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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

Global financial markets experienced a significant shift in performance over the last two quarters. A portion of this shift, specifically the muting of domestic small-cap returns in the first quarter, can be explained by investor recognition that the pace of change coming out of Washington D.C. may be slower than initially anticipated. This Eye on the Market ("EotM") examines what has happened year to date and what may lie ahead.

LET THE GOOD TIMES ROLL

Whether it is continued appreciation in the stock markets, or a night out with friends, we are inclined to believe that the "good times" will continue to roll. It's not until after the market shifts – or the next morning – that we realize we may have stayed too long at the fair.

As Table 1 highlights, U.S. small caps rallied in the fourth quarter on post-election optimism followed by a swift slowdown over the next three months, leaving our investor stuck with the bill when everyone else left the party.

Table 1*

Total Return (%) (as of April 21, 2017)				
Category	**Index**	**Q4 2016**	**Q1 2017**	**Year-to-date 2017**
High Quality Bonds	Bloomberg Barclays US Agg Bond TR USD	-2.98	0.82	1.75
High Yield Bonds	BofAML US HY Master II TR USD	1.88	2.71	3.17
Global Bonds	Citi WGBI USD	-8.53	1.55	2.81
Emerging Market Bonds	JPM EMBI Global TR USD	-4.21	3.90	5.25
Large-Cap U.S. Stocks	S&P 500 TR USD	3.82	6.07	5.54
Mid-Cap U.S. Stocks	Russell Mid Cap TR USD	3.21	5.15	5.01
Small-Cap U.S. Stocks	Russell 2000 TR USD	8.83	2.47	2.06
Developed International Stocks	MSCI EAFE NR USD	-0.71	7.25	6.68
Emerging Market Stocks	MSCI EM NR USD	-4.16	11.45	11.95

*Source: Morningstar Direct. The Barclays US Aggregate Bond Index is composed of the Barclays Government/Corporate Bond Index, the Barclays Mortgage-Backed Securities Index, and the Barclays Asset-Backed Securities Index, and is generally considered to be representative of the U.S. bond market. The Bank of American Merrill Lynch High Yield Master II Index is an unmanaged representation of the performance of below investment-grade U.S. domestic bonds. The Citigroup World Government Bond Index (WGBI) is a market-capitalization weighted index consisting of fixed-rate government bonds with a remaining maturity of at least one year and is generally considered to be representative of the global government bond market. The J.P. Morgan Emerging Markets Bond Global Index is an unmanaged index, which tracks the total returns for external-currency dominated debt instruments of emerging markets: Brady bonds, loans, Eurobonds, and U.S. dollar-denominated local markets instruments for 33 countries. The S&P 500 Index is a market-capitalization weighted index of 500 stocks, and is generally considered representative of the U.S. stock market.The Russell Mid Cap Index is a subset of the Russell 1000 Index and measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on market cap and current index membership. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The MSCI EAFE Index is a market-weighted index of non-U.S. companies and is widely used as a benchmark for international investments. The MSCI Emerging Markets Index is a market capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. An index cannot be directly invested in. Past performance is no indication of future results.

We see 2017 shaping up to be a good year for emerging market stocks, with the MSCI Emerging Markets Index ("MSCI EM") clocking in as a top performer thus far. Does this mean investors should start partying like it's 2006 with emerging markets as the darling of the party? Probably not.

The recent recovery in emerging market equity performance is due, in part, to investor recognition of the valuation gap between developed-market and emerging-market stocks. Chart 1 displays the relative price-to-earnings ratios, a popular gauge for equity valuation, for the S&P 500 and MSCI EM Indexes. Since late 2011, emerging market equities have been less expensive on a relative basis as compared to U.S. large-cap equities. While this gap has narrowed since early 2016, emerging markets remain less expensive.

Chart 1

Source: Morningstar Direct and Raymond James.

WELL DRINKS OR TOP SHELF?

While each of us has our drink of choice, investors also exhibit their preference for which asset classes they favor by what they are buying and selling. As Table 2 indicates, investors allocated capital across all asset classes, except for high-yield bonds during the first quarter of this year. From a product standpoint, fund flows were about even for mutual funds and exchange-traded funds (ETFs).

Table 2*

Estimated Net Flows for Mutual Fund & ETFs (as of March 31, 2017)				
Category		Jan-17	Feb-17	Mar-17
U.S. Bonds	Intermediate-Term Bond	+	+	+
	High Yield Bond	+	-	-
Global Bonds	World Bond	+	+	+
	Emerging Markets Bond	+	+	+
U.S. Equity	Large Blend	+	+	+
	Mid-Cap Blend	+	+	+
	Small Blend	+	+	+
International Equity	Foreign Large Blend	+	+	+
	Diversified Emerging Mkts	+	+	+

Does this represent a longer-term comeback for the mutual fund industry? It is too soon to tell, and EotM believes that unless an actively-managed mutual fund can prove itself to be worthy of being on the top shelf, investors will use less expensive alternatives.

