Investors Trust

Investment and Trust Services

Your Goals. Our Knowledge.

Second Quarter 2017

Bob Fontana, CFA

			Total Return	
Index	**6/30/2017**	**12/31/2016**	**2017 YTD**	**Q2 2017**
Dow Jones	21,349.63	19,762.60	8.0%	3.3%
S&P 500	2,423.41	2,238.83	9.3%	3.1%
Nasdaq	6,140.42	5,383.12	14.7%	4.2%
S&P 400 Midcap	1,746.65	1,660.58	6.0%	2.0%
Russell 2000	1,415.36	1,357.13	5.0%	2.5%
Yield on 10-Year Bond	2.30%	2.45%		

Source :FactSet

Investment Summary

The first half of 2017 was kind to equity investors, with the major averages up between 5-15% for the year. For its part, the second quarter saw the major equity indices up between 2-5% for the quarter. Despite little progress on healthcare reform or legislation encouraging more pro-growth economic activity, confidence among business leaders surged in the first half of the year. Most importantly, earnings growth, which ultimately drives stock prices, increased sharply both in the US and overseas, boosting investor confidence. Indeed, investors have overlooked the issues in Washington, whether it be an impulsive tweet or questionable comment from President Trump to ongoing dysfunction among members of Congress, largely due to the improving earnings picture. While the markets are overdue for a pullback and there is no shortage of potential issues for us to worry about, we remain hopeful that returns for 2017 should be nicely positive.

A key variable impacting the equity markets remains policies coming out of Washington, DC, and the most significant policy likely relates to corporate taxes. Given the inability of the Republicans to find consensus around key issues thus far, the Street increasingly believes that prospects for tax reform have diminished, perhaps notably. Accordingly, a major tax reform similar to what occurred in 1986 is now unlikely. However, a corporate tax cut, which requires much less debating and has greater support than broader tax reform, still remains a realistic possibility. If that were to occur, earnings growth would likely accelerate sharply in the subsequent quarters. Encouragingly, earnings growth in the first quarter topped 13%, the strongest quarterly growth since 2011, so it is quite possible that markets continue to act well without any corporate tax cut if indeed earnings growth remains robust. While acknowledging the potential for a short-term pullback, we currently remain constructive on the longer-term outlook for the markets given the improving economic landscape.

In the bond markets, yields dropped to the lowest levels of the year before finishing the quarter with only a slight decline. This occurred despite the Fed raising rates by another 0.25% at its meeting in June and continued suggestions that another 0.25% increase in rates would likely occur before the end of the year. As things now stand, we do expect the Fed to raise rates one more time this year given the economic backdrop, though we remain convinced that the Fed will proceed cautiously with rates if the economic data turn down. Irrespective, our view remains unchanged that rates have already bottomed and the longer-term trend for rates is likely higher. Accordingly, we continue to keep durations relatively short in our bond portfolios.

Our Services:

Individual Retirement
Company Retirement
Investment Services
Trust Services

FAQ: What makes Investors Trust Company Different? Does Investors Trust Company only manage trust accounts?

Read More FAQs Here

Chapel Hill Office

121 North Columbia Street
Chapel Hill, NC 27514
P: 919.945.2459

Charlotte Office

5925 Carnegie Blvd., Ste. 550
Charlotte, NC 28209
P: 704.940.3544

Greensboro Office

127 North Greene St., Ste.100
Greensboro, NC 27401
P: 336.274.3334

Economy

US economic growth slowed in the first quarter despite hopes for improvements from less regulation, corporate tax reform, and a boost in infrastructure spending. Gridlock in Washington has reduced hopes that corporate tax reform or infrastructure spending will be realized this year, though an easing of regulations on corporations does appear to be taking hold. But the impact for 2017 will likely be muted. Indeed, the US saw growth of only 1.4% in the first quarter of 2017, down from 2.1% in the fourth quarter, and economists' expectations suggest full year 2017 growth of around 2.2%. Admittedly, that would be better than the 1.6% growth realized in 2016, but hardly something to get particularly excited about.

With that said, optimism among corporate executives remains high. We continue to wait (hope) to see whether this optimism leads to increased investments that should drive further economic growth. History suggests that it will. Further, despite media reports to the contrary, we continue to believe that some type of deal around corporate tax cuts will be realized. Indeed, while the media has focused heavily on the dissension in Washington, all members of Congress have corporate constituents that would likely benefit from a reduction in the US corporate tax rate. The fact that the current US corporate tax rate (35%) is the highest among the developed economies and likely hurts the ability of US companies to compete globally could compel otherwise hesitant Congressmen to support some kind of reduction in rates. We view this as particularly important, less so for 2017 but more so for 2018. Indeed, as Chart 1 below shows, the impact on corporate earnings growth simply from a reduction in the corporate tax rate is substantial. Indeed, earnings growth could range from roughly 17% to over 30% depending on what corporate tax rate is ultimately settled upon, and this is before any benefit from investing money that otherwise would have gone to the government in areas to spur further growth.

