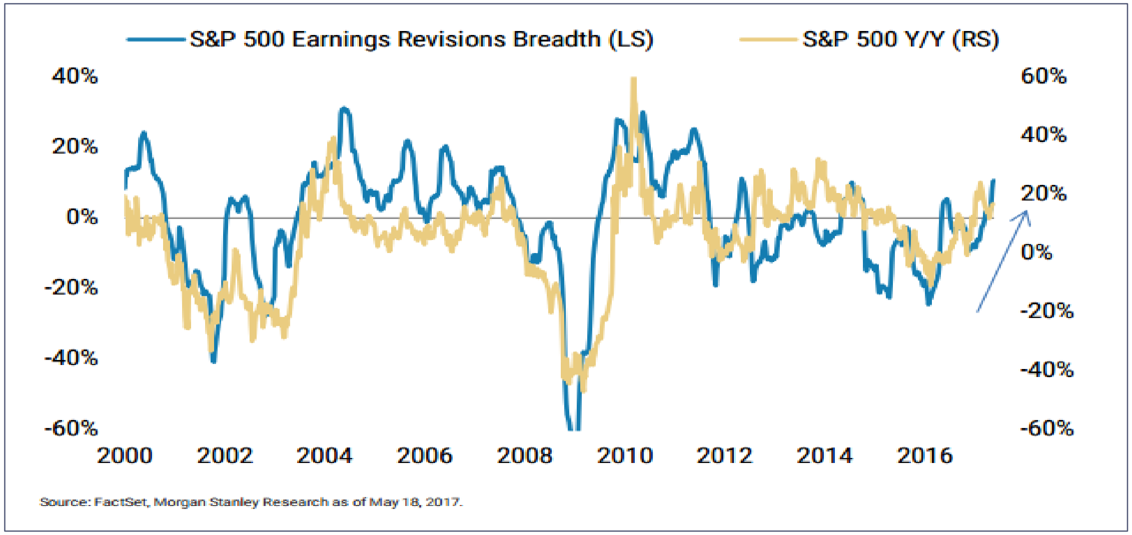
Market Recap

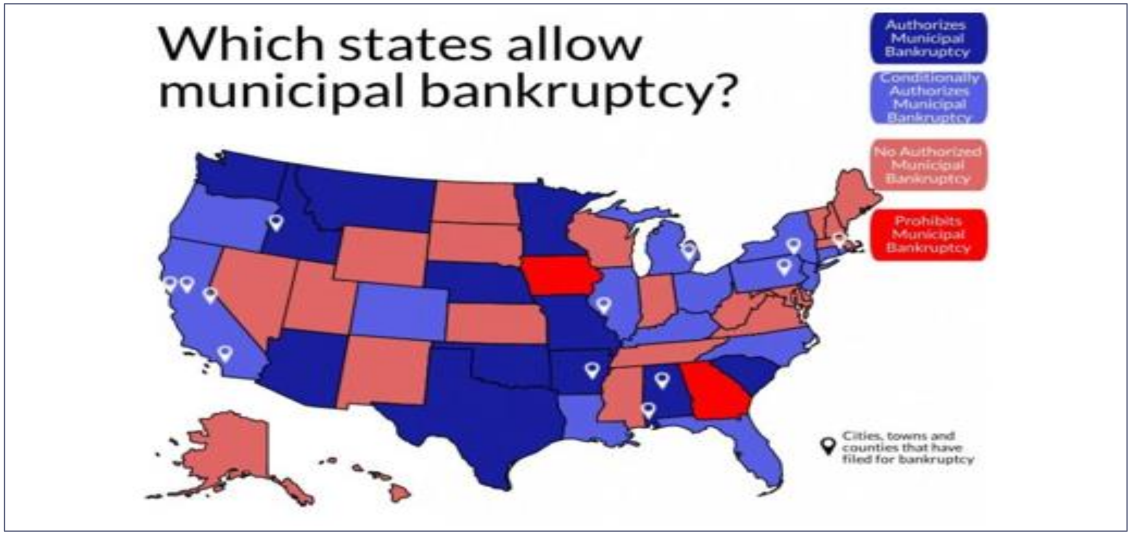
Reading the Tea Leaves on Earnings Revisions



