Q1 2017
INVESTMENT PERSPECTIVES

DAVE KEEVINS
CHIEF INVESTMENT OFFICER

ANDREW KREI, CFA
HEAD OF INVESTMENT RESEARCH

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- **EQUITIES ADVANCE:** Global equities extended their post-election gains to start 2017 as measures of investor sentiment and consumer confidence reached multi-year highs. Emerging markets and developed international stocks led the move higher, with US large cap equities close behind.
- **BUT, THE "TRUMP TRADE" TAKES A BREATHER:** Equity market leadership shifted from the cyclical sectors that rallied in Q4 2016 (financials, industrials, energy, materials) to growth (technology, consumer discretionary, biotech) and defensive (utilities, consumer staples) sectors during Q1 2017. Small caps lagged large caps after substantially outperforming them in Q4 2016.
- **FED HIKES RATES AGAIN:** At its March meeting, the Fed elected to raise rates by 0.25% on the heels of its 0.25% rate increase in December 2016. The rate increase was widely anticipated by markets. A number of commentators dubbed the Fed's action a "dovish hike" in light of the accommodative language accompanying the announcement. In fact, the Fed's decision actually precipitated a decline in Treasury rates as well as US dollar weakness to end the quarter.

MARKET RECAP

While market performance had a slightly different tenor in Q1 2017 relative to the post-election rally, the results were largely the same for domestic risk assets: positive returns with limited volatility. A marked change from Q4 2016 was the strong performance from non-US stocks and core bonds. With those asset classes actually contributing to returns versus detracting, diversified portfolios that may not have fared as well into year-end likely received a lift.

WHO ARE THE WINNERS AFTER ALL?

In our last newsletter, we highlighted a few of the consensus winners as a result of the Trump presidency—namely, US small cap stocks ("America first") and companies in the energy, materials and financial sectors. After the election, this group shot higher under the belief that an agenda that included substantial tax and regulatory reform would be a boon for corporate profits. However, since the beginning of the year, these sectors have generally lagged,

FIXED INCOME

	USD Total Return (%)	
INDEX	Q1	2016
Barclays 1-10 Yr Muni	1.6%	-0.1%
Barclays US Agg. Bond	0.8%	2.7%
BofA/ML HY Master II	2.7%	17.5%

EQUITIES

	USD Total Return (%)	
INDEX	Q1	2016
Russell 3000	5.7%	12.7%
S&P 500	6.1%	12.0%
Russell 2000	2.5%	21.3%
MSCI All Country World	6.9%	7.9%
MSCI EAFE	7.3%	1.0%
MSCI Emerging Mkts	11.5%	11.2%

Source: Morningstar (Data as of 3/31/17)

with pockets of the energy sector hit especially hard by slumping natural gas and crude oil prices. Whether this represents a consolidation phase or a true change of expectations remains to be seen, but on the heels of the Obamacare "repeal and replace" failure, expectations about the scope and magnitude of legislative initiatives may be tempered going forward.

