Review & *Outlook*

FIRST QUARTER 2017

119 N. Commercial St., Ste. 191 ▪ PO Box 1618 ▪ Bellingham, WA 98227
P: 360.671.0148 ▪ P: 800.292.8794 ▪ F: 360.671.8936

Review

The stock market's performance in the first quarter of 2017 can be divided into three distinct phases: a flat January; an exuberant February; and a less hopeful March. From December 9, 2016 to January 23, 2017, the S&P 500 index traded in a tight range around 2,269. The market reached a high of 2,396 on March 1st, but by the end of March 2017, the total return year-to-date had ground down to 6.07%.

For the first two months of this quarter, large, mid, and small cap stocks performed similarly. However, following their peak on March 1st, all stock indices tailed off, with the S&P Mid Cap and Small Cap indices dropping significantly more than the S&P 500 index. The chart shows the total returns for the S&P Indices for the full quarter. The small and mid-cap March fade was largely in line with a growing view that the pro-growth "Trump" agenda might be politically difficult to achieve, and a lot more benign in effect if budget neutrality is enforced along the way. The recent collapse of efforts to "repeal and replace" the Affordable Care Act was not particularly reassuring for those hoping for GDP growth to be driven up a percentage or two.

	Total Return as of 3/31/2017	
Index[3]	Q1 2017	Trailing 12 Months
S&P 500 Index (Large Cap)	6.07%	17.17%
S&P 400 Index (Mid-Cap)	3.94%	20.92%
S&P 600 Index (Small Cap)	1.06%	24.59%
Morningstar Short-Term Bond Index	0.11%	0.68%

Outlook

There don't appear to be any obvious stormy events on the horizon domestically or internationally. In the Netherlands, the recent defeat of anti-EU Geert Wilders has calmed markets, adding confidence to the view that anti-immigrant/EU Marine Le Pen is unlikely to take the French elections. The Brexit process looks to grind on into the foreseeable future, but it does not appear to be driving any sharp market movements for the time being. Also in Europe, the specter of deflation has diminished, and some forward-looking economic data has turned positive in recent months. In Asia, China appears to have meaningfully stemmed capital outflows for the time being, helped in part by a US dollar that has stopped gaining strength.

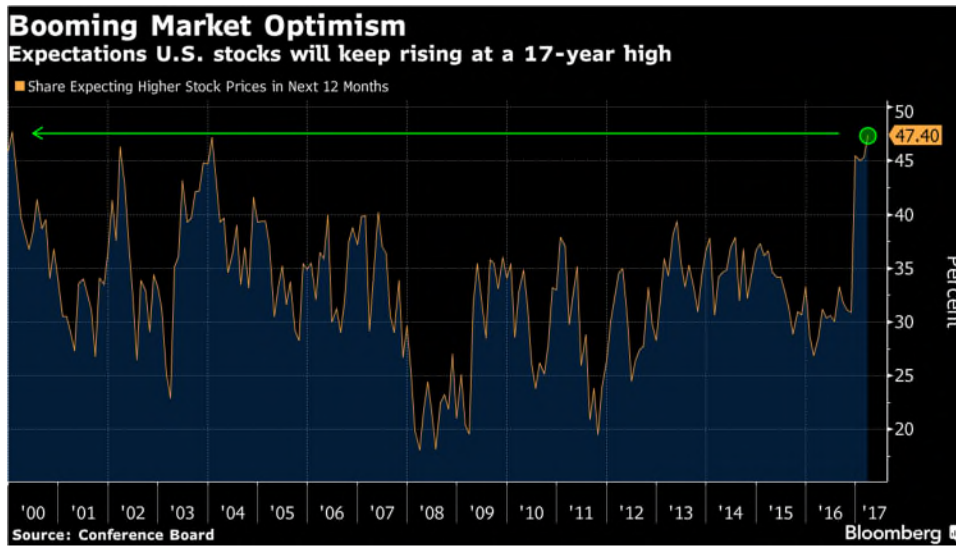
Emerging markets have also benefitted from what appears to be greater confidence in Asia and Europe, and a US dollar that has weakened somewhat as US growth prospects are questioned. A weaker dollar can be helpful for servicing debt, as many loans in emerging markets are denominated in US dollars, and commodities are generally priced in US dollars.

