First Quarter Newsletter

April 20, 2017

What a difference a year makes. Twelve months ago, markets had come through one of the worst sell-offs in history, driven largely by fears of global recession which, thankfully, never came to pass. Contrast that to the "animal spirits" that have driven the stock market higher so far this year. While we think further gains in 2017 are possible thanks to positive economic momentum globally, we also continue to believe that a focus on risk management is the most prudent investment strategy.

Indeed, while the U.S. stock market as measured by the S&P 500 is still up about 3% year to date, more recently, we've witnessed a slight pause in the action as the market has slid over 1.5% so far in April. The bond market, which spent the first quarter of this year in negative territory as measured by the Barclays' US Aggregate Bond Index, has bounced back a stunning 2% in April and is now up 1% year to date thanks to an 8% decline in 10-year Treasury bond yields.

The Trump Bump

There's widespread agreement that much of the stock market's rise since the election as well as year to date is attributable to the expectation that pro-growth Trump economic policies will come to pass. Indeed, Trump himself has targeted a 4% growth rate in real Gross Domestic Product. If he is successful, that would double the pace that economic growth has averaged since coming out of the Great Recession in 2009.

He is counting on the following initiatives to accomplish his goal:

- A reduction in both individual and corporate taxes through sweeping tax reform: Simplifying and lowering taxes for individuals could boost spending if folks have more money in their pockets. Likewise, lower corporate taxes could result in higher investments as well as share repurchases and dividend increases.
- Rolling back regulations: Trump wants to make it easier for corporations to conduct businesses without running afoul of regulations. One of his very first executive orders was that for every new regulation created, two existing regulations need to be eliminated. Certainly an argument can be made that bureaucratic red tape can clog up the works for businesses—whether in their formation or growth. Indeed, expectations for a repeal of the Dodd-Frank bill, which placed new regulations on the banking industry after the financial crisis when passed in 2010, was cheered by the financial industry, which in stock market terms soared 20% from the beginning of November to the end of 2016 (representing almost the entire performance for the sector for the year).

- Infrastructure Spending Boost: Trump has announced a $1 Trillion increase in infrastructure spending, aimed at rebuilding America's roads, tunnels, airports and bridges, among other things. Presumably this would create demand for raw materials, equipment and labor which could provide another strong stimulus to growth.

Despite the failure of the first item on his legislative agenda, the repeal of the Affordable Care Act, investors still seem to be holding out hope that Trump's other big initiatives will have better support not only from both parties, but particularly within his own Republican party.

If the other initiatives don't gain traction however, the stock market could be in for a rocky ride.

Global Economic Growth Springs Back

Not all of the optimism behind stocks' rise can be attributed to Trump, however. Corporate earnings growth could be finally revving up. Our new President took office just as the U.S. economy started gaining some positive momentum. Even though a recovery in wage growth has been stubbornly disappointing in this economic cycle, there are signs that it is finally picking up. The Bloomberg Consumer Comfort Index is back to its previous peak in 2007, suggesting folks may be more in the mood to spend their paychecks. Indications from the industrial side of the economy have also shown improvement, in part thanks to higher energy and commodities prices. Oil and gas drilling rig counts are up, railcar loadings are rolling along and U.S. housing data is still quite strong.

Risk Management Key

Positive indicators aside, we feel that rising uncertainties surrounding Trump's legislative agenda could result in higher volatility, at some point. Furthermore, recent geopolitical events—in Syria, North Korea and Afghanistan to name a few—have also increased the likelihood that instability abroad could flow through to financial markets and make investors lose their appetite for riskier assets like equities.

From our standpoint, regardless of what transpires on either front, we are always focused first and foremost on helping you achieve your goals and doing so by paying close attention to risk management. To that end, we have maintained our allocation to equities and where necessary, we have broadened our exposure to ensure that we are more closely aligned with the benchmarks that you judge us by. This includes adding to international equities, where an economic recovery is also finally gaining traction and valuations are still fairly reasonable when compared to the U.S. So far, this strategy has paid off, with the 7.2% year to date rise in international markets, as measured by the iShares MSCI All World ex-US Index outpacing that in the U.S. by more than double.

We have also not changed our stance on fixed income. The improvement in U.S. economic conditions has not gone unnoticed by the Federal Reserve, which, having already raised interest rates once this year (on the heels of three increases since December 2015), seems poised to raise at least twice if not three times more in 2017. As such, we believe it is prudent to manage our interest rate risk by investing in bonds with relatively short term maturities.

As always, we are focused on not only helping you achieve your goals, but also providing you with the best service possible. To that end, please be on the lookout for some initiatives we will be taking this summer to address certain concerns that we have heard from many of you, for instance, the mountain of paper that Schwab sends you for confirmations, etc. In the meantime, please don't hesitate to reach out to us if there's anything you have questions about.

Sincerely,

Scott Upham, Managing Partner   Odette S. Galli, Partner   John D. Duffy, Partner