Chartwell Consulting

CHARTWELL REVIEW

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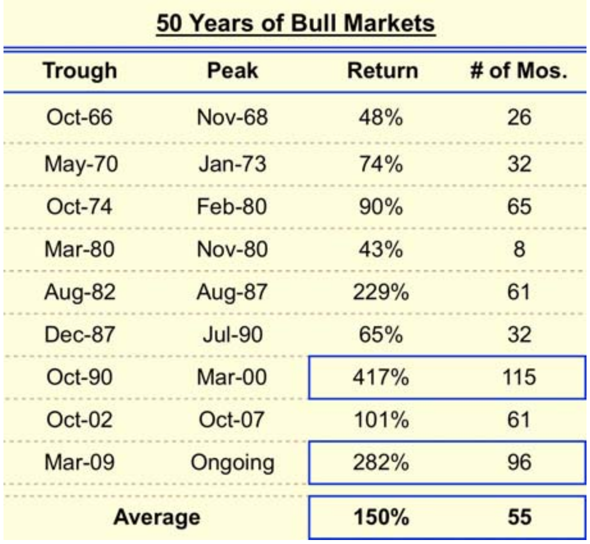
SHOW ME THE MONEY!

Per Figure 1, FOMO* and TINA* are still in the bar. There was evidence in March they might be packing it up, but they've chosen to stay. From the mix of returns, it looks like we might be in the early stages of an international rebound.

The current bull market celebrated its 8th birthday during the quarter. It has returned over 280% to investors. The press has referred to it as one of the least loved and least trusted bull markets ever. Yet, the mother of all bull markets, which ended seventeen years ago in March 2000, was up almost exactly the same amount as this one after its first 96 months.



50 Years of Bull Markets

Trough	Peak	Return	# of Mos.
Oct-66	Nov-68	48%	26
May-70	Jan-73	74%	32
Oct-74	Feb-80	90%	65
Mar-80	Nov-80	43%	8
Aug-82	Aug-87	229%	61
Dec-87	Jul-90	65%	32
Oct-90	Mar-00	417%	115
Oct-02	Oct-07	101%	61
Mar-09	Ongoing	282%	96
Average		150%	55

The animal spirits of the millennium carried that earlier market up for another nineteen months and 134%. But so did earnings – they rose 22%. This time will need to be no different. After declining for over two years through last summer, earnings of most U.S. public companies are finally showing signs of life. It's *Show Me the Money!* time.

** FOMO (**F**ear **of** **M**issing **O**ut) and TINA (**T**here **i**s **N**o **A**lternative)*

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	1Q 17	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	6.1	17.2	10.4	13.3	7.5
U.S. Top-cap Stocks	6.4	17.6	10.6	13.3	7.5
U.S. Mid-cap Stocks	5.2	17.0	8.5	13.1	7.9
U.S. Small-cap Stocks	2.5	26.2	7.2	12.4	7.1
Non-US Stocks (**EAFE**)	7.4	11.7	0.5	5.8	1.1
Non-US Stocks (**Emerg**)	11.5	17.2	1.2	0.8	2.7
3 mo. T-Bills	0.1	0.3	0.1	0.1	0.6
U.S. Aggregate Bonds	0.8	0.4	2.7	2.3	4.3
High Yield Bonds	2.7	16.4	4.6	6.8	7.5
Global Aggregate Bonds	1.8	(1.9)	(0.4)	0.4	3.3
Consumer Prices	*1.0*	*2.4*	*1.1*	*1.2*	*1.7*
Bloomberg Commodity	(2.3)	8.7	(13.9)	(9.5)	(6.2)
MSCI World REIT's	2.8	0.3	7.6	8.0	1.2

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	1Q 17	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	5.6	16.0	8.4	12.0	6.9
U.S. Mid-cap	4.4	18.1	7.1	12.1	7.1
U.S. Small-cap	1.9	22.6	6.6	12.1	7.0
International Lg. Cap	7.8	11.0	0.5	5.5	1.6
International Sm. Cap	9.2	9.9	2.7	9.0	4.0
Emerg. Mkt. Equity	11.5	16.4	1.0	1.7	2.6
Balanced/Hybrid	3.6	9.9	4.4	6.9	5.3
General Bond	1.0	1.7	2.5	2.7	4.6
High Yield Bond	2.3	13.3	3.4	5.7	6.2
Equity Hedge Funds	3.6	11.3	2.9	4.8	3.0

*Annualized trailing returns for periods ending 3/31/17.

