Economic & Market Commentary

The first quarter saw a continuation of the upward move in asset prices that prevailed at the end of 2016. Stocks had a positive January and February, then stalled from March into April, as the euphoria of the presidential campaign message gave way to the reality of governing. Bonds eked out a positive return as interest rates peaked in December, with the ten year Treasury yield reaching about 2.60%, then drifting off to the current level under 2.25%. The character of the markets was a mirror image of the year end picture. The so called "Trump Trade", with cyclical issues outpacing defensive, value doing better than growth, small and mid-cap besting large cap, and the U.S. being the top performing global market, reversed in the quarter. The best performing sectors of late 2016 were turned on their heads as we began 2017. Financials, energy and industrials were the worst performers, while consumer staples, healthcare and some technology issues went from worst to best. Likewise, growth and large cap traded places with value and small cap. Globally, of the 21 countries monitored by *The Wall Street Journal,* 15 outperformed the U.S equity markets.

The first three months of the Trump presidency have been revealing, with probably the largest revelation being the realization that even with a Republican in the White House and a congressional majority the enactment of legislation is not assured. The high expectations of campaign and post inaugural rhetoric have been replaced by fears that many of the beneficial policy measures promised may not come to fruition. The failure to repeal and replace Obama Care and the issues with immigration have called into question the ability to enact tax reform, a much needed infrastructure program and further reduction in onerous regulation. All of these policies are thought to be beneficial and supportive of future economic growth. Without them the trajectory of the U.S. economy could be called into question. Compounding this is the mercurial and contradictory nature of the Trump Administration. We have noted this before, and the recent past has done nothing to diminish these concerns. *The New York Times* recently published a long list of contradictions that the President has uttered. There were 15 or more, including statements about Syria, Russia, China, NATO, NAFTA, tax reform, the Fed, taxes, and more. These statements and contradictions have deeply unsettled and confused leaders both here and abroad, clouding credibility.

We wrote last time we felt like the proverbial two handed economist – "on the one hand and on the other hand" - the past three month has done nothing to change that feeling. Our base case for the U.S. economy is as it has been for several years – a below trend growth environment with U.S. real growth in the 2% area and global growth about 3%. As a result of what looked like a growth oriented change in Washington, we said we would tilt our assumptions higher for the next couple of years. In truth, the improvement in the U.S. economy began before the election. All measures of confidence – business, consumer, CEO's, small business, trended upward and are close to record highs. While the U.S. economy has been soft in the first quarter (current estimates are for +1% real growth), the global economy has picked up. The World Bank currently estimates nominal global growth of close to 6% for the year. Our more positive tilt going forward of course is dependent upon this growth agenda being passed.

This brings us to "the other hand", as there are enough distractions and contradictions to call into question the ability to get some of these measures to and through congress. The fiscal path will not be smooth, as has been indicated by earlier problems. Additional bumps in the road include the April 29th expiration of the government spending authority (potential government shut down), and the expired debt ceiling; both must be addressed. Congressional rancor and extreme partisanship, which won't go away, will make all of these issues difficult to resolve. Compounding our domestic problems is the geopolitical situation which has become more heated. Syria, Russia, North Korea and China present significant tests to the new, inexperienced, administration. Then there are European elections and Brexit, which we have no control over, but could present problems. The Netherlands election turned out well, but France (round 1 April 23 and round 2 May 7), Italy, and Germany (2018) could be significant. At the very least, these geopolitical problems will be distractions, or worse, for a mercurial and untested administration.

The financial markets have taken the confusion of this quarter with surprising equanimity, as volatility has been almost nonexistent. The S&P 500 has gone more than 100 days without a decline of 1%, the longest period since 1995. We are surprised at this, and do not expect it to continue. We wrote last time that we expected volatility to increase, and we still do. The markets have high expectations built into current prices and could suffer if the Trump message gets sidelined or derailed. Given the current backdrop it is not inconceivable that this could happen. U.S. stocks are currently trading around 18x expected earnings, in their 10th decile of valuation (more expensive than they have been 90% of the time). Profit margins are near record levels and revenue growth is modest. Therefore it seems to us that consensus profit expectations are high (+11 – 12%) and likely to come down over the course of the year. Most of the fiscal policy initiatives proposed will not affect 2017 in a significant way, but rather (should they be enacted) will be 2018 measures. Analysts estimate that a reduced corporate tax (23% area) and repatriation of foreign cash could add $10-$11 to S&P500 base earnings (close to $130) in 2018 – not an insignificant number. On balance, we come down thinking that U.S. stocks will probably "mark time" for several months with increased volatility, while the fiscal policies of the administration get sorted out. We see no reason to make major changes to our current positions, and like the option of having liquidity to take advantage of opportunity should it arise.

