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FIRST QUARTER 2017 MARKET RECAP

U.S. Stocks Had Their Best Quarter Since 2015
What Lies Ahead?

U.S. Stocks Have Been Rising. Will These Good Results Continue?

The Standard & Poor's 500 Index (S&P 500) surged +6.07% in the first three months of this year, its strongest quarterly performance since the fourth quarter of 2015. The quarter was characterized by gains associated with President Trump's pro-growth policy rhetoric as well as a strengthening economy considered strong enough to withstand a 25 basis point (one quarter of one percent) U.S. Federal Reserve ("Fed") interest rate hike on March 15th. Investor optimism was also bolstered by a solid recovery in corporate earnings, up 9.30% according to the Commerce Department, the most since 2012. Notwithstanding a fade in momentum in early March (as doubts intensified whether or not Republicans could deliver legislative passage of the President's ambitious plans), well over 65% of companies in the S&P 500 advanced in the first quarter. First quarter gains extended a rally that began just before the 2016 elections, pushing the S&P 500 up 14.31% since October 4th.

Within the S&P 500 Index, Technology (+12.57%), Consumer Discretionary (+8.45%) and Healthcare (+8.37%) led all sectors over the first quarter while Energy (-6.68%) and Telecom (-3.97%) were the worst performers. U.S. small cap companies trailed large and midcap companies and growth-oriented stocks outperformed value stocks.

Foreign Stocks and Emerging Markets Stocks Did Well Too!

Overseas, the MSCI EAFE Index ("Europe, Austral-Asia, and Far East"), which measures developed market stock returns outside the U.S. and Canada, rose 7.25% during the quarter. Investor optimism was spurred on by improving economic conditions and centrist political party wins within Europe. Emerging market stocks, as measured by the MSCI Emerging Markets Index, rebounded from a 4.17% loss in fourth quarter 2016 rising 11.45% in the first quarter 2017. The first quarter's emerging markets performance has already outpaced its own 11.19% full-year gain in 2016, which was its first annual gain in four years.

We recommend reduced weightings in large U.S. stocks as the current values of these assets reflect expectations for a near-term boost to corporate earnings from President Trump's fiscal policy proposals. While we continue to expect corporate tax reform, including a one-time repatriation of overseas earnings, and an infrastructure spending bill to get approved, the legislative path to approval for each bill will likely take longer than currently anticipated given the deep divide between Democrats and Republicans and within the Republican party. The Freedom Caucus and moderate GOP members have yet to agree on a path forward together.

We generally recommend adding capital to emerging markets ("EM") stocks and alternative and tactical assets. The emerging markets are becoming an increasingly attractive opportunity due to the stabilization in commodity prices and the improved fiscal conditions of many of their underlying economies. Emerging market stocks are also one of the few global sectors still trading below its 25-year historical valuation levels. (The emerging markets sector represents less than thirty of the more than 130 emerging economies. The managers we use only invest in the EM countries with a stable political system, solid financial markets, and generally accepted accounting principles.) The recommended increase in alternative and tactical assets will boost the weightings of investments that have very low correlations (or relationships) with traditional stocks and bonds. These assets help to stabilize portfolio returns while providing differentiated sources of returns during periods of weak stock and bond performance. The increase in alternative and tactical assets will also increase exposure to stock sectors that we expect to outperform the broader market over the market cycle. These sectors include financials, healthcare, and information technology along with others.

We continue to recommend lower concentration in foreign developed market stocks than would be normal, given the uncertain political landscape in Europe. The economic recovery in developed foreign markets, particularly the Eurozone, continues to strengthen while the annualized performance of this sector has significantly lagged its long-term historical average annualized return for an extended period of time, well over ten years. We anticipate potentially increasing exposure to these stocks as we get better visibility into the outcomes of key European Union elections, particularly after the second round of presidential elections in France on May 7. The election of more populist/nationalist candidates could disrupt the status quo and undermine the economic outlook in Europe.

