2017
MID-YEAR MARKET REVIEW

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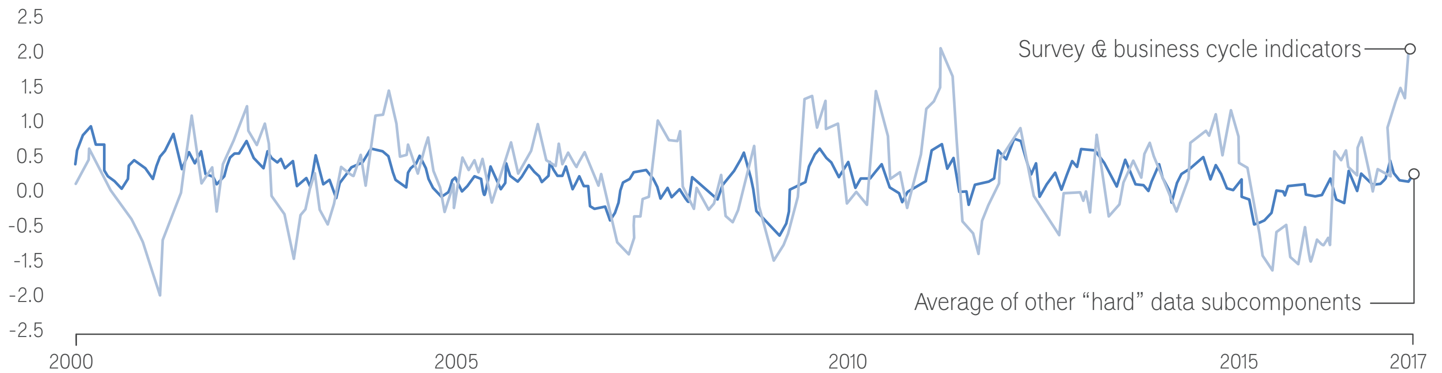
The disparity between quantifiable information (hard data) and reports based on sentiment (soft data) has widened considerably (see Exhibit 1, next page). Since the election last November, optimism within soft data has surged amid expectations for tax reform, deregulation, and infrastructure spending. However, hard data reveal a more pessimistic point of view as reflected by weaker-than-expected numbers for durable goods orders, job creation, wage growth, commodity prices, and retail sales.

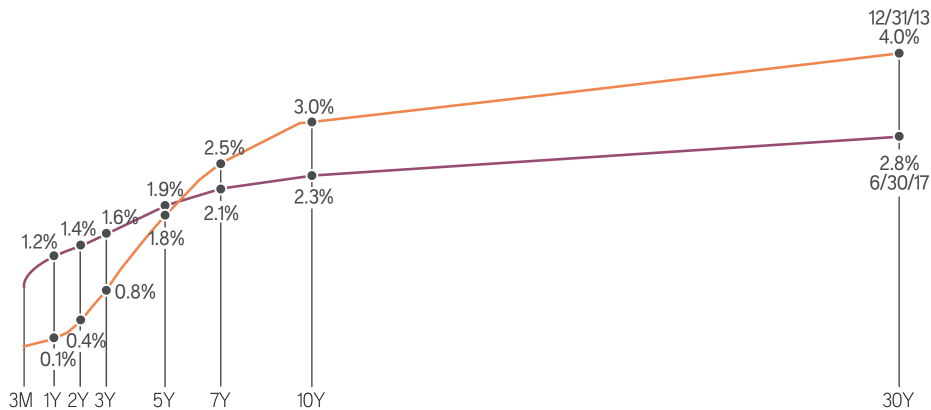
EXHIBIT 1. THE WIDENING GAP BETWEEN HARD AND SOFT DATA



Source: Bloomberg, Morgan Stanley Research, data as of June 30, 2017

The Federal Reserve (Fed) raised the federal funds rate another 0.25% in June after concluding that the U.S. economy is showing signs of improvement. Moreover, the Fed upgraded its forecast for U.S. economic growth and expects lower unemployment rates this year. Markets, however, have expressed skepticism as the U.S. Treasury yield curve has flattened significantly over the past six months (see Exhibit 2). Typically, a flattening yield curve is an indicator of economic pessimism, a sentiment driven by the Fed's short-term rate hikes, falling long-term government bond yields, weaker growth, and declining core inflation.

EXHIBIT 2. U.S. TREASURY YIELD CURVE



Source: J.P. Morgan Asset Management

In addition to raising rates, the Fed provided more detail on how it will unwind its $4.5 trillion balance sheet. This year, the Fed will begin setting a monthly limit on the amount of bonds they allow to mature as they conduct their policy of reinvesting proceeds.

