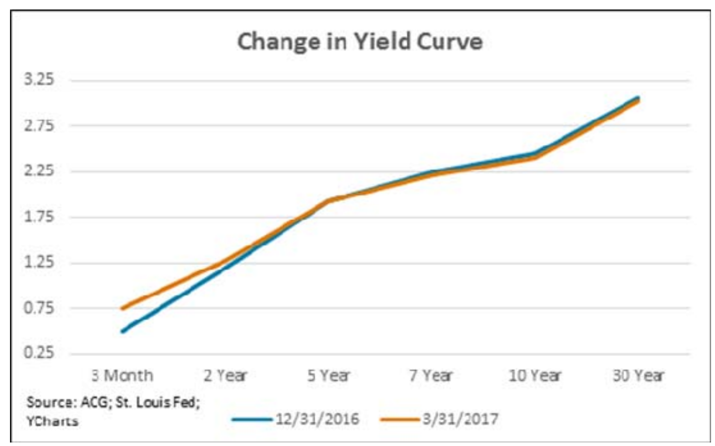
Photography: Jimmy Pickert - Nevada 2017

Quarterly Update & Economic Commentary—March 31, 2017

Quarter in Review

The equity markets saw a strong start to the year during the first quarter, despite running out of gas in March. The S&P 500 TR returned 6.07 percent for the quarter making it the sixth straight quarter of positive returns for the index as well as the best opening quarter since 2013. Large cap stocks outperformed small and mid-cap stocks during the quarter. The Russell 2000, a proxy for U.S. small cap companies, returned 2.47 percent for the quarter. There was also a change in market leadership during the quarter. In general, growth stocks outperformed value stocks across the market capitalization spectrum. The information technology sector was the top performer in the S&P 500 index, returning 12.57 percent, followed by consumer discretionary at 8.45 percent and health care, up 8.37 percent. The biggest laggards for the first quarter were energy and telecom, which lost 6.68 percent and 3.97 percent, respectively.

Most bond indexes finished positive during the first quarter. Changing interest rates are a big influence on the returns of bond investments. The yield (or interest rate) curve, pictured below, can be informative when setting expectations for fixed income. The short end of the yield curve moved higher during the quarter but the long end of the curve saw rates fall slightly. The short end of the curve is more influenced by Fed actions while the longer end is influenced by inflation and economic expectations. The Fed raised the federal funds rate in March, which influenced short-term rates, but longer-term rates fell during the second half of March as questions surfaced concerning President Trump's ability to enact legislation. The most common bond proxy, the Barclays U.S. Aggregate Index, returned 0.82 percent during the quarter while lower quality bonds like the Barclays U.S Corporate High Yield



Index, returned 2.70 percent. Given the strong equity markets, the fact that high yield bonds outperformed higher quality bonds is not a surprise.

Commodity returns were mixed during the quarter. As mentioned above, energy stocks performed poorly during the quarter due to the price of oil falling about five percent. The cause for the decline was driven by concerns about OPEC's commitment to the production cuts its members agreed to last year. OPEC officials met in March and concluded to extend the production cuts for another six months. This helped to support oil prices, but markets are still wary of the willingness of member countries to comply. Other commodities, like precious metals, saw strong returns during the quarter, which can be attributable to the link between their prices and inflation expectations. Silver, gold and copper were up 14.18 percent, 8.64 percent and 5.47 percent, respectively.

As we saw closing out 2016, the markets' primary focus during the first quarter was on any news coming from either the White House or Capitol Hill. The equity markets' strong start to the quarter was a continuation of the rally investors have seen since Trump's election in early November. After his inauguration, Trump coupled his flair for ostentatious rhetoric with the rollout of several executive orders. Despite the controversial nature of some of his orders, namely his travel ban, markets generally viewed the sum of his actions through the end of February as a signal that he intended to uphold his campaign promises of fiscal stimulus and deregulation. Political realities, however, began to set in during March as it became increasingly clear that Trump's first legislative effort, the repeal and replacement of Obamacare, did not have enough Republican support in Congress to pass. The proposed bill saw little common ground in the House between more moderate republicans and the more right-leaning Freedom Caucus, and it was ultimately pulled before a vote on March 24. It would be an overstatement to say equities sold off during March in response to this, but the new caution in the markets was clear.

For the better part of this decade, the markets' main focal point has been the Fed and its intended actions. Since the election of President Trump, the Fed has become secondary news. Chair Janet Yellen likely appreciates that, at least for now, the Fed can focus more on its mandate of employment and inflation without fretting over severe market reactions regarding rumors or news. The Fed made a move during March and raised the federal funds rate by 25 basis points to a target rate between 0.75 and 1 percent. The move was driven by a strong employment picture and stable economic growth in the U.S. Depending on the measurement, inflation readings remain slightly above or below the Fed's target of two percent. The Fed's decision to raise rates will have little impact on many Americans, although credit card interest rates may be impacted more quickly than house or auto loans. Savings rates or CD rates may tick up slightly with the rate increase.

The U.S. employment picture continues to impress; the unemployment number is below five percent and wages are improving. Perhaps the most remarkable economic indicator is consumer and business confidence. If consumers and businesses are feeling confident they are more likely to spend and invest, which is great for the economy. Another bright spot in the economy is the manufacturing sector. The Markit U.S. Manufacturing PMI peaked in January before falling off slightly in February and March but remains at much higher levels than its lows in 2016.

