# SPIN

## QUARTERLY COMMENTARY, 3Q 2017

*First, I am proud to announce that my wife and I have welcomed a baby girl, Seneca, into our family. Seneca was born on September 28th and I've been spending these past weeks in dad heaven... this quarter's commentary was written in between feedings and diaper changes, yet I think it might be my favorite yet—or maybe I'm still Free Fallin'...*

### IF YOU'RE NOT INSIDE...

Given Tom Petty's recent departure I think this quote is an appropriate way to begin today's commentary:

*It's a circle of deception, it's a hall of strangers*
*It's a cage without a key, you can feel the danger*
*And I'm the one who oughta know, I'm the one you couldn't trust*
*I'm the lonely silent one, I'm the one left in the dust*
*I'm an insider, I been burned by the fire*
*And I've had to live with some hard promises*
*I've crawled through the briars*
*I'm an insider*
"Insider" (1981) – Tom Petty and the Heartbreakers

In any situation, there are people on the inside and people on the outside. People on the outside learn through traditional news outlets, blogs, and of course through various types of social media. These outlets run the gamut and one can find news with just about any bias that discusses just about any political or non-political topic... of course, I try to keep this commentary as neutral and objective as possible but I'm sure there are times I fail to remain in the center. After all, we are all human and we all have our perspectives! As Immanuel Kant suggested, nearly every action we take can be attributed to something other than pure duty.

Given Kant's axiom, the next section of this commentary will examine the different ways a story can be spun and how it may appear to affect (or not affect) the markets. We'll also review market performance, performance of liquid alts strategies and then give you a sneak peek into a factor analysis tool we created in-house.

### SPIN

Spin is everywhere. Everyone has a story, everyone has an agenda—especially as it relates to the markets where on a day-to-day basis my loss is your gain. Cynical? Perhaps. But I also think that kind of mindset is necessary in order to find pockets of opportunity. And because stories are just that—stories—our goal as money managers and wealth managers is not just to look past the subjective and into the objective, but also to relate the objective to the subjective.

To observe the price of an asset is perhaps the most objective form of observation. The way prices respond to stories, though, is quite subjective. So let us look at a few stories and observe the market's reaction (through the eyes of the author) to stories as they unfolded. For the sake of the reader's (and my) sanity, we will only go into depth for the bolded bullets, though I would encourage the reader to think about other stories out there as well...

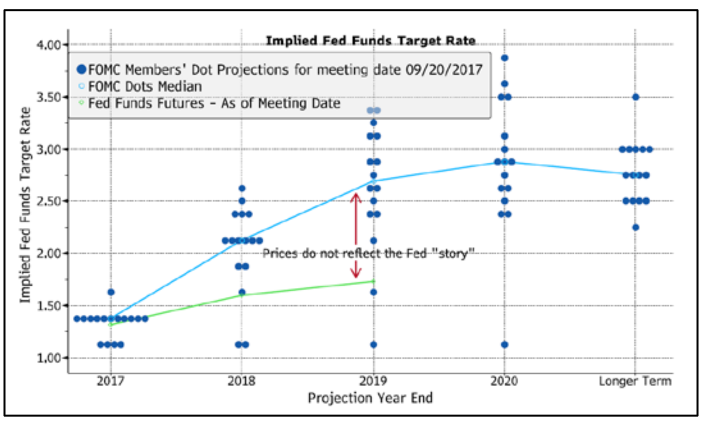
- **Fed-speak, interest rates and the US Dollar**
- **Oil will not go above $60**
- **Tax reform**
- Hurricanes
- North Korea
- Populist agendas

## FED SPEAK, INTEREST RATES AND THE US DOLLAR

Probably the most obvious attempts at sleight of hand come from the Federal Reserve and how it effects interest rate policy. Fed Chair Janet Yellen (and others) have pointed directly to using language to signal (i.e. move) markets, which paints the Fed into a bit of a corner: The ventriloquism now must continue until the Fed either becomes less transparent or less involved in markets.

