Quarterly Economic Update 1Q 2017

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The Quarter in Brief. An improving global outlook and record levels of optimism allowed the Trump rally to continue though many of last quarter's winners were the laggards of Q1.

Economic News. The Bureau of Economic Analysis released the final estimate of the Q4 2016 GDP, an annualized rate of 2.1 percent, down from the 3.5 percent posted in Q3 2016. The annual rate of 1.6 percent in 2016 marks the eleventh consecutive calendar year that the U.S. economy has failed to grow at least 3 percent. However, corporate profits increased $11.2 billion in Q4 – the second consecutive quarterly increase in corporate profits. This follows five straight quarters of corporate profit declines.

The three-month average for non-farm payrolls was 177,600. The March number of only 98,000 (down from 219,000 in February and 216,000 in January) was largely ignored by the market, citing extreme weather earlier in the month. The unemployment rate in March dropped to 4.5 percent, and average hourly earnings rose again in March, up 2.7 percent over the last 12 months.

Existing home sales rebounded in March (4.4 percent), putting year-over-year sales growth at 5.9 percent. The median home price increased 6.8 percent from March of last year, due in part to the fact that supply remains near an all-time low.

The ISM Manufacturing Index (PMI) was 57.2 percent in March, a slight decrease from February (57.7 percent), but well above the 50 percent level that indicates expansion. The ISM also noted that of the 18 manufacturing industries, 17 reported growth in March.

In a widely anticipated move, the Fed raised the target fed funds rate by .25 percent at its March meeting. While short rates moved higher, "dovish" comments by Fed Chair Janet Yellen helped push rates on the long-end of the curve down, creating a flatter yield curve. Nonetheless, the "normalization" of the Fed Funds Rate continued, leaving the consensus estimate for two more .25 percent hikes in 2017, followed by three in 2018.

While the economy continues to provide a reasonable foundation for growth, the more compelling story is the optimism brought by the prospects of regulatory reform and fiscal stimulus championed by the Trump administration. In March the Conference Board's Consumer Confidence Index hit its highest level in 16 years. The NFIB Small Business Optimism Index hit its highest levels since 2004 and the Business Roundtable's CEO Economic Outlook Survey rose to its highest reading since 2009. While confidence was rattled when the House was unable to pass its proposed health care reform bill in March, both consumer and business surveys remain at historically high levels.

International economies have shown renewed momentum as well. The International Monetary Fund raised its outlook for global economic activity, especially in developing economies. Europe continues to see progress in its recovery and consumer and business surveys reflect a level of confidence not seen since 2009.

The Markets. The combination of a solid economy, better earnings power, and growing investor confidence helped push most asset classes into the black. U.S. stock indices established record highs in the first two months, but stalled in late March when it became painfully obvious that healthcare reform was dead on arrival. Despite the sell-off in late March, the S&P 500 still managed to post a gain of 6.07 percent. The index has now posted a positive return in 16 of the last 17 quarters.

While the Trump rally (up 10.5 percent since the election) continued into Q1, the U.S. equity market showed a reversal in leadership from Q4 2016. The Russell 2000 (small caps) lagged the S&P 500 by 3.6 percent in Q1 with a 2.47 percent total return after outperforming the S&P 500 by over 5 percent last quarter.

Index Performance	Q1 2017	Q4 2016	YTD
Domestic Equity			
S&P 500	6.07%	3.82%	6.07%
Russell Mid Cap	5.15%	3.21%	5.15%
Russell 2000	2.47%	8.83%	2.47%
International Equity			
MSCI EAFE	7.24%	-0.71%	7.24%
MSCI Emerging Markets	11.49%	-4.08%	11.49%
Fixed Income			
Barclays Aggregate	0.82%	-2.98%	0.82%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

International stocks also reversed. A rosier outlook for global growth, stronger manufacturing data, and the strengthening of local currencies relative to the U.S. dollar all helped international stocks outperform the U.S. in Q1. While developed international delivered strong returns (MSCI EAFE +7.24 percent), the MSCI Emerging Markets index was the big winner – up 11.49 percent, the biggest quarterly gain since 2012. Relatively cheap valuations, rising commodity prices, and stability in China helped boost demand for emerging markets assets.

