LWM Market Commentary
May 28th, 2017

Dear Clients and Friends,

I spent most of this past week in Orlando, Florida at the Strategic Investment Conference. It is always well attended. More importantly, it attracts a very diverse group of "A-listers" in the economics / geopolitical / "market thinkers" world. Accordingly, I wanted to share some of the more interesting topics of discussion from the week. This is not meant to be an exhaustive review of the economy and markets. Rather, as is always the case in my writings, it is meant to discuss the most interesting things that are NOT generally being talked about in the financial press.

What if Trump Is Impeached?

Markets will likely react to a Trump impeachment in much the same way they reacted to his improbable victory in the general election. Futures markets were down extremely hard overnight when Trump won the election. But by the close of the first day of trading post-election --- the markets were up quite nicely. Seems like people changed their mind on whether Trump would be good for business literally overnight. And the markets have essentially been in rally mode ever since.

In the same way, I think it is likely that markets may draw down hard at first --- and then rally quite strongly. Why? Because a Trump impeachment implies that Mike Pence will replace him. Vice President Pence is widely regarded as more pro-business than Trump. And he is a seasoned politician who knows his way around Washington. I think it is likely that "the markets" would ultimately perceive Pence as the best parts of Mr. Trump. Without some of the baggage.

(Incidentally, my own opinion is that an impeachment is unlikely. After several months of intense investigation there seems to be no material evidence of an impeachable offense. Without a "smoking gun", our Republican-controlled Congress will not likely feel compelled to even attempt impeachment hearings.)

Federal Reserve Board Appointees

Much has been made of Trump's opportunity to potentially appoint several Supreme Court justices over the course of his presidency. However, nobody is talking about his opportunity to appoint new members to the Federal Reserve Board. This 12-member Board is responsible for "managing" the U.S. banking system/economy and by extension the world economy. And it was this Board that embarked on QE (quantitative easing) and ZIRP (zero interest rate policy) in response to the Great Recession. While initially helpful, it remains to be seen what the unintended consequences of those policies may yet be.

There are 5 temporary board members who rotate onto the board from the various district banks around the country. But the 7 permanent board members who serve 14 year terms are appointed by the President. There are 3 vacancies right now. 2 more members will likely roll off early next year. (Janet Yellen, Chairwoman and Stan Fischer, Vice Chair will likely resign after their leadership terms are up --- even though their 14 year terms are not completed. They can earn big money in the private sector after serving in those leadership positions.) That gives Trump the ability to replace 5 of the 7 permanent board members within a

year. That is a big deal --- and will likely re-shape how the U.S. economy is managed. It is entirely possible that this shift in management might be very healthy in the long term --- but it may also introduce substantial pain in the short term.

Regulatory Complexity coming down

President Trump is trying to simplify and lower taxes on corporations as well as middle class Americans. He is also attempting to repeal portions of Dodd Frank (banking legislation). He has made a concerted effort to "talk up" reducing regulatory complexity. But even if he is not able to get any legislative changes accomplished --- he IS appointing pro-business people to the posts that enforce all of the laws that are currently in place. I believe that this power of appointment is quite significant --- and can substantially reduce regulatory friction on vast swaths of American business without any legislative changes. (Think EPA, FDA, SEC, DOL…) This is a much bigger deal than the markets realize.

ETF Risks

As you may know --- ETFs (exchange traded funds) are taking over the investment world. In 2005, there were approximately 200 ETFs. That number has grown to more than 2,000 today. Over $1 trillion has flowed into ETF products since 2005!

But more importantly, ETFs have changed the way we invest --- or should I say speculate. For example, the Vanguard S&P 500 Index mutual fund has an annual turnover rate of 42%. (Turnover rate is the % of fund shares that change hands annually.) Mutual funds can only be traded once a day --- at the end of the trading day. The popular and comparable iShares S&P 500 Index ETF --- which holds the exact same underlying positions as the Vanguard S&P 500 Index fund --- has an annual turnover rate of 3,507%. That is an obscene amount of trading… which is possible because ETFs can be traded every second --- all day long.