So do markets listen to the Fed? Absolutely. But not in the way the Fed would like. In an attempt to produce something concrete for market participants, the Fed began publishing its members' short-term interest rate forecasts vis-à-vis the infamous "dot plot." The dot plot chart below shows where each Fed Governor (voting or not) believes short-term interest rates should be in the near future. *These are the people responsible for setting rates telling you where they want to set them!* The blue line in the chart below is the median of those points, while the green line is the implied short-term rates by market participants. Alas, markets do not believe the Fed will be able to hike rates like they say they can.

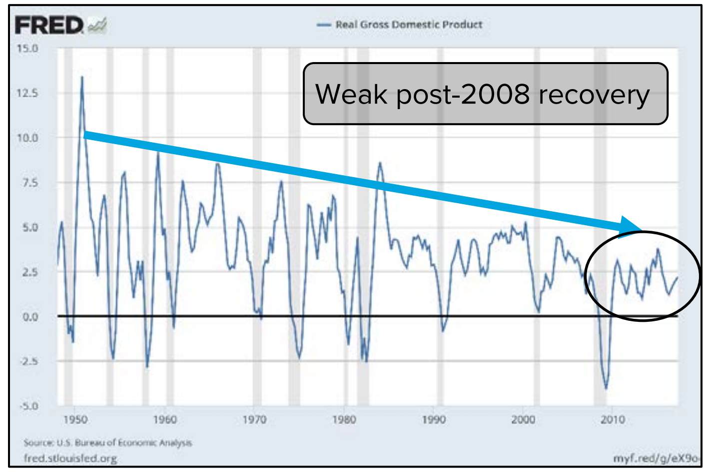



Source: Bloomberg

Now that we have established the market sees the Fed's story as fiction, the next logical question is why? My best answer: "Where's the growth?" There are other numbers out there that cannot lie. Of course, Fed governors would not lie either, but numbers like gross domestic product (GDP), wage growth, and global debt are all concrete, objective figures that cannot be disputed like the Fed's numbers in the chart above.

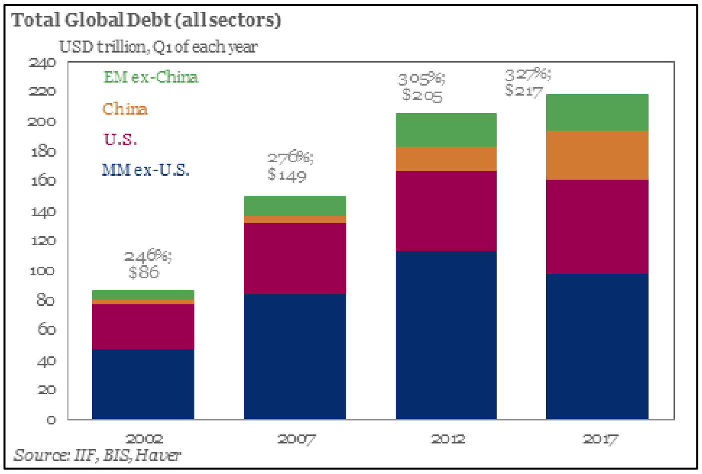
Let's take a look at where GDP, wage growth and global debt stand relative to history:

US real GDP (after inflation) has been shrinking for the past 50 years—not uncommon for a developed nation—but most troubling about this chart is that recessions have beget weaker and weaker bounces off the bottom. 2008 was the real kicker.




Given the US economy is driven by the consumer (approx. 70% of GDP, according to the St Louis Fed), it probably comes as no surprise to see wage growth running at lower and lower levels as well. See the chart below from the Federal Reserve Bank of Atlanta:


Finally, there have been many studies about debt levels and how they affect growth. Of course, as we borrow more money we have to set aside more money to pay interest on that debt. Those interest payments do not fund future growth—instead debt service funds growth that already happened. The chart below shows the growth of global debt over the last 15 years:




The picture is not pretty. Imagine what would happen to these debt service payments if interest rates began to rise!

So, the Fed attempts to paint a picture; the markets look right through it.

## OIL IS A DYING COMMODITY

As a tech geek and money manager, the energy story challenges me. In the long run I think carbon fuels will go the way of the dinosaur. Come 2035, famed futurist Ray Kurzweil says solar energy will dominate the energy landscape, meaning oil would be much closer to $0 than it is today.

Even today, fracking and "just in time" oil has caused market participants to generally agree that it would be difficult for oil to rise about $60 because there is so much supply "waiting in the wings" that can be turned on at a moment's notice.

