

Morning Markets Briefing

Market Commentary: May 3, 2017

A snapshot of the markets through the lens of Convergex.

This presentation is not intended for retail clients.

Stocks finished higher on Tuesday amid a slew of corporate earnings reports. (Dow +0.17%, NASDAQ +0.06%, S&P 500 +0.12%). The Nasdaq closed at a record (6,095.37). Crude-oil futures fell 2.4% to \$47.66 a barrel, and gold futures rose \$1.50 to \$1,257 an ounce. Industrials and health care outperformed, while energy and consumer staples trailed the broader market indices. Small-cap stocks declined: Russell 2000 (-0.57%). The VIX increased 4.75% to 10.59. In economic news, Gallup's Economic Confidence Index averaged plus 5 in April compared to plus 9 in March.

VIX and Volatility – Follow up Thoughts

Summary: Last night's note on the lack of US equity market volatility drew the strongest reader response of anything I've written this year. The primary reason for the interest: volatility drives trading volumes, and those ultimately determine the health and corporate strategies of many Wall Street businesses. Over the course of today I had several in depth discussions with a wide range of partner-level industry executives. Those led to some follow-on topics I will outline in this note. The big question: how long can this period of protracted low volatility last? Also in the mix: what role does current US equity market structure play, and what conditions cause lasting (rather than transient) volatility? My answers below...

I know what you care about. OK, not at a deep emotional level... But the email software we use to send out this note registers when you open it and how long all of you collectively spend reading it.

Thanks to that system (and a catchy title), I know that the readers of this missive care more about the current low levels of US equity market volatility than they do about Donald Trump, US equity valuations, or even the history of famed NYC nightclub Studio 54. Last night's note "A VIX Below 10 Means This..." had more opens and careful reads than all of those other recent topics. Over 750 of you even took time out of your personal time in the evening to read it between 9pm and midnight....

That interest spilled over to today, and I had the chance to have in depth conversations with a variety of MD/Partner level executives across the Street. They weren't so much interested in what a low VIX might mean for the direction of stock prices. Our takeaway from last night's note was clear enough: history says we are going to tread water for 12 months. Rather, they wanted to connect the dots between volatility and trading volumes.

Volumes matter to a range of financial services companies, from brokers to service providers and even financial media outlets. Low volatility correlates strongly to trading volumes and attention to capital markets. When volatility is as low as it is this year, everyone in these businesses notices the difference to their bottom lines.

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I have clustered some of the key points from these conversations into 3 questions, with my answers here:

Question #1: How long can this last?

Answer: The CBOE VIX Index closed today at 10.6, lower than 99.2% of all end of day prices since January 1, 1990. Put another way, the VIX had only registered a lower close on 55 days over the last 6,887 trading days. At current levels we are very close to the all-time closing low of 9.31 on December 22, 1993.

All that would seem to indicate we must be near a low. Even a 10-handle-or-below VIX close has only occurred 137 times since 1990, or 2% of that time series.

At the same, consider that the current 50-day moving average of the CBOE VIX Index is 12.3 and the record low for that statistic is 10.8. That low reading occurred on February 26, 2007. Moreover, the 50 moving average for the VIX has stayed below 11.0 for +30 consecutive trading days back in early 2007.

The bottom line is that we are almost certainly at a bottom for the VIX and therefore actual equity market volatility, but history says we can bump along that bottom for weeks.

Question #2: What role does equity market structure play in lower structural volatility?

Answer: Reg NMS went into effect in 2005 and it had the effect of codifying and regulating a fragmentation of US equity market structure. Instead of trading at one or two venues (the NYSE or NASDAQ, for example), you can execute trades at dozens of locations. As a result, US market structure went through a technological revolution with billions of dollars spent on the hardware and code needed to deliver best execution across this much more complex market infrastructure.

As US equity markets transitioned from human-based to algorithmically driven, the stage was set to start introducing fundamental and technical trading signals as an overlay on simple market making. Computers can read and react to news headlines like earnings reports or M&A announcements faster than humans, after all. They can also analyze historical correlation patterns and trade more quickly when different stocks diverge from their typical paths.

