



A TALE OF TWO MARKETS: RISK ON OR RISK OFF?

It was the best of time, it was the worst of times

A Tale of Two Cities (Markets)

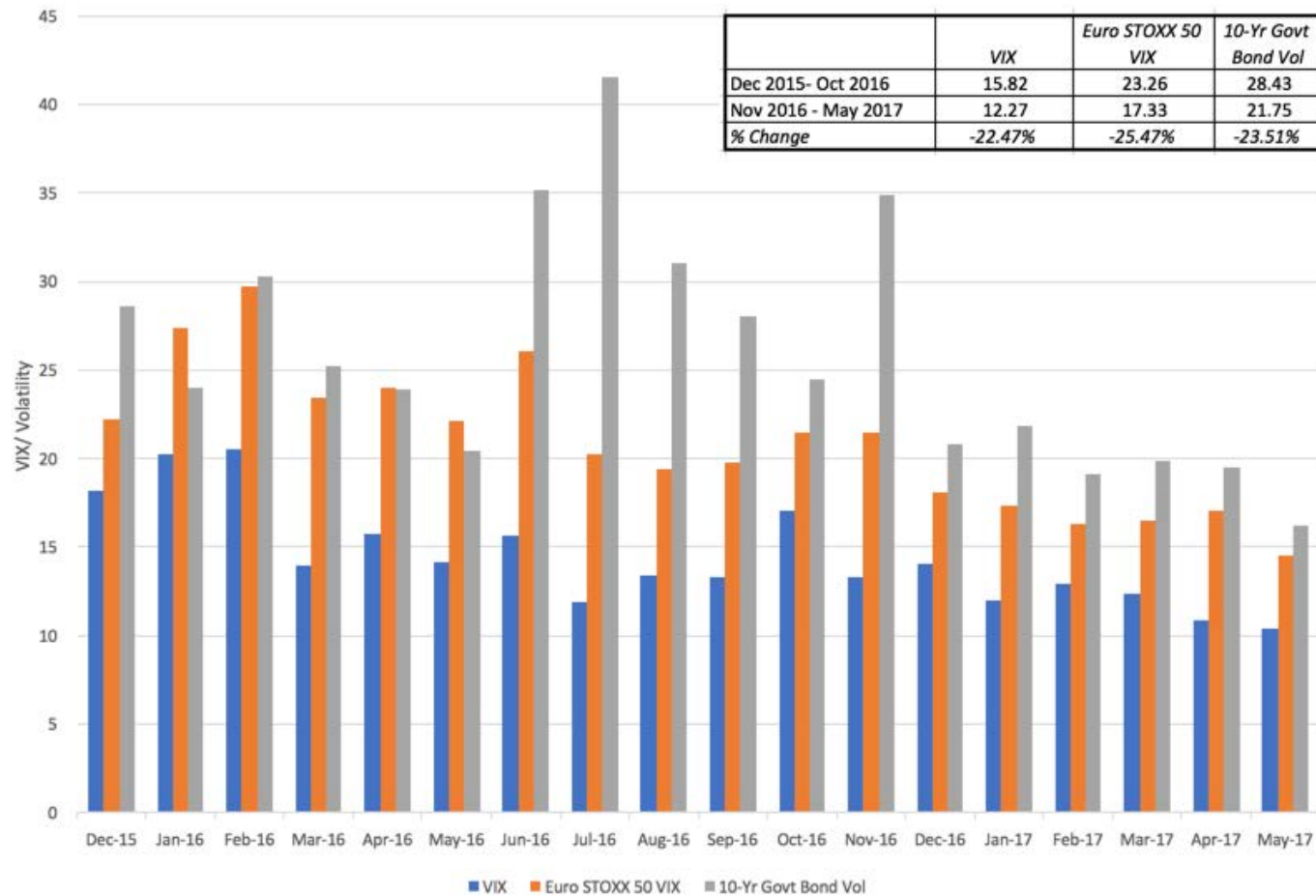
- "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way."
- While disagreement among market participants has always been a feature of markets, seldom has there been such a divide between those who believe that we are on the verge of a massive correction and those who equally vehemently feel that this is the cusp of a new bull market, and between those who see unprecedented economic and policy uncertainty and market indicators that suggest the exact opposite.

Equity Risk: The Divergence

- Risk off: Market Indicators of risk including the Volatility indices, bond yield volatility and default spreads are all down significantly since November 2016.
- Risk on: Measures of economic policy uncertainty have spiked since November 2016.