Chart 1: Estimated Earnings per Share Growth from Corporate Tax Cuts

	Estimated
Corporate Tax Rate	**EPS Growth**
25%	~17%
20%	~25%
15%	>30%

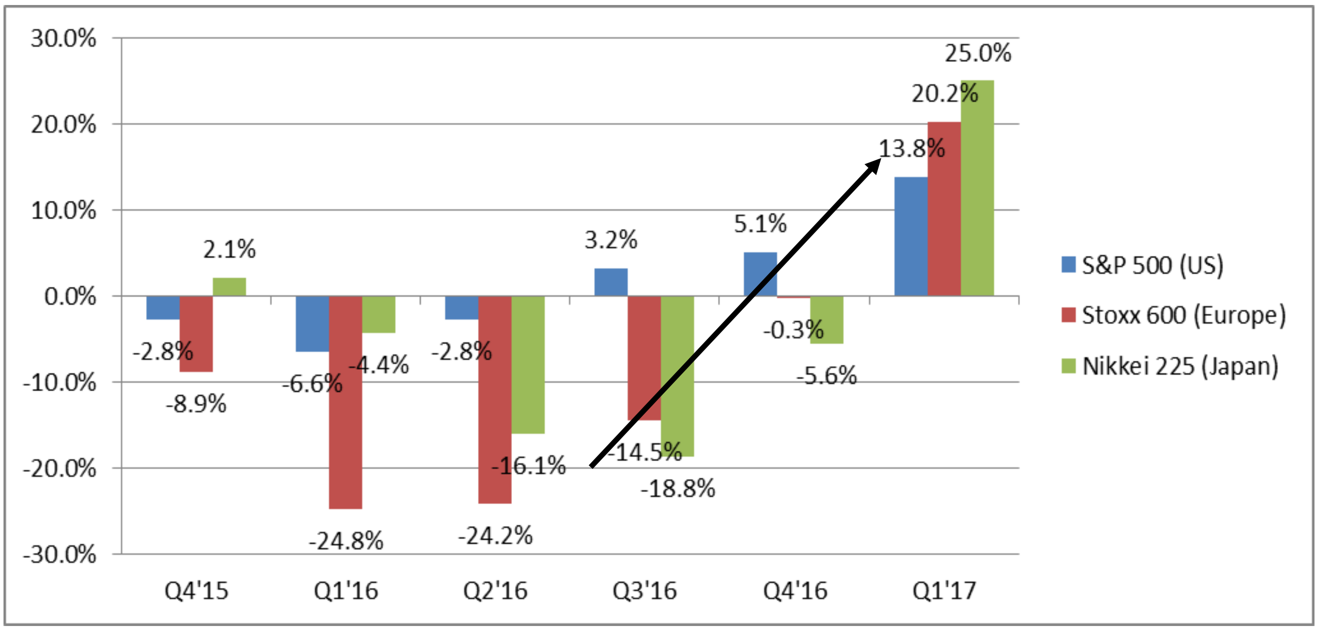
Beyond the prospect for a change in tax policy, underlying economic data remain supportive of healthy US growth. Specifically, a key measure of US manufacturing activity (the ISM Manufacturer's Report) hit in June its best level since 2011, suggesting the outlook for the sector is strong. In addition, the Unemployment Rate has declined to levels not seen since 2001, leading to measures of Consumer Confidence that sit near 16-year highs. While consumers have shifted where and on what they spend their money, the outlook for consumer spending continues to be solid. Overall, irrespective of tax policy, the current economic data indicate an improving landscape.

Equities

The equity markets have performed quite well the first half of 2017, and done so in the face of little to no progress on what investors had hoped would be a more business-friendly and pro-growth economic agenda out of Washington, DC. Indeed, the total return for the S&P 500 for the first half of the year was 9.3%. Consistent with the first quarter, the "risker" growth stocks have outperformed the "safer" dividend-paying stocks for the year thus far. The single biggest question we are asked is why the markets are doing so well in the face of so many apparent blunders from President Trump and Congress. While the Street is accustomed to dysfunction out of Washington, our unequivocal response to that question is EARNINGS!

It is easy to get caught up in the headlines of the day, oftentimes which are negative and suggest that the markets should actually be declining. But investors have quickly learned that an impulsive tweet or offhand comment by President Trump that may make the nightly news typically has no impact on corporate earnings. As we have said numerous times in the past, corporate earnings are what ultimately drive stock prices, and corporate earnings growth has rebounded sharply across the globe. As Chart 2 below shows, after several quarters of largely negative earnings growth, the first quarter of 2017 saw strong double-digit corporate earnings growth in the US, Europe, and Japan. This includes the best quarterly earnings growth in the US since 2011 and is why the equity markets have performed so well thus far for the year.