Portfolio Protection Can Be Furnished With Bonds

Looking at bonds, investment grade bonds of all types, including U.S. Treasury Bonds, mortgage backed securities, and corporate bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, gained 0.82% during the first quarter led by a +1.22% return on U.S. corporate investment grade bonds. The rebound in U.S. investment grade bonds, which declined 2.98% in the fourth quarter 2016, was driven by increased demand for these assets given their relatively attractive yields compared to other developed markets. Investment grade bonds also benefited from an increasing realization that the Fed will raise its short-term policy interest rate at a more measured pace than what was previously thought following the election of President Trump. Globally, investment grade bonds, as measured by the Bloomberg Barclays Global Aggregate Total Return USD Index, were up 1.76%. Foreign investment grade bond valuations benefited from a decline in the U.S. dollar during the quarter versus other major currencies.

We generally continue to advocate holding a portion of client portfolios in investment grade bonds, both domestically and abroad, as these assets can be significantly less volatile compared to other bond sectors and stocks. Investment grade bonds help to stabilize portfolio returns by allowing investment assets to compound more efficiently over time. This is achieved by substantially reducing the frequency and breadth of negative portfolio returns during “down” stock markets.

We expect the Fed to continue its gradual approach to “normalizing” rates over the course of this year as intentions for a quick implementation of fiscal policy stimulus, such as infrastructure spending and tax reform, will be slow to materialize. We intend to mitigate the impact of rising U.S. interest rates by lowering the overall sensitivity of bonds to interest rate fluctuations by holding shorter duration bonds with an emphasis on credit (i.e. non-government) assets. Assuming the actual content of President Trump’s fiscal policies is approved by Congress and implemented, these bonds should hold up well if the Fed has to accelerate the pace and breadth of its interest rate hikes to prevent the U.S. economy from overheating. Should such a situation occur, we will consider shifting some investment assets to those that “hedge” against the impact of rising inflation expectations, such as commodities and other hard assets.

What Should You Expect Going Forward?

General consensus among economists and market strategists at the beginning of the year was that the current administration’s proposed fiscal stimulus package would propel the domestic economy out of 2016's post-financial crisis low of 1.6% growth. While this view has helped boost business and consumer sentiment, the added confidence has not led to increased consumer spending or business investment, both of which are necessary for sustained growth. While the administration has taken some steps to provide a more advantageous business environment through reduced regulatory oversight, intentions for a quick implementation of fiscal policy stimulus such as infrastructure and tax reform are still "concepts" without drafts of actual proposals for consideration. The longer it takes to enact positive fiscal policy, the greater the potential for sentiment momentum to lose steam, potentially leading to an unexpected headwind for the economy.

The question is how much patience investors will have for proposed infrastructure and tax reform to become reality and what will be the market reactions if the policy falls short in size or scope. Many are also concerned with foreign policy missteps that may have adverse implications on growth, such as renegotiation of trade agreements. Trade barriers and tariffs against foreign trading partners could lead to retaliation, increasing the chances of negative effects on the U.S. economy. Lastly, should the Fed be compelled to adopt a more aggressive policy of tightening (interest rate increases) due to much stronger than expected economic data (likely increasing inflation), this could create a headwind as well.

Our View Suggests Caution

We see the potential for positive equity results, but with measured gains likely to be below historical averages, particularly here in the U.S. We do not recommend any significant deviations from a long-term stock and bond allocation. Attempting to mitigate unforeseen volatility in an increasingly uncertain environment, it is prudent to retain exposure to investment grade bonds as well as to alternative investments that have low correlations to traditional stock investments. In this portion of the investment cycle, we prefer managers with flexible investment styles that provide discretion and the ability to move nimbly within their mandates when faced with the changing circumstances we anticipate going forward.

As always, please do contact us if you have any questions or concerns about your investment portfolio.