Investment Update

First Quarter 2017

Building on the late 2016 rally, large-cap stocks had a strong start to the year although they were outpaced slightly by international equities. Small-cap stocks and bonds, which were major winners and losers respectively in the month after the election, stayed close to flat throughout the first quarter. Throughout the first quarter, year-over-year returns for all stock indices have been generally strong due to the sharp drop experienced in January and early February of 2016.

Equity Markets (Total Return)	1Q17	1-Yr
Dow Jones Industrials	5.19%	19.91%
S&P 500	6.07%	17.17%
S&P Mid-Cap	3.94%	20.92%
S&P Small-Cap	1.06%	24.59%
MSCI All-Country World	6.91%	15.04%
MSCI Foreign Developed Markets	7.25%	11.67%
MSCI Foreign Emerging Markets	11.44%	17.21%
US Bond Markets	**1Q17**	**1-Yr**
Barclays US Govt/Credit Intermediate	0.78%	0.42%
Barclays US Govt/Credit Long	1.58%	0.98%
BAML Municipal Intermediate	1.40%	0.18%

Interestingly, since the November elections the stock market has largely been free of the volatility seen in recent years. Late in the first quarter the S&P 500 snapped a 109 trading day streak without a loss of greater than 1% (longer such streaks occurred in 1995 and several times in the 1950s and '60s). Perhaps more to the point, within the same period, the S&P 500 went 54 trading days without a gain of more than 1% either. These streaks might seem odd given that volatility in world affairs and news headlines (tweets included!) has not correspondingly diminished. Correlations between economic sectors have fallen to levels not seen since 2009; within a given trading day they are moving in different directions from one another more so than before, reducing the overall volatility of the broader indices. While some commentators worry that the lack of volatility represents the "calm before the storm," the underlying cause is a positive as different stocks and sectors are being judged on their own merits rather than being bought or sold in lockstep, which was the case for many years when central bank policies were foremost on investors' minds.

Why, though, has the stock market been so strong since the election? At the time of our last update there was a common narrative that by the end of summer, healthcare reform, personal and corporate tax reform, and an infrastructure bill all would have made it to the President's desk. While not a stretch, we predicted that legislative changes would happen more slowly and have been proven correct as major items like tax reform are now being talked about as not likely to happen until 2018. Stocks were weak for several days after the failure of the healthcare bill, but expectations over the Republicans' ability to capitalize on their majority recalibrated quickly.

As this adjustment in expectations has occurred through the first quarter, many of the stocks and sectors that initially led the market rally late in 2016 as presumed beneficiaries of prospective tax and spending changes have ceded "market leadership" to companies that are expected to simply be beneficiaries of a stronger economy. Beginning last fall, S&P 500 earnings started growing again, largely due to the rebound in commodity prices revitalizing energy companies' earnings, and economic data have been steadily improving ever since. Thus no matter what comes out of Washington, the trajectory of the underlying economy continues to support current stock market levels, and we think there will need to be far more legislative failures on the part of Republicans before investors' faith in eventual change is significantly at risk.

We certainly acknowledge that this administration has been, and likely will continue to be, polarizing. Consumer sentiment surveys show the combination of extreme positive and negative sentiment to be at record levels, but overall sentiment is sharply up amongst consumers and small business owners since the election. Many business-friendly regulatory changes have and will continue to occur outside of Congress. While the economic benefit of any one of them alone may be small, business owners seem optimistic that these changes are the beginning of an overall shift in the ease and cost of doing business. It remains to be seen whether this strength in sentiment will translate into further gains in hard economic data and company results.

Despite this general enthusiasm about regulatory and tax code changes to come, companies may be hesitant to commit to projects until more clarity is achieved. Further, when companies do start to invest it could come at the expense of margins and the earnings per share growth tailwind that share buybacks have recently provided. We have argued here before that companies would be better served in recent years to invest for the future rather than buy back their shares, but now that they might do so, we could see a deceleration in growth that gets misinterpreted by investors and causes the market to fall. The same could be said of margins, which, having been at or near all-time highs for some time, could come down temporarily as companies engage in investment rather than cost-cutting.

Finally, we remind our readers and ourselves that bull markets do not die of old age, and that the laws of gravity do not necessarily apply on Wall Street. The stock market run and accompanying economic expansion since 2009 are historic in their length, but recessions usually occur when an economy overheats and the Fed overshoots in slowing it down with monetary policy. Corrections in the stock market occur when investors think they see a recession coming and bear markets occur when they are proven correct. While we think that the market need not fall simply because it has gone up, this certainly is an opportune time to rebalance and take any money out of stocks that might be needed soon should even a healthy pullback occur.

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