Strategy Asset Managers

MARKET ENVIRONMENT

The market continued its positive momentum in the second quarter of 2017 as strong first quarter company earnings combined with the beginning of reduced business regulations to overcome waning hopes of tax reform in 2017. According to Factset, year-over-year earnings growth for the S&P 500 was 13.9%, which represented the fastest growth since the third quarter of 2011. Additionally, 75% of S&P 500 companies exceeded their earnings estimates – well above the five year average of 68%. We look for continued earnings growth in the coming quarters and, unfortunately, continued political malaise.

During the quarter, the current bull market that began in March 2009 became the second longest on record to the 12+ year bull market that ended in the Spring of 2000 – only four more years of positive returns for the record! The total return of the S&P 500 index for the second quarter was 3.1% resulting in an impressive 9.3% return for the first half of 2017. The "Trump rally" since the November 8th election has now produced a 14.8% return.

Outside of the US, the MSCI-EAFE index returned 6.3% for the quarter and 14.2% for the first half of the year aided by expectations of slowly improving growth in Europe and weakness in the US dollar. As an example, France's CAC 40 index returned 7.9% for the first half of 2017 in Euros while in US dollars the index returned 16.8%. We do not expect further significant US dollar weakness in the months ahead.

Despite another 0.25% hike (to 1.25%) in the federal funds rate by the Federal Reserve this quarter, the US Bond market managed to return 0.9% for the quarter and 1.7% in the first half as measured by the Bloomberg Barclays Intermediate Government/Corporate index. The Federal Reserve has increased interest rates for three quarters in a row and we now expect one more increase this year, most likely in December. Aside from further rate hikes, the current discussions at the Fed about how/when to reduce its $4.5 trillion bond portfolio (accumulated via "Quantitative Easing" during the financial crisis) may well prove unsettling to the bond market. On the positive side, the Fed's favorite measure of core inflation remains stubbornly below its 2% target and should help buffer the chances of significantly higher rates.

In the second quarter, Healthcare was the lone standout performer among sectors returning 7.1% as managed care companies rallied strongly on the delay of healthcare reform and medical device makers responded positively to takeover activity. On the downside, two sectors had negative total returns. Telecommunications (-7.0%) led the downside as continued price wars and slowing subscriber growth remained problematic. Energy once again had negative returns (-6.4%) as oil prices fell 9% during the quarter, and energy product inventories remained at relatively high levels.

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OUTLOOK

The “Goldilocks” (not too hot, not too cold) economic environment for stocks remains well entrenched for now. Moderate economic growth (~2%), low inflation (less than 2%), low interest rates and low unemployment (currently 4.4%) have put the bears on an extended vacation. As we discussed last quarter, this type of economic environment presents a friendly climate for steady growth in corporate earnings and therefore stock prices. Thankfully, earnings growth in the long run has a much greater influence on stock prices than politics and most geopolitical concerns.

Politically, we are following the advice that many of our parents taught us, “if you don't have something nice to say, don't say anything”. Healthcare reform, tax reform, financial regulation reform – can anything get accomplished by this Congress? Therefore, we are keeping a watchful eye on the fiscal 2018 budget negotiations as we head into the Fall. While the above reforms may take forever, we feel that both parties have learned their lessons from prior government shutdowns and believe they will choose their fights in other arenas.

While the market remains on the historically high side of valuation, we believe it is supported by the likelihood of a continued Goldilocks scenario that produces positive earnings growth. While we do not see outsized gains in the near term for the market due to a likely lack of valuation multiple expansion, earnings growth should be enough to propel positive returns.

Finally, we would be remiss not to mention that historical volatility of the stock market is currently at an extremely low level and therefore, has a much better chance of increasing than decreasing in the coming quarters. Many investors have been lulled to sleep over the past 5 years or so and we would like to remind everyone that while the S&P has risen by approximately 10% per year over the past 90 years, it has not done so in a straight line.

June 30, 2017