Gyroscope Capital Management Group

Friday, April 21, 2017

Quarterly Review and Commentary

THE STOCK MARKET "TRUMP BUMP" STALLS

The U.S. stock market began 2017 by delivering solid returns. The S&P 500 Index rose 5.53% and the broader Russell 3000 Index climbed 5.24%. Abundant confidence in the Trump administration's stimulative economic proposals and the expectation that economic and corporate earnings growth would accelerate drove the market higher. However, as the second quarter unfolds, "nervousness" appears to be overshadowing the market. The swift implementation of Trump's policies has now been called into question after the failure of the American Health Care Act (Trump's healthcare replacement proposal or "AHCA") that seemed possible in the days immediately following the election given a Republican-controlled Congress.

President Trump has proposed several initiatives intended to accelerate economic growth. Although it is still early in his presidency, measurable progress toward implementing these proposed policies his been minimal. With the exception of the withdrawal from the Trans-Pacific Partnership, Trump has yet to fulfill the goals outlined in his "Contract with the American Voter" with regard to promises to improve trade, economic policy, defense, health care, education, and immigration. Investors are now closely monitoring the administration's efforts regarding spending bills, an as yet to be defined tax overhaul, and a $1 trillion infrastructure package in order to gauge the probability of future political successes and failures.

MEANWHILE, AT THE FED…

The Fed reported in its March 1, 2017 publication on the current U.S. economic conditions, "The Beige Book", that 2017 has seen growth in the broad economy accompanied by increases in consumer spending, retail sales, manufacturing activity, and wages & employment. Should these conditions hold, additional rate hikes in 2017 seem plausible. The Fed is still early in the process of a "normalization" of interest rates and has recently announced its intention to begin unwinding the $4 trillion in bonds currently on its balance sheet. Doing so would involve selling the bonds to investors, thereby decreasing the money supply and, presumably, increasing interest rates. Indeed, Fed members including Janet Yellen have conceded that doing so would itself amount to a rate hike.

WHERE ARE RATES HEADED?

If the Fed does begin liquidating assets and continues to "reload the gun" by raising interest rates to a level at which rates can again be used as a policy tool (in order for the Fed to combat a recession/economic slowdown through the use of interest rates, interest rates must start from a relatively high level in order for the lowering of rates to be impactful), we could see substantially higher rates in the not-so-distant future.

INTEREST RATES AND OPTIONS

While the impact of interest rates on equity markets is a debated topic, increases in interest rates often result in increases in option prices. The most commonly used option-pricing models incorporate an interest rate in the equation. Holding all other factors constant, **higher interest rates translate into higher option premiums and higher distributions to investors of covered call overlay portfolios, such as our Dividend Income, Growth & Income, and Optimal Weight Portfolios.**

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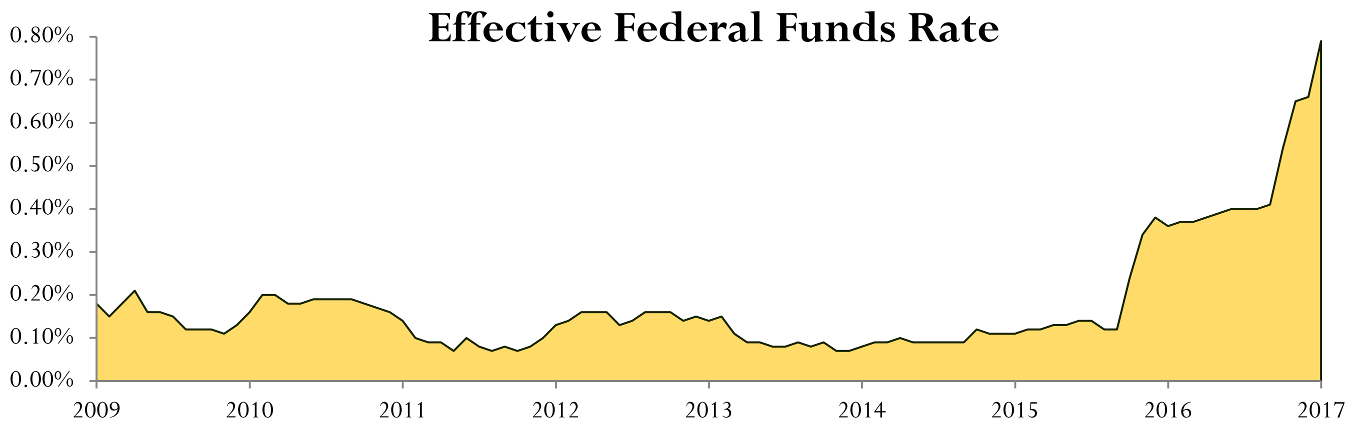