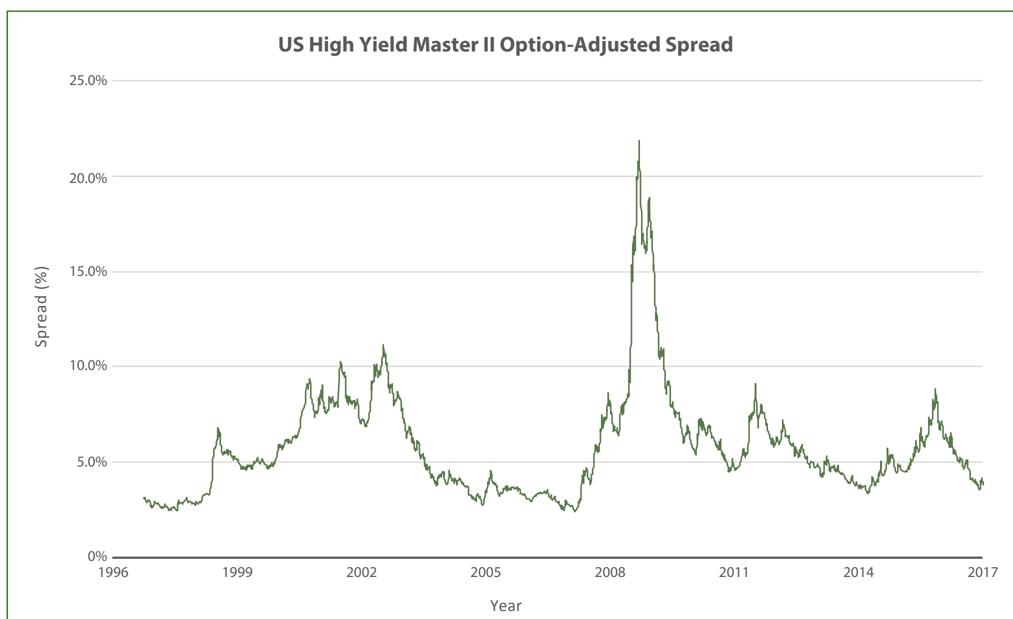
On the other hand, some of the perceived losers from a Trump presidency—the tech sector, emerging markets, and interest rate sensitive securities such as core bonds or utility stocks—have served as market leaders to begin 2017. This may simply be a function of investor rebalancing resulting from the large relative performance divergence in Q4 2016. Alternatively, the strong performance may signal skepticism among investors about the severity of the Trump administration's trade renegotiations as well as doubts about economic growth and inflation meaningfully accelerating.

INTEREST RATES FIND THEIR FOOTING

After spiking higher in Q4 2016, the benchmark 10-year Treasury rate settled into a narrow trading range during Q1 2017 and ended the quarter little changed. Core taxable bonds—as measured by the Barclays US Aggregate Bond Index—finished Q1 2017 with a 0.82% gain, and intermediate muni bonds—as measured by the Barclays Municipal 1-10 Yr. Index—fared even better, returning 1.55% during the period. Additionally, after the yield curve steepened in Q4, short-term rates pushed higher in Q1, leading to a flatter yield curve. A flatter yield curve generally implies a more tepid outlook for economic growth and inflation.

CREDIT SPREADS – NOW VS. THEN

Where credit spreads are today relative to the depths of the Q1 selloff last year is remarkable from a historical perspective. Spreads on high yield bonds—or the additional yield that investors demand relative to Treasuries—narrowed 530 basis points from their highs on February 11, 2016, to their lows March 1, 2017. The BofA/ML High Yield Master II Index yield declined from 10.1% to 5.6% and generated a total return of 27.8% during that period. Over the last 20 years, when spreads reached the levels seen in Q1 2016, it usually took multiple years for rates to return to their prior levels.



Source: YCharts; Morningstar (Data as of 3/31/17)

