Investment Insights: August Review

September 20, 2017

Asset Allocation & Market Strategy

Volatility Revival

Most major indices and markets finished slightly in the green for the month of August after faltering in the first half. Financial markets seemed confused, caught in the middle of a myriad of positive news which was overshadowed by negative events throughout the world. For the first time all year the Barclays U.S. Universal Bond Index beat global equity markets, as represented by the MSCI All Country World Index. This could be a sign that the queasiness of a roiling investment and geopolitical market may be catching up to seafarers and that lower-risk assets, such as bonds, might be the haven of choice for market participants.

On a positive note, most of the second quarter's earnings had closed and showed solid growth for U.S., Japan, and Eurozone companies; however, geopolitical risks continued to spark headlines – most notably from the Korean Peninsula. After the North Korean regime had threatened the U.S. with a missile strike, the VIX Index, which is considered a barometer for volatility, dropped only slightly and stayed stagnant in the mid 9 to 10 range. This was a head-shaker for many. If the threat of a nuclear strike couldn't shake the fortitude of the market, then what could? Enter hurricane season. Storms that seemed to punctuate the end of August finally pushed the VIX up above 14 and even into the 15 range before coming back down to 10.59 by the end of the month as uncertainty settled in once again.

While we don't believe that these tensions or the hurricanes will ultimately knock domestic and global markets off of the current growth trend, it does add to the negative column on the T-chart. When you combine these externalities with a domestic government who continues to add its own form of uncertainty into markets and the economy, both on what was the upcoming debt ceiling debate in August and the ongoing fiscal policy gridlock, it starts to add up to nervousness for investors. Thankfully, nervousness hasn't translated into real fear quite yet. Despite our strategies remaining only slightly overweight on equities, we do prefer the stock asset class over global bonds for the next few of quarters. To recap, the Global Investment Management team has been continuously taking profits within equities and shifting to alternative assets and, to some degree, fixed income investments. Our team continues to remain slightly overweight to stocks, neutrally positioned within alternatives, and underweight to fixed income investments in the current environment.

Equities

The Donald Versus...

World equity markets seemed to falter in August as geopolitics dominated headlines. The MSCI ACWI, which attempts to gauge stock markets around the globe, gained just 0.44 percent during the month compared to the almost 3 percent return in July. Global stocks were mixed as regional worries flared and economic data took a backseat to geopolitical issues. Emerging markets was one of the best performers in August as evidenced by the 2.27 percent return of the MSCI Emerging Markets Index. Other data from MSCI showed international developed economies' stock markets were flat for the month; however, Europe was a detractor this time around, losing 0.76 percent. The U.S. market, gauged by the S&P 500 Index, was able to eke out a gain of 0.31 percent despite the political turmoil seen during the month.

U.S. stock prices rocked and rolled as tensions between the U.S. and North Korea escalated. The threat of military conflict seemed imminent when the solitary regime threatened to fire missiles at the strategically important U.S. territory of Guam. Despite growing global sanctions and rebuke, authorities in North Korea have continued testing its arsenal of intercontinental ballistic missiles, even going so far as to fire over Japan. Markets reacted swiftly as President Trump and North Korean leader Kim Jong-un goaded each other and traded threats. The S&P 500 Index dropped approximately 1.50 percent in a few

different trading sessions over the month as tensions escalated on North Korea and, separately, the President's comments on protests domestically, which led many members of the President's advisory councils to resign. Even with the threat of military strikes, the domestic stock market remained resilient and ended the month slightly positive.

The lag in European equities can mostly be attributed to the appreciating euro versus other major currencies. As earnings have risen, GDP has firmed and unemployment has shown positive trends. The local currency has also moved higher, appreciating more than 10 percent versus the U.S. dollar, which may end up putting a damper on exports, but may also slow the upcoming tightening by the ECB. The earnings trend that the Eurozone experienced in the first half of the year ultimately could falter if the euro doesn't decline back to beneficial levels – a trend we are keeping a keen eye on due to our overweight in the region. After a solid 2016, emerging and frontier markets have taken 2017 by storm, up over 28 percent and 22 percent, respectively, according to MSCI data, mostly due to beneficial earnings revisions stemming from global trade partner economies seeing rebounds. However, these economies may face longer term struggles like rising interest rates, appreciating currencies in developed countries, poor debt levels, lack of investment in productivity, and lackluster corporate governance, which could have a significant influence on their financial markets.

Fixed Income

Yellen the Soothsayer

Spurred by geopolitical crises, investors flocked to safe-haven assets and pushed yields lower during the month of August. The 10-year Treasury continued its months-long decline and reached the lowest level so far this year, touching down at 2.12 percent at the end of the month; the yield has declined steadily from a recent high of 2.39 percent in early June. The increased demand and sinking of the yield curve led to positive, albeit modest, returns for bond investors. The Barclays U.S. Universal Bond Index gained 0.86 percent for the month as the Treasury market advanced, but other bond sectors stayed relatively flat; Barclays data showed broad Treasuries returned 1.08 percent while spread products like investment grade corporates gained 0.78 percent. High yield bonds, which have been a top performer in the bond market over the last few years, remained almost flat after declining 0.04 percent.

The big news in the bond markets continues to be the Fed's unwinding plan. The FOMC will hold their September meeting on the 19th and 20th of the month and it is very likely Yellen and her team will officially announce their plan to allow bonds to roll off their ballooned $4.5 trillion balance sheet. As our team has reviewed in the past, the most likely scenario would be the Fed, starting in 2018, will allow $6 billion in Treasuries and $4 billion in mortgage-backed securities to mature each month, increasing each quarter to a max of $30 billion and $20 billion, respectively. Based on fed funds futures data from Bloomberg, markets are showing no chance for an interest rate hike at the September meeting and just below a 50/50 at its December meeting. Investors should expect Yellen to emphasize the gradual nature of the balance sheet normalization in order to keep financial markets calm; however, markets have yet to have a real reaction to the change. While the full effect of the unwinding is a mystery to the markets and even top Fed officials, a combination of gradual reduction, limited asset roll-off, and transparency seems to be helping the Fed keep investors soothed.

