Gyroscope Capital Management Group

Monday, June 04, 2018

Quarterly Review and Commentary

Throughout most of January, the U.S. stock market appeared as if it would continue 2018 in a manner similar to that of 2017. Growth and momentum factors continued to outperform, inflation remained tepid and under control, widely-anticipated corporate earnings growth began to be realized and all indications suggested the "goldilocks" economy (one characterized by a strong U.S. economy, sustained global growth and low inflation) would persist. However, investors received a rude awakening beginning in late January as stocks experienced a sharp selloff and market volatility reemerged.

To review, 2017 saw consistent positive monthly gains for the S&P 500 at abnormally low levels of volatility. In fact, the S&P 500 Total Return Index had a *15-month streak of positive monthly returns* beginning with November 2016. But the year changed course over the first quarter, volatility spiked and remains elevated, interest rates rose, and investor confidence deteriorated.

Over the last eight years, investing has appeared to be a pretty painless activity for most investors. Investors in U.S. equity markets have not only enjoyed strong returns, but the apparent riskiness of both individual stock investments and equity portfolios has seemed low. The reintroduction of market volatility has brought stock market stability into question despite a promising economic backdrop.

WHY HAS VOLATILITY INCREASED?

The market appears to be struggling to find direction, which is not surprising given that there are numerous uncertain forces acting as headwinds and tailwinds. These uncertain forces have led to heightened volatility as investors update their perspectives and attempt to evaluate each force's respective upside/downside risks.

As for headwinds…

Trade Uncertainty – Investors continue to weigh the impact of protectionist trade policies and trading partner tensions. Announced but not yet finalized tariffs/trade deals have weighed on stock markets around the globe.

Tighter Monetary Conditions – The Federal Reserve raised its benchmark interest rate by 25 basis points so far this year and appears to be on track for three or four total rate increases for 2018. Further, the Fed's continued "normalization" of its \$4 trillion plus balance sheet targeted scheduled asset sales of \$20 billion a month in Q1 2018 and sales are scheduled to increase to \$50 billion per month by Q4 2018 and continue at this pace. High volume asset sales by the Fed act as effective rate hikes since they put upward pressure on bond yields.

Peak Quarter Concerns – Through much of 2017, investors have been expecting an acceleration in corporate earnings growth and subsequently set a high bar for Q1 2018 earnings. Thus, investor responses to many otherwise "solid" earnings reports has been to “sell the news”. High expectations, elevated valuations, and trade uncertainty have amplified concerns that Q1 2018 may mark the peak of earnings growth.

Potential Military Conflicts – The potential for conflict on the Korean peninsula remains a headwind for stocks. The US-Saudi-Iranian rivalry also remains a tense situation as Washington and Riyadh have become more aggressive toward Tehran. The US-Iran rivalry also extends to the seven-year-old Syrian conflict, which remains a potential geopolitical flashpoint given the breadth of nations with physical presences and regional interests.

As for tailwinds…

Solid Corporate Earnings Equation –U.S. companies have found a formula for beating Wall Street earnings forecasts: higher pretax profits and lower tax bills. With 93% of the S&P 500 having now reported (as of 5-22-18), the blended growth rate for Q1 S&P 500 earnings per share now stands at 24.5%, up from the 11.3% expected at the start of the quarter.

Global Growth Narrative Remains Intact – After years of moderate economic expansion following the great recession, 2017 saw “some 120 economies, accounting for three quarters of world GDP” pick up steam according to The International Monetary Fund (IMF). IMF forecasts global growth of 3.9 percent for 2018 and 2019, up 0.2 percent from global output estimates for 2017.

Corporate and Personal Tax Cuts Coming into Effect – The Tax Cuts and Jobs Act (TCJA), the recent U.S. tax cuts and update to tax laws which permit faster expensing of capital investments, should promote increased corporate spending on CAPEX and increase disposable personal incomes over the remainder of 2018.

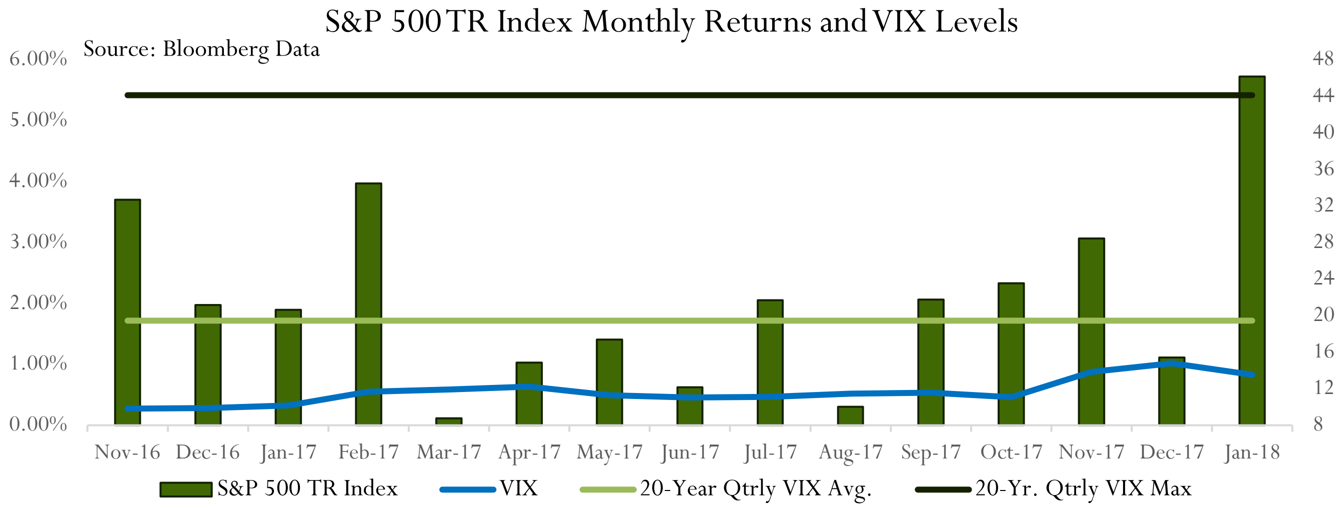
Cash Repatriation – The TCJA also substantially eliminated the deferral of foreign income that had been kept overseas. The new law imposes taxes (at a maximum rate of 15.5% rather than the prior 21%) on these deferred earnings regardless of whether overseas assets are repatriated. Having already taken the tax “hit”, multinational corporations no longer face this deterrent to repatriating assets held overseas. Repatriated cash may provide greater shareholder value in the form of M&A activity, dividends, and/or share repurchases.