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CONSUMERS ARE FEELING GOOD…

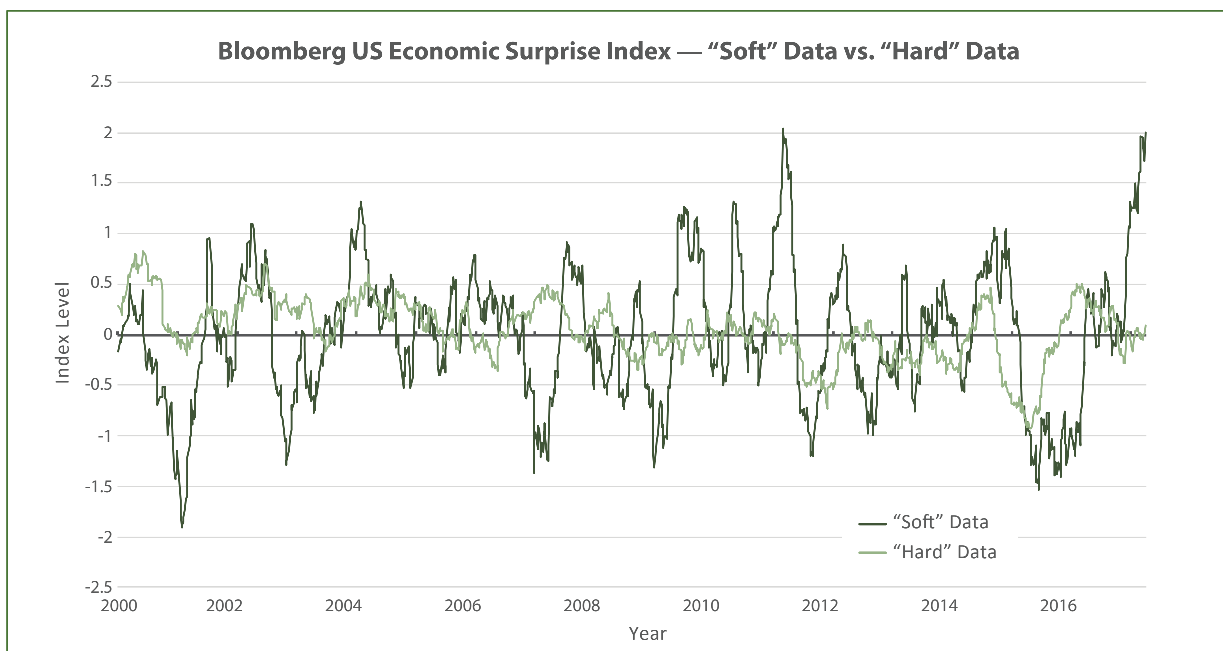
In March 2017, The Conference Board Consumer Confidence Index—an index that tracks consumer attitudes and spending intentions—jumped to its highest level since December 2000. These readings have only been exceeded during two other periods since the 1960s—first, from 1967 to 1969 during the so-called "go-go years" and then most recently, at the end of the technology boom from 1997 to 2000. Optimism abounds as consumers are feeling good about the current economic environment, the economy's future prospects, and the labor market.

…AND SO ARE BUSINESSES

The National Federation of Independent Business (NFIB) Business Optimism Index—a measure of business confidence across a variety of factors (e.g., plans to hire, expected capital spending, economic outlook, etc.)—sustained its lofty post-election readings during Q1 2017 and both the Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing Surveys—measures of economic activity based on surveys of executives—showed business expansion proceeding at a strong pace. Further, The Conference Board Measure of CEO Confidence—an index that reflects CEOs' perceptions of economic conditions—jumped higher as executives became increasingly sanguine about the near-term prospects for the US. Over 70% of CEO respondents said they expected to modestly raise prices during 2017—a sign of a more buoyant economic landscape.

WILL THE "HARD" DATA CATCH UP WITH THE "SOFT" DATA?

Despite elevated measures of consumer confidence and business optimism ("soft" data), "hard" data that measures quantifiable levels of consumer and business spending has lagged significantly in 2017. In fact, a comparison of the "soft" data and "hard" data components of the Bloomberg US Economic Surprise Index—an index that tracks a variety of economic indicators and data relative to consensus expectations compiled by Bloomberg—shows a record divergence between the two measures as of March 26—as illustrated by the chart below.



Source: Bloomberg (Data as of 3/31/17)

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VANISHING "VIX"...

Since spiking in late October 2016, the CBOE S&P 500 Volatility Index (VIX)—a measure of investors' near-term volatility expectations derived from option prices—has tumbled to multi-year lows. Investors have expressed increased confidence in the near-term path of markets, and option prices imply minimal concern about a modest equity market correction. What is notable about this VIX decline is that it has occurred against a backdrop of a rising Global Economic Policy Uncertainty Index—a composite index of various measures of uncertainty. Historically, these indices have been in harmony with one another; as political uncertainty rises, the VIX rises. However, this relationship has recently changed, with the Uncertainty Index going up and the VIX going down, leading some investors to wonder if markets have become too complacent.

...BUT REAPPEARING "SKEW"

Paradoxically, while volatility levels have ebbed post-election, the CBOE SKEW Index—a measure of investor demand for tail risk hedging on the S&P 500—hit its highest levels since Brexit during Q1 2017. A move of this magnitude in the SKEW Index implies that market participants are willing to pay up for insurance against a material market decline.