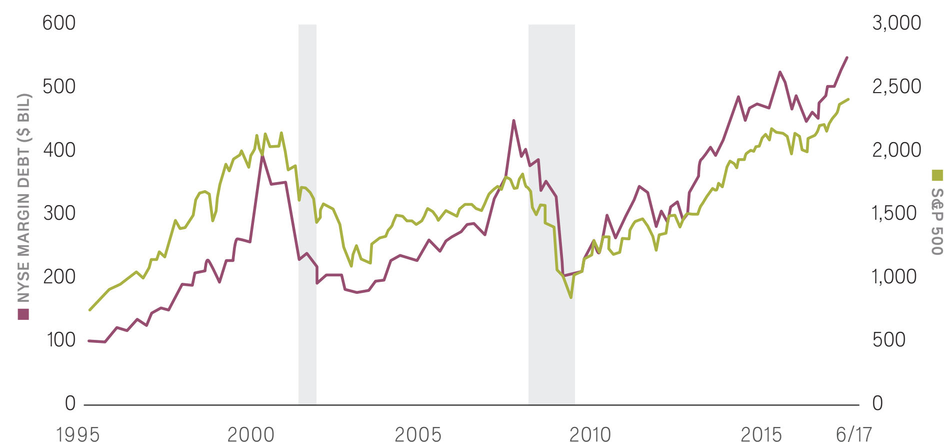
Investors have simply ignored these warning signs as they continue to search for any available yield, driving prices higher and further stretching valuations. An example of this behavior was seen in the demand for Argentina's recently issued 100-year bond. Offering a 7.9% yield, it was 3.5 times oversubscribed despite Argentina defaulting eight times in its 200-year history.

Equity Markets

Equity investors have shown a greater willingness to take risk. Margin debt levels have increased as investors borrow more and more money to invest in stocks (see Exhibit 3). Furthermore, investors continue to pour money into ETFs, driving stock market indices to new highs.

EQUITY INVESTORS HAVE SHOWN A GREATER WILLINGNESS TO TAKE RISK.

EXHIBIT 3. NYSE MARGIN DEBT AND S&P 500



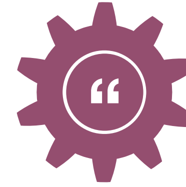
Source: dshort.com

U.S. equity markets registered more solid gains for the first half of 2017 after completing their eighth straight year of positive results. U.S. large cap stocks, measured by the S&P 500 Index, were up 9.2% for the period. Growth stocks outperformed value stocks in every market capitalization. Biotech was the best-performing sector, up 30.57%, while Healthcare and Technology also delivered double-digit gains. Energy and Telecom were the only sectors experiencing losses.

Since the 2008 Financial Crisis, the U.S. has outperformed international equities largely because global investors view the U.S. as a defensive and stable growth market. During the first half of this year, however, both Developed and Emerging international markets outpaced the U.S., rising 13.86% and 18.11%, respectively. Russia was the only country to post negative returns, declining 13.4% during the period. Economic growth in the Eurozone continued to recover as both the labor market and corporate investment activities improved on the back of stronger business sentiment.

Europe's key political risks also receded during the first half of 2017. In France, Emmanuel Macron's victory over anti-EU candidate Marine Le Pen was welcomed by markets. Moreover, the European Central Bank agreed to provide debt relief to Greece, enabling the country to avoid default. However, investors should remain cautious, as Europe's banking sector poses a key source of risk. In June, several Italian banks were bailed out at taxpayer expense. Despite passing stress tests in 2016, Banco Popular, Spain's sixth-largest bank, had to be bought by Banco Santander as part of a rescue package.

Chinese equity markets were up 14.9% for the period. Despite this strong performance, Moody's downgraded China's credit rating to A1 in response to weakening financial conditions and increasing economy-wide leverage. The country's total debt now stands at 250% of GDP, and China is exhausting its financial reserves at an alarming rate.



ECONOMIC GROWTH IN THE EUROZONE CONTINUED TO RECOVER AS BOTH THE LABOR MARKET AND CORPORATE INVESTMENT ACTIVITIES IMPROVED ON THE BACK OF STRONGER BUSINESS SENTIMENT.