WHAT DO WE MEAN WHEN WE SPEAK OF VOLATILITY?

Investment volatility measures the frequency and magnitude of asset price swings over a certain period of time. Volatility can be a historic measure of actual realized price changes or it can be a measure of expected future expected price movements implied by option prices. Investing is a discipline which focuses on the future and, thus, future volatility is of much greater concern than past. The CBOE Market Volatility Index (“VIX”) provides the most widely-recognized estimate of future volatility. The VIX is a statistical measure of the implied volatility of the S&P 500 index that explains the relationship between option pricing and expectations of future market performance.

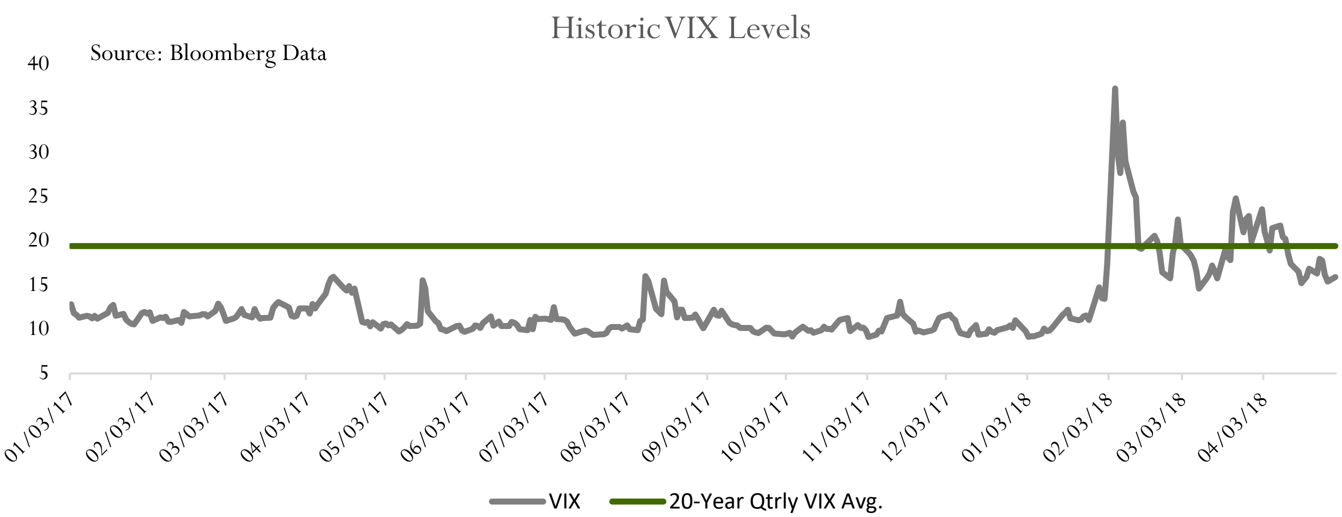
Gyroscope Capital Management Group

As we mentioned earlier, the 15 months prior to February 2018 were characterized by consistent positive returns and abnormally low volatility. The chart below depicts monthly returns of S&P 500 Total Return Index (assumes reinvestment of dividends) and historic VIX levels.



Clearly, the VIX remained below the 20-year average (using quarter-end data from 3/30/90 to 3/31/18) and far below the highest quarter-end level.

However, this low-volatility regime came to an abrupt end starting in February (see graph below). On February 5th, the VIX experienced its largest single-day increase in history, rising 116% from 17.31 to 37.32. Those investors who were "short vol" received a rude awakening and some leveraged inverse VIX exchange traded products were shut down after losing substantially all of their value. Volatility has remained elevated above average 2017 levels since.



GYROSCOPE CAPITAL
MANAGEMENT GROUP

Gyroscope Capital Management Group

WHY DOES THIS MEAN FOR INVESTORS?

We believe that volatility will remain elevated and considerably higher than that witnessed in 2017 as investors continue to incorporate new information related to the headwinds and tailwinds we discussed above. The battle between these opposing forces should result in more volatile price movements. Regardless of the outcome for U.S. equity returns, we expect volatility to persist and remain well above 2017's abnormally low levels.

Several of our strategies are designed to help investors achieve their investment objectives during periods of heightened volatility. For more information regarding how Gyroscope Capital can help you meet your investment objectives, please contact us.

Thank you for investing with us!