If that wasn't enough, in just a few years it will be much cheaper to ship solar panels to developing nations than to set up infrastructure required for more traditional carbon fuels that were the bedrock of our nation's growth.

So, fracking is keeping prices low today, emerging markets may not use carbon fuels like the US did, and solar power is in our (somewhat distant) future. Why invest?

Well, markets have reacted to (at least some of) this information and energy companies have suffered a second leg down even after oil prices came crashing down in 2014/2015 and recovered somewhat in 2016. The chart below shows year-to-date prices of energy stocks and bonds on the top half of the chart and the price of oil on the bottom half. We found opportunity in the divergence between junk bonds of energy companies (the green arrow) and equities of energy companies (red arrow) and purchased a meaningful position in energy stocks at the end of August for all of our clients in Total models (models with traditional stocks and bonds as well as alternatives)


**Source: Bloomberg, as of 9/30/2017[1]**

It is widely understood by market participants that energy companies generally move in line with the price of oil because their ability to generate revenue is dependent on that one factor. That said, there are also times when price changes are not as correlated to moves in oil prices, many times around inflection points.

Could energy be a value trap in the making? Perhaps. But we believe markets have overreacted to the story about energy stocks and have taken a position to reflect that.

## TAX REFORM

Tax reform is a hot button issue, but this story is probably one of the easiest stories to feed investors because almost every investor wants earnings to go up… if the corporate tax rate was reduced from 35% to 20% that would be a windfall for companies in the S&P 500, right? Sure: We have seen estimates of an

[1] Energy stocks represented by Energy Select Sector SPDR Fund. High Yield Energy Bonds represented by the BofAML High Yield Energy Total Return Index. Oil represented by Bloomberg WTI Cushing Crude Oil Spot Price.

immediate increase in corporate profits of between 7% and 12%, which might mean a similar boost in the value of the S&P.

If taxes are assumed to come down then shouldn't the companies with the current highest tax rates benefit the most? After all, they would have the most to gain. So how have companies with higher effective tax rates done since the pre-announcement in early-September? In fact, companies with higher tax rates actually underperformed companies with lower tax rates by about 1.4% in September and trail their peers by about 5% YTD.[2]

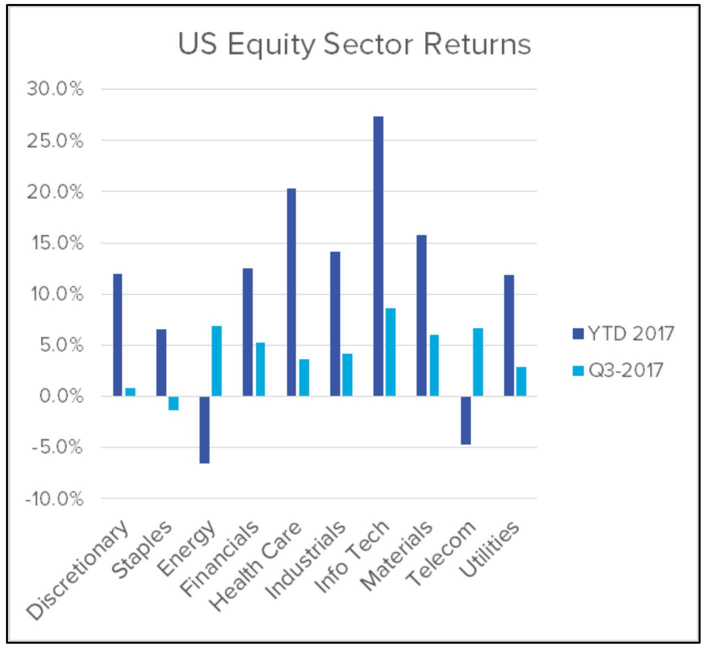
The story here is that lower corporate taxes should help companies with higher tax rates and yet in the short period of time since the tax bill was announced that has not been the case!

Bottom line: Headlines are fascinating and make for great cocktail hour banter. Many times they encourage the consumer to become more educated! But many times stories can be distractions to a money manager if not digested through a lens of real, objective market data.

