then-FBI director James B. Comey. Investors dumped stocks as they whispered about a destabilizing chain reaction in Washington that could lead to impeachment. ...

Notably, the CBOE Volatility Index, Wall Street’s so-called fear gauge, spiked roughly 44 percent to 16.12, its highest level since Trump’s election. (We added the VIX chart. In a CNBC interview on Tuesday, DoubleLine's Jeffrey Gundlach, who manages TOTL, our preferred ETF for parking excess funds, made another prescient call: "I think going long the VIX is really sort of free money at a 9.80 VIX level today. I believe the market will drop 3 percent at a minimum sometime between now and December. And when it does I don't think the VIX will be at 10." The interview is worth watching: https://www.cnbc.com/2017/08/08/billionaire-bond-guru-gundlach-predicts-he-will-make-400-percent-on-his-bet-against-the-stock-market.html) **And gold, a safe haven, closed at its highest price in two months**. ...

Whatever measure Trump is owed for unleashing the rally that followed his November victory, his agency in shaping the market’s performance has shifted unmistakably since. Back on Feb. 9, for example, Trump announced he’d be revealing "something phenomenal in terms of tax" within three weeks. Investors believed him, and stocks rallied to new highs. ...

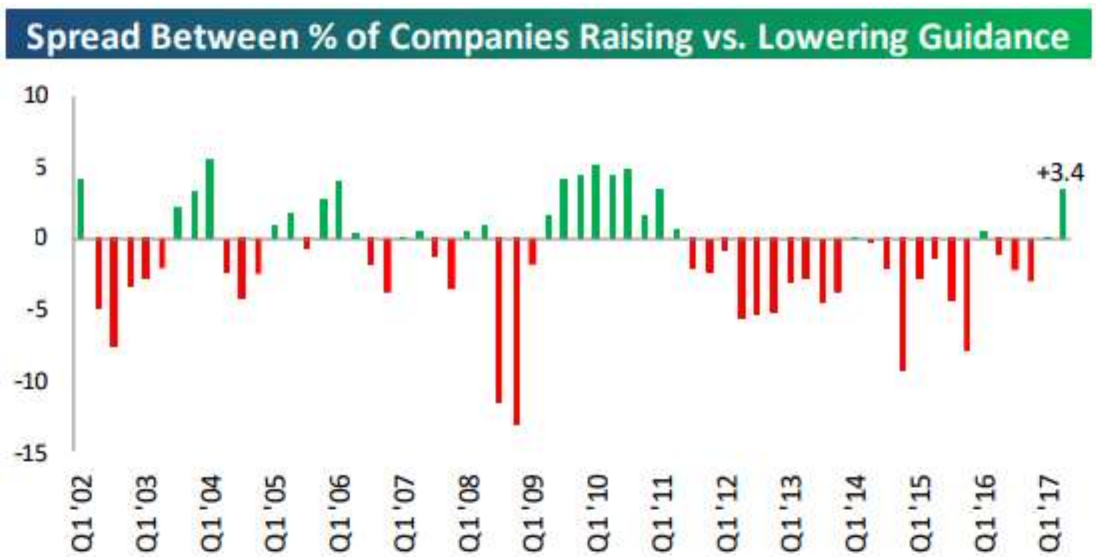
We now know nothing — phenomenal or otherwise — was forthcoming then. Six months later, the promised tax code overhaul has barely budged. **So investors have learned to stop making decisions on the assumption Trump's pronouncements correlate to policy outcomes. The president only commands the market's attention now when he's threatening destruction.**

From Friday's Global Investment Strategy:

"Global equities dropped over the past few days on the back of rising risks of conflict in the Korean peninsula. Our geopolitical strategists believe that neither the U.S. nor North Korea will launch a preemptive strike. Despite its bluster, North Korea has a history of rational action. It wants a nuclear deterrent and a peace treaty. The U.S. has forsworn regime change as a policy goal. China has recommitted to new sanctions and the South is pro-engagement. This raises the likelihood that a diplomatic solution will be found.

