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BAYSTATE WEALTH MANAGEMENT

Battling Recency Effect

Since this market has yet to see a headline it didn't like, many investors are expecting a continuation of low volatility and higher market levels into the fall and winter months. Similar to a law of physics, which states that "things in motion, stay in motion," many investors "feel" that this strong market will continue for the foreseeable future. Much of this stems from the fact that Mr. Market seems to be shrugging off presumably "scary" events, both here in the US and abroad.

However, for an investor to be content with what the market gives at a given point in time may not be the best approach. This tendency to accept the market in its current state, and to presume that it will continue in its current direction, stems from a common cognitive tendency known as "recency bias." Recency bias is a behavioral issue where an investor (or person in general) believes that whatever has happened most recently will continue, without regard to unforeseen variables in the future. This is a bias/problem all investors must be aware of, and battle, on an ongoing basis.

To fight off some of this recency bias, we recently shared a letter with clients outlining some potential headwinds facing the market. Based on the feedback we received, it seemed appropriate to share these views more broadly beyond just our clients. That said, some of these items may be repetitive for certain readers, although they could be new topics for others. Regardless, these topics, like that of interest rates, valuations, and geopolitical concerns (namely North Korea) do warrant attention.

As professional investors, our focus is not predicting a response to any given event, as that can be a fool's errand. Our focus is, and has always been, on potential steps which can be taken to prepare for many potential outcomes. Of the short list laid out above, the toughest to prepare for seems to be those involving geopolitics. This is mainly because geopolitical events typically arise suddenly and are hard to predict with any accuracy, at least in timing, size and scope. Looking at the most recent concerns with North Korea, it is unclear to many investors what President Trump's response will truly encompass, beyond his relatively "aggressive" public statements. Is this a true harbinger of military action, or simply a way to deflect attention from the administration's inability to move forward with its agenda of health care, tax reform, infrastructure spending and job creation? Regardless, when dealing with humans and governing bodies, one must look at a situation like North Korea as being fluid, as opposed to reacting in a way that is completely defensive.

In contrast to geopolitical events, interest rates and valuation concerns are more capable of prediction and are a more transparent variable. Interest rates and valuations are the outcome of buyers and sellers, with asset prices reflecting this activity. While current valuations are a function of price and expected earnings, it is the interest rate environment that may be the most concerning in terms of future expectations. Recall that since 2009, the Federal Reserve (the "Fed") has engaged in multiple stages of Quantitative Easing ("QE"). These QE programs have driven interest rates to historic lows, where they have remained for a long time. To complicate this a little, there are two aspects that are of potential concern regarding the end of QE.

First, the Federal Reserve has begun to raise its benchmark interest rate. These changes in rates affect the cost of borrowing by major banking institutions with a "flow through" effect to consumers. These rate announcements by the Fed have been somewhat orchestrated with a high level of transparency. This level of transparency, which is relatively new for the Fed compared to prior regimes, has allowed the market to set reasonable expectations. Thus, the rate decisions may have created some short-term noise, but have been non-events for the most part, given that the market had expected the hikes in advance.

The second aspect of the end of the QE program, is how the Federal Reserve will handle its massive balance sheet. Recall that prior to the crisis of 2008, the Federal Reserve owned and managed roughly $800 billion in US Treasury bonds. The holding of and transacting in these bonds is how the Fed can create or reduce liquidity at any given time based on economic cycles. So, holding bonds on the balance sheet is not an issue in and of itself. However, in the years since 2008, as part of the multiple QE programs, the Fed came to the market to buy bonds on multiple occasions, and now owns roughly $4.2 Trillion in US Treasury and Agency bonds (mortgage bonds). These purchases were made after exhausting all other options with an eye toward continuing to ease credit in the US economy. (Lower interest rates allow companies to borrow money in the bond market at lower rates and helps with leverage.)

The concern now is how the central bank will "unwind" or reduce its massive balance sheet, to get back to a level somewhere between the current $4.2T and the original $800 billion in bonds. And further, it is unclear how the bond (and the stock) markets will be effected when the Fed is no longer buying bonds in the open market. But what we do know is that in an environment of historically low rates, the stock market has taken off to new highs. This has led some to believe that there is a correlation between the recent strong bull market in stocks and the ultra-low interest rate environment since 2009. Thus, the concern currently is that if there is a relationship between low interest rates, somewhat rich equity valuations, and high asset prices, will the reverse be true once rates rise? Beyond not knowing when rates will rise, no one knows how the stock market will respond in general to a lower degree of Fed involvement, because there is no historical precedent, beyond raising benchmark rates in a traditional tightening cycle.

These concerns surrounding the Federal Reserve and its eventual unwinding are not new, at least not new in the last year or two. Nor are the threats and actions out of North Korea, but in a battle to fight off recency bias, the question we face, as money managers, is how to best position a portfolio. As for portfolio positioning, remember there are three basic asset classes available to investors: stocks, bonds, and alternatives.