As it pertains to high-yield bonds, from a performance perspective, they have continued to generate positive total returns as indicated in Table 1. While this may be the case, the negative estimated net flows reflected on Table 2 may be a function of narrow credit spreads (spreads being the difference between the yield of a lower-quality bond and that of a U.S. Treasury bond). This implies that aside from the coupon payment, investors aren't being compensated very much for the amount of credit risk they are taking on.

High-yield bonds pay a higher coupon, but they also have the potential to provide investors with capital appreciation. This occurs when credit spreads are wide and then become narrow (and bond prices subsequently rise). The opposite holds true as well – when credit spreads widen, the prices of the underlying bonds decrease. EotM hopes that investors can recognize when they've have had enough high yield "to drink," and walk away from the bar. If this isn't the case, investors run the risk of having a bad headache once the party is over.

*Source: Morningstar Direct. Intermediate-term bond portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and typically have durations of three and a half to six years. High-yield bond portfolios concentrate on lower-quality bonds, which are riskier than those of higher-quality companies. These portfolios generally offer higher yields than other types of portfolios, but they are also more vulnerable to economic and credit risk. These portfolios primarily invest in U.S. high-income debt securities where at least 65% or more of bond assets are not rated or are rated by a major agency such as Standard & Poor's or Moody's at the level of BB and below. World bond portfolios invest 40% or more of their assets in foreign bonds. Some world bond portfolios follow a conservative approach, favoring high-quality bonds from developed markets. Others are more adventurous, and own some lower-quality bonds from developed or emerging markets. Some portfolios invest exclusively outside the U.S., while others regularly invest in both U.S. and non-U.S. bonds. Emerging-markets bond portfolios invest more than 65% of their assets in foreign bonds from developing countries. Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large-cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index. The typical mid-cap blend portfolio invests in U.S. stocks of various sizes and styles, giving it a middle-of-the-road profile. Most shy away from high-priced growth stocks, but aren't so price-conscious that they land in value territory. Small-blend portfolios favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small-cap. Foreign large-blend portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more developed markets, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan). Diversified emerging-markets portfolios tend to divide their assets among 20 or more nations, although they tend to focus on the emerging markets of Asia and Latin America rather than on those of the Middle East, Africa, or Europe. It is not possible to directly invest in a category or index.

MASS-MARKET OR CRAFT

EotM has discussed a wide range of risk and return concepts over time but has yet to bring attention to the potential for consolidation in the investment management industry. While this concept does not necessarily translate to a direct loss, it does force investors to consider whether an asset manager has the size and scale to maintain a meaningful presence in the investment industry going forward. At the end of the day, there are only so many ways to package stocks and bonds and – given the challenges the investment industry currently faces with regard to high fees – it should come as no surprise that firms are merging to gain greater scale. This was the case with the Janus Capital merger with Henderson Global Investors, which created a larger investment organization with broader scale across equities, fixed income, and asset allocation strategies. Just in the last few weeks, there were several merger and/or acquisitions announced, including Touchstone Investments' Touchstone Advisors acquiring a range of products from Sentinel Asset Management.

Mutual Fund Research & Marketing ("MFRM") takes into consideration the scale and scope of an investment management company when considering placing a mutual fund on its Highly Recommended Funds List. This is the case, as MFRM seeks to find investment teams that have shown a consistent, sustainable, and repeatable process.

I THINK I'LL HAVE ONE MORE

While much has been made about the end of active management, MFRM continues to believe that active strategies can be an effective way for investors to meet their investment goals and objectives. This is particularly the case in less efficient asset classes, including fixed income, small-cap equities, and non-U.S. equities.

While consolidation may be a relatively recent trend in the investment management industry, it is not new. In a similar manner, the beer industry over the last decade has experienced its own consolidation. Just last fall, in October 2016, Anheuser-Busch InBev ("AB InBev") merged with SABMiller, creating Anheuser-Busch InBev SA/NV. The purpose of the merger was to increase scale and improve distribution in a commoditized industry. While many beer lovers have their favorite brand, the ingredients for most beers include: water, barley, hops, and yeast.

SIDE NOTE

Many of our favorite spirits and cocktails were originally created to treat a variety of ailments and even viewed as medicine. For example, brandy was used to treat fevers, as a sedative, and to resuscitate individuals who fainted. Spirits known as digestifs are designed to aid digestion, as the name suggests, and work to settle the stomach after a meal while beer has been used to treat osteoporosis and arthritis. Whatever your drink of choice is, here is to your health.