Chart 2: US/Europe/Japan Corporate Earnings Growth, Q4 2015 – Q1 2017



Source: FactSet, Strategas Group

Can this type of earnings growth continue? As noted above, corporate tax rates could have a significant impact on just how strong corporate earnings growth could be. The fact that we saw such strong earnings growth in the first quarter is quite encouraging, especially since there was virtually no benefit from business-friendly policies from Washington. Second quarter corporate earnings reports begin in mid-July, and investor expectations have moderated given the lack of progress on healthcare and tax reform. Investors will be trying to determine if the surge in confidence among business leaders that was evident earlier in the year has waned.

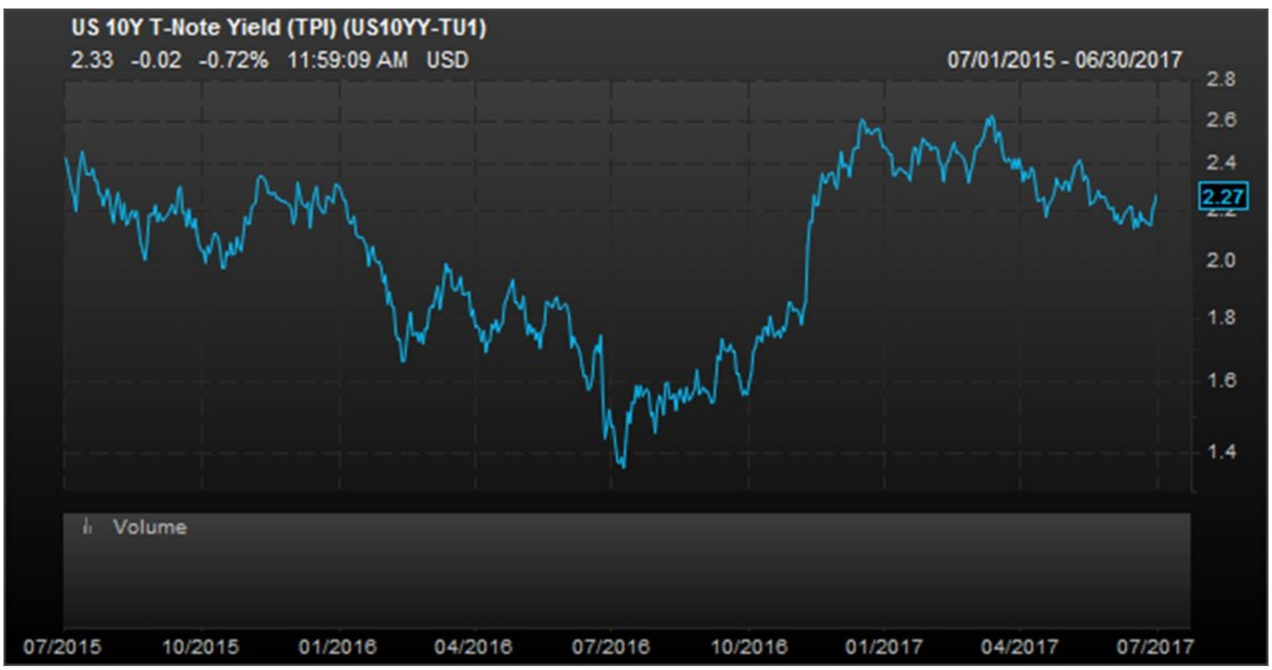
We remain encouraged about the outlook for the equity markets given reasonable likelihood for improved earnings growth. While the strong run in the first half of the year makes the markets vulnerable to a short-term pullback, we would currently use such a pullback to deploy cash in stocks that we expect to move higher.

Fixed Income

Increasing concern about geopolitical events and US economic growth that has not been as strong as some had hoped caused yields to hit their lowest levels since the US presidential elections during the quarter. As Chart 3 below shows, after hitting a 2017 low of 2.13%, the yield on the US 10-Year Treasury finished the quarter at 2.30%, which is down from 2.45% at yearend 2016 and 2.39% at the end of the first quarter. The Federal Reserve raised rates by another 0.25% at its meeting in June, the second such increase this year, and Fed governors continue to signal that at least one more rate increase should occur before year-end. The Fed is actively trying to "normalize" rates from the emergency levels imposed after the 2008-2009 financial crisis now that the US economy is on stronger footing. In addition, the Fed has begun to discuss reducing its balance sheet, which increased sharply since the financial crisis as the Fed purchased various fixed income securities to help stabilize the markets. At the same time, the Fed does not want to move too quickly for fear of hurting the economy.

Given this backdrop, we continue to believe that the trend in rates will be to move higher. We had previously suggested that rates would likely trade within a range of between 2.20% to 2.70%; while rates dipped slightly below the 2.20% level, we continue to view that range as reasonable. Our fixed income portfolios for our clients remain positioned with relatively short durations on the view that the long-term trend in rates is higher.

Chart 3: Yields on US 10-Year Treasuries, July 1, 2015 – June 30, 2017



Source: FactSet