Source: Morgan Stanley

Corporate profits are off to a strong start in 2017, as 1Q17 earnings surged +14% y/y, a marked improvement from the -7% y/y figure from the comparable period one year ago. Given the historical longevity of the current economic recovery, however, some investors question the sustainability of this trend. One reason for optimism is the increasing breadth of earnings revisions that has accompanied recent profit growth. The breadth of earning revisions (i.e. the proportion of companies revising earnings higher) tends to correlate highly with equity market returns. Following first quarter results, the breadth of these revisions now stands at its highest level since 2012. Based on a Morgan Stanley study, over the past 25 years, anytime earnings revisions' breadth improved by +15% over a 3-month timeframe, subsequent 12-month equity market returns have averaged +12.6%. While based on historical performance, these figures may give us some confidence that current earnings momentum is sustainable.

The Changing Landscape of Municipal Bonds



Source: PBS

One of the most attractive and frequently cited aspects of municipal bond investing is very low default rates relative to other debt markets. General Obligation (GO) bonds have only experienced nine defaults from 1970-2005, translating to an annual default rate of 0.003%. In the last 24 months, however, two situations (Illinois (credit downgrade) and Puerto Rico (default)) triggered investor concerns that the pace of such credit events may be on the rise. The Illinois downgrade was fueled by a perpetually underfunded pension obligation (a condition that afflicts many municipalities today), while Puerto Rico's default was marked by a 24% haircut on the government-backed money that bondholders were initially owed. In particular, Puerto Rico's default – and the fact that the territory was allowed to declare bankruptcy – stoked fear among investors and may drive the cost of debt issuance upward for many weaker municipalities in the future.