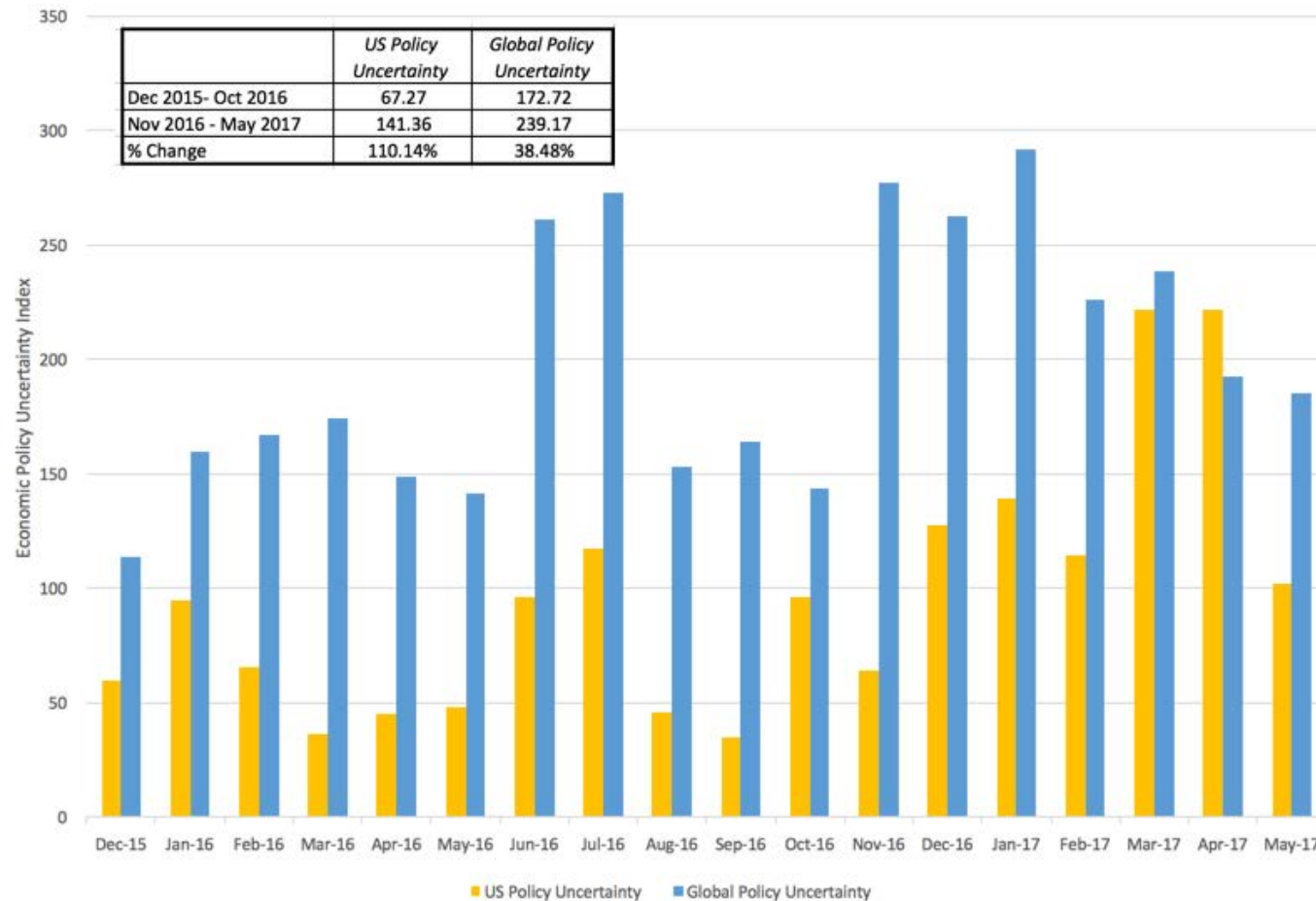
Stock Market Volatility

Risk Off? Market Measures of Uncertainty



Economic Policy Uncertainty

Risk On? Economic Policy Uncertainty Indices



Fund Flow

- The ultimate measure of how comfortable investors feel about risk is whether they are putting money into stocks or taking them out and fund flows have historically been a good measure of that comfort.
- Put simply, if investors are wary and risk averse about an asset class or market, you should expect to see money flow out of that market and if they are sanguine, you should see money flow in.

Funds in?