Economies, Economics, Prices, and Policy

	3/2017	3/2016
CPI - headline, y-o-y	2.4%	0.9%
CPI - core, y-o-y	2.0%	2.2%
Real GDP Growth, 1-year *	1.6%	2.6%
Employment (000's)	153,000	151,301
Employment / Population %	60.1%	59.9%

** 4Q16 vs. 4Q15, y-o-y*

The American economy continues to expand at a sluggish rate. Real GDP growth was only 1.6% last year, compared to 2.2% in 2015. During the last seven years, real GDP growth has averaged just 2.2% per annum.

Final estimate of the 4th quarter's annualized GDP growth was 2.1%. Personal spending's contribution to growth skyrocketed in Q4. Fixed residential spending shot up 9.6%. Business investment spending remained in "no growth" mode, but inventory accumulation was a large +$50bn.

Offsetting the consumer's charge, our import/export mix was moribund. Exports fell 4.5% as the strong dollar bit. Imports jumped 9.0% due to rising commodity prices.

Figure 3: Breaking Down Real U.S. GDP

	% Change from Preceding Period			
Factor	1Q ‘17*	4Q '16	3Q '16	2Q '16
Real GDP Growth	0.7	2.1	3.5	1.4
Nominal GDP Growth	3.0	4.2	5.0	3.7
Real Final Sales	1.6	1.1	3.0	2.6
Personal Spending	0.3	3.5	3.0	4.3
Private Investment	4.3	9.4	3.0	(7.9)
- Fixed, Businesses	9.4	0.9	1.4	1.0
- Fixed, Residential	*13.7*	*9.6*	*(4.1)*	*(7.7)*
*- Chg. In Inventories **($bn)***	*$10*	*$50*	*$7*	*($10)*
Export growth	5.8	(4.5)	10.0	1.8
Import growth	4.1	9.0	2.2	0.2
Government Spending	(1.7)	0.2	0.8	(1.7)

** BEA advance estimate on 4.28.17*

Most economists expect GDP growth declined in the 1st quarter compared to the 4th. The Blue Chip consensus forecast is for a 1.4% annualized growth rate, down from a 2.3% forecast as the quarter began. The Atlanta Fed dropped its forecast sharply as the quarter passed, from 2.5% in late February to only 0.5% in early April. The U.S. Bureau of Economic Analysis' advance estimate (just released) is just 0.7%. Figure 3 has the details.

The pace of payroll jobs growth weakened as we moved through the quarter, but ultimately 533k jobs were created. This compared favorably to 443k jobs in Q4. The household survey indicated a strong quarterly gain of 889k jobs, and the unemployment rate fell to 4.5%.

The strong jobs market has inevitably led to rising wages, but increases to date remain very modest. Average hourly earnings of all private nonfarm employees increased just 2.4% during the past year, and 0.0% in real terms, despite payroll jobs growth of 2.2 million. This has economists somewhat perplexed, since the employment-population ratio (see left) is at its highest since early 2009, and would normally be expected to pressure real wages upward.

Before seasonal adjustments, **"headline" CPI** rose 1.0% during the first quarter, but only +0.4% after seasonal adjustment. The index increased 2.4% during the past year, up from only 0.9% the prior year.

- **Core CPI** (*ex-food & energy*) rose 0.9% during the first quarter, and +2.0% during the past year.
- The **Producer Price Index** for goods and services rose a robust 1.2% during the latest quarter, and 2.3% the past year, after falling -0.1% the prior year. The PPI *ex-food & energy* was up 1.6% the past year.
- **Import** prices rose 4.2% during the twelve months due to rebounding commodity prices. **Export** prices have risen 3.6% during the past year, after falling over 6% in each of the prior two years.