## MARKET PERFORMANCE

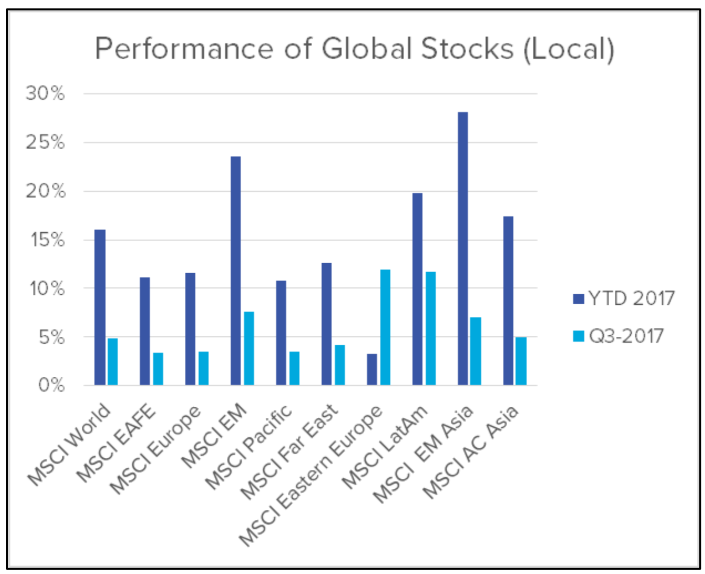
Speaking of market data, let's look at market performance for the quarter and year.

Equity markets continued their upward trajectory in the third quarter, led again by technology sector, which is up a staggering 27% YTD[3]. Small cap stocks and energy stocks saw a nice rebound in September and are beginning to show signs of life, while value stocks continue to look weak relative to high-flying growth stocks. Please see the chart below to see sector returns both for the third quarter (light blue) and for the year (dark blue):




**Source: Bloomberg, as of 9/30/2017**

Emerging markets stocks had another strong showing during the third quarter, particularly in Latin America and Eastern Europe. This market performance is important to us and I will expand why later in this section. See the chart below for country and region indices (in their local currencies):




**Source: Bloomberg, as of 9/30/2017**

Europe, for example, was a trade we initiated in our portfolios the day after the Dutch election in March of this year. That trade has continued to work in our favor as more attractive valuations than the global market, a

[2] Source: AlphaCore Capital and Bloomberg, as of 9/30/2017

[3] Source: Bloomberg, as of 9/30/2017

stronger Euro/USD rate and improving investor sentiment has contributed to the return.

The yield curve flattened during the quarter and has flattened considerably YTD, close to levels in mid-2016 when US Treasury yields bottomed. A flattening yield curve is usually synonymous with tightening credit conditions and tends to happen later in the economic cycle.


**Source: Bloomberg, as of 9/30/2017**

September looked a lot like a reflation trade (remember the "Trump Bump" last November/December?), signaling some bullish sentiment, while defensive stocks like utilities, real estate and consumer staples moved out of favor. Fixed income markets are moving in tandem with defensive and high dividend paying equities, which lead us to believe that high dividend companies may further disappoint if interest rates continue to rise.

Currency markets tell a slightly different story: In November/December of last year, the US Dollar went on a tear, rising over 4% in the last two months of the year. This September, the US Dollar Index rose about 0.5% as credit conditions tightened and value stocks rallied, but a 0.5% move is much less significant. If the dollar stays weaker then it could mean inflation is in fact around the corner! As I have written about many times, the US Dollar is of critical importance and something we are watching closely because it has the ability to influence so many different factors (like interest rates, inflation and overseas revenues).

Finally, I have also addressed in a previous commentary that as markets move closer to the top, the most aggressive assumptions prompt the riskiest asset classes to perform best. Emerging markets stocks and technology stocks are historically the riskiest sectors within their categories, which signal markets may be in extra innings at this point. Given the extraordinary measures taken by the Federal Reserve, however, it is dangerous to try and predict if a market top is imminent.

Alternative strategies performed well in the third quarter with all Morningstar Alternative Categories earning a positive return (except Multicurrency, which fell -0.1%) Generally speaking, long/short equity managers fared well as they were buoyed by gains in the US stock market. Global macro managers were also able to take advantage of both currency and equity gains, although the whipsaw in fixed income markets caused some managers trouble. Event-driven strategies continued to grind higher although merger activity is not quite keeping up with investor demand.