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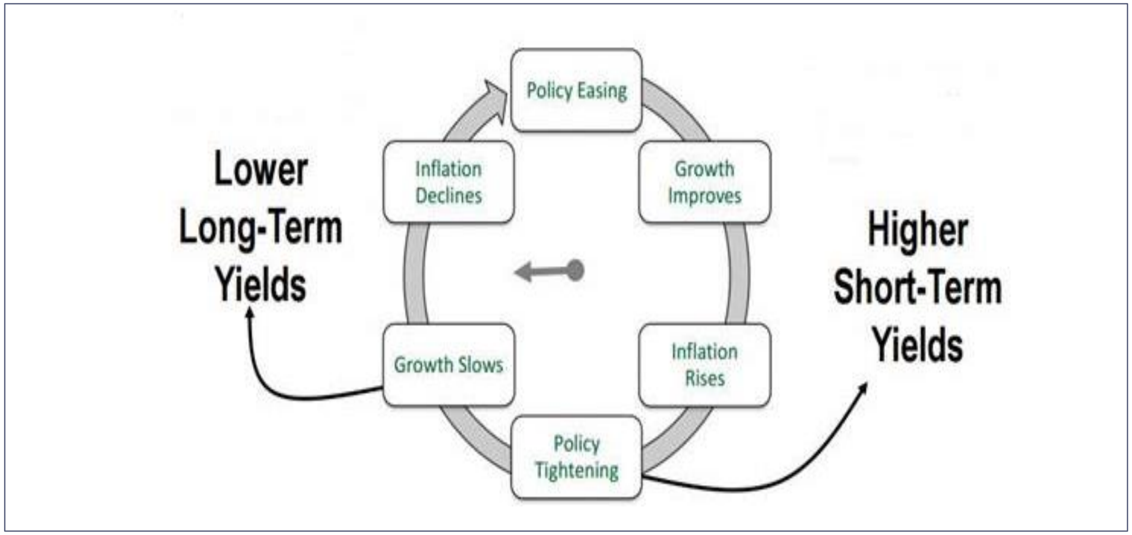
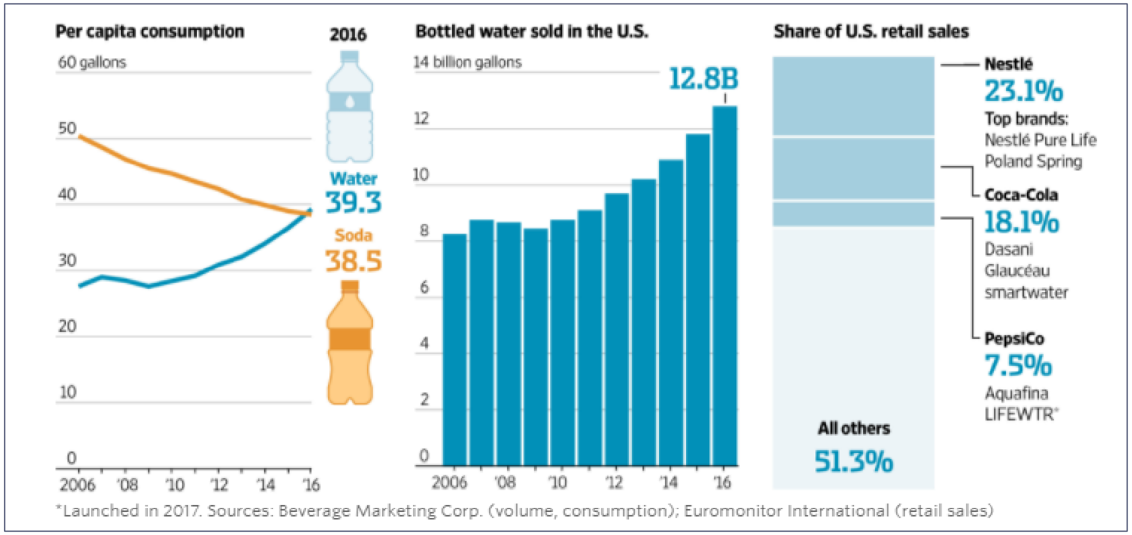
A Different Pattern for Fed Tightening Cycles?



Source: Cornerstone Macro

Bottled Water Sales Surpass Soda Sales in 2016



Source: Wall Street Journal

The Fed's dual mandate is deceptively simple: to maintain high domestic employment and stable prices for consumers (i.e. mitigating inflation swings) throughout the business cycle. The main tool the Fed uses to influence the economy is interest rate policy – higher rates tend to slow the economy down and curb inflation, while lower rates encourage incremental borrowing and demand. In light of recent stronger employment numbers, many market participants have been expecting a rate hike cycle to follow. However, softer core inflation readings and falling bond yields suggest that short-term rates may be unlikely to move materially higher anytime soon. Given the bifurcating evidence around employment and inflation, some economists argue that we are experiencing a wrinkle in the traditional pattern of Fed activity. Rather than trying to explicitly tighten financial conditions in anticipation of an overheating economy, the Fed's near-term priority is simply to normalize policy conditions to provide it with the latitude to adjust rates higher or lower depending on future data.

Over the last decade, sales of sugary drinks have experienced a steady decline as Americans grow increasingly health-conscious, opting instead for bottled water. In the U.S., 2016 marked the first year in which bottled water out-sold soda, 12.8 billion gallons to 12.4 billion gallons. In 2016, the average American consumed 38.5 gallons of soda, down from 50 gallons in 2006. Bottled water sales have charted the inverse trend, rising from per capita consumption of 27.6 gallons in 2006, to an all-time high of 39.3 gallons in 2016. Despite the growing popularity of bottled water, its manufacturers struggle to cultivate the brand loyalty that drives the soda industry, given the uniformity of the product. As a result, the soda market remains more profitable, generating $39.5 billion in 2016. Bottled water sales totaled $21.3 billion, with falling prices exacerbating the industry's already-low profit margins.

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