On the monetary policy front, the disconnect between the actions of the European, Japanese and English central banks, and the US Fed is increasing. The former three remain firmly fixed on flat base interest rates (0.25% at BoE, 0.0% at the ECB, and -0.1% at the BoJ), and all continue net market purchases of bonds (quantitative easing). The Fed raised its Funds target for the third time during the quarter, to 0.75-1.00% (the actual rate is averaging 0.9%). Instead of quantitative easing, the Fed is publicly floating the idea of beginning to shrink is balance sheet later this year. And 2-3 additional Fed Fund increases are planned for 2017.

Discussion of future fiscal policy continued along the same lines as the 4th quarter, with the markets focused on the execution of a highly business friendly agenda in 2017. As a result, "risk on" asset prices were again bid up aggressively through February. However, the absence of any specific policy initiatives or announcements of consequence during the quarter cooled expectations in March. With no details forthcoming in regard to future tax rate decreases or infrastructure spending increases, growth forecasts for 2017-8 have been reduced. In offset, dramatic changes in trade agreements no longer appear front and center, which is good news for investors.

On another a positive note, consensus expectations for synchronized global economic growth are solidifying. According to the IMF, global economic activity is picking up with a long-awaited cyclical recovery in investment, manufacturing, and trade. World growth is expected to rise from 3.1% in 2016, to 3.5% in 2017, and 3.6% in 2018. Emerging market countries are forecast to be at the forefront of that growth.

Bond Investors Take a Break

After the prior quarter's significant trend reversal for bonds, the 1st quarter was a relatively benign one for fixed income investors. Per Figure 4, every primary bond sector posted positive total returns, although some did not return their coupon (i.e., prices fell as yields rose).

Sovereign bond yields were a mixed bag for the quarter, with 10-year yields in most developed market countries (except the US) rising moderately, and yields in emerging market countries falling. Per Figure 6, the US stands at the crossroads of the sovereign bond market; its 10-year yield is higher than all other major developed countries except Australia, and lower than that of all major emerging market countries.

In simple "yield-to-maturity per unit of credit risk" terms, US Treasuries look like a global bargain. Many say that's a sucker's bet, as US interest rates are rising, aka *normalizing*, much faster than those of other major economies. At current global bond yield levels, rising term rates push total return to the negative – as they did during the 4th quarter.

During the past twelve months the developed country anomaly is Britain. Term UK rates have fallen 37bps, even as they've risen in every other developed market. At the other end of the risk spectrum, term yields of Brazilian, Greek, Russian and Indian bonds all dropped rather sharply during the past twelve months, as investors increasingly sought out high coupon securities.

The Global Aggregate ex-US index currently reflects a yield-to-maturity of only 0.8%, versus the 2.6% y-t-m of the U.S. Aggregate index. With short term rates also much higher in the US than other developed markets, and rising, the dollar's strength looked set to continue as investors took advantage of the global carry trade. But that was not the case in Q1, as the Dollar fell 2.5% during the quarter versus other developed countries, and 3.5% versus emerging market countries.

Domestically, the 3-month US T-bill was most influenced by the Fed Fund's rate hike, and rose 26bps. Two-year yields increased a modest 6bps for the same reason. Term rates fell 3bps, and the Treasury-Long index returned 1.4%. Credit bonds outperformed all other US sectors, as spreads fell. The High Yield index returned 2.7%.

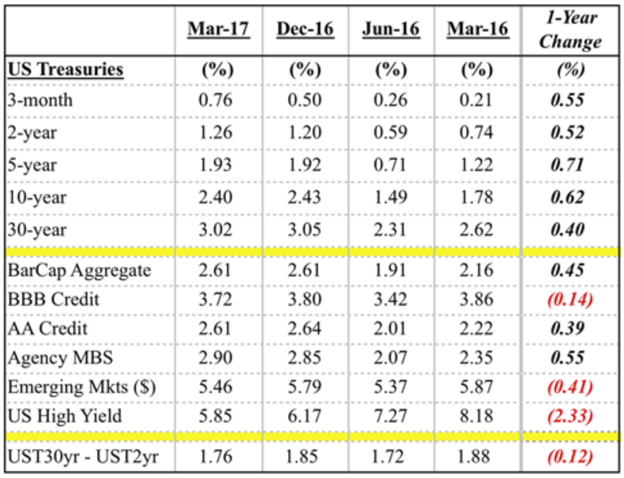
Only Emerging market bonds outperformed US high yield. EM($) bonds advanced 3.9%, and EM (local currency bonds) returned a very nifty 6.50%.

