Market Commentary

Second Quarter 2017

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The second quarter of 2017 saw US equities continuing to build on their gains since Election Day. The benchmark S&P 500 Index had a total return of 3.1% during the second quarter, bringing its gain to 9.3% for the first six months of 2017. From the February 2016 lows, the S&P 500 has climbed over 36% on a total return basis through the end of June. Volatility remained near multi-decade lows as evidenced by the 2.8% maximum drawdown of the S&P 500 for the first six months of 2017. Historically, the average drawdown over the first half of the calendar year is over 11%, so this year has been an anomaly. The 10-year note yielded 2.30% on June 30, 2017, below the 2.40% yield at the end of March. Returns for most fixed income holdings were modestly positive during the quarter as inflation expectations trended lower.

Economic and Market Outlook

Oil prices declined during most of the quarter, falling by 9% from $50.60 on March 31 to $46.04 on June 30. This continues the decline from the $53.72 at the beginning of the year. Oil did fall to just above $42 a barrel during June, marking yet another bear market for the commodity. We continue to use a $50 midpoint for oil in our economic forecasts (within a range of $40-60 per barrel) but view a sustained lower price as a benefit to consumers and disposable income.

The Federal Reserve increased the Federal Funds rate by an additional 25 basis points in Mid-June to a new target range of 1.00%-1.25%. This third hike in six months continues the normalization of interest rates. Confounding many, the long end of the interest rate curve is not moving higher, most likely due to scant evidence of inflationary pressures. The Fed believes it will raise rates by an additional 25 basis points at some point in late 2017 and an additional 75 basis points in 2018. This would result in a Federal Funds rate of approximately 2% in late 2018.We continue to believe that the "terminal rate" in this cycle will approximate 2% and not the 3% to 4% that many still expect. To see Federal Funds move meaningfully above 2% would require faster than expected economic growth along with rising inflationary pressures. Importantly, the Fed for the first time said it would give details on unwinding its bloated balance sheet in the coming months. We expect a modest start to the unwinding in late 2017 with the Fed rolling off maturing Treasuries and mortgage backed securities over the next three years to bring its balance sheet down from the current $4.4 trillion to approximately $3.3 trillion in late 2020. This unwinding of the balance sheet may be the catalyst to drive long-term rates higher.

To many, the resiliency of the US stock market is confounding. Over the past few years, the market has grinded higher whether the news is good or bad. We believe a good part of this is due to the overwhelming amount of liquidity that central banks have pumped into the financial system since the 2007-2009 recession. The huge amount of monetary stimulus has resulted in almost $10 trillion of Sovereign debt carrying a negative yield worldwide. These extremely low global yields have forced investors to search for returns which have helped drive many into stocks.

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After a nearly unbroken climb higher since the 2016 elections, we see a number of potential issues that could cause a short-term pullback in markets during the balance of 2017. These include delays in healthcare reform and/or tax reform. As we move into the fall, we need a resolution to the impending US government debt ceiling negotiations. These tend to always be messy and disconcerting, yet always seem to get resolved after a prolonged period of grandstanding by both sides. On the geopolitical front, North Korea is at the forefront, but continued tensions in the Mideast along with deteriorating US-Russia relations could serve as flashpoints in the coming months.

Portfolio Positioning

The second quarter saw more acceptance that the "Trump trades" (financials, small-cap stocks, certain industrial companies) will not move higher in a straight line due to the uncertainty involved in passing any meaningful legislation. We continue to believe that a more benign regulatory environment combined with an easing of lending practices would be the most beneficial drivers of a stronger economy. Equity portfolios remain focused on stable growth companies, eschewing the "hot" areas that may drive markets over the short –term, but entail significant risk. While we made only minor changes in equity portfolios during the quarter, fixed income portfolios saw a move towards more "credit" risk and away from duration risk. Put simply, we moved to cushion portfolios against steadily rising interest rates, taking advantage of the sharp decline in yields over the past few months to make the changes.

Conclusion

In summary, the US economy continues to perform well, and is doing better than many had expected as recently as six months ago. That said, projections for GDP growth remain in the 2% range for 2017 and 2018, so there is ample potential for higher growth. We have long counseled to block out the daily "noise" and focus on what actually drives stock prices over the long-term – economic growth along with corporate earnings. Earnings, along with interest rates and inflationary expectations are the key drivers. Political and daily news chatter may cause short-term fluctuations but as long-term investors, keeping focused on the key drivers will lead to better overall performance. The US economy is doing better than many had projected, unemployment is near a decade low and inflationary pressures remain nearly non-existent. We are watching the Federal Reserve as it attempts to both normalize interest rates as well as shrink its balance sheet. Assuming a benign Federal Reserve and muted geopolitical risks, stocks should be able to grind higher on the back of continued earnings growth. Successful healthcare reform along with tax reform would be additional catalysts to push valuations higher. With markets moving upwards at a nearly unbroken pace since Election Day, we would expect to see modest pullbacks along the way over the next 12 months. These pullbacks will likely be modest (3-5%) and healthy, allowing investors the time to recharge for the next move upwards.

As always, we encourage dialogue with our client base and enjoy hearing from you. We believe the better the communications between our clients and us; the stronger the long-term relationship will develop. Please contact us if you have any comments or questions about your investment portfolio or any financial topics in general.

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