POPULISM AND NATIONALISM DEALT A BLOW

The results of the Dutch elections in mid-March were a relief to both centrist voters and the pro-European Union (EU) contingent throughout Europe. The anti-immigration and anti-EU Party for Freedom led by Geert Wilders was defeated by the Liberal party—a result that defied most predictions. After the Brexit vote, Donald Trump's victory, and strong early polling results for populist candidate, Marine Le Pen, in France, it appeared that populism and nationalism were going to ride a wave of momentum throughout 2017. The tide has been stemmed for now, but the results of the upcoming French elections in April and May will provide a better indication of the path forward. ●

Is Diversification Dead?

In an investment environment in which US large cap stocks have consistently been amongst the top performers over the past 5 years, it has become easy to dismiss the value of diversification in portfolios. Why not simply put everything in an S&P 500 index fund and walk away?

Perhaps we are undergoing some sort of long-term regime shift in markets with the advent of robo-advisors and the increased popularity of ETFs, but the odds are against it. Rather, we would suggest that this multi-year period of US large cap-led returns will eventually end—just like other investment trends in the past—and performance leadership will rotate to another segment of global markets.

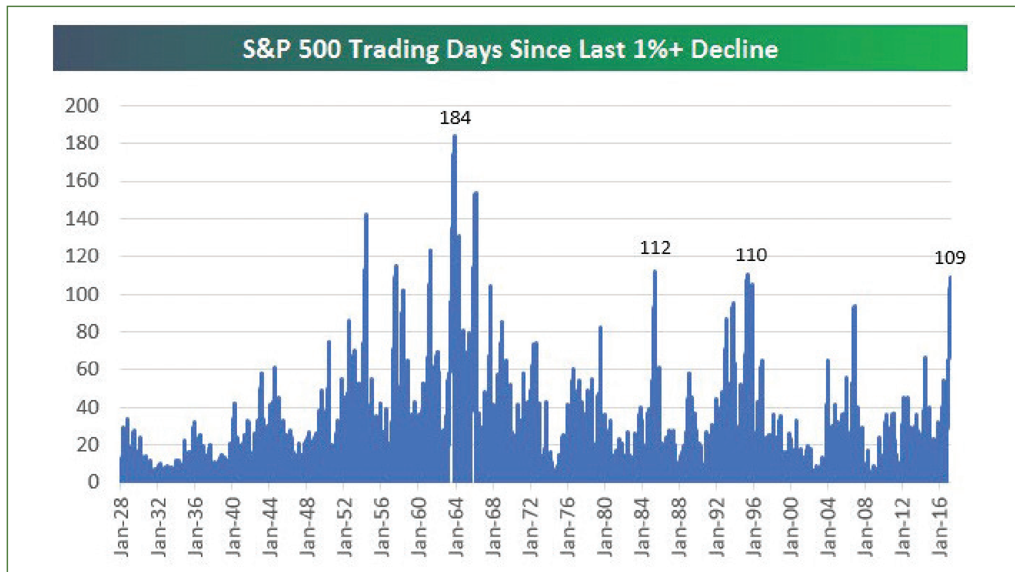
The "returns quilt" below illustrates annual returns by asset class over the past 15 years and helps to demonstrate the ups and downs of various asset classes over time. We only have to look back to the mid-2000s to find a period when emerging markets and developed international stocks had an extended run among the top performers, and when US large caps actually underperformed a broadly diversified portfolio.

Moreover, we have only talked about returns thus far—not volatility. As interest rates normalize and volatility eventually returns to markets, we suspect that investors will once again appreciate the stability that quality bonds (and even cash that had recently been yielding 0%) can provide for portfolios during turbulent times. Core fixed income may not be the most exciting investment in your portfolio, but it serves a purpose.

Keep in mind the famous disclaimer, "Past performance is not indicative of future returns," and don't discount the value that diversification can provide over time.