All this makes for US equity markets that more quickly and efficiently assimilate new information than any period prior to the introduction of Reg NMS in 2005. Yes, traders have been using computers to trade stocks since at least the 1960s. But in the current highly complex market structure of 2017, technology provides an end-to-end solution that is new and, therefore, may partially explain the current low level of US equity market volatility.

The key takeaway here: low volatility is not new (see Question #1), but US equity market structure is dramatically different from the prior historical low points for the VIX. If you asked me "Could the VIX go lower than it ever has before?" I would answer "Yes, because (in theory, at least) a high speed and increasingly automated market structure can more quickly and accurately incorporate new information into stock prices than any prior paradigm."

Question #3: What conditions create lasting, rather than transient, volatility?

Answer: Looking at history again, there are only two things that drive volatility higher and keep it there. The first is a geopolitical event that almost always spikes oil prices. Think 1973 (Saudi embargo), 1979 (Iranian Revolution), 1990 (Iraq invades Kuwait), and 2001 - 2003 (9/11 terror attacks and Iraq invasion). The other is the bursting of a large financial bubble (2000 and 2008).

The nasty truth about equity market volatility is that it is more binary than most people realize, with the difference between "1" and "0" largely driven by unforeseen shocks followed by periods of relative calm. The CBOE VIX Index can sit well below its long term average of 20 for years (1991 - 1996, late 2003 to mid-2007, mid 2012 to mid-2015, 2016 to the present). Then it can spike and stay over 20 for years as well (1998 to mid-2003, mid-2007 to mid-2012). It is not a sine wave cycling predictably around that average of 20.

Will volatility return to US equity markets? Of course.

Are current levels too low? Of course.

But unlike many features of capital markets, there is no "Invisible hand" that will drive reversion to that mean of 20.0 for the VIX. Volatility is ultimately the mathematical measurement of human emotion on stock prices. Emotions are by their nature unpredictable, which makes the VIX equally inscrutable.

All we know is that human emotions still exist, and therefore volatility will return.

U.S. Equities

Merck (+0.51%) beat adjusted first quarter profit and revenue expectations. Pfizer (-0.50%) exceeded adjusted first quarter earnings forecasts, but missed revenue expectations. Aetna (+1.56%) reported adjusted quarterly profit and revenue above estimates. Hilton (+3.66%) beat adjusted quarterly profit and revenue expectations. Advanced Micro Devices (-24.23%) reported a quarterly loss in line with forecasts. CVS Health (-3.61%) posted adjusted quarterly profit and revenue above estimates. Tenet Healthcare (+21.56%) reported a smaller than expected adjusted quarterly loss.

Important Earnings Today (with Estimates) From...

- DDD: \$0.11
- TAP: \$1.3
- ALG: \$1.08
- TSLA: \$-0.81
- CAKE: \$0.73
- TWX: \$1.46
- FB: \$1.12
- YUM: \$0.6

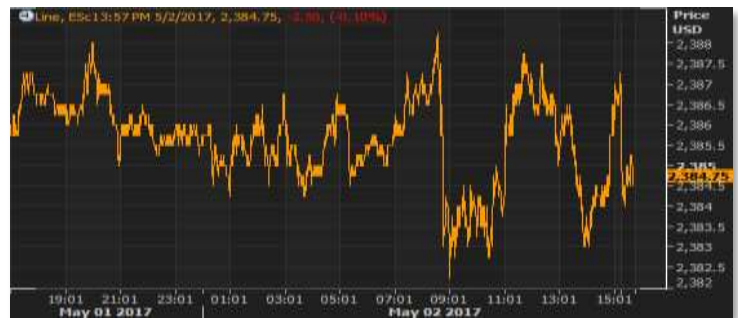
Source: Yahoo Finance

Important Conferences/Corporate Meetings Today:

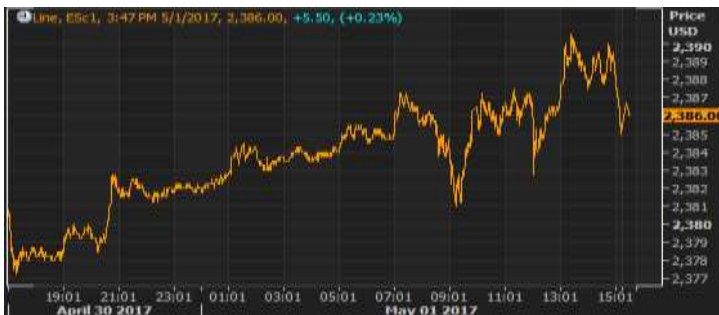
- Deutsche Bank Health Care Conference – Boston
- Midcap Partners Conference – Paris