Throughout the first quarter, one near constant was a deluge of new bonds for investors to purchase. Overall, investment-grade and junk-rated companies sold more than $490 billion of bonds in the quarter, the most of any quarter on record, according to Dealogic. Even so, we saw domestic credit spreads continue to fall, especially at the low end (i.e., non-investment grade). Investors still have strong appetite for corporate debts' higher yields.

Figure 4: Primary Bond Sector Returns (%)

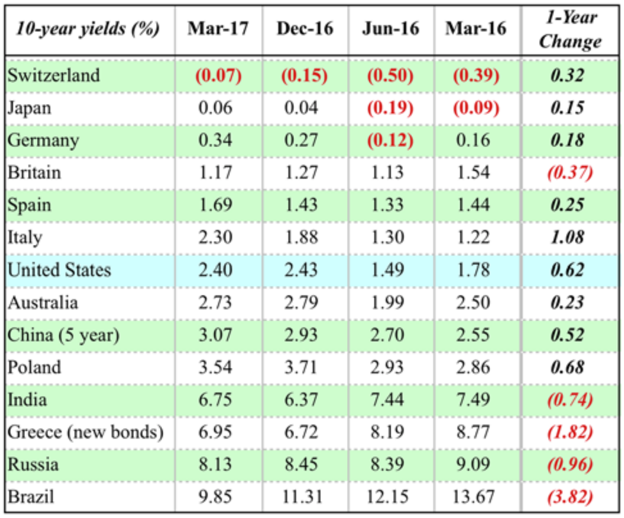
Index	**1Q '17**	**1 Year**	**3 Years**	**5 Years**
US Aggregate Bond index	0.8	0.4	2.7	2.3
US Gov't/Credit: (1-3)	0.4	0.7	1.0	0.9
US Treasury: Long	1.4	(5.0)	5.8	4.0
US Inflation-Linked (1-10)	1.1	1.5	1.5	0.6
Mortgage-Backed (MBS)	0.5	0.2	2.7	2.1
CMBS	0.9	0.9	2.7	3.2
Asset-Backed (ABS)	0.5	1.2	1.7	1.6
Inv. Grade US Credit	1.3	3.0	3.5	3.7
Leveraged Loans	1.0	7.1	4.0	4.9
US High Yield Credit	**2.7**	16.9	4.6	6.9
Municipal Bonds	1.6	0.2	3.4	3.2
Global Aggregate, ($ hdgd)	0.4	1.1	3.6	4.3
Global Credit, ($ hdgd)	1.5	5.5	4.2	4.7
Emerg. Mkts Bonds (US$)	3.9	8.8	5.7	5.3

Figure 5: Primary US$ Bond Yields



	Mar-17	**Dec-16**	**Jun-16**	**Mar-16**	***1-Year Change***
US Treasuries	**(%)**	**(%)**	**(%)**	**(%)**	***(%)***
3-month	0.76	0.50	0.26	0.21	***0.55***
2-year	1.26	1.20	0.59	0.74	***0.52***
5-year	1.93	1.92	0.71	1.22	***0.71***
10-year	2.40	2.43	1.49	1.78	***0.62***
30-year	3.02	3.05	2.31	2.62	***0.40***
BarCap Aggregate	2.61	2.61	1.91	2.16	***0.45***
BBB Credit	3.72	3.80	3.42	3.86	***(0.14)***
AA Credit	2.61	2.64	2.01	2.22	***0.39***
Agency MBS	2.90	2.85	2.07	2.35	***0.55***
Emerging Mkts ($)	5.46	5.79	5.37	5.87	***(0.41)***
US High Yield	5.85	6.17	7.27	8.18	***(2.33)***
UST30yr - UST2yr	1.76	1.85	1.72	1.88	***(0.12)***

