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Investment and Trust Services

Your Goals. Our Knowledge.

First Quarter 2017

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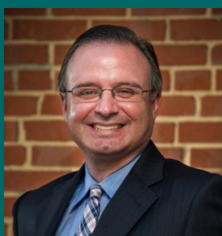

			Total Return	
Index	**3/31/2017**	**12/31/2016**	**2017 YTD**	**Q1 2017**
Dow Jones	20,663.22	19,762.60	4.6%	4.6%
S&P 500	2,362.72	2,238.83	6.1%	6.1%
Nasdaq	5,911.74	5,383.12	10.1%	10.1%
S&P 400 Midcap	1,719.65	1,660.58	3.9%	3.9%
Russell 2000	1,385.92	1,357.13	2.5%	2.5%
Yield on 10-Year Bond	2.39%	2.45%		

Source :FactSet

Investment Summary

The equity markets rallied nicely in the first quarter, up between 2-10% depending on the index, as investor optimism around an improved economic environment and a friendlier climate for business drove positive returns. The market rally came despite some controversial actions and comments from President Trump, ranging from a travel ban to the US from selected countries to a failed initial attempt to repeal and replace ObamaCare. On the surface, uncertainty in the markets has increased thanks to unknowns coming out of Washington, which historically would not be good for the markets. So the nice returns in the first quarter appear counterintuitive. We believe that the underlying driver of returns remains the belief that corporate tax reform likely occurs, which would be a significant driver of earnings growth. As we have said in the past, earnings is the ultimate driver of stock prices over time, so investors have been tolerant of the early controversies in the Trump administration thanks to the hope that earnings will indeed be better in the future.

On a near-term basis, we have become incrementally more cautious on the equity markets. This is in part due to the strength seen in the first quarter; indeed, as of the end of the first quarter, the market was up over 10% since the election. That is a dynamic move in a relatively short period of time, so a 4-6% pullback in the markets would be normal following such a positive move. In addition, economic data have yet to show the type of economic growth that investors are hoping for, which is starting to test the patience of investors. Finally, growing divisions within Congress have become more apparent in Washington, DC, which lowers the likelihood that corporate tax reform gets done sooner rather than later. As we noted last quarter, our outlook for the equity market in 2017 is tied to meaningful progress on the pro-growth policy initiatives being discussed in Washington, DC. Corporate tax reform is at the top of the list. If corporate tax reform advances and looks like it will indeed get done, then the equity markets likely will continue to do well. If not, then the rally that has been based on the hope for improved earnings would likely come to an end.

In the bond markets, yields ticked down in the first quarter following the sizable move higher in the fourth quarter post-elections. After raising rates in December, the Fed chose to hike rates another 0.25% at its March meeting, and continues to set an expectation that two more rate increases could occur before yearend. We believe that the Fed will likely raise rates only one more time in 2017, then wait to watch how the economy fares subsequently. Bigger picture, we believe that rates bottomed back in 2016, so the longer-term trend for rates should be higher.

