Market Commentary

First Quarter 2017

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The first quarter of 2017 was a very strong period for US equities, continuing the steady move higher since Election Day. The benchmark S&P 500 Index had a total return of 6.0% during the first quarter, and set several new all-time records through mid-March before closing the quarter about 1% below its all-time high. From the February 2016 lows, the S&P 500 has climbed almost 30% through the end of March. The 10-year note yielded 2.40% on March 31, 2017, not far from the 2.45% yield at the end of 2016. Returns for most fixed income holdings were modestly positive during the quarter.

Economic and Market Outlook

Following an extremely long period of very low volatility in equity markets, the S&P 500 went 110 trading sessions without a single day decline of 1% or more, before declining by 1.24% on March 21. This long period of calm coincided with a nearly uninterrupted 10% move higher in the S&P 500 beginning in October 2016. We had been looking for a small pullback for many weeks, believing that consolidation after a rapid move higher is healthy for markets over the longer term. The so-called "Trump trades" (financials, small-cap stocks, certain industrial companies) have lagged the broader market recently after running higher in the months following the Presidential election. Investors are coming around to the understanding that implementing major legislation (including fiscal stimulus and deregulation) is a lengthy, tedious process and nothing is assured to pass.

Oil prices were volatile particularly in the last few weeks of the quarter. After beginning the year at $53.72 a barrel for WTI, the price oscillated during the first several weeks of 2017 before pulling back and ending the quarter at $50.60. As we stated in our last commentary, supply/demand forces should cause oil to stabilize in a range around a $50 midpoint for the near future. Any moves below $40 or above $60 are unlikely, barring exogenous shocks to the system.

The Federal Reserve increased the Federal Funds rate by 25 basis points in Mid-March to a new target range of 0.75%-1.00%. We applaud the move as we continue to believe the Fed risks falling behind the curve in normalizing rates. Where we differ from many is in how far we expect the Federal Funds to move before reaching a "normal" rate. With most developed markets still holding to extremely low interest rates, we believe the Fed does not want to raise rates too dramatically while the majority of the developed world is still involved in quantitative easing which would lead to further distortions in global asset prices. Both equity and bond markets were prepared for the March increase and showed little movement in the aftermath of the rate hike. The Fed continues to see two more 25 basis point rate hikes in 2017 and an additional 75 basis points in 2018. This would result in a Federal Funds rate of approximately 2.0% in late 2018. From that point forward, we do not see much reason for higher rates unless economic growth is strong enough to bring increased inflationary pressures. What garners little discussion is the Fed's balance sheet, which holds approximately $4.5 trillion in US Treasuries and mortgage-backed securities. If the Fed were to allow maturing securities to roll off without reinvesting the proceeds, it could slowly and methodically shrink the balance sheet with minimal disruption to financial markets. Reducing the balance sheet would serve to modestly tighten monetary policy along with higher rates.

"The simple message is the economy's doing well", Fed Chair Yellen stated in her news conference following the March rate hike. Following the March Fed meeting, the "dot plot" was unchanged meaning the Fed was still expecting a slower rate of rate hikes than the market had been pricing in. This caused a rally along the entire fixed income yield curve through the remainder of March.

Lost amid the noise emanating from Washington over the past several weeks was a request from the Department of Commerce seeking information on the impact of federal permitting requirements on the construction and expansion of domestic manufacturing facilities and on regulations that adversely impact domestic manufacturers. This is very important because fewer regulations will tend to release the entrepreneurial spirits of America's capitalist system.

There are a number of potential headwinds that could trip up markets over the next several months. Some of these include delays in tax reform and healthcare reform, a messy resolution to raising the debt ceiling, the elections in France, and a Federal Reserve that moves rates higher faster than currently expected. We could also toss in North Korea as a potential flashpoint. While these are issues we are watching, we also believe most if not all can be resolved in a non-disruptive fashion to markets.

Portfolio Positioning

Since the election, certain areas of the market that had long underperformed have moved significantly higher. Financial stocks were among the biggest beneficiaries of the "Trump bump" as investors believed faster economic growth along with less regulation would lead to higher interest rates and thus better profits for banks. We had added to financials earlier in 2016 in anticipation of faster economic growth but have made minimal portfolio changes during the past three months. The current move in equities seems to be extended with the S&P 500 having only one day in the past four months with a single day decline of 1% or greater. Although the market has gone several weeks without setting a new high, neither has it declined much from its peak. Strong market momentum combined with improving economic fundamentals favor equities over other asset classes. We observe that investors continue to have available cash on the sidelines and the "buy the dips" mentality is firmly in control.

Conclusion

As we look out over the next 12 to 18 months, we see many positive signs for the US economy. As regulatory burdens continue to subside and consumers look forward to tax cuts, animal spirits should lead to increased spending and investments. The very strong equity returns since Election Day have factored in a good deal of positive economic and fiscal news so we would not be surprised to see a short-term stock market pullback from record levels. Barring an unforeseen exogenous shock, we do not see any reason for this bull market to end in the near term based on our readings of economic data.

We always enjoy hearing from clients and find that enhanced communication fosters a better long-term relationship. We encourage you to call or email us if you have any comments or questions about your investment portfolio or any financial topics in general.

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