Figure 6: Sovereign Bond Yields, selected countries



10-year yields (%)	**Mar-17**	**Dec-16**	**Jun-16**	**Mar-16**	***1-Year Change***
Switzerland	**(0.07)**	**(0.15)**	**(0.50)**	**(0.39)**	***0.32***
Japan	0.06	0.04	**(0.19)**	**(0.09)**	***0.15***
Germany	0.34	0.27	**(0.12)**	0.16	***0.18***
Britain	1.17	1.27	1.13	1.54	***(0.37)***
Spain	1.69	1.43	1.33	1.44	***0.25***
Italy	2.30	1.88	1.30	1.22	***1.08***
United States	2.40	2.43	1.49	1.78	***0.62***
Australia	2.73	2.79	1.99	2.50	***0.23***
China (5 year)	3.07	2.93	2.70	2.55	***0.52***
Poland	3.54	3.71	2.93	2.86	***0.68***
India	6.75	6.37	7.44	7.49	***(0.74)***
Greece (new bonds)	6.95	6.72	8.19	8.77	***(1.82)***
Russia	8.13	8.45	8.39	9.09	***(0.96)***
Brazil	9.85	11.31	12.15	13.67	***(3.82)***

US Stock Investors Shift to Growth

The furious rally of 2016 took the S&P price index from a low of 1829 last February 11th, to 2238 at the close of the year (+22%, before dividends). January and February saw this rally extended, and the index reached an all-time high of 2396 on March 1st. With talk of 2400 widely muted, it was instead all slightly down from there, to 2363 as the first quarter ended. Still, on a total return basis the S&P is up more than 30% since last year's low.

Overall, pure large-cap stocks (the Russell 200 index) posted a total return of 6.4% for the quarter. This contributed to a very strong 17.6% total return over the past twelve months, following 2016's first quarter correction. Unlike 4Q16, small-cap stock indices underperformed by quite a wide margin during the first quarter, with mid-caps indices slotted in between. The Russell 2000 index gained only 2.5% in the quarter. Much of that Q1 underperformance looks to have been a straightforward re-balancing, as small-caps have returned a gaudy 26% during the past year.

Opposite to the 4th quarter, growth stocks sharply outperformed value in the quarter (*Figure 7*), whether looking at the small-, mid-, or large-cap sectors. Size/style performance differentials ranged from nearly +10% for large-cap growth, to a low of -0.1% for small-cap value.

The past twelve months paint a very different picture. Value outperformed growth across the board, and small-cap stocks returned as much as 10% more than large-caps.

Figure 7: U.S. Equity Market - Size/Style Returns

			Trailing	
	1Q '17	**1-yr**	**3-yrs**	**5-yrs**
Growth				
Large Cap	9.6	16.3	12.7	13.9
Mid Cap	6.9	14.1	7.9	12.0
Small Cap	5.4	23.0	6.7	12.1
Value				
Large Cap	3.1	19.0	8.6	12.7
Mid Cap	3.8	19.8	8.9	14.1
Small Cap	(0.1)	29.4	7.6	12.5

The performance differential across large-cap market sectors was 19%, as technology stocks returned 12.6% and energy stocks lost 6.7%. In small-cap space, the quarter's sector performance differential was 23%. Small health care rallied 12.5%, and small energy lost 10.7%.

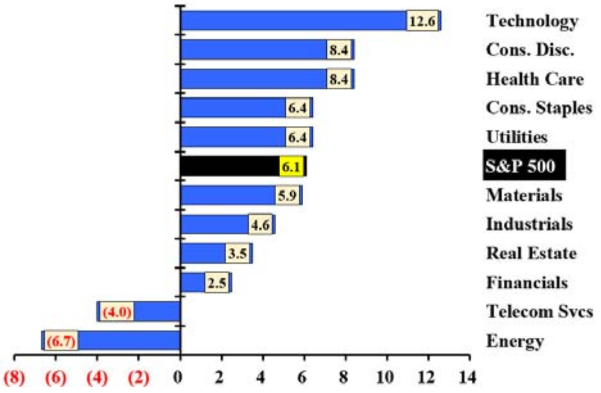
Of the total stock market's (Russell 3000) 5.7% return, the heavily cap-weighted information technology sector accounted for 42% of it. Health care stocks contributed 21%. Three stocks - Apple, Facebook and Amazon, accounted for 20% of the total market's Q1 return.