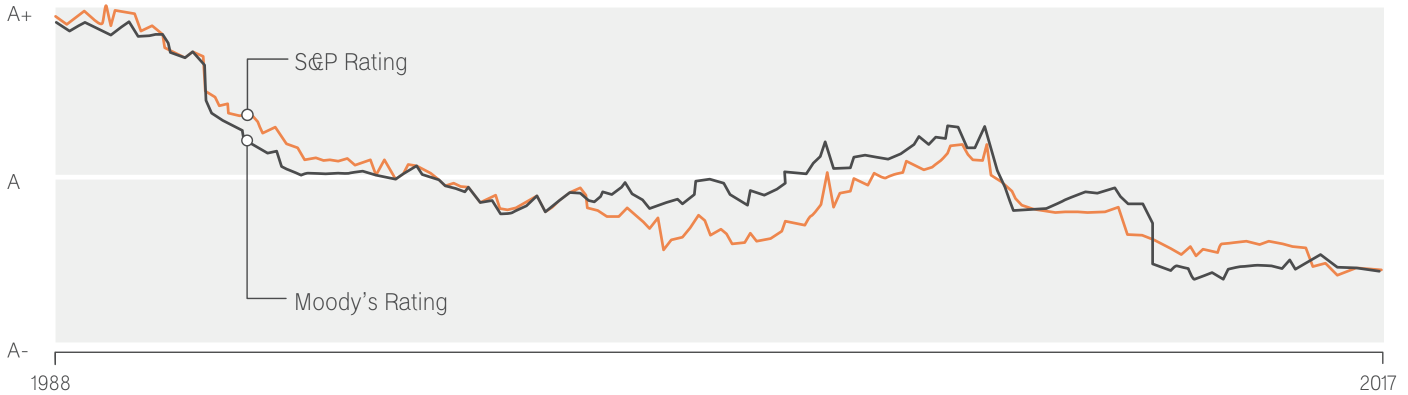
Fixed Income Markets

Overall, fixed income performed well during the first half of 2017 amid stronger corporate earnings and robust demand for yield. Every sector delivered positive returns, led by Emerging Market debt (+6.2%), high yield (+4.9%), and municipal bonds (+4.2%). U.S. fixed income also fared well as the Bloomberg Barclays U.S. Aggregate Index posted a 2.3% return. Treasuries gained 1.9% with the 10-year yield dropping from 2.45% to 2.31% during the period.

The high yield Energy sector endured a sharp selloff in June due to oil price volatility. Outside of Energy, however, the high yield market remained stable as U.S. economic indicators continued to show modest strength, new issue supply was light, and U.S. equity markets held firm.

In this current credit cycle, companies have taken advantage of low interest rates to engage in Merger & Acquisition (M&A) activity and to finance acquisitions through debt markets. This has worked to boost corporate earnings but has resulted in lower credit quality and higher debt levels. As shown in Exhibit 4, the average credit quality of the Bloomberg Barclays Credit Index has fallen dramatically.

EXHIBIT 4. AVERAGE CREDIT QUALITY OF THE BLOOMBERG BARCLAYS CREDIT INDEX

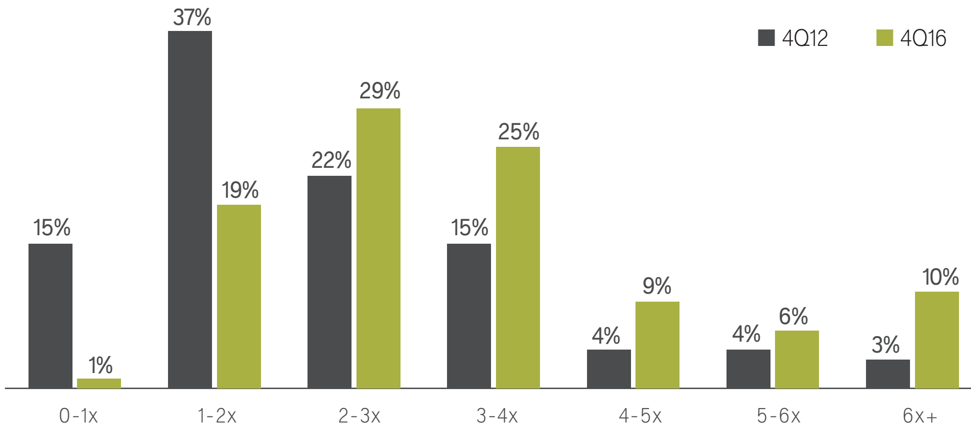


Source: Bloomberg Barclays Point, TCW, data as of June 30, 2017

In the past, rating agencies were more willing to downgrade companies due to higher leverage resulting from M&A activity. A leverage ratio of 3x used to be the cutoff between investment grade and high yield ratings. Recently, companies with increasing levels of debt were able to maintain investment grade status as rating agencies have become more lenient. As shown in Exhibit 5, the percent of investment grade companies with leverage exceeding 3x has grown significantly. This could lead to potential risk-taking for bondholders who rely on rating assessments to make investment decisions.

EXHIBIT 5. LEVERAGE LEVEL BREAKDOWN OF INVESTMENT GRADE UNIVERSE

% of investment grade debt



Source: J.P. Morgan and TCW

Commodities

Since January, WTI oil and natural gas prices were down 14.3% and 18.5%, respectively. WTI oil prices fell from $48.30 per barrel on June 1 to a low of $42.50 on June 21 amid fears of non-compliance with OPEC production cuts and increased supplies from the U.S., Libya, and Nigeria. Gold continued its range-bound trading pattern, fluctuating between $1,200 and $1,300 per ounce. In June, gold prices fell 2.16% ahead of the Fed's interest rate hike.

Conclusion

Recent optimism in the U.S. economy appears to be fueled more by positive sentiment than hard data. This optimism has led to substantial gains across global financial markets. That said, we remain vigilant for signs of waning investor psychology. And we remain cautious due to factors such as financial risks in Europe and China, a flattening yield curve, lower credit quality, and higher use of leverage.

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