Source: Morningstar (Data as of 12/31/16)

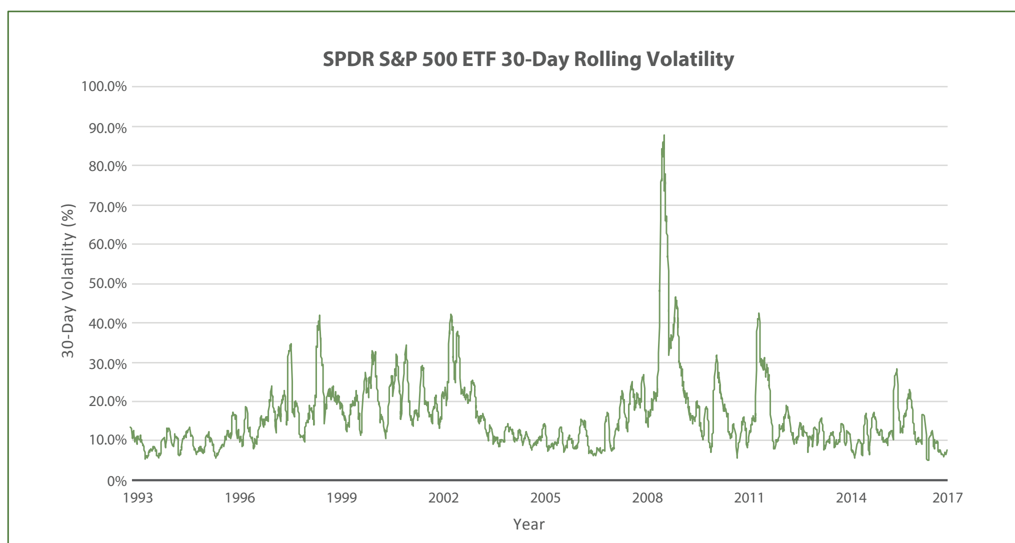
Chart of the Quarter



Source: Bespoke Investment Group (3/20/17);
URL: https://www.bespokepremium.com/think-big-blog/chinas-record-stock-market-streak/

Our Chart of the Quarter is a histogram plotting the number of trading days between 1% or greater declines in the S&P 500 dating back to 1928. Post-election, the US large cap index entered a historically rare stretch that spanned 109 consecutive trading days without such a decline—the ninth longest period ever recorded and the longest uninterrupted period since 1994-1995. It is a remarkable statistic considering it is only the fourth time since 1970 that the S&P 500 managed a streak of over 100 days.

We have included an extra chart this quarter that shows the rolling 30-day volatility level of the S&P 500 (as measured via the "SPY" ETF—see below). During this recent period devoid of pullbacks, volatility has steadily declined, nearly reaching its lowest level since July 2014 in February 2017. Volatility levels at the end of Q1 2017 were roughly 60% below the S&P 500's long-term average.



Source: YCharts; Morningstar (Data as of 3/31/17)

Growth vs. Value – A Crash Course

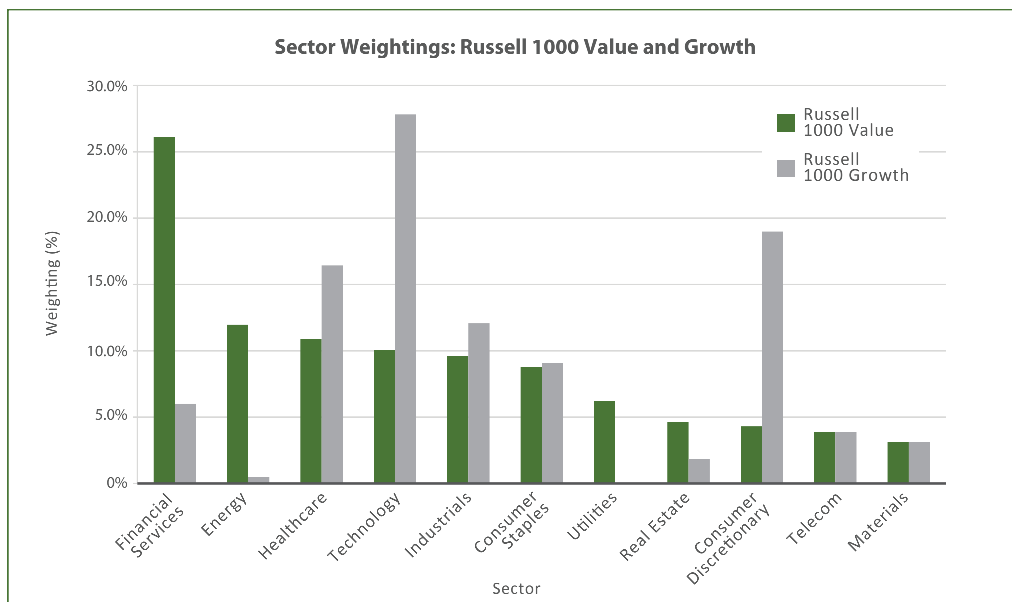
When you look at your Q1 2017 statement and see that growth stocks outperformed value stocks by anywhere from 2% to 6% this quarter, you might wonder why or how this could happen. Growth and value generally trade in a relatively narrow range, but from time to time, there are material deviations between these two investing "styles."