One looming issue in the United States that could potentially spark a short-term crisis is the need for Congress to put a spending bill in place by the end of April in order to avoid a government shut-down. Given the political damage that has followed from past shut-downs, this outcome is unlikely, and would, with any luck, be transient. As focus within the US shifts from health care reform to tax reform and infrastructure spending there will be continued hope within the markets that business-friendly policies might be successfully put in place. Even with recent set-backs, the market optimists still seem to be winning the battle with market pessimists.

In general, our view is a global economy that is doing better, with slow but steady growth. In part, this view has supported our recent move back into global developed and emerging market investments for our clients.

In Focus

Since the election, there has been a lot of talk about a “Trump Trade” that has bolstered stocks. In general, this is the idea that a business-friendly stream of policies are to be rolled out, including dramatic reductions in regulation; taxation reform including large tax cuts for corporations and the middle class; and a mighty shot of infrastructure spending. The view is that these policies will bolster economic growth and inflation, in turn driving stocks, interest rates, and the US dollar higher. This optimism has worked its way into the general sentiment. The Conference Board just released survey results through March 16th, showing some of the best consumer confidence figures in decades. Measures include consumer expectations for next six months, including business conditions and job availability in the coming months.[1] Retail expectations for U.S. stocks rising over the next year is at a 17-year high (see “Booming Market Optimism” chart).[2]



While optimism abounds, the facts on the ground are a little more sedate. In particular, there is an increasing realization that to the extent policy is required to be budget neutral, and the politics intransigent, there will likely be little net boost to the rate of economic growth. Rather, there will simply be a lot of shifting resources from Peter to Paul; for example, taking funds from the National Institute of Health (NIH) to build a wall along the Mexican border.

While the recent surge in the stock market has been impressive, it is not clear that the anticipation of earnings growth will be proven out in the coming years. Also, the exuberance in the stock markets is not exactly being replicated in the bond markets. Since the close on November 8th, the broad market is up about 10%, which is a good run for five months.

The bond market, however, shows little confirmation of the view for accelerating economic growth. Long term interest rates, measured by the US 10-Year Treasury, have been moving in a range of 2.3 to 2.6%. This is not consistent with a view of either increasing growth or increasing inflation.

The next two earnings report cycles should confirm or refute the contradicting signals from the bond market. If earnings are sufficiently strong, we should continue to see a strong stock market, and interest rates should rise. Conversely, the stock market will likely respond poorly to disappointing reported earnings, and interest rates should remain low. Meanwhile, growth outside of the US will also be important to watch; if we see continued growth in Europe and Asia, the demand for US bonds may soften as foreign bond rates rise. This could result in a fairly sharp lift to longer-term interest rates. As one of the main risk events we see for clients remains a rapid rise in interest rates, we continue to use a “laddered” fixed income strategy with short duration bonds so that clients can hold them to maturity, protecting them from potentially significant capital losses.

1. Laya, P. (2017, March 28). U.S. Consumer Confidence Unexpectedly Surges to a 16-Year High. Retrieved March 28, 2017, from https://www.bloomberg.com/news/articles/2017-03-28/u-s-consumer-confidence-rises-to-highest-since-december-2000
2. Golle, V. (2017, March 28). Americans Haven't Been This Optimistic About Stocks for Nearly Two Decades. Retrieved March 28, 2017, from https://www.bloomberg.com/news/articles/2017-03-28/american-household-optimism-about-stocks-at-17-year-high-chart
3. Index Return Source Data: S&P 500 Index, http://us.spindices.com/indices/equity/sp-500. S&P 400 Index, http://us.spindices.com/indices/equity/sp-400. S&P 600 Index, http://us.spindices.com/indices/equity/sp-600. Morningstar Bond Index: http://news.morningstar.com/index/indexReturn.html.

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