THE NORTH PIERspective

Market & Economic Commentary: Goldilocks and the ZERO bears

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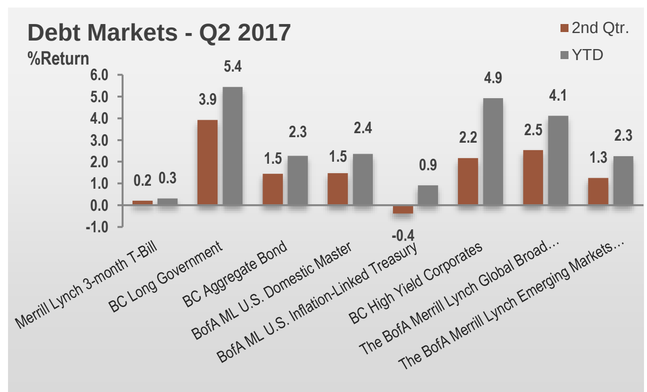
Goldilocks and the ZERO bears

The first half of the year is behind us. Whether it proves to be a fairytale where everyone lives happily ever-after or a fable with a moral at the end, the story of 2017 keeps unfolding. Despite the constant barrage of dramatics from the White House and an ineffectual 115th Congress, the economy, corporate earnings, and stock prices continue to surge. U.S. markets, both stock and bond, were unfazed following three consecutive increases of the discount lending rate from the Fed – an event that even if hinted at prior to a year ago, would have sent markets reeling. Instead, broader U.S. indices saw an unrivaled lack of downside volatility. During Q2 (as well as the first seven months of the year as a whole) the S&P 500 never declined more than about two percent from its continually newly set highs. First, Dow 20,000 fell, then 21,000, and now 22,000. An advance of this nature would be remarkable under normal settings, but set within the Trump-area theater, it is downright amazing.

How the Markets Fared



Domestic debt markets were as quiet as the U.S. stock markets during the quarter. Even with the Fed raising rates a third time, the intermediate and long-end of the yield curve saw little movement. The yield on the 10-Year Treasury fell a paltry eighth of a point during the quarter, trading in a tight range of about 25 basis points. With no real negative news regarding the economy surfacing, credit spreads continued to tighten a tad more, adding to the recent impressive run of gains in the high yield space. The U.S. Dollar Index declined five percent during the quarter which helped lift the prices of most international debt, developed and emerging markets alike.

On the equity front, theses declines in the dollar led to strong appreciation in developed market international securities, better than doubling the returns of U.S. stocks for the quarter. Both here at home and abroad, technology stocks continued to drive performance gains in the growth indexes, which again beat more cyclical value stocks by a few percentage points for the quarter… and by a whopping ten points for the year. This marks a complete reversal of 2016's ten-percentage point outperformance by value stocks in a whipsaw of dramatic portions. For markets that used to be so highly correlated, those of the last few quarters have been anything but. Continued easing of commodity prices once again served as a headwind for nature resource names, especially in the small cap space. Though small cap growth stocks have advanced handsomely, the Russell 2000 Value Index continues to be stalled in neutral. This retreat in commodities spilled over into more resource dependent equity names in the emerging markets, like Latin America, whose markets actually saw modest declines during the quarter, even despite the weak dollar. The same could not be said of Asian EM stocks, which topped the leaderboard in performance for the quarter. With firming global economies, the manufacturing focused economies of developing Asian nations are reaping the benefit of restored global optimism.

PIER*ing* Ahead

Though we may be beginning to sound like a broken record, North Pier's optimistic view of the near-term global economy fortifies our belief that the recent advance of equities is founded on reasonable assumptions… at least in the near-term. Strong labor markets, and increased earnings for workers and corporations alike are likely to sustain for the foreseeable future. Housing prices continue to advance at reasonable levels (~6% year-over-year) with supply and demand still not in equilibrium. Add in a soaring stock market and one has all the ingredients needed to give consumers (who are the foundation of the U.S. economy) all the reasons they need to be as optimistic as the sentiment indexes indicate.

Though many talk about this period of economic recovery as being long in the tooth, we believe that there is compelling reason to believe that the real boom has actually just begun. With their zero interest rate policy (ZIRP) lasting as long as it did, the Fed never projected confidence in the recovery prior to late 2016. Regardless of one's political tilt, it can't be ignored that the current administration and Congress, which are both perceived as pro-business, have given breathing room for corporate America to stretch its legs and run a little. Now the Fed is onboard and the rest of the world is joining the party. The only real question is how long will the party last? Sooner or later, swelling equity valuations will meet resistance from a maturing growth spurt in the economy. When that happens, the bears will join this Goldilocks story. When they do, we are likely to encounter a Papa Bear like correction that is "too hard" instead of a Baby Bear consolidation that is "just right." Either way, this story has lots of chapters left to play out. It's bound to be a real page-turner.

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