BRAVE BOAT Capital Advisors™

The Brave Report

February 2017

The melt-up continues. The market has continued to march higher since the inauguration. With all of the geopolitical uncertainty that has been driving the market this type of move has been surprising. It seems the markets continue to shrug off any negative news coming out about the new administration. The month has not been without scandals, whether real or perceived. We have seen a number of controversial executive orders, the "firing" of the National Security Advisor and more news continues to emerge about Russia's influence and yet the market doesn't seem to be impacted at all. Historically speaking, such news would usually cause the markets to take a pause or pullback as it digests any new geopolitical risks. It seems that the markets have been desensitized to any of this new risk and continue to focus on the prospects of economic growth under the new administration.

Fundamentally, there been a lot of positive signs about the economy. Earnings season has been going well, jobs reports have been good and the Fed continues to speak positively about the economy, hinting at further rate hikes. All of this helps justify the move the market has been making. However, I fear that negative tail risk and other geopolitical risks are not being properly priced into the markets. I am not saying that markets can't continue to move higher, I just think the chances of a major market moving event are much higher than they have been in previous years and should be factored in.

Market Overview

Over the last month, the S&P 500 has added just over 4% and we have seen the three major US indices all reach new all-time highs. This move hasn't happened with a few sharp one day moves, but a gradual march higher. Over the month we have only had three days with more than a 0.6% move and none higher than 0.8%. There has also only been two negative days in the last fifteen trading sessions. This gradual move is not what I expected due to all of the geopolitical uncertainty still present in the markets and I still am cautious about a short-term pullback. With that said, it is refreshing to see the markets focusing on earnings and fundamentals for a change. If some of the geopolitical uncertainty can be sorted out and some of the administration's plans start to become clearer, the market should be able to continue this move higher and may even break out to the positive side.

The fixed income space has been relatively stable over the last month, with the 10-year treasury hovering between 2.35% and 2.52% over that time frame. There have not been any real catalysts to move rates in either direction. Janet Yellen's comments earlier this month didn't shed any new light on rate increase expectations, and if anything just reiterated their current stance.

Earnings: Earnings season has been very positive by most measures. Over 70% of companies have beat on earnings and we have seen the largest number of companies expanding earnings estimates since 2011. These earnings seem to be pushing the markets on a daily basis and helping to justify what many feels has been an overvalued market based on forward price-earnings ratios.

Any Trump influence will not be seen in current earnings numbers but the adjustment of forecasts tell us that most companies are positive about the economic prospects under the new administration. The prospects of new trade policy, tax reform, and the overall global growth outlook are

Current Overweight
Technology
Small-Cap US
Industrials
Financials

Current Underweight
Fixed Income
Europe

being viewed positively. Even without any concrete plans in either of these areas, companies seem to be optimistic about the direction of the economy.

Negative news, no problem: As positive as earnings season has been, there is still a major geopolitical overhang in the markets and the economy. With each day, seems to come a new outrage or controversy with the new administration but the markets don't seem to care. It is good that the markets are not overreacting to every new story but I am surprised that more of this news isn't being priced in. There is still a significant amount of uncertainty surrounding the new administration and increased fear about Trump's unpredictability. This kind of unpredictability would normally cause an increase in fear in the markets and yet the VIX (a gauge of volatility in the market and often seen as a measure of fear) is still very close to its 52 week low. As mentioned earlier, I am wary of the tail risks in the current market and I don't think that the VIX is fully factoring that in.

Trump Policies: Outside of the initial barrage of executive orders, which focused primarily on immigration and the Affordable Care Act, we are still in a wait and see mode when it comes to the economic policies and priorities of the new administration. Paul Ryan indicated earlier this month that they won't begin to tackle the issue of tax reform and infrastructure spending, both key priorities of Trump's campaign, until later in the spring. At that point, we will hopefully start to get a better idea of what the administration will try to push through. Until then, everything is just speculation and it seems like any speculation is primarily viewed as positive.

Most of the news that is coming out about the administration has had more to do with immigration and foreign policy issues. While these areas do not directly impact the economy in the short term, it will be interesting to see how these issues continue to be perceived by the markets. So far they haven't seemed to have any meaningful effect but at some point, I wouldn't be surprised to see them become a drag on the markets, especially when it comes to currencies and trade. Further, if a border tax is proposed and comes to fruition in some form, we could see a sharp move up in the dollar accompanied by a rise in inflation as companies raise prices to account for the tax.

Strategy Commentary

With the markets' continued rise we have patiently maintained our allocations and not made any major changes outside of regular rebalances. The run-up of the last month has seemed to have lifted most sectors so we are still cautious about making any widespread changes to our allocation.

I continue to maintain a bias toward the US. I am still watching some international positions but have only dipped my toe in a little, adding some German exposure for a short time, which I have since exited. Germany still intrigues me from a valuation standpoint but does not seem to be outperforming yet. I have been watching emerging markets and some developed Asia closely, as they have outperformed so far this year but have not increased either of these allocations.

I am maintaining my overweights to financials, industrials, technology and small cap. Earnings releases in these areas continue to justify these sectors and I think they all have room to run. The only major shift I am thinking about adding is to buy some protection for any potential negative tail risk events. I think the market can continue to climb but I want to be insulated should something major happen to the negative side. I haven't added this protection yet but will be looking for an attractive entry point over the next few weeks. With volatility at such low levels, this protection is currently cheap.

I am still negative on fixed income and will continue to maintain more cash as a replacement for these fixed income allocations.

Please reach out to us directly if you have any additional questions or would like to arrange a free initial consultation to assess your needs and understand more about our services.

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