Performance contribution was narrower in the value and growth indices. Tech and health care companies each accounted for 30% of the R3000 Value's 3.0% advance.

Tech stocks account for a large 32% of the R3000 Growth's market cap, and contributed an even larger 45% of the index's 8.6% first quarter return.

Large-cap sector returns are reflected in Figure 8. consumer, tech, and health care stocks dominated 1st quarter returns. Over the past year, financial Services (+32%), tech (+25%), and materials (+20%) have led.

Figure 8: US Sector Returns –1st Quarter 2017



Per Figure 9, US stocks remain very pricey compared to recent history. At a 21.2x P/E, the S&P is trading fundamentally 40% above where it traded four years ago (15.0x P/E). The P/E ratio for small growth stocks is 70% above where it was four years ago! Investors are absolutely paying up for much higher future growth than we've seen recently. Optimistically, the 1990-2000 bull market saw P/E ratios expand to over 27x.

Figure 9: One-year Trailing P/E Ratios – Mar. 2017

	Value	Blend	Growth
US Large	18.3	21.2	24.2
US Mid	23.2	25.2	28.1
US Small	24.7	28.5	34.2
EAFE		18.7	
Emerg. Mkts		14.9	

Margin debt rose to $528.2 billion in February, surpassing the record it set the previous month, according to New York Stock Exchange data. This represents a cautionary tale. A peak in margin debt has historically preceded a steep market fall, as demand for increased leveraged positions wanes.

International Markets Rebound

Global stocks rallied amid strong earnings growth and improving economic data in the US, Europe, Japan and Emerging Markets. In a reversal from Q4, the US dollar weakened versus the euro, yen and most other developed and emerging market currencies, creating a disparity between local market and US dollar-based returns (Figure 10). EAFE developed markets rose 7.4% in US$ terms. Emerging Markets rallied 11.5% and posted their best quarterly increase in five years. Canadian markets were held back by a 7% drop in oil prices in Q1, and rose only 2.5%. The very broad MSCI All Country World ex-US index rose 8.0% for the quarter. Economically sensitive sectors (technology, industrials, health care) generally outpaced defensive sectors (telecom, real estate). Energy was the only negatively performing sector, as oil prices slipped on oversupply concerns.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 3/31/17	1Q '17	1-Yr	1Q '17	1-Yr
World ex-USA	**7.0**	**12.5**	**4.5**	**18.0**
- MSCI Growth	*8.0*	*7.5*	*5.7*	*13.0*
- MSCI Value	*5.7*	*16.5*	*3.3*	*23.2*
- Europe ex-UK	8.4	10.7	6.9	17.7
- Pacific, ex-Japan	11.8	18.4	7.9	19.5
- Japan	4.5	14.4	(0.2)	13.5
- United Kingdom	5.0	7.4	3.8	23.5
Int'l Small Caps	**7.6**	**11.6**	**5.0**	**16.8**
Emerging Mkts	**11.5**	**17.7**	**7.8**	**15.1**
- EM Asia	*13.4*	*18.1*	*9.7*	*16.9*
- EM Europe	*1.4*	*11.3*	*(3.0)*	*9.0*
- EM Lat Amer	*12.1*	*23.3*	*7.7*	*19.6*
- EM BRIC	*11.6*	*23.4*	*9.7*	*19.5*

European stocks rose 7.4%, despite political uncertainty in the region. The UK triggered Article 50 of the Lisbon Treaty to begin the 2-year countdown to exiting the European Union. The UK stock market still advanced 5% during the quarter. Markets responded positively to voters rejecting the trend toward nationalism in the Netherlands. In France, political tensions escalated ahead of federal elections in April and May, as sentiment for anti-establishment candidates rose in the polls. German Chancellor Angela Merkel faces re-election later this summer. Shrugging off this uncertainty, France and Germany rose 7.2% and 8.4%, respectively. In Q1, the best performing European market was Spain (14.8%) and the weakest was the Netherlands (1.4%). After nearly reaching parity at the end of 2016 ($1.03), the euro hit $1.075 in late March.