Unfortunately, getting from here (open hostilities) to there (negotiated solution) will take time, which leaves the door open to increased market volatility. Nevertheless, we expect any selloff to be short-lived, owing to the positive earnings picture. More than anything else, strong profit growth has underpinned the cyclical bull market in stocks, and we expect this to remain the case over the coming months.

More than 80% of S&P 500 companies have reported Q2 results. Based on these preliminary numbers, EPS appears to have increased by 11% over the previous year, marking the fourth consecutive quarter of margin expansion. The strength has been broad based, with all eleven sectors reporting positive growth. U.S. earnings estimates for both 2017 and 2018 have remained steady since January, bucking the historic pattern of downward revisions throughout the course of the year. (The chart below is from an August 4th Bespoke report. It shows "the spread between the percentage of companies raising guidance minus lowering guidance stands at +3.4 this season, which is now the highest level we've seen since 2010.")



The picture is even more impressive outside the U.S., where earnings estimates continue to move higher. The Euro STOXX 600 is now expected to deliver EPS growth of 12.6% this year. EPS of stocks listed on the Japanese Topix is expected to rise 14.8% this year and 7.3% next year, giving them an attractive 2018E P/E of 13.6. We recommend overweighting euro area and Japanese stocks over their U.S. counterparts in currency-hedged terms. (We have continuously stressed the importance of International diversification.)

EM stocks have seen the strongest positive earnings revisions this year. We continue to worry about some of the structural headwinds facing emerging markets (high debt levels, poor governance, etc.). However, the cyclical picture remains more upbeat. Chinese H-shares remain our favorite EM market, trading at just 7.5 times 2017 earnings estimates."

Mike Nash, as previously shared:**"I'm neither smart enough nor dumb enough to forecast the future."** With that caveat, back to BCA Research:

"The past three U.S. recessions were all caused by the unravelling of financial sector and asset market excesses: The housing bust lay the groundwork for the Great Recession; the collapse of dotcom stocks ushered in the 2001 recession; and the failure of hundreds of banks during the Savings and Loan crisis paved the way for the 1990-91 recession.

Unlike the last few recessions, the next one may end up being more akin to those of 1960s, 70s, and 80s. Those earlier recessions were generally triggered by aggressive Fed rate hikes in the face of an overheated economy and rising inflation.

The good news is that neither wage nor price inflation is likely to soar over the next 12 months. This means that the bull market in global equities can continue for a while longer. The bad news is that complacency about inflation risk is liable to cause central bankers to fall increasingly behind the curve.

Rising inflation will force the Fed to pick up the pace of rate hikes in the second half of 2018. This is likely to lead to a stronger dollar and higher Treasury yields. The resulting tightening in U.S. financial conditions could trigger a recession in 2019 or 2020 ("could" and "2020" were added to their forecast this week). Investors should remain overweight risk assets for now, but prepare to scale back exposure next summer."

From Monday's WSJ:

Hot-Stock Rally Tests the Patience of a Choosy Lot: Value Investors

Value funds around the globe are on track to post their worst performance since before the financial crisis

By Steven Russolillo Aug. 6, 2017

Value investing is mired in one of its worst stretches on record, prompting concerns that the investment style favored by generations of fund managers is losing its effectiveness.

Value stocks, those that are cheaper than many peers relative to earnings or reported net worth and are typically purchased by fund managers anticipating long-term appreciation, have significantly lagged behind their growth stock counterparts this year, compounding a gap that has persisted since the end of the financial crisis.

Instead, investors have gravitated toward companies with fast earnings or price growth, such as Amazon.com Inc., Netflix Inc. and Tesla Inc., and the market's price-earnings ratio has continued to rise ....

Stocks that look cheap relative to traditional fundamental metrics such as profit or cash flow have fallen so far out of favor that Goldman Sachs in June questioned whether the markets are witnessing the death of value investing. With value investments in Europe and Asia also struggling, value funds globally are on track to post their worst performance this year relative to growth funds since before the financial crisis.

