2017 First Quarter Review of the Markets

Index	1st Qtr Return
S&P 500	6.07%
MSCI ACWI Ex USA	7.86%
Barclay's Bond Index	0.82%
Consumer Price Index	0.38%

Investment Commentary

President Trump's first two months in office dominated the news flow in the first quarter. The S&P 500 returned 6.1% for the quarter as both earnings estimates and valuations increased. As we cautioned in our last review, small cap stocks are quite expensive by historic standards and performed poorly relative to larger companies returning only 2.5% over the same period. Equities continued to march higher despite political uncertainty including the defeat of the American Health Care Act. Volatility remained low throughout the duration of the quarter as investors remain sanguine with regard to the prospects for the global economy.

The performance gap between U.S. stocks and their non-U.S. counterparts narrowed this quarter as international stocks returned 7.9%. Allegations of Russian influence in the U.S. presidential election dominated foreign relations headlines. Additionally, U.K. Prime Minister Theresa May triggered Article 50, formally beginning the process for negotiating terms around the U.K.'s exit from the European Union. Article 50 allows a period of up to two years for negotiation, so we may be hearing about this for quite a while.

Fixed income returns were positive, albeit modest, as the yield on the 10 year U.S. Treasury fell from 2.45% to 2.4% during the quarter. However, positive returns did not come without volatility as the yield on the 10 year bond reached a post-election high of 2.6% near the middle of March. From peak to trough, the Bloomberg Barclays Aggregate Bond Index lost 1.5%. The total return for the quarter was 0.8%.

Economic Outlook

For years, markets have focused attention on central banks around the globe. We've seen markets interpret good news as bad news, because any good news increased the probability of tighter monetary policy from the U.S. Federal Reserve ("The Fed"). Markets now appear to be pricing in multiple interest rate hikes in 2017, yet risk assets continue to move higher. While some dismiss the post-election run in equities (and any hiccups along the way) as a result of only changes in sentiment, it is true that analyst average earnings estimates have increased (making equities more attractive, everything else held constant). Further, the fourth quarter marked the first time the S&P 500 displayed year-over-year growth in earnings for two consecutive quarters since Q4 2014 and Q1 2015.

That said, equity valuations have increased as forecasts for stronger economic and corporate earnings growth have permeated markets. Despite low (by historical standards) interest rates, U.S. stocks are trading above long-term average valuations. As we know, when valuations are higher, future return expectations should be lowered.

As elections in Europe approach, the polls show “fringe” candidates are still in contention in several tightly contested races. Consequently, discussions of tail risks for developed, non-U.S. stocks have re-emerged. We reiterate (as we did through Brexit and the U.S. presidential elections) that we will not engage in political speculation as a driver of investment theses.

Ultimately, much of the market movement we have seen post-election has been built upon expectations of higher levels of economic growth and inflation under the new administration. In the short run, the “reflation trade”, as it has been dubbed, has been good for risk assets (stocks) and negative for bonds. This sentiment shift has also given the Fed an opportunity to move closer towards normalizing policy after a long stretch of unprecedentedly accommodative monetary policy. At this point, the optimism that has been reflected in the “soft” data (i.e. survey based measures of sentiment) has yet to meaningfully materialize in terms of “hard” economic data.

The economy is likely on strong enough footing to translate its optimism (as reflected in the soft data) to capital spending, even as short term interest rates increase. Global Purchasing Managers’ Indexes for manufacturing (“PMIs”) are at their highest levels seen in several years. This indicates an increase in global economic activity. Additionally, potential positives from the Trump administration do still remain in place with tax reform, decreased regulation and infrastructure spending all likely to be addressed in the coming years.

Investment Strategy

Markets have been unusually calm, as the first quarter had only two days with greater than a 1% move up or down on the S&P 500. We do not think this trend will remain. Elevated valuation levels give little margin of safety in U.S. stocks. If corporate earnings or economic data disappoint, prices have plenty of room to fall. Thus, we maintain our neutral risk weighting across risk profiles.

In fixed income, we have taken advantage of increased short term rates by allocating to an ultrashort bond fund. The gap between money market rates (still basically 0%) and bonds with maturities around one year is meaningful enough to allocate to these short dated bonds as safer assets in the face of elevated equity valuations and tight credit spreads in high yield bonds (meaning investors are paid relatively less to hold risky bonds compared to their credit risk free counterparts). Further, during the quarter we used the temporary increase in intermediate term interest rates as an opportunity to add to client positions in intermediate term Treasury bonds.

While our current approach should not be necessarily viewed as cautious, the lack of volatility in conjunction with elevated valuations means that opportunities to invest in assets or asset classes that have attractive risk-reward characteristics are currently few and far between. Our client portfolios remain well diversified and are not dependent upon any one scenario playing out. Volatility will eventually return and opportunities will be presented to those who are willing to be patient and opportunistic.

As always, we encourage you to reach out to us to discuss portfolio positioning as well as any questions or concerns you may have.