The Global Investment Management team continues to believe the Fed's unwinding will likely shift yields higher across the curve. In addition, it is possible that other central banks will initiate further tightening policy in tandem with the Fed, like the ECB announcing an unwinding of its own stimulus program, or the Bank of England raising its key rate. Our strategies remain underweight duration, which means they will be less sensitive to these rate increases; however, we are monitoring valuations in the shorter part of the yield curve. We are evaluating opportunities in the market and may make additional allocation shifts to spread products.

Rocking Out with Heavy Metal

While equity markets were mixed due to geopolitical frictions, alternative assets remained positive despite Hurricane Harvey battering the Gulf along with select energy markets. The Bloomberg Commodity Index was on par with the S&P 500 Index in August and returned 0.31 percent as oil slid, but base metals advanced. Real estate was a bright spot during the month as inflation seemed to tick up and most central banks, particularly the European Central Bank, remained accommodative in order to support the existing global recovery; the MSCI World Real Estate Index climbed 1.18 percent over the period. Hedge fund strategies gained 0.28 percent during the month, according to the HFRX Global Hedge Fund Index, as opportunities arose amid the stock volatility and jump in prices for base metals.

Nickel, zinc, and aluminum were the top three constituents within the Bloomberg Commodity Index in the month of August, gaining 15.29 percent, 12.52 percent, and 10.35 percent, respectively. Much of the gains can be attributable to increased demand as the U.S. dollar continues its months-long decline, and a shortage in production for one of the world's powerhouses. The U.S. dollar seems to have recently peaked in late-2016 as it approached a level not seen since 2002. However, since then, the currency has been on a steady decline and has lost 9.34 percent of its value this year through August, according to spot prices calculated by Intercontinental Exchange. The other source for the rally in base metals may have been China's recent crackdown on polluting industries, which seems to have curbed production for the country; production of 10 different base metals by China fell 2.2 percent to a one-year low, according to Reuters, which sited official Chinese government data.

Our team continues to look to alternative assets as a significant factor for investment portfolios over the coming years. Currently, the Bank of the West alternative strategies remain fairly defensive toward higher volatility vehicles. As such, we continue to employ absolute return strategies, like those that invest in insurance-linked securities and alternative lending, in order to diversify the overall portfolio and provide additional and comparatively consistent income. The remainder of our alternative portfolios focuses on hedging risk in the equity markets and real returns over inflation. We continue to believe in this positioning in the current environment and will adjust as opportunities arise.

Glossary

Alternative investments are investments that are not one of the three traditional asset types (stocks, bonds and cash).

Barclays U.S. Universal Bond Index is an unmanaged index comprising US dollar-denominated, taxable bonds that are rated investment grade or below investment grade.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Brexit is an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.

Bureau of Labor Statistics is the arm of the U.S. Department of Labor that researches and publishes a range of data, from inflation and consumer spending to employment, productivity and wages, as well as other economic measures.

CBOE Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. 1st & 2nd month expirations are used until 8 days from expiration, then the 2nd and 3rd are used.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Sometimes referred to as "headline inflation."

Corporate bonds are debt obligations issued by corporations. An investment in corporate bonds is subject to a variety of risks including credit and default risk, market risk, event risk, call risk, interest rate risk, foreign risk, and sector risk.

Emerging Market countries have economies that are progressing towards becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU's goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Eurostat is the agency within the European Union charged with providing statistical information for the continent, as well as to ensure that member countries are using acceptable methods to track and report statistics within their borders.

Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.

Federal Open Market Committee (FOMC) is a committee that sets interest rate and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities.

Federal Reserve (Fed) is the federal banking authority in the U.S. that performs the functions of a central bank and is used to implement the country's monetary policy, providing a national system of reserve cash available to banks.

Frontier Markets are less advanced capital markets from the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. They are also known as "pre-emerging markets".

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. Real Gross Domestic Product is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices. Often referred to as "constant-price," "inflation-corrected" GDP or "constant dollar GDP". Real GDP can account for changes in the price level, and provide a more accurate figure.

HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

High yield bonds are high paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below 'BBB' from S&P, and below 'Baa' from Moody's. Bonds with ratings at or above these levels are considered investment grade. Credit ratings can be as low as 'D' (currently in default), and most bonds with 'C' ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Investment-grade (IG) is typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgement of the rating agency, are projected to have relatively low default risk.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Municipal bonds are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects. The interest income from municipal bonds is generally exempt from federal taxes and may be exempt from state and local taxes. Municipal bonds are subject to a number of risks such as interest rate risk, call risk, inflation risk, credit and default risk, and tax risks.

Price-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings.

Russell 2500 Index features 2,500 stocks that cover the small and mid cap market capitalizations. The Russell 2500 is a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities. The index is designed to be broad and unbiased in its inclusion criteria, and is recompiled annually to account for the inevitable changes that occur as stocks rise and fall in value.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

Treasuries are debt obligations issued and backed by the full faith and credit of the U.S. government. Treasuries are subject to interest rate risk, call risk, and inflation risk. As Treasuries are backed by the full faith and credit of the federal government, they have low credit or default risk. As a result they generally offer lower yields relative to other bonds.

One cannot invest directly in an index.

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Investing involves risk, including the possible loss of principal and fluctuation in value.

Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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