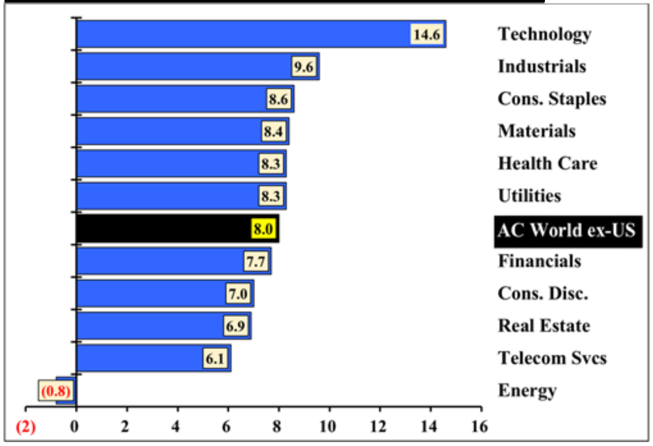
In the Pacific region, Japanese equities lagged their neighbors, rising "only" 4.5%. Japan's economy grew at an annualized 1.2% rate in 4Q16. It was the first time Japanese GDP rose in all four quarters of a calendar year since 2005. Japanese industrial output rose 2% in February and unemployment fell to a 22-year low of 2.8%. This good news was offset by a 3.8% drop in household spending in February, indicating the tightening labor market has not driven wages up enough to boost consumption. The yen rose 5% versus the US$ during the quarter, weighing on exporters, including automobile manufacturers (Toyota, Nissan and Fuji Heavy). Sharp jumped 74%, after announcing its first profit in two years. In other parts of the region, Hong Kong gained 13.4%, led by a booming real estate market. Australian equities rose 10.9%, as gains in banking stocks offset mediocre results in the materials sector. The Australian dollar strengthened 5% versus the US dollar.

Emerging markets rallied on reassuring economic data from China, higher prices for industrial metals, and a weaker US dollar. Asian emerging markets were top performers, rising 13.4%. As in other parts of the world, technology stocks led the way, with Samsung, Tencent, Alibaba and Taiwan Semiconductor returning 17%-24%.

India recorded its best quarterly advance since 2012 (+17.8%), overcoming a major currency recall late last year. China advanced 12.9%, on the strength of tech stocks and financials/banks. Latin America rose 12.1% and leadership in the region shifted from Brazil (+10.4%) to Mexico (+16%). The peso rebounded 9%, to its highest level against the US dollar since last November's US presidential election, on expectations the new administration will soften its NAFTA rhetoric

After strong returns in 2016, Russia was the only negative performing emerging market in Q1, falling -4.6%. Energy producers Gazprom and Lukoil slid as oil prices retreated 7%. Russian markets faced further pressure from diminished expectations that economic sanctions against Russia would be lifted in the near term.

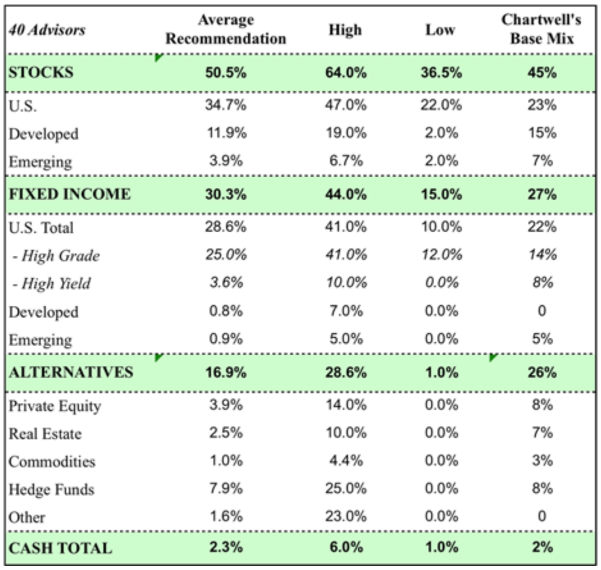
Figure 11: Ex-USA Sector Returns (1st Qtr 2017)



Back Page Perspectives – Asset Allocation

Barrons recently asked 40 of the largest investment advisory firms for their "primary" (i.e. base case, or starting point) recommended client portfolios. Summarized results (sans outliers) are set forth below.