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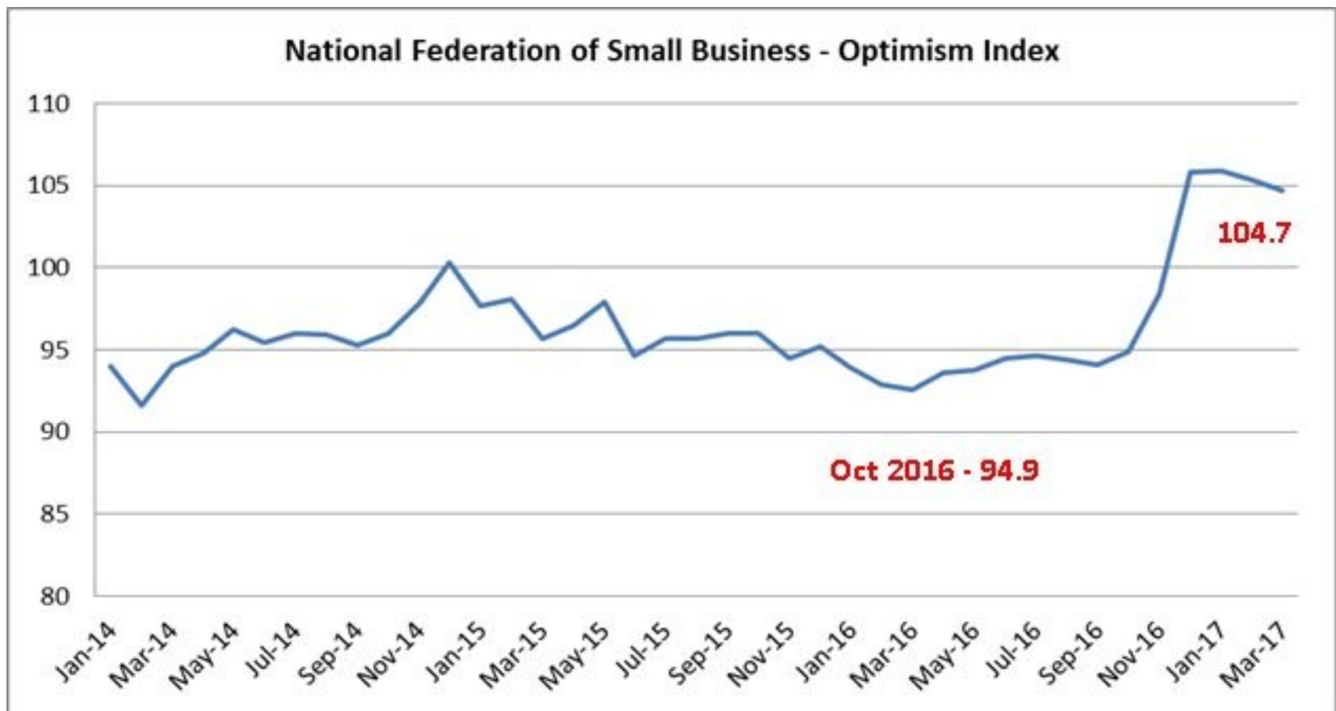
Economy

The hope for an improving US economy remains high on the Street, but the data showing an improving economy have been a bit more elusive. Numerous anecdotes, conversations with senior managements, and surveys of business executives suggest that optimism among business leaders on the future is near record highs. Indeed, Chart 1 below shows the March 2017 survey from the National Federation of Independent Business (NFIB) Small Business Optimism Index, which has risen significantly since the US presidential election. Similar surveys among large corporate executives show high degrees of business confidence as well, thanks to expectations about corporate tax reform and a more supportive administration in Washington. The key question, however, is when (if?) this meaningful increase in optimism among corporate decision makers leads to increased investment in employees, capital spending, etc. that should spur strong economic growth. History would suggest that the answer to this question is a resounding "Yes!" Indeed, estimates for capital expenditures for 2017 suggest growth of over 7%, which would be a nice boost in economic activity. But we are not there yet.

Chart 1: NFIB Small Business Optimism Index: January 2014 – March 2017



Source: NFIB and Strategas Group

While we are inclined to favor a more supportive economic outlook for the US, the economic data have been slow to validate what these anecdotes and surveys have suggested. After posting a strong 3.5% growth rate in the third quarter of 2016, the US economy grew at a healthy, albeit slower, 2.1% in the fourth quarter 2016, and economists' forecasts for the first quarter of 2017 call for economic growth of around 2.0% to 2.5%. After healthy gains over the past few months, US Payrolls came in at a relatively weak 98K in the month of March; while this can be a lumpy number month-to-month, it has raised eyebrows among investors about growth in hiring activity. In addition, US Auto sales, which reached a 10-year high in December 2016, actually saw a year-over-year decline in March 2017, reaching a two-year low. Admittedly, the recent uptick in interest rates could have impacted that, and Auto sales have been known to bounce around on a month-to-month basis, but this highlights the tug-of-war between the hope based on growing optimism and the hard data that does not reflect it.

