Trumbower Financial Advisors, LLC
1st Quarter 2017
Investment Market Commentary

Running in Reverse

Investors defied Presidential tweets by putting American stock markets last during Q1 – except for tech-laden Nasdaq. Emerging and Developed overseas indices climbed +11.45% and +6.47%. Post-election trends reversed and large multinationals helped nudge the S&P 500 (+6.07%) ahead of Mid (+3.94%) and Small Cap (+2.47%) US equities. Just like some government policies, Style preferences "pulled a 180" favoring Growth over Value. Technology, Consumer Discretionary and Health Care sectors (up +12.2%, +8.1% and +7.9%) powered Growth momentum. Energy and Telecomm sectors, down -7.3% and -5.1%, led Value oriented stocks backwards. Q1 was boom town for IPOs featuring robust demand for shares like SNAP that come with no voting rights – whatsoever.

Emerging Markets benefitted from rising prices for Silver, Gold, Aluminum and Copper which helped offset the -10% slide in crude oil. Commodities dipped -2.5% in the aggregate during Q1 but are up 8.3% over the last 12 months. Perhaps the diminished likelihood that the US will implement threats to advantageous trade agreements raised expectations for the lesser developed world. The dollar's halted advance also alleviated concerns about servicing dollar denominated debt.

The US dollar index soared as much as 7% post-election. After the health care reform bill was shelved, the index slumped to a 4-month low and ended the quarter down -1.72% despite the March rate hike and suggestions of more to come. There is evidence that a two-year shortage of access to US dollar denominated money market funds overseas may be waning. Japanese and European banks are finding acceptable alternatives to shore up balance sheets.

Unemployment rates have remained stable. Subdued since 2009, wage growth rates picked up toward the

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1st Quarter Equity Market Results

	1st Qtr. % Chg.	12-mth. % Chg.
S&P 500	6.07	17.17
S&P 400	3.94	20.92
Nasdaq	10.14	22.88
Russ 2000	2.47	26.22
MSCI EAFE	6.47	8.53
MSCI Emg	11.45	17.22

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end of 2016 before retreating during Q1. US corporate profit margins have benefited from years of stagnant labor costs and "free" credit but those tides are poised to change. In the meantime, corporate America has been stingy with capital investment. Highly anticipated fiscal stimulus may be less effective under these conditions. Squeezed by rising costs and mediocre gains in productivity, corporate profits might need a shot of tax relief to release the multiplier effect into our economy. Will they get it?

The FOMC raised the Fed Funds rate 0.25% in March citing near full employment and mild inflation. Future hikes are predicated on gradual progress toward their 2% inflation target. The core PCE deflator ticked up to 1.8% in February after lingering ~ 1.7% for the past six months. Yields on securities maturing in 5 years or less climbed in Q1. The 2-year US Treasury hit 1.4% on March 14th – the highest level since 2009. Long yields fell slightly – flattening the yield curve. Flat curves are not attractive economically speaking. They are indicative of weakness and persistently low inflation. Evidence of the latter is noted in the falling spread between the yield on 10-year Treasuries and TIPS (inflation protected securities).

Recovery in the Eurozone continued during Q1 although core inflation remains stubbornly low. Brexit is formally proceeding and grumblings within other countries have prompted some concern over the longevity of the euro. While unlikely, the process of reviving legacy currencies would throw a sledge hammer on the European Central Bank's less accommodative monetary policy goals.

Seasoned stockholders are used to reversals – in trends and fortunes. Some famous investors bank on renowned "Fama/French" research revealing the superior historical (1926 – 2015) performance of Value vs Growth (1.8% among Large Caps and 4.4% in Small Cap US stocks). Principles are appealing – especially as price-earnings ratios swell – but successful Value investing takes patience and a willingness to sit back and relax while Growth runs its course. When Growth stocks are in fashion premiums can be staggering, and we aren't running endowments with a 100 year time horizon. So we try to take advantage of turnarounds by rebalancing.

8 years ago on March 9th the S&P 500 bottomed in the wake of the 2008 Financial Crisis. The index has since returned 16% annualized and investors seem reluctant to put it in reverse. A bull market's duration does not, in and of itself, dictate its demise. In fact, one could argue that we are in the early stages of a secular (long term) bull cycle. The last one ran from 1982 to March 2000. The S&P 500 returned nearly 15%, annualized, over that period.

The secular bear that emerged in 2000 may have ended as early as March 2013. Despite two strong bull cycles in those 13-years (2002 to 2007; 2009 to 2013), the S&P 500 delivered -0.15% (Small and Mid Cap US indices fared better). Market historians typically call a cycle's end when losses are recouped and indices touch new highs. US equities in the aggregate recovered lost ground in 2013 and set record highs more or less continuously through mid-July 2015. Losses suffered in a subsequent correction were restored in July 2016 when the next leg up commenced. It is possible we are in the midst of a much younger secular bull.

Or is this a "Bubble?" Univ. of Chicago Professor Fama defines a bubble as an "irrational strong price increase that implies a predictable strong decline." Ned Davis of Ned Davis Research worries that billions of dollars flowing into passive index funds has created indiscriminant demand for the largest constituents in cap weighted benchmarks – in other words a bubble. Should it burst the passion for passive strategies may reverse.

Prof Fama argues that "Bubbles" aren't predictable. There are only two historical broad market episodes (1929 and 2000) that meet quantitative "Bubble" criteria, i.e. price increases of 100% over two-years followed by losses of at least 40% within the subsequent two years. Two Harvard Univ. professors found more populous data points by studying 40 cases since 1928 where equity prices in specific industries rose by at least 100% over two years. The "Bubbles" burst during the next two years 53% of time. The most vulnerable were marked by heightened volatility, large number of IPOs with new issue prices rising disproportionately higher, acceleration in the run up rate coupled with above-average P/E ratios.

P/E multiples are high relative to long-term norms, but not as extreme compared to 20-year means and even less so in the context of little inflation. The VIX (volatility) index remains quite low. The total stock market index has returned just 15.7% over the last two years and no single industry is up by anything close to 100%. This doesn't mean a correction isn't imminent, but there are reasons to put images of busting bubbles behind us.

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