2017 Primary Recommended Asset Mixes



40 Advisors	**Average Recommendation**	**High**	**Low**	**Chartwell's Base Mix**
STOCKS	**50.5%**	**64.0%**	**36.5%**	**45%**
U.S.	34.7%	47.0%	22.0%	23%
Developed	11.9%	19.0%	2.0%	15%
Emerging	3.9%	6.7%	2.0%	7%
FIXED INCOME	**30.3%**	**44.0%**	**15.0%**	**27%**
U.S. Total	28.6%	41.0%	10.0%	22%
- High Grade	*25.0%*	*41.0%*	*12.0%*	*14%*
- High Yield	*3.6%*	*10.0%*	*0.0%*	*8%*
Developed	0.8%	7.0%	0.0%	0
Emerging	0.9%	5.0%	0.0%	5%
ALTERNATIVES	**16.9%**	**28.6%**	**1.0%**	**26%**
Private Equity	3.9%	14.0%	0.0%	8%
Real Estate	2.5%	10.0%	0.0%	7%
Commodities	1.0%	4.4%	0.0%	3%
Hedge Funds	7.9%	25.0%	0.0%	8%
Other	1.6%	23.0%	0.0%	0
CASH TOTAL	**2.3%**	**6.0%**	**1.0%**	**2%**

A few observations –

- The range of recommended base case allocations to any particular asset class or sector is very wide. It's not easy for investors to sort out "the right" answer, which is necessarily a function of their specific needs;

- The average allocation to stocks, including private equity, is a low 54.4%. The hi/lo ranges for each stock sector are surprisingly wide. There is plenty of scope for advisors and investors to become significantly more bullish, if circumstances warrant;

- Many advisors have alot of gaps in their mixes. Only three sectors are universally "core" in nature – US stocks, non-US stocks, and high grade US bonds;

- The average recommendation set is surprisingly domestic in nature. The very low non-US bond numbers are not a shock, but non-US stock allocation at only 29% of total equities (including private equity as domestic) is really quite far below the world's actual equity breakdown. There is plenty of scope for investors to add to non-US stock holdings without becoming "overweighted."

- Chartwell's conservative position on public stocks is mostly offset by a much higher private equity recommendation. Chartwell's combined 53% is only 1% below consensus when it comes to total equities;

- Chartwell is 3% below consensus in the fixed income sectors. Our base high yield position is 4% above the average, as is our EM bond recommendation. We buy into the premise of global reflation as synchronized global growth gradually increases. Absent special circumstances (e.g., an LDI strategy), we suggest clients underweight investment grade-only Aggregate or Global Aggregate bond portfolios. Among necessary evils, we prefer credit risk to rate risk in order to capture current returns. We believe sovereign (Treasury) yields will be flat-to-rising, as real interest rates "normalize." Given low starting yields, that spells trouble for high grade bonds;

- We recommend much higher real estate and commodities/natural resources exposure than consensus. This is consistent with the reflation and global growth theme. Real estate additionally offers higher current yields than stocks or bonds. Both of these sectors are potentially too volatile for investors with short time horizons.

We're about 100 days into the new US president's term of office. For investors, market returns have been good. Actual policy outcomes have been few, but those that have taken place have been equity investor friendly. These have primarily been regulatory in nature. If that's all that gets accomplished, we think market expectations will be seriously unmet. It is the expectation of major corporate tax reform, soon, that has underpinned the equity market's sharp rise since election day, justifying in investors' minds the continued disconnect between US and non-US stock valuations. We expect the US market will correct and adjust even if actual tax reform falls short, but only so long as companies continue to grow their earnings above trend. (Show Me the Money!)

We said last quarter the natural tendency is to expect Fed Fund's rate hikes to increase the 10-year Treasury yield, but that investors should not expect purely parallel shifts in the yield curve. This is especially the case when hope for economic growth wanes, as happened in Q1.

The quarter's big mover was the US Dollar, which declined versus most G-20 currencies. As we've noted, its strength since 2011 has been rather extreme. A strong Dollar favors imports, crushes exports, reduces inflation, lowers interest rates, and hollows out domestic manufacturing. Washington probably wants a weak Dollar (they've touted for both recently).

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA