2017 Second Quarter Review and Outlook

While political turmoil, Russian hacking and Trump's tweets dominated the news during the second quarter, financial markets calmly extended their gains. Their steady progress underscores the convergence of economic growth in countries worldwide and the cumulative effect of monetary stimulus by central banks since 2008. The long US expansion—now in its ninth year—is showing signs of fatigue, but still plods ahead. Economic growth has picked up in Europe, Japan and emerging markets. Corporations are posting rising revenues and solid earnings. This coordinated upswing is especially significant for US investors given the fact that in today's increasingly interrelated economy, S&P 500 companies earn more than half their revenues outside the US. The global economy is poised for growth of 5.7% this year, the best rate since 2011.

Monetary stimulus has also had a powerfully positive effect on financial markets. Negative and near-zero interest rates have raised the price of bonds and driven capital to riskier assets including stocks, high yield bonds and REITs in the search for income. Valuations on financial assets around the world are currently at average to above average levels. Few markets look cheap.

Investors enjoyed strong equity returns in the first half of 2017. International markets led the way, with the MSCI All-Country World Index up +11.48% while the S&P 500 Index had a total return of +9.32%. Soft inflation data and falling energy prices also fueled a modest bond rally. The Barclays Aggregate Bond Index ended up +2.27% despite the Fed's June rate hike (its second this year). Our portfolios posted solid results for the period, with international equites and credit sensitive bonds helping our returns.

Outlook

Global economic indicators point to a continuation of the slowly broadening economic expansion. A brightening international outlook, low interest rates, moderate inflation and positive consumer sentiment could set the stage for yet another leg in this aging bull market.

Some markets, however, look more attractive than others. After years of lagging, opportunities overseas have become more compelling. The US has led the post-crisis recovery, but domestic growth (e.g., auto sales and housing starts) appears to be cooling. Unemployment at 4.3% is the lowest in 17 years and a tightening labor market will likely constrain growth going forward. Today's high valuations on US stocks should temper expectations for future returns. Moreover, the market's preternatural calm cannot last forever.

The Fed plans to continue raising interest rates while at the same time unwinding its $4.5 trillion balance sheet. With bonds even more expensive than stocks, we expect little joy from fixed income investments in this environment, though we believe bonds will still serve a crucial purpose in diversifying portfolios. Investors are entering a new phase in which economic growth and the private sector might need to pick up the slack for receding government stimulus. A return to more conventional (i.e., less supportive) monetary conditions will require greater selectivity on the part of investors and a higher tolerance for volatility. The Fed's initial rate hikes have so far been absorbed without trouble. Historical precedent suggests that so long as economic growth remains robust, the early phases of central bank tightening need not imply the end of the bull market in financial assets, but forecasters have already begun looking over the horizon to the next potential recession.

The political landscape, meanwhile, remains muddled. As he approaches the mid-point of his first year in office, President Trump's agenda is proving harder to implement than his supporters may have hoped. Our ongoing economic expansion seems less a product of the "Trump Effect" than the outcome of the previous eight years of economic and monetary policy. The administration's popularity is uncomfortably low, and with mid-term elections already a lever in legislative deliberations, future 'wins' on healthcare, infrastructure spending and fiscal reform are uncertain. For now, the market appears to be ignoring these concerns, but this complacency may not last if widely anticipated reductions in corporate tax rates fail to materialize.

Economic leadership is shifting and, for the first time since 2011, manufacturing data internationally is stronger than in the US. Despite political uncertainties, the Eurozone is enjoying a pickup in growth. Meanwhile, emerging markets, are benefitting from stabilized currencies, cooling inflation and improved corporate earnings. Currency has for several years been a headwind, but a weakening trend in the US dollar now makes foreign market gains even more attractive for US investors. International stock market valuations are lower than in the US while dividend yields are higher. Taken together, these factors suggest that overseas investments may outpace the US for some time to come.

Realistic expectations, combined with a willingness to look beyond domestic markets, and diversification between equities, bonds and alternative strategies, should serve investors well in this late cycle environment that for the time being, still shows little sign of tipping into recession.

Turning to LongView news, we've included a copy of the recent New York Times article that features our new venture in educator retirement services. Spearheaded by Doug Lynam, who joined LongView in May, we will focus on providing schools and colleges with superior retirement options including individual counselling to help teachers plan for retirement with confidence. We have known Doug for many years (he taught Harlan and David's kids at Santa Fe Prep) and admire his integrity, can-do spirit and desire to be of service. As a longtime teacher and now as an investment advisor, Doug brings a unique perspective and passion to the challenges faced by educators. Please join us in welcoming Doug to our team and let us know if we can be of help to you in this area. As we mentioned last quarter, we also encourage you to talk to us about our environmentally sustainable and socially responsible investment options. Performance data bears out the fact that investors need not sacrifice returns to invest in alignment with their values and we welcome any inquiries on this subject. Finally, please remember to visit the Resources page on our website longviewasset.com for news, market updates and reports.

With our best wishes for a beautiful summer!

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