Here are a few things to keep in mind as you evaluate the performance of each style and think about the role each serves in your portfolio.

1. **Philosophy:** The fundamental difference between growth and value is the way that investors who subscribe to each philosophy think about investing. Buying growth stocks is about trying to identify companies that are going to grow revenues and cash flows more rapidly than their peers and/or the broader market. Generally, these companies focus on reinvesting cash flows to sustain or accelerate their growth rates rather than paying out dividends or buying back their own shares (think of companies like Amazon or Facebook).

   Investing in value stocks is an exercise in identifying companies that are underpriced relative to their intrinsic value. A mispricing may occur for a variety of reasons—e.g., a dip in sales due to a poorly executed product launch, a downturn in a cyclical industry, a misguided strategy by a previous management team, or simply an indiscriminate market sell-off—but the key is that the investor believes the mispricing is temporary and will be recognized by the market over time. Value stocks may not be the newest, sexiest companies, but buyers believe they represent bargains.

2. **Sector exposures:** At the core of the performance differences between growth and value lies each style's underlying sector allocations. When looking at the Russell 1000 indices (US large cap stocks), consider that the largest weightings within the value index are financials (26% vs. 6% in growth) and energy (12% vs. 1% in growth), whereas the largest weightings in the growth index are technology (28% vs. 10% in value) and consumer discretionary (19% vs. 4% in value). The relative performance of these four sectors is a significant determinant of which style wins from period to period.



Source: YCharts; Morningstar (Data as of 2/28/17)

3. **Economic sensitivity:** Value indices generally have a greater sensitivity to economic strength than growth indices and perform better during periods of robust expansion. This is largely driven by the more pro-cyclical sector bias referenced above. Further, value indices are more levered to business spending versus consumer spending. When consumption is driving growth—as it has in recent years—expect growth indices to outperform value indices.

4. **Interest rate sensitivity:** Given the financials-heavy weighting of value indices and the inverse relationship that has historically existed between P/E multiples and interest rates (growth stocks typically trade at higher multiples), periods of rising rates generally favor value over growth. Conversely, periods of declining rates and more supportive monetary conditions typically favor growth over value.

Any attempt to forecast each of these factors with a high degree of accuracy highlights the difficulty of simply picking one investment style over the other. That is why we typically suggest having some combination of growth and value investments in a portfolio. Perhaps the allocation tilts one way or the other based on capital market conditions, but incorporating both styles provides diversification and more well-rounded exposure.

Contact us

Dave Keevins
Chief Investment Officer

Andrew Krei, CFA
Head of Investment Research

Crescent Grove Advisors, LLC

100 Field Drive, Suite 120, Lake Forest, IL 60045
847-752-0292

333 N. Plankinton Avenue, Suite 216, Milwaukee, WI 53203
414-386-5340

3284 Northside Parkway NW, Suite 495, Atlanta, GA 30327
678-585-6625

crescentgroveadvisors.com

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