The struggle for value stocks over such a prolonged period contradicts the popular investment approach coined by financial analyst Benjamin Graham, known as the father of value investing, and since popularized by Warren Buffett. The billionaire investor and Berkshire Hathaway Inc. chairman has attracted a legion of followers who remain confident that value investing will never go out of style.

From the Great Depression to the U.S. tech bubble to the global financial crisis, the notion that a new paradigm would replace value investing has repeatedly occurred. Those predictions have ~~almost~~ always ended poorly.

While value investing appears to have lost some luster now as the so-called FAANG stocks— Facebook Inc., Amazon, Apple Inc., Netflix and Google parent Alphabet Inc. —have surged in value, the most steadfast devotees to value-style investing are often the ones that benefit most in market downturns.

The market's attraction to highflying stocks punished value investors in a similar fashion in the late 1990s during the dot-com bubble. Growth stocks beat their value peers toward the end of two major bull markets that peaked in 2000 and 2007, before large market selloffs reversed the trend, putting value stocks ahead.

Some investors today worry that the longer growth stocks are viewed as nearly invincible, the worse the likely pullback will ultimately be.

"The super-stocks that lead a bull market inevitably become priced for perfection," said Howard Marks, the co-founder of Oaktree Capital Management who correctly predicted in January 2000 that tech and internet stocks were overheated and about to fall—two months before the dot-com bubble burst. "And in many cases, the companies' perfection turns out eventually to be either illusory or ephemeral."

The attraction to growth stocks, investors and analysts say, stems from the low interest rates, slow economic growth and mild inflation that have gripped the world. Central banks have been accommodative for so long that they have skewed conventional investor wisdom, analysts say, benefiting companies that can generate growth.

In the U.S., the Russell 1000 Growth Index outperformed its value stock counterpart by 10 percentage points in the first half, the widest spread over that period since 2009. Over the past decade, the performance of U.S. growth stocks has been almost three times better than that of value stocks, contributing to what index fund giant State Street Global Advisors calls "the longest period of underperformance for value since the late 1940s."

Investors have pulled $116 billion from U.S. large-cap value funds over the past 10 years, according to Morningstar, with more than one-fourth of that outflow occurring over the past 12 months.

In Europe, the MSCI Europe Value index, which includes stocks with low valuations on metrics such as price-to-earnings and price-to-book ratios, gained 3% in the first six months of the year. The MSCI Europe Growth index gained 9% over the same period.

The trend also holds true in Asia, where an MSCI regional value index underperformed its growth counterpart by 10 percentage points in the first half. ...

Value fund managers have felt the pinch. The median value fund around the world lagged behind the median growth fund by 7 percentage points in the first half of the year, on pace for the worst underperformance since 2007, according to eVestment. The data and analytics firm measured actively managed value and growth funds in the U.S., Europe and Asia—which collectively have $8.8 trillion in assets under management—and found that so far this year value funds have lagged behind growth in all three regions for the first time since 2010.

To be sure, much of value's underperformance could still be cyclical. Historically, calling the end of value investing has been a fraught exercise.

"Sometimes value investing strategies will probably cease to work as investors flock to exploit them, yet it certainly does not follow that value investing as a whole will ever be out for good," Nobel Prize-winning economist Robert Shiller wrote in his book "Irrational Exuberance."

But for some who have practiced value investing throughout their careers, value stocks' time in the wilderness is starting to seem awfully long.

"This time seems very, very different," longtime value investor Jeremy Grantham, the co-founder and chief investment strategist at Boston money manager GMO, wrote in a recent quarterly letter. In a follow-up note, he added that valuations have stayed richer for far longer than historical cycles have previously dictated. "As a value manager, I wish it were not so."

Positions

While there were no new positions added, or closed for all clients, in July, we did want to let the DIYers out there know that OBIOX, our favorite OEF for Foreign exposure for clients with an IRA, like GPIIX, is now Hard Closed: