Economic readings in aggregate were as expected, but with moderation in the U.S. more than offset by upside surprises in Japan and the Eurozone. That led the World Bank to bump up 2017 growth estimates to 1.9% for developed and 4.1% for emerging economies. There were no outsized political developments to shake out the market complacency as the implications of a Tory no-confidence vote in Britain are as yet unclear, although the unexpected swing to the Labor Party suggests populism is alive and well.

In the U.S., first quarter gross domestic product growth was revised up yet again from 1.2% to 1.4% on increased consumer spending and exports, but other reports were more subdued, particularly with respect to wage pressures and inflation. The mid-June core consumer price index (CPI) release showed a three-month increase close to zero, even in some of the services components (which should be tied to unemployment rates and wage gains). While the May unemployment rate declined to 4.3%, employment growth slowed and average hourly earnings rose just 0.2% month-over-month. Finally, a late-month report showed that inflation was not only not increasing but actually falling, with core personal consumption expenditures receding to 1.4% from 1.8% at the start of the year. Nonetheless, the backdrop remained benign, with equities, home values and the job market extending gains and the current-conditions index hitting 16-year highs.

U.S. equities outperformed, gaining nearly 1% despite giving up some earlier gains. Financial stocks surged 6%, while 3% losses were found in the interest-sensitive utility and telecom names as well as the technology sector, which succumbed to some profit taking but was still up 17% year-to-date. The rotation was also seen in a style perspective as large-cap growth was the only segment to see losses.

While international equities advanced modestly, European stocks fell 1.5%, the victim of profit-taking and, to some extent, good economic news as European Central Bank (ECB) head Draghi suggested that, even if the negative interest rate and bond purchase program ended, monetary policy would still be characterized as accommodative. From the end of 2014, the Eurozone has led advanced-economy growth; this is expected to continue, with confidence rising to a post-crisis high. While the ECB lowered its inflation outlook, core Eurozone CPI has doubled to 1.1% since 2015 and German CPI surprised to the upside. Yen weakness capped Japan’s gains at 1.3% as growth came in at 1% annualized and the country fell into a trade deficit.

Emerging markets continued their run as the 1% move brought 2017 gains up to 18%, with returns somewhat reflective of commodity price movements, as oil prices have fallen 18% after June’s 5% decline. China led emerging Asia’s 1.7% gain, boosted by strong purchasing manager index and retail sales figures, as well as growing foreign exchange reserves. India and China, both energy importers, have gained 20% in 2017, while Russia has new fallen 4% for the month and 14% this year as weak oil prices have weighed on the market. Brazil also lagged as, despite an interest rate cut, new political developments triggered a 1.4% loss.

Continued on next page.
Global bond prices were mixed in the month of June. Bond markets were mixed, reflecting the crosscurrents of soft inflation reports and plunging energy prices weighed against the possibility of coordinated global monetary tightening in the developed world. The Federal Reserve Board (Fed) raised the funds rate, as expected, by 25 basis points in mid-June and announced plans to start incrementally reducing its balance sheet by year end. Investors took the balance sheet news as a partial substitute for rate hikes, and marked down the odds of an additional Fed rate increase in 2017 to roughly 50/50. In contrast, the tightening contingent expanded overseas, with Bank of Canada Governor Poloz hinting that a rate increase cycle is about to begin in the direction of a 3.25% neutral policy rate.

The Treasury curve once again saw significant flattening as yields in maturities up to 10 years increased 5-10 basis points, but with 30-year yields declining. From a return perspective, long-dated Treasuries gained 0.6%, while beating intermediate-maturity bonds by 110 basis points. High-quality corporates saw modest spread tightening result in gains of 0.3%, while Treasury Inflation-Protected Securities were hit hard by falling energy prices and inflation, losing nearly 1% and wiping out most of their year-to-date gains. High-yield bonds stayed in the black despite lower energy prices. Municipal bonds lost 0.4% and underperformed, particularly in the 3-5 year maturity range. Emerging market debt was modestly positive, as the weaker dollar boosted local-currency bonds.

**Overvalued Complacent Markets:**
**Time to Pull Out the Offensive Playbook**

The combination of (1) an aging business and credit cycle, (2) normalized price-earnings ratios exceeded only in 1929 and the dot.com bubbles and (3) investor complacency levels approaching 25-year peaks only seen just prior to the 1993/1994 bond crash and the 2008 crash makes markets dependent on continued good news. For now, financial markets remain in the “goldilocks zone” with above-trend growth without the inflation pressures that would drive accommodative central banks off the stage. Nonetheless, they are vulnerable to negative surprises, particularly given the market’s expectation of only one rate hike between now and the end of 2018 despite a growing list of advanced economies starting a tightening cycle in the face of continued above-trend global growth. While incremental buyers on weakness, we continue to counsel patience.

Little has changed in our listed equities posture, where we remain underweight, but we continue to favor international equities over domestic shares despite the former’s 2017 year-to-date 17% return and 850 basis point outperformance. Our work shows the U.S. equity market to be meaningfully overvalued, without even considering that normalized earnings approaches (such as the Schiller CAPE ratio) fail to capture the added leverage (and artificially low cost) in corporate balance sheets, which is approaching 2006 highs.