Bonds

First and foremost, rising interest rates directly affect most bonds. As rates go up, bonds lose value, with bonds of longer maturity being more sensitive to rate movements. (Intuitively, think of it this way, if one owns a 5-year bond with an interest rate of 1.5%, but can now buy a new 5-year bond issued by the same company or government at an interest rate of 2%, that makes the original bond not as valuable.) So, if an investor is concerned about interest changes, and specifically that interest rates will increase at some point in the future, one might suggest that investors position their bond exposure with a bias toward short-term bonds. This means that on average, when a 1 or 2-year bond matures, the proceeds can be reinvested in new bonds with presumably higher interest rates than the ones that just matured. Of course, it is important to keep in mind that we have been here before, a place where it seemed obvious that rates will go up. In the last few years, while the belief may have been for rising rates, the reality is that rates have been rangebound, with a trend toward going lower, not higher.

Based on our current outlook, it seems prudent to hold short-term bonds with a lower level of interest rate risk. Of course, as with all decisions, a short-term bond position might come at the cost of forgoing a potential higher rate of return if rates do not increase for some time. This is a risk we are willing to bear, as we are more comfortable with a lower rate of return as the trade-off for a lower level of risk of loss when rates do rise. Further, investors should think of bonds as a diversifier from risk markets, and an instrument that offers some yield, and not to view them as opportunities for high returns.

Stocks

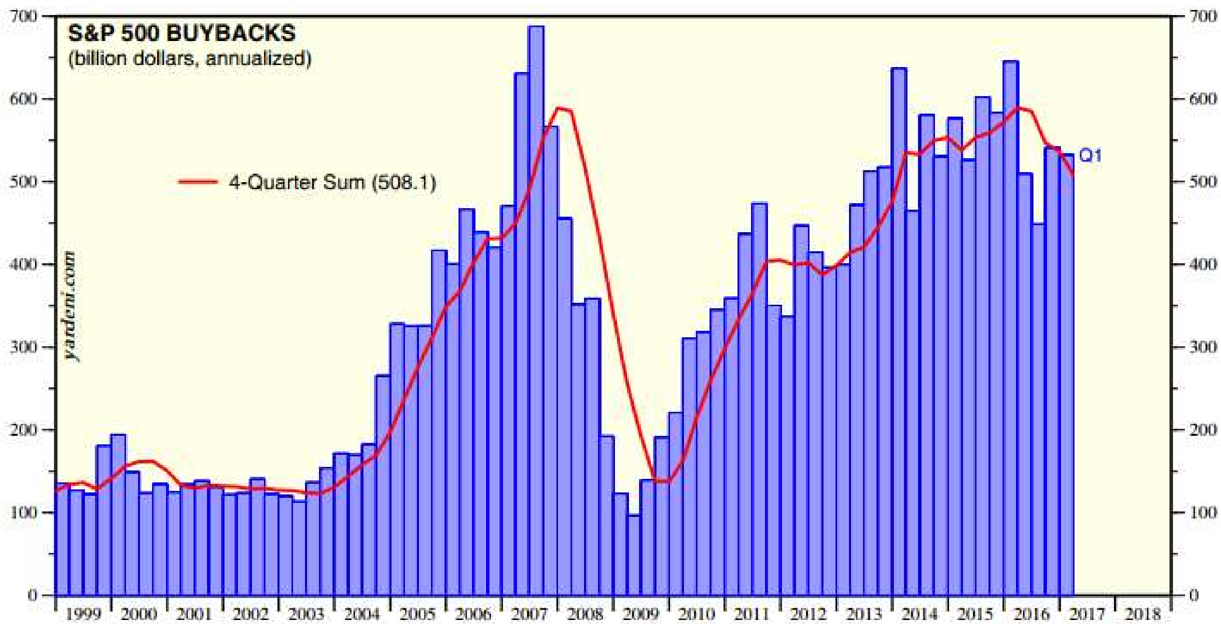
The second part of this equation, in preparation for a rising rate environment, is how to position stocks. This question of positioning comes from the concern of how higher interest rates might affect stock market valuations. From a simplistic point, here is an example as to how higher interest rates on bonds may affect one's decision to buy/own stocks.

If an investor has a choice of whether to receive a 4% interest rate on a 10-year government bond, or have the risk of the stock market with the potential for a greater return over ten years, the choice is not always simple. One of those investments (the bond) is presumably risk free and the other (the stock market) is risky with no guarantees. Since most investors are risk adverse, the payoff of a 4% return typically offsets the risk for higher returns in the stock market (especially true for pensions).

However, this option to own a high-grade or US Treasury bond yielding 4% has not been available to investors for more than 10 years, resulting in the phenomena known as "TINA" which stands for: "**t**here **i**s **n**o **a**lternative." TINA is a function of the fact that 10 year bonds are paying around 2% (give or take), and that inflation is running around 1.5-2%, so the net (or real) return is very little, if anything at all. This low to zero return on bonds has led many investors to reach out on the risk curve for a better growth rate over inflation, thus buying stocks for the hope of a higher return.