S&P Futures

One Day (High – 2388.25; Low – 2382.25):



Prior Day ES/1 (High – 2390.25; Low – 2381.00; Close – 2386.00):



Three Day (High – 2390.25; Low – 2377.25):

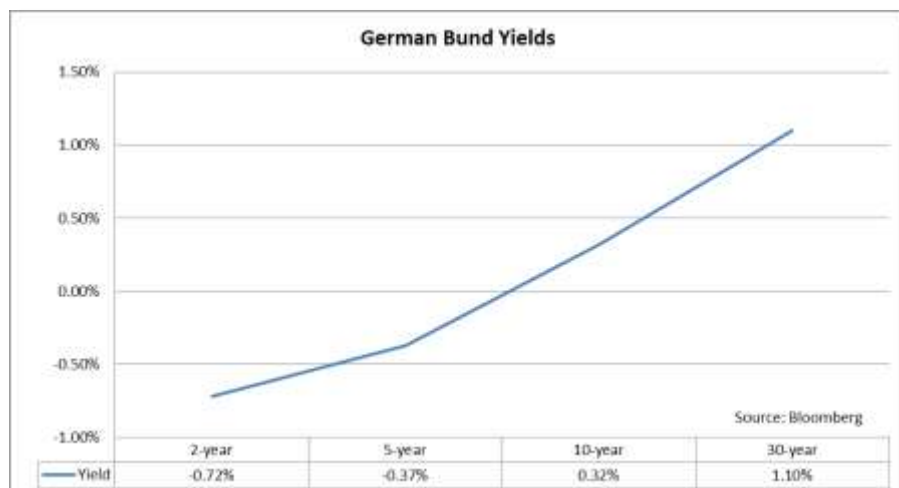
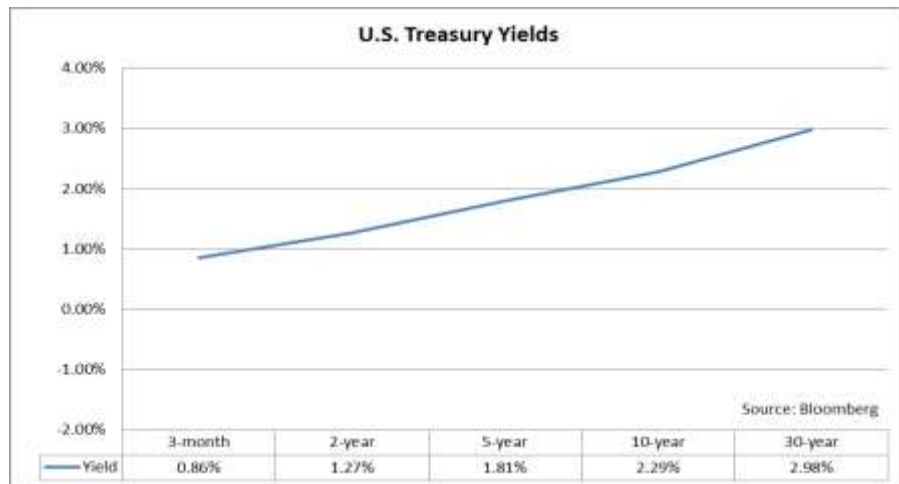


Fixed Income

Treasuries gained on Tuesday before the Federal Reserve's monetary policy statement. Fed Funds futures give a 66.3% chance for an increase in near-term rates by the Fed in June and an 81.2% probability in September. The 30-year Treasury yield declined to 2.98%, and the 10-year and 5-year yields fell to 2.29% and 1.81% respectively.