Fixed income investments bounced back to post positive returns (Barclays Aggregate +.82 percent) after booking negative returns in Q4. Though the Fed raised short-term rates in March, rates on longer-term treasury yields decreased modestly, resulting in a flatter yield curve. The 10-year Treasury yield reached a high above 2.60 percent in March before dropping to 2.40 percent by the end of Q1.

S&P 500 Sector Performance	Q1 2017	Q4 2016	YTD
Consumer Discretionary	8.45%	2.31%	8.45%
Consumer Staples	6.36%	-2.02%	6.36%
Energy	-6.68%	7.28%	-6.68%
Financials	2.53%	21.10%	2.53%
Healthcare	8.37%	-4.00%	8.37%
Industrials	4.56%	7.21%	4.56%
Information Technology	12.57%	1.19%	12.57%
Materials	5.86%	4.70%	5.86%
Real Estate	3.54%	-4.41%	3.54%
Telecommunications	-3.97%	4.78%	-3.97%
Utilities	6.40%	0.14%	6.40%

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Sector leadership also reversed – and the difference between the best and worst performing sector was enormous. Energy, one of the best performing sectors in 2016, was the worst performing sector (-6.68 percent) in Q1, as a rise in the price of oil hurt the group. Technology rallied 12.57 percent to lead the S&P 500 index, and consumer staples and real estate were in the black after suffering losses in Q4. Healthcare (+8.37 percent) recovered nicely, benefiting from better performance in biotech and the fact that the Obamacare repeal was tabled. Consumer Discretionary was up 8.45 percent even though just about everything in retail (except internet retailers) was negative. Consumer staples, utilities, and industrials (6.36 percent, 6.40 percent and +4.56 percent respectively) were all higher for the quarter. A flattening yield curve derailed financial sector returns (+2.53 percent) after posting a whopping 21.10 percent return last quarter.

Outlook. Q1 marked the eighth anniversary of the current bull market, rising over 250 percent (price only) since the March 9, 2009, low. Much of the rally has been the result of aggressive monetary stimulus but that seems to be changing as the economy is stronger and the Fed is beginning to remove some of its support.

The economy appears to be in good enough shape to support further rate hikes, but future moves are likely to be gradual. Economic stimulus will now turn from monetary (Fed) to fiscal (taxes, deregulation, spending), shifting much of the heavy lifting from the Fed to government officials in Washington.

Investor euphoria has waned a bit as the inability to get health care reform passed highlights the challenges we are still likely to face – even with a Republican majority. Nonetheless, sentiment levels remain high and whether or not the "hard data" (economic numbers) can support the "soft data" (surveys) going forward remains a risk.

Stock market volatility remains at extremely low levels, even in the face of high geopolitical uncertainty. The S&P 500 went 110 trading days without experiencing a daily drop of 1 percent until the streak ended on March 21. At some point investors will demand an eventual pick up in the economic data, earnings, or both to validate the premium valuation levels (13 percent premium to the average of last 15 years) that exist in the markets today. As of March 31, 2017, consensus estimate for Q1 2017 S&P 500 operating EPS was $29.17, up 9.9 percent year-over-year. That would mark the highest earnings growth rate in five years and would be a very good start.

International equities represent over half of the world's market capitalization, and until Q1, have been laggards throughout this rally. That reversed in Q1 as capital flows increased to both developed and emerging market equities. Cheap valuations relative to the U.S. could allow this to persist, and if so, would remind us all why diversification across the globe is so widely adopted.

Improving economic fundamentals, a stronger earnings picture, and surging confidence all point to an economy that is sitting on a much firmer foundation. Fiscal policy in the U.S. and political risk in the Eurozone will remain in the headlines in the months ahead. The biggest risk for investors might be missing out on the next leg of the secular bull market, as positive news on either front could be a major catalyst to push the market higher.