Corporate earnings for the fourth quarter, announced during the first quarter, were strong. The positive earnings growth for both the third and fourth quarters of 2016 marked the first consecutive quarterly year-on-year earnings growth since late in 2014. About two-thirds of the companies in the S&P 500 beat consensus analyst estimates.

Britain took the first formal step to withdraw from the European Union in March. Prime Minister Theresa May delivered a letter that invoked Article 50 of the Treaty of Lisbon. This begins the legal process that must end in two years with Britain leaving the EU. This will be a complex issue that will require plenty of work from both sides to ensure a somewhat amicable divorce. The impact is not completely known at this point, but it is expected to impact Britain the most and have very little impact on the U.S.' economy.

European economic news outside of Britain has continued to improve. As has been seen in the U.S., consumer confidence has been on the rise and many European companies are beginning to show earnings growth. Additionally, the two European elections so far this year in Austria and the Netherlands have seen the defeat of the anti-euro candidate. This provided some assurance that the European Union may not be dismantled in the coming months. Japan's economy remains stable but has been hurt by the strengthening Yen.

Many emerging market countries are also seeing improving growth prospects. The MSCI Emerging Market Index saw the strongest return among major global equity indexes with a gain of 11.45 percent. Emerging markets, in general, have been somewhat due for a rally after nearly a decade of lackluster returns. Fears about a slowing China have subsided for now, the dollar's strength has somewhat stabilized and the actual impact of Trump's views on countries like Mexico and China appears to be softer than his rhetoric suggested.

A Look at the Numbers

Name	1st Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	5.19	5.19
S&P 500 TR USD	6.07	6.07
S&P MidCap 400 TR	3.94	3.94
S&P SmallCap 600 TR USD	1.06	1.06
NASDAQ Composite TR USD	10.13	10.13
MSCI EAFE NR USD	7.25	7.25
BBgBarc US Agg Bond TR USD	0.82	0.82
Wilshire US REIT TR USD	0.03	0.03
IA SBBI US 30 Day TBill TR USD	0.11	0.11

Forecast In Brief

Despite the great start to the year in equity markets, the Trump-related causes for concern in March seem legitimate and will likely continue in some degree. Since the election in early November, the markets have been pricing a business environment with lower taxes, less regulation and a government infrastructure spending plan. With Trump's failure to gain congressional support for the proposed health care bill, the markets are now reevaluating those assumptions. It was expected that Trump would address Obamacare first, given his campaign promise and the GOP's seven year pledge to scuttle the divisive law. The rest of Trump's legislative agenda will be both more impactful on the greater economy as well as more difficult to achieve. It appears that the next item on the agenda will be tax reform; however, there are several voices calling instead for Trump to focus first on an infrastructure package. Infrastructure spending is one of the few major initiatives that both Trump and Clinton campaigned on, and for the most part their views differed only in that Trump guaranteed a bigger spend than Clinton did. Because this topic has legitimate support from democrats across the aisle, Trump may have an easier time passing legislation. Focusing on infrastructure first may be what Trump needs to regain momentum. Ultimately, whether the recent stumble is evident of an ineffective administration or, as is seen with all new presidents, simply the growing pains of a new governing coalition, the markets will be watching closely.

Though the Fed is no longer the primary driver of markets, the actions it takes will still impact returns in the short term and affect the overall economic environment going forward. If the current economic outlook persists— one of improving optimism, employment data and steady inflation within the Fed's target—it is likely that the Fed will hike interest rates another 25 basis points during the meeting in June. More interesting than the timing of the next rate hike is the question of how and when the Fed will begin to reduce the $4.5 billion balance sheet it accrued during the two rounds of quantitative easing after the financial crisis. A number of former and current Fed officials believe that the balance sheet is irrelevant and not a point of concern; however, it appears to have garnered enough attention among officials to compel the Fed to discuss its options this year. Of the options mentioned, the simplest and least impactful to the markets would likely be to cease reinvesting the bond investments at maturity and instead let them roll off the balance sheet. Investors would likely view this announcement as either neutral or positive; other, more restrictive alternatives may inject uncertainty into the markets.

Expectations for corporate earnings—ultimately what drives stock returns—are positive as companies prepare to deliver their first quarter numbers. According to FactSet, the estimated earnings growth rate for companies in the S&P 500 is 9.1% for the quarter (year-over-year). If this turns out to be the case, it will be the highest earnings growth rate for the index since the fourth quarter of 2011. The S&P 500's forward price-to-earnings metric, a measure of the market's valuation, finished the first quarter at 17.5.

Economic sentiment indicators—from both consumers and businesses—have been remarkably strong since the election. Given the fresh uncertainty around President Trump's ability to pass legislation, it will be interesting to see whether these indicators hold up or recede somewhat in the coming months. Considering the market rally seemed to price in every pro-business Trump agenda item out there, it's inevitable that there has to be some sort of pullback. The question is, by how much? Trump still has the authority to enact substantial deregulation across a number of industries, and in any case the U.S. economy was in a positive trend prior to the election when the consensus was a Clinton victory. Investors may not get the massive fiscal stimuli they have been betting on since November, but the U.S. still looks like a comparatively attractive place to invest.

It is too early to see any meaningful signs coming out of Britain regarding their departure from the EU, but any unexpected news could create sudden movement in international markets in either a positive or negative way. The French election in May will be closely watched