Today's Important Economic Indicators/Events (with consensus estimates):

- MBA Mortgage Applications (7:00am EST)
- ADP Employment Report (8:15am EST): 170k/263k
- Gallup US Job Creation Index (8:30am EST)
- PMI Services Index (9:45am EST): 52.3/52.8
- ISM Non-Mfg Index (10:00am EST): 55.8/55.2
- EIA Petroleum Status Report (10:30am EST)
- FOMC Meeting Announcement (2:00pm EST)



International Market Summary

Asian Markets

Asian markets were mixed on Tuesday after the Bank of Australia left its cash rate unchanged. (Nikkei +0.70%, HSI +0.33%, ASX 200 -0.10%). In China, the Shanghai Composite Index and Shenzhen Composite Index dropped 0.35% and 0.04% respectively. In Hong Kong, Bank of China lost 0.53% and HSBC Holdings rose 0.31%. Property shares ended lower: Henderson Land Development Co Ltd (-0.10%), China Vanke Co Ltd (0%), and China Resources Land Ltd (-1.62%).

In Japan, auto stocks finished mixed: Toyota Motor Corp (+1.67%), Honda Motor Co Ltd (-0.31%), and Nissan Motor Co Ltd (+1.13%). Technology shares followed suit: Sony Corp (-0.52%), Toshiba Corp (+3.93%), Sharp Corp (-0.24%), and Panasonic Corp (+0.11%). Bank shares advanced: Mitsubishi UFJ Financial Group Inc (+0.59%), Sumitomo Mitsui Financial Group (+0.73%), and Mizuho Financial Group Inc (+0.73%).

In Australia, mining shares were mixed: Fortescue Metals Group Ltd (+0.38%), Newcrest Mining Ltd (-0.38%), BHP Billiton Ltd (-0.50%), and Rio Tinto Ltd (+0.18%). Bank shares declined: Westpac Banking Corp (-0.91%), Commonwealth Bank of Australia (-0.72%), ANZ Bank (-2.12%), and National Australia Bank Ltd (-0.23%). ANZ reported a 23% increase in 2017 half year cash profit.

Important Economic Indicators/Events (with Consensus estimates):

- N/A

European Markets

European markets advanced on Tuesday ahead of the French presidential election this weekend. (FTSE +0.64%, DAX +0.56%, CAC 40 +0.70%). In Germany, Deutsche Bank and Commerzbank climbed 0.90% and 1.06%. Auto shares were mixed: Volkswagen (-0.58%), BMW (+0.43%), and Daimler (-0.42%). In France, bank shares gained: BNP Paribas (+1.53%), Credit Agricole (+1.06%), and Societe Generale (+0.58%).

In the U.K., Aberdeen Asset Management PLC (+4.26%) posted a 10.6% rise in first half revenues. Bank shares finished mixed: HSBC Holdings PLC (+0.53%), Barclays PLC (-1.13%), Lloyds Banking Group PLC (0%), and Royal Bank of Scotland Group PLC (-0.30%). Energy shares followed suit: BP PLC (+1.60%), Royal Dutch Shell PLC (+0.47%), and Tullow Oil PLC (-2.53%). BP said its first quarter profits nearly tripled compared to last year. Mining shares retreated: Anglo American PLC (-2.49%), BHP Billiton (-0.47%), and Rio Tinto PLC (-0.52%).

Important Economic Indicators/Events (with Consensus estimates):

Eurozone

- GDP y/y (9:00am EST): 1.7%/1.7%

Great Britain

- Markit/CIPS Construction PMI (8:30am EST): 52/52.2

Germany

- Unemployment Rate (7:55am EST): 5.8%/5.8%

Additional Reading (Online Blog and News Stories)

(Please click on the titles below to view the links)

BuzzFeed

[Who Decides What Gets Played On The Radio? More And More, It's Listeners](#)

Zero Hedge

Charts with returns: [The Best And Worst Performing Assets In April And YTD](#)

[JPMorgan Lists Six "Red Flags" Why It Is Starting To Sell Stocks](#)

Real Time Economics

[College Enrollment Among High-School Grads Nears Record High](#)

The Atlantic

Interview with Harvard psychologist Susan David: [The Fear Of Feelings At Work](#)

Links: [The Best Business Reads Of April](#)

The Reformed Broker

Latest GMO quarterly letter: [Jeremy Grantham On The New Profit Margin Phenomenon](#)

[Three Things That Will Never Change In Wealth Management](#)

Wolf Street

Price by city compared to last year: [The Great Unwind Grips The 12 Hottest US Rental Markets](#)

[Are American Debt Slaves Getting In Trouble Again?](#)

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