## OUR PORTFOLIOS

The AlphaCore equity sleeves fared well during the quarter as our overweight to international equities as well as our purchase of energy equities were both causes of our outperformance. The one exception was our income-focused portfolios, which underperformed slightly due to the overweight to higher-dividend paying stocks. Most portfolios are slightly underweight to stocks, but within our equity sleeve we are comfortable taking some risk because of the significant allocations we carry to alternative strategies across our portfolios.

Our fixed income sleeves also outperformed their benchmarks mainly due to our high yield bond allocation. Most portfolios remain underweight fixed income, reflections the caution we wish to take in the asset class.

Real assets performed well, particularly our metals and mining position. While diversified real assets fared moderately well (underperforming equities but outperforming commodities), the push and pull of the real estate (detractor) and upstream mining (contributor) made for a reasonably strong quarter. We hold these real assets as an inflation hedge but they are generally considered to be equities. We are overweight real assets in many of our portfolios today.

The alternative strategy portfolios delivered positive performance during the third quarter largely due to a reversal in the underwhelming first half performance by both our long short equity and managed futures strategies. Across many models, our long short equity and managed futures sleeves were the largest contributors, while our event driven sleeve was the only detractor. The models also saw some minor allocation changes in terms of sub-strategy sleeve weightings, generally resulting in a slight increase in overall equity beta. However, the most notable change to our portfolios during the quarter was the replacement of our event-driven manager.

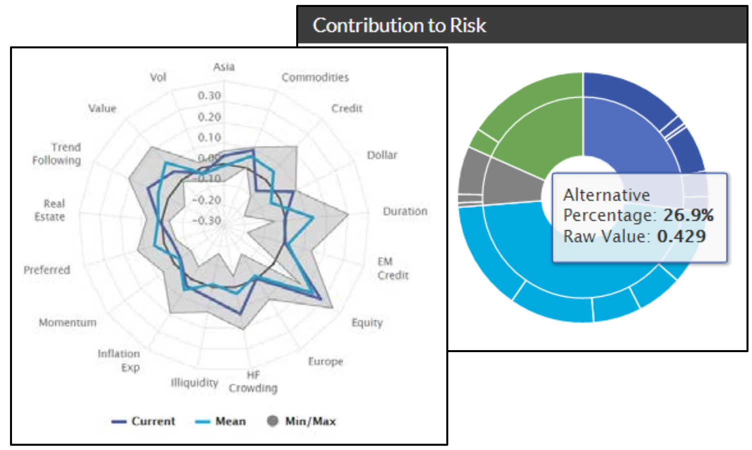
We believe this replacement will provide us with a higher quality approach to harvesting the idiosyncratic event risk in the equity markets. We still maintain strong conviction in the event driven space, and believe that our managed futures exposures provide an appropriate hedge to offset the dominant equity beta of an investor's portfolio.

## FACTOR-E

One of the reasons we feel confident in our alternative strategy selection is because of our understanding of the risk factors that drive the returns of many of these strategies.

Generally speaking, risks in the liquid alternative strategies space are difficult to uncover, which can make portfolio construction a challenge. Just because they are more challenging to uncover does not make factor analysis any less important! In fact, we wrote a paper on just that earlier in the year. But, because there was no tool in the marketplace that assisted in fund analysis and portfolio construction—particularly portfolios with alternative strategies—we decided to build one: We call it factorE. (Math geeks: The E is the error term when performing some kinds of statistical analyses)

We will be rolling out this software for our clients and we are excited to share some of the discoveries we have made in creating this tool... please stay tuned for the release upcoming later this year, but in the meantime here are a couple of screenshots from factorE that allow us to look at risks in our portfolios:




## CONCLUSION

In summary, there are stories are aplenty and equity markets look toppy, but we remain confidently invested for our clients. Please be sure to get in touch with us if you have questions about your portfolios, about the markets, the factorE or about any of the analysis contained herein. We thank you for your partnership and look forward to continue working hard to earn your trust.

Jonathan Belanger, CFA

Director of Research

AlphaCore Capital, LLC

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