Within international equities, the call between developed and emerging market shares has become more of a toss-up given the latter’s 22% return in 2017. We have enjoyed the 17% gain in Eurozone equities this year, but are capping exposures at target levels - while relative valuations are attractive, in an absolute sense they are only fairly valued at best and already reflect the ongoing recovery. Within the region, we maintain meaningful exposure to European financials given their valuation, growth prospects, ECB tightening and the long-overdue clean-up of bad loans in Italy. The recent currency strength is less of a concern, as while mindful of the Euro’s 10% gain this year, it remains reasonably valued (and quite cheap for Germany’s economy). Furthermore, unlike the last time overseas investors flocked to Europe in 2014 and 2015, investors have directed funds towards investments more geared to the local economy rather than exporters. Incrementally, Japan has become more attractive as the market has lagged and valuations are more reasonable.

Emerging markets have one important edge: since they did not engage in quantitative easing or negative interest rates, they face no direct risks of the unforeseen consequences of the reversal of those stimuli. While emerging market equities still have more attractive normalized earnings metrics despite the rally, this is offset by negative earnings revisions for 2018 and a structurally lower energy-price outlook. China remains a difficult call, as while 2017 growth has surprised to the upside, real interest rates are increasing from negative levels as purchasing price indices have fallen and authorities are tightening to squash speculation in the shadow lending and property sectors. While not without risk, the policy moves seem well-timed, as the recent growth recovery in China has allowed the corporate sector to repair balance sheets and much of the pressure on the renminbi has been removed (as the pre-2014 “carry trade” has been fully unwound). Accordingly, China gets a tepid thumbs up despite the inevitable second-half-growth slowdown, but would be vulnerable to dollar strength if the Fed raised rates as much as I envision.

Treasury bonds are vulnerable, particular after their recent rally, which was based more on a knee-jerk reaction to lower oil prices than any change in the growth outlook. I admit that the continued decline in core inflation during 2017 is not what I expected, but will point out that wage pressure is much stronger than appreciated when normalized for a shifting mix towards lower paying jobs and low levels of productivity. I expect three rate increases before the end of 2018 and a potentially steeper yield curve.
We remain underweight credit-spread product, whether in taxable or municipal form. High-yield corporate debt is not worth the risk, given tight spreads, an inevitable increase from an unsustainably low 1.5% default rate and increased sensitivity to potentially higher interest rates. The high-yield market has outperformed my expectations this year, as BB-rated bonds have benefitted from traditional investment grade buyers reaching down in quality in the search for yield; the sector even managed positive returns in July, despite rising rates and lower energy prices.

Higher yielding municipal markets have more than recovered from their fourth quarter weakness, now having nearly matched high-yield corporate returns in 2017, even on a pre-tax basis. Whether representing a “bell-ringing” moment remains to be seen, but the recent municipal issue of the Meadowlands “American Dream” project points to the frothiness across credit markets: $1B project, 2050 maturity with a yield of 6.6% for a troubled development that first broke ground in 2004 and has needed a bond issue to complete the project. Elsewhere, while Illinois (non-resident) investors were thrilled with the state’s 32% income tax increase (as the bonds tightened more than 100 basis points), the rating agency kept the state on its watch list for a credit downgrade to non-investment grade, which would be a first for any state.

The defensive positioning described above represents our typical response to environments with a shrinking number of attractive investment opportunities. However, on occasion, we have identified investment areas where pricing has reached such extremes that the hedge is also an attractive risk/reward on a standalone basis. Examples included shorting technology stocks in January 2001, and buying gold and shorting credit in 2005-2006.

In a world virtually devoid of undervalued assets, one stands out as strikingly undervalued, trading in its cheapest 5th percentile going back decades - the “asset class” of volatility. The price for owning volatility has become so low that, intelligently structured, it potentially represents insurance with a relatively modest cost (in terms of downside risks), even if the hurricane never hits.

The strategy ticks off a number of boxes. First, the general area has been among the worst places to invest, particularly in its most common form, that of being long the VIX index (implied S&P 500 volatility). One typical VIX fund has lost 99.96% since inception in 2009 and 70% over the last 12 months. Second, the “term structure” of the pricing for volatility out in time has become much more attractive, particularly in the fixed income market. While a technical concept, it is similar to investing in commodities, where actual returns can often be driven as much by the shape of the curve than simply changes in spot prices. Third, it is a direct and indirect play on the distortions created by quantitative easing and its eventual unwinding. It is a direct play in that the Fed’s holdings of mortgage bonds have removed natural buyers of fixed income volatility from the market (as the Fed doesn’t hedge). It is an indirect play in that the reach for yield has driven investors to become sellers of volatility in an effort to enhance returns.

Our base case is that the “momentum trade” in shorting volatility will subside with the upside case being that the unwinding of these short volatility positions could become disorderly as investors reverse positions. While it is tempting to play equity-market volatility, as the VIX has just hit 20-year lows, non-equity volatility markets (bonds and currencies) set up with less downside risk if markets remain anesthetized. In terms of implementation, while there may be opportunities in the future to execute trades directly, we are starting with allocations to specialist hedge funds.