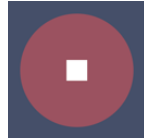

LongView
ASSET MANAGEMENT

2017 First Quarter Review and Outlook

The investor fervor that greeted Donald Trump's election continued into the first quarter of 2017. Financial markets rose on the new administration's promises of looser regulation, tax cuts and increased infrastructure spending. Business optimism and consumer confidence surged, reflecting a consensus that the administration's pro-business agenda will invigorate what has been a steady but frustratingly slow economic expansion. The Federal Reserve's March interest rate hike and Janet Yellen's intimation of further increases this year have reinforced this view.

Stock market gains reflected improving sentiment, with the MSCI All-Country World Index gaining +6.91% during the first quarter. Emerging markets +11.44% and developed international markets +7.25%[1] outpaced the S&P 500 Index return of +6.07%. Signals from the bond market were more mixed. Despite the rise in short term interest rates, the yield on ten year Treasuries actually fell during the quarter. The resulting 'flattening' of the yield curve presumably reflects greater circumspection about long term economic growth prospects among bond than among stock investors. The Bloomberg Barclays US Aggregate Bond Index returned a fairly meagre +0.82%. High yield and international bonds both outpaced the broader market.

It remains to be seen how successful Trump will be in enacting his platform. An initial attempt to repeal the Affordable Health Care Act was unsuccessful. Tax reform will be contentious at the very least and any sizeable increase in infrastructure spending is likely to be resisted by deficit hawks in the President's own party. Implacable divisions in Congress, and Trump's low 39% approval rating, could make it hard to pass *any* ambitious legislation. Meanwhile legal challenges to executive orders that affect civil liberties and environmental and consumer protections can be expected to continue.

Even if coming months produce only modest legislative change, underlying economic conditions appear resilient. Far from the economic 'disaster' that the president claims to have inherited, first quarter data shows a continuation of long-term trends including a decline in the unemployment rate, improving wage gains and, more recently, an acceleration in manufacturing in both developed and emerging markets. The biggest apparent threat to this brightening picture is the possibility of a tariff war triggered by American repudiation of global trade agreements. However, Trump's softening rhetoric around the NAFTA renegotiation has helped to allay these concerns, evidenced by the ferocious first-quarter rally of the Mexican peso.

Adding to this generally benign environment, Q1 earnings for the S&P 500 are expected to post their strongest performance in six years with gains of over 7%, continuing the rebound from 2015's earnings slump. After its post-election surge, the dollar has stalled, lessening the headwind for US based multinational corporations. Deregulation, the easiest part of Trump's agenda to implement,

[1] MSCI Europe Australia Far East Index (EAFE)

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could encourage corporate spending. Oil supply and demand are in balance and the US energy sector is once again profitable at $50/barrel. Finally, while the Federal Reserve anticipates two to three rate hikes this year, the overall pace of increases has been slow by historical standards and interest rates remain relatively low.

Geopolitical surprises aside, our sense is that the principal risk to the financial markets at this juncture is complacency. Business optimism and consumer confidence are high. Expectations for faster economic growth, more US manufacturing, better trade agreements and other "wins" have soared. One reflection of this optimism is the high valuation on most stocks. Q1 2017 also had one of the lowest levels of volatility in stock market history. If economic and financial fundamentals fall short of expectations, or if some external crisis hits, investor complacency could quickly evaporate.

As we pointed out in our last quarterly report, opportunities in developed international markets may be more compelling over the coming months than those in the US. Global manufacturing data for March is the best in five years. Canada, Australia, the UK, Europe and Japan are all doing well. European unemployment has inched steadily downward. Credit demand is strong and corporate earnings are rising. If upcoming elections demonstrate that the ascent of nationalist parties on the Continent has stalled, it would be a great boost to the EU's stability.

Emerging markets, meanwhile, offer faster Gross Domestic Production (GDP) growth than the developed economies and have recently enjoyed a turnaround in corporate earnings. Fears about the negative effects of a rapid rise in the dollar or in US interest rates appear overblown and fundamentals in the developing world continue to improve, helped by stronger commodity prices. While the US is late in its economic expansion, overseas economies, both developed and emerging, have been slower to recover and still have more room to improve. In comparison to US equities, international equity valuations remain attractive.

As we move through 2017, we expect that the Fed will continue its cautious process of raising interest rates to more normal levels. We are therefore maintaining our defensive emphasis on bonds with lower interest rate sensitivity. As suggested above, we are looking abroad for equity returns that may outpace those available at home.

In this complex environment of global economic expansion balanced by unusually high levels of geopolitical uncertainty, it seems important to remain patient, avoid emotional biases and stick to a sound investment plan.

We welcome any questions you have and wish you a beautiful spring.

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