Similarly, readings of consumer sentiment continue to sit at very high levels, with the March Consumer Confidence index hitting its highest level since the end of 2000. Yet the hard Retail Sales data for March show that consumer spending is sluggish. Will the confident US consumer start to increase his spending? History would again say "Yes!" but we are not there yet.

Equities

The equity markets started the year on a strong note, as investor hopes for a favorable backdrop for corporate profit growth increased. Indeed, the tone from corporate managements in their most recent earnings reports in January generally took a more hopeful (and in some case, outright upbeat) stance, albeit with an understanding that policy changes out of Washington, DC have not yet materialized. The net result was the S&P 500 posted an impressive 6.1% total return in the first quarter, while the technology-heavy Nasdaq posted an even stronger 10.1% total return. That is consistent with the change in investor sentiment that began after the elections, which showed increasing investor willingness to take on more risk in anticipation of stronger earnings growth. As a result, the "riskier" growth type of stocks generally outperformed the "safer" dividend-paying stocks in the quarter.

While investor optimism has increased, estimates for corporate earnings and sales growth have actually started to come down, though still sit at healthy levels. As Chart 2 below indicates, the S&P 500 is now estimated to show earnings growth of about 10% and sales growth of about 4.8% in 2017, which is down from earlier estimates of around 13% and 5.6% respectively. However, this would represent the strongest growth in both earnings and sales in several years.

Chart 2: S&P 500 Earnings and Sales Growth, 2012-2017

	2012	2013	2014	2015	2016	2017E
Earnings per Share	6.71%	5.17%	6.65%	-0.24%	1.20%	9.96%
Sales per Share	3.90%	2.48%	4.23%	-2.38%	3.16%	4.78%

Source: FactSet

From a valuation perspective, the overall market currently trades at levels that are above historical averages at roughly 18x projected earnings. Historically, a "normal" valuation level for the markets is around 16x projected earnings, so while the market valuation is a bit high, it is not egregiously so. This suggests that investors are indeed expecting accelerated earnings growth in the coming quarters. It is also a reason why we are closely watching events in Washington, DC, as failure to advance pro-growth policies could cause valuation levels to fall back to more normal levels historically.

First quarter corporate earnings reports begin in mid-April, and investors will be listening closely for any change in tone from corporate managements on the future of their businesses. In general, expectations among investors are elevated going into these reports, with the hope that some progress showing an improving outlook will be visible. Unfortunately, elevated expectations can lead to some disappointments; we much prefer expectations to be lower, which often lead to positive surprises.

Based on the above, we are currently in "watch" mode for our equity portfolios. Cash levels are higher than normal given the prospect for a market pullback in the near-term, though we remain prepared to deploy that cash as individual stocks hit attractive entry points.

Fixed Income

After rising sharply following the US presidential election in the fourth quarter of 2016, the movement in US interest rates was relatively uneventful in the first quarter. After hitting a two-year high at 2.62% in the first quarter, the yield on the US 10-Year Treasury ended the quarter at 2.39% compared to 2.45% to begin the year. There is an ongoing tug-of-war in the bond markets currently: on the one hand, the hope of accelerated economic growth and early signs of inflation have put upward pressure on interest rates. Indeed, the Federal Reserve raised rates another 0.25% at its meeting in March, and has suggested that another two rate increases could come before yearend as a result of the improving economic backdrop. On the other hand, the hard economic data have not yet shown much accelerated economic growth, and rising concerns about Washington's ability to deliver on policies that will indeed stimulate growth have combined to put downward pressure on interest rates.

Given this landscape, our view on interest rates remains largely unchanged. While we had expected rates to give back some of their sharp gains from the fourth quarter, we believe that the trend in rates will be to move higher. As Chart 3 below shows, the yield on the US 10-Year Treasury bottomed back in July 2016 shortly after the Brexit vote in Europe and has risen notably since that time. This dynamic move in such a short period of time leads us to believe that rates will likely be range-bound between 2.20% and 2.70% for the next several months. As long-term investors, we continue to position our bond portfolios with relatively short durations to mitigate the impact of rising rates.

Chart 3: Yields on US 10-Year Treasuries, April 1, 2015 – March 31, 2017