Fixed Income Market Review 1Q17

Treasury yields rose for most of the first quarter, based on continued enthusiasm by investors for the proposed policies of the new administration including increased infrastructure spending, lower taxes and less regulation for businesses. Then in mid-March, the Federal Reserve raised its target for the Federal Funds Rate by 25 basis points as widely expected at its meeting. Although yields across the curve had been rising in March up until the Fed's announcement, yields subsequently began to fall once the announcement was made. This was due to some dovish comments by Federal Reserve officials following the Fed meeting as well as due to the delay in implementing the proposed fiscal stimulus programs and tax cuts for both individuals and businesses proposed by the new administration. The Fed reiterated its target for 3 rate hikes this year, but is willing to continue being cautious and patient with its actions to avoid dampening economic and employment growth.

As the quarter headed towards its close, investor skepticism grew about the timing and ability of the new administration to pass its economic policies. Treasury Secretary Steven Mnuchin even stated that the proposed tax reform deadline of this August is “not realistic at this point.” This has led to a significant rally in bond prices and a decrease in bond yields that began in mid-March. The Treasury yield curve flattened further with very short-term rates (less than 2 years) rising and all other rates falling during March. The story is virtually the same for the quarter with short-term rates (3 years and less) rising sharply with the 1-Year Treasury up 21 basis points and all other rates falling slightly with the 10-year Treasury yielding 2.39% at the end of the quarter, a level 6 basis points less than where it began the year.

In addition to the new policy delays, there have been indications of some weakness in economic growth. One measure of inflation, the Consumer Price Index fell 0.3% in March which was more than expected by economists. At the same time retail sales fell for a second straight month, declining 0.2% in March after decreasing by 0.3% in February based on U.S. Commerce Department figures. It is important to note that lower prices may have impacted these figures as well since these data points are not adjusted for changes in inflation. While the first quarter is typically a weaker period for retailers so the decline was mostly factored into forecasts, the inflation data was surprising given recent signs that businesses had regained some pricing power.

These economic indicators provide more support for dovish Fed officials to take their time in raising rates. Although expectations for further rate hikes are a bit lower than last month, there is still a 32% probability for the Fed to achieve its targeted 3 interest rate hikes for 2017, based on futures market expectations, including a 50% probability for a June rate hike. We believe the Fed will need further data before changing its targeted number of rate hikes for this year, particularly since the Fed’s favored inflation indicator, the Personal Consumption Expenditures (PCE) Index’s most recent level revealed a 2.1% inflation rate as of February that now exceeded the Fed’s 2% inflation target and is up significantly from its 0.6% level a little more than a year ago.

For the quarter, the Bloomberg Barclays Aggregate Bond Index returned 0.82% reflecting the aforementioned late-quarter rally in bond prices. The corporate bond sector was among the best performing sectors returning 1.25% in the benchmark index.

FI PORTFOLIO STRATEGY REVIEW

While interest rates for maturities longer than 2 years were little changed from their starting point to the end of the quarter, the underlying story is the yields rose substantially during the quarter before dropping back down near to starting levels. Similar to the sudden rise in yields that we saw after November's election, yields rose sharply in February through mid-March, with the 10-year Treasury yield increasing from 2.33% on February 9th to reach 2.63% on March 13th, before closing the quarter at 2.39%. As mentioned in previous letters, despite the Federal Reserve's intention to gradually push up interest rates, the movements in yields more often than not come in pronounced, rapid movements. Our clients' portfolios are primarily invested in short-to-intermediate term bonds and designed so that the maturities provide an opportunity to invest periodically as interest rates change.

We continue to believe corporate bonds provide good relative value compared to other bond sectors, although the incremental yield earned in corporates has lessened as spreads have continued to tighten. The spread on corporates to Treasury bonds in the Bank of America Merrill Lynch US Corporate Index declined from 160 basis points last June to just 120 basis points in March. Still, the spread tightening is not that surprising given the strengthening corporate balance sheets, growing corporate profits and free cash flows available to support the corporate debt.

Municipal bonds were relatively strong during the quarter, with the Bloomberg Barclays Municipal Bond Index returning 1.58% during the 1st quarter, which helped offset its underperformance last quarter. Due to the appreciation in municipal securities, the 10-year municipal bond yields are now 94% of 10-year Treasury yields compared with 107% last December. That is, while municipal bonds are still advantageous for taxable investors, they are relatively less attractive compared to the end of last year.

Treasury yields continued to fall at the start of the 2nd quarter, as fixed income investors looked for the administration's fiscal programs to get back on track in terms of both timing and probability of being enacted. Although bond yields for maturities over 2 years decreased by the end of the quarter to levels near where they began 2017, yields still have moved appreciably higher from pre-election levels, while remaining well below recent historical levels.

Furthermore, the Federal Reserve still desires to return rates to "normalized" levels. The Fed will proceed cautiously and, if further data supports slowing the pace of interest rate hikes, it has the flexibility to do so, but it has not backed away from the 3 interest rate hikes targeted for this year. The Fed's meeting notes also included discussion of reducing the Fed's balance sheet for the first time. Although a specific timeframe was not discussed, the reduction of Federal Reserve's Treasury and mortgage security holdings could also drive yields higher. For these reasons, our clients' fixed income portfolios are designed to mitigate the impact of significant increases in interest rates, while having the flexibility to invest cash from maturing securities as interest rate levels adjust to changes in fiscal and monetary policy as well as the economy.