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Q1 2017 Market Commentary

If you like action, the first quarter was fast and furious (no movie pun intended).

The stock market continued to find new highs almost daily, with the Dow Jones Industrial Average surpassing 20,000 for the first time. Before the market caught its breath, the 21,000 level was shattered in just 24 trading days.[1] Some of the air was let out of the balloon in March as the Federal Reserve ("Fed") raised the federal funds rate by 25 basis points and healthcare reform died in Congress, clouding the picture for future tax cuts.

Overall though, the U.S. stock market has responded positively to a pro-business agenda emanating from the new leadership in Washington. With the backdrop of a growing economy, full employment, expanding wages, low inflation and a confident consumer, the promise of less regulation and lower taxes has fueled this market. While this formula brought us here, the question remains, can the concepts be converted into policies and reality? Stay tuned.

As far as the markets are concerned, the technology heavy Nasdaq Composite led all comers with a 10% gain, setting record highs in the first quarter. The Standard & Poor's 500 ("S&P 500") stock index added 6%, while the blue-chip Dow Jones Industrial Average gained 5%. It was the Dow's sixth consecutive quarterly gain, its longest streak since 2006. The Russell 2000 index of small companies rose 2%.[2]

The U.S. market has found leadership from only a handful of stocks this year. Ten stocks in the S&P 500 have shouldered roughly half of the index's gain thus far in 2017. On top of that, forty stocks or 8% of companies in the S&P 500 make up roughly 85% of the index's return year-to-date.[3] Energy was the primary laggard as oil prices found their way to just below $50 per barrel, down from a high of $56 in mid-February.[4]

On a more global level, stock returns were generally positive around the world last quarter with emerging markets and international developed leading the way. Currently, we are witnessing an unprecedented disconnect between U.S. equities and non-U.S. equities. International markets are becoming more attractive after under-performing the U.S. over the last few years. Also, emerging market equities are bouncing back from a six-year slowdown as confidence seems to be renewed among investors. This recent acceleration in overseas economic growth is becoming reflected in their stock prices and a reversion to the mean seems to be underway.

Bonds traded in a tight range for the quarter with the 10-year U.S. Treasury reaching a peak yield of 2.6% and bottoming out at 2.3%. Credit spreads also tightened a bit providing an incremental lift to bond prices. Investment grade spreads were slightly tighter and high yield rallied 0.3%, helping this sector outperform.[5]

Interest rates should continue to rise in 2017 on the back of more robust growth, greater inflation pressure and bigger government budget deficits. The Fed could hike interest rates two to three times during the year, and we expect the dot plot of Fed governors' projections and market expectations for future rate levels to continue converging.

With all of that said, this remains an interesting time for

1 FactSet financial data and analytics. www.factset.com

2 FactSet financial data and analytics. www.factset.com

3 The five markets charts that matter for investors. (2017). Financial Times. Retrieved from https://www.ft.com/content/c4de73e2-17a1-11e7-9c35-0dd2cb31823a

4 FactSet financial data and analytics. www.factset.com

5 FactSet financial data and analytics. www.factset.com

the bond market. The Federal Reserve is on a long overdue mission to raise short-term interest rates and return to normal monetary policy. This could be the first year in the last decade where the Fed raises rates on multiple occasions. In addition to a few more rate hikes this year, the Fed also must reduce their balance sheet by selling trillions of bonds they purchased during the multiple quantitative easing programs. This process will take years to unwind. It's okay to own bonds for the basic reasons of income, principal preservation or volatility control, but temper your expectations for this asset class as we move through the year.

So, what does the outlook for April and the rest of the year look like? We believe more positive than negative for the immediate future. The Trump bump lost some momentum in March thanks to the GOP failure to repeal Obamacare, but both markets and corporate results delivered solid results in the first quarter. Meanwhile, year-over-year quarterly earnings growth is projected to have hit a multi-year high. For first quarter 2017, the blended earnings growth rate for the S&P 500 is 9.2%. If in fact 9.2% is the actual growth rate for the quarter, it will mark the highest year-over-year earnings growth for the index since the fourth quarter 2011 (11.6%).[6]

After several years of slowing growth, 2017 looks to end the deceleration trend, as the U.S. once again becomes the lead driver of global economic activity. Longer-term technicals/data continue to look firm and, we believe, could lead to potentially higher prices. Sentiment is more of a mixed picture, which coupled with high uncertainty may lead to increased volatility. While our base case view is positive, the risks around it are greater than usual. These include the possibility of an aggressive Fed response to over-accelerating growth in the U.S., a more severe downturn in China, and the eruption of trade wars. There is also the upside risk that political and market developments trigger a positive chain reaction that challenges the whole secular stagnation narrative and results in better longer-term growth prospects.

It is important to remember that markets move higher over time, but they do not move higher all the time. The first quarter was a solid one despite a slight pullback in March. We believe the markets are fairly valued here, but not overvalued. Stocks moving higher from here by year-end and bonds earning the coupon are reasonable 2017 expectations. Like 2016, there will be some bumps in the road. An employed and confident consumer in a lower tax world should lead the way to moderately higher stock prices. Stay invested and use any pullbacks as a buying opportunity.

To discuss this commentary further, please contact us at 914-825-8630.

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6 Butters, John (2017, April 13). Earnings Insight.
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