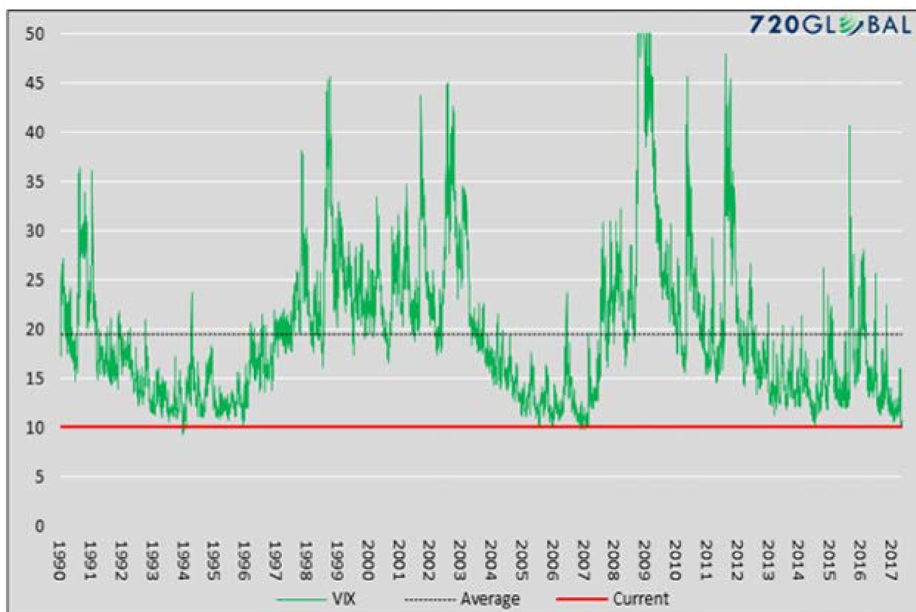
This trading activity is distorting certain markets --- because the ETFs are creating the illusion of liquidity. For example, the fact that you can trade an ETF for Emerging Market High Yield Bonds every second of the trading day hides the fact that the underlying securities inside that ETF are often far less liquid (meaning they can't be traded so quickly because there aren't enough market participants who care to trade them). In a "normal" market this is not a problem --- as the buys and sells at the ETF level cancel each other out --- and the underlying holdings of the ETF are not required to change dramatically. In fact, as the ETF becomes more popular it can actually raise the price of the underlying holdings --- when the ETF becomes virtually the only buyer of those underlying positions.

However, when we have the next recession/significant market correction, all of the trading activity will be in the opposite direction ---- SELL! And at that point markets will test the liquidity of the underlying holdings as ETFs reduce their holdings at the exact same time that they discover they were the only buyers in the first place. I believe that most investors are completely unaware of this liquidity risk that is likely lurking in the higher risk holdings of their ETF portfolios.

(Hat tip to Steven Bregman on this. For his much more thorough explanation of this phenomenon, see the following link: https://vimeo.com/209940152/f2154e4d3d.)

Volatility is Low

The VIX is an index that has been used to measure volatility for decades. Low numbers represent quiet and generally good markets. In fact, the VIX generally experiences its lowest readings when markets are at or near their peaks. Conversely, high VIX numbers generally show up in recessions and strong market corrections. Check out the following chart (taken from one of John Mauldin's recent "Outside the Box" posts):



As you can see, we are at historic lows on the VIX --- below 10. This is not sustainable long term…

Wrapping Up

Of course, at Laureate Wealth Management, we are focused on sourcing and holding alternative investments to compliment traditional holdings that can perform well in both rising and falling markets. The more we can do so --- the less dependence we have on guessing correctly when to get out of the market before the next big correction. I have no idea when that will actually happen --- but market corrections are as certain as death and taxes.

Please feel free to reach out with any thoughts or questions. I really do enjoy the feedback --- both positive and negative.

Kind Regards,
Jeremy Boynton