To complicate matters even more, some companies have issued debt (bonds) at these historical low rates only to use the money received in return to buy back their own stock. While this trend of stock buybacks has been slowing, per the chart below one can easily see that buybacks have been very strong over the last 4-5 years. This rather strong buying spree of risk assets has inflated stock market prices to all-time highs, and led to above-average valuations.

Chart 1: S&P 500 Company Stock Buybacks, Billions, Annualized



Source: Standard & Poor's Corporation.

In fact, per research done by one of our analysts, Ethan Somers, CFA, corporations have been among the biggest buyers of stocks during the stock market's recovery from the lows in 2009. Per the chart below, corporations have been increasing their purchases of stocks, and may have their biggest year in 2017, with an estimated $800 billion in stock purchases. Actually, without corporations buying stocks, this market would be seeing net sellers of stocks from 2010 through last year. These massive corporate purchases are not dissimilar to the massive buying spree of the Federal Reserve in the bond market. (Keep in mind, if there are more buyers than sellers, the price of the security tends to rise.)

Chart 2: Goldman Sachs forecast of 2017 US equity demand, Billions, Annualized, as of January 4, 2017

	Net US equity demand								
Category	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016 Ann.**	**2017E**
ETFs	$ 42	$ 80	$ 69	$ 124	$ 197	$ 191	$ 174	$ 89	**$ 200**
Mutual Funds	106	69	7	(46)	197	94	56	(96)	**(50)**
Foreign Investors	194	131	48	137	(58)	117	(187)	(148)	**25**
Life Insurance	0	9	15	(3)	(13)	(5)	(3)	(6)	-
Pension Funds	(57)	(47)	(152)	(104)	(378)	(313)	(179)	(127)	**(175)**
Households	(13)	(225)	(253)	(183)	138	168	16	34	**(400)**
Other	84	45	75	11	38	24	(4)	(36)	
less									
Foreign equities by US	(64)	(79)	(7)	(104)	(287)	(432)	(203)	(139)	**(150)**
Credit ETF purchases	(46)	(30)	(46)	(52)	(12)	(52)	(55)	(94)	**(50)**
Net flow ex- corporations	**247**	**(47)**	**(245)**	**(220)**	**(178)**	**(207)**	**(385)**	**(523)**	**(600)**
Corporations	(15)	219	416	370	369	403	561	644	**800**
Total net US equity flow	**$ 233**	**$ 172**	**$ 171**	**$ 150**	**$ 191**	**$ 196**	**$ 176**	**$ 122**	**$ 200**

Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Of course, as always, we are not investors at the extremes. So, while valuation and interest rates pose concerns for the stock market, they are not a cause for panic. Since beginning my career in 2001, I have seen markets rise and fall for many different reasons. Throughout it all, however, one thing that has proven true is that in the end, over time, stock markets increase in value (of course the ride may be rough at times). While this time may feel "different" because of the historically low interest rates and the historically high level of central bank involvement, the stock market will prevail in time, regardless of short term pullbacks and noise. This is not to say that one cannot take a tactical underweight to stocks, and maybe not "love" them in this environment, but it is to say that the panic button should not be hit, and risk tolerance should prevail as reasoning behind a position and not market concerns broadly speaking.

Alternatives

Looking at the third leg of our investment stool, it is important for investors to be aware of opportunities in alternatives. For simplicity, we refer to any investment that is not a pure stock or bond as an alternative. Further, the types of alternatives we are referencing here are those that trade daily and have high levels of liquidity, unlike that of Private Equity of some types of hedge funds. It is our view that through positions in alternatives, portfolios can be somewhat insulated from volatility in either the stock or the bond markets. Keep in mind that alternatives also can be a meaningful source of return and diversification. And while the return stream from a given alternative may not have been as strong as what one might have received from the stock market currently, the alternative does provide good diversification away from the potential risks present in both the stock and bond markets. And, as has often been the case, true diversification exists when different asset classes perform in different ways.

Going Forward

It is our hope that the Federal Reserve's unwinding of their balance sheet, and the presumption of rising rates, will be somewhat orderly, but neither is guaranteed. Keeping in mind that the Federal Reserve's level of intervention over the last 8-9 years is unprecedented, therefore so too will be the central bank's exit. And, with these factors at play, it's anyone's guess how all markets will react. Regardless, as fiduciaries and stewards of our clients' capital, we believe a cautious level of positioning within Risk Assets is a prudent approach to what may become even more interesting times.
To be clear, this commentary is by no means advocating for or even arguing that the stock market is poised to fall in the imminent future. However, it is our belief that there are risks posing some threats to this current run in stock prices, and that investors should be aware of the potential for recency bias.

As always, please call on us if we can be of service.

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