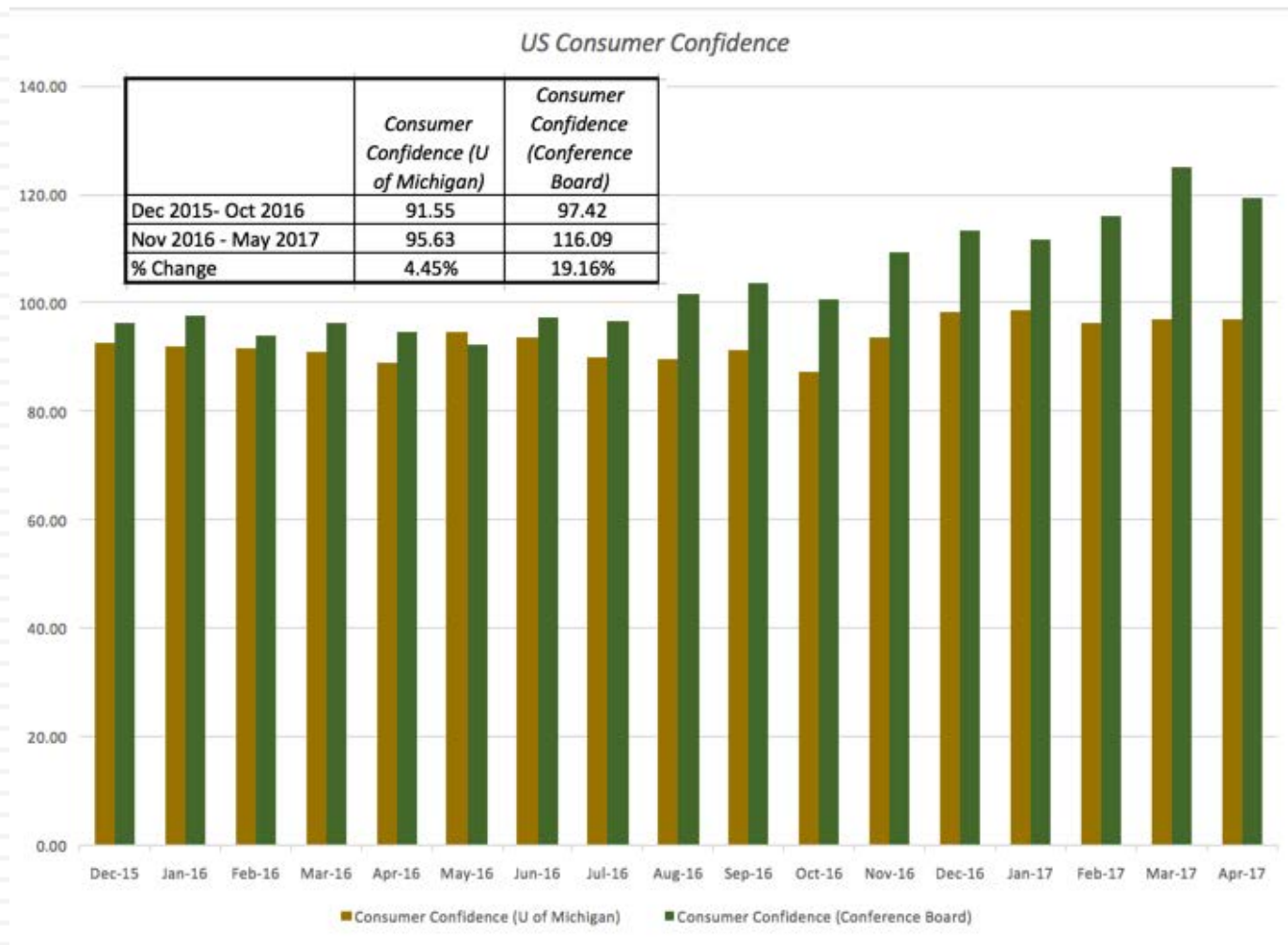
Funds out?

- The perennial market bears have become even more bearish, with concerns about macroeconomic risk augmenting their long-standing concerns about stocks trading at high PE ratios.
- There are big name investors who are cautioning that a market correction is around the corner, with Jeff Gundlach being the latest to argue that it is time to sell the S&P 500 and buy emerging market stocks.
- There is some evidence that money is leaving US stocks, with the Wall Street Journal reporting that money going into US stocks is at a 9-year low, while inflows into European stocks hit a five-year high.

Confidence up, Spending meh!

- Ultimately, risk does not come from market perceptions or newsletters but is reflected in consumer and business mood and behavior.
- The mood indicators (consumer and business confidence) are flashing green.
- The spending indicators (consumer spending and business investment) are not showing the same robust growth.