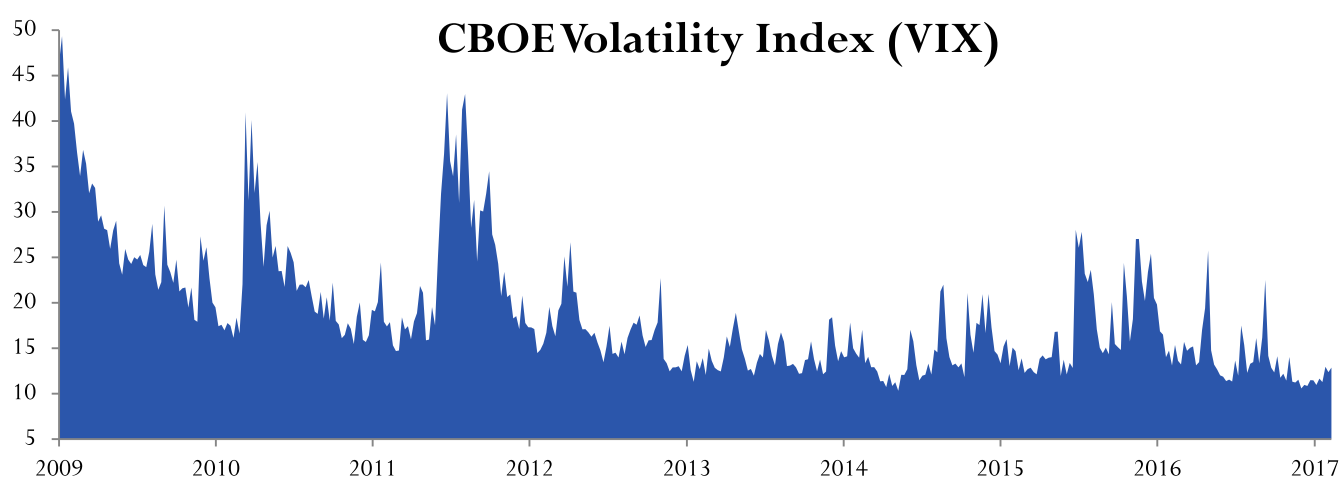
Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDFUNDS, April 9, 2017.

WHAT ABOUT VOLATILITY?

The year opened with notably low volatility. In fact, the first quarter of 2017 was the least volatile quarter for the S&P 500 in decades. Curiously, this low level of volatility has occurred in an environment in which there are considerable uncertainties on the economic, geopolitical, and corporate earnings fronts. While no one answer explains the cause of the recent drop in volatility, it is worth noting that the recent decline in stock market volatility has occurred during a period of slow yet very stable economic growth, although it is uncertain whether the two are related. Most investors surely welcome recent equity market returns at this lower level of volatility. However, such an extreme condition has historically proved unsustainable.

The CBOE Market Volatility Index ("VIX") is a widely-recognized 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.

The VIX measures the magnitude of potential changes in equity markets but does not provide an indication of the direction of the change. **Generally speaking, the higher the level of the VIX, the higher the price of equity options.** Volatility is the only variable in option pricing models that is not directly observable and has a strong positive effect on the price of both call and put option prices because it increases the magnitude of possible increases and decreases of equity prices.



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The recent "calm" experienced by equity markets is the exception rather than the norm. **The VIX is currently (as or 4/7/17) about 37% below its average level over the last ten years** and any number of events could re-introduce market volatility. While we do not make it a habit of attempting to predict the future, we recognize the following possible events as potential catalysts for an increase in market volatility over the near term:

- A failure by congress to pass a spending bill, implement tax reform, and/or secure funding for infrastructure improvements
- An increase in tensions between the U.S. and Russia as a result of the ongoing civil war in Syria
- Expanded political/military tension between the U.S. and North Korea
- Any number of missteps regarding international trade
- Increased tension in the South China sea
- Disruptive foreign elections, including the possibility of FREXIT

OUR OUTLOOK

We remain optimistic regarding the future health and growth of the U.S. economy for the remainder of 2017. Like that of many market observers, our optimism regarding the prospect of Trump policies resulting in robust economic growth over the remainder of the year has been subdued by the failure of the AHCA. However, we do acknowledge that it is early in Trump's presidency and, should Trump succeed in implementing broad regulatory reform and aggressive tax cuts, the potential for further U.S. equity market strength exists.

As we have mentioned in previous commentaries, our team welcomes interest rate increases as they may result in higher option premium yields and we expect two more rate increases in 2017. While we never wish for an event that could send markets downward, we would welcome a re-introduction of "normal" market volatility, which may also be favorable for option premium yields.

As always, we welcome your questions/comments and are available at your convenience to discuss the Portfolios.

Thank you for investing with us!