Consumer Confidence



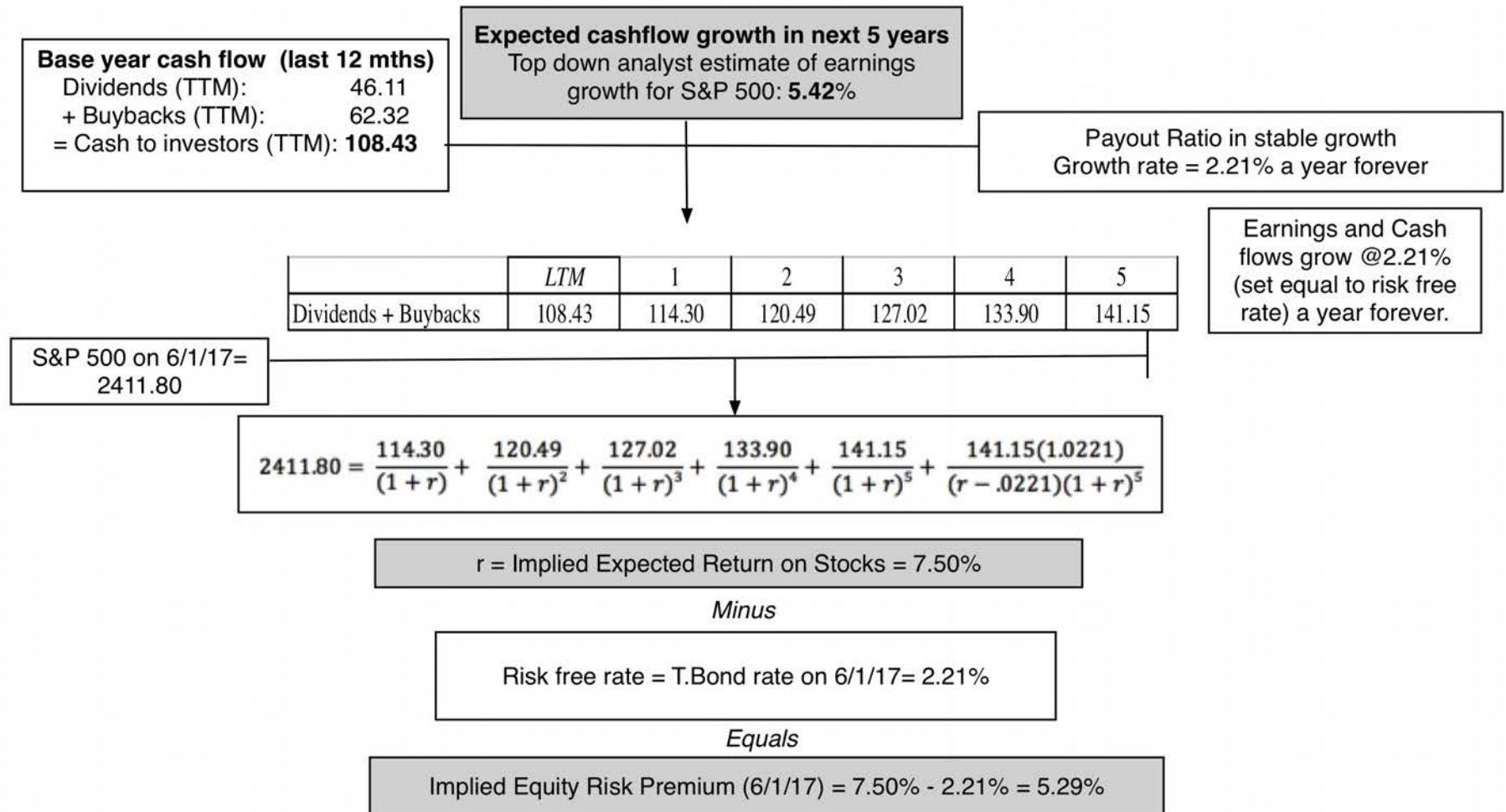
Consumer Spending



Explaining the Divergence

- Markets have become inured to crises: Investors, after a decade of market crisis after market crisis, have learned to roll with the punches and ignore experts who predict doom.
- Disagreement about economic policy changes/effects: It is also possible that economic pundits and investors are parting ways on both the likelihood of economic policy shocks and/or the consequences.
- Politics first, analysis later: It is no secret that we live in partisan times, and investing increasingly reflects political partisanship.

My tie breaker: The Implied ERP on June 1, 2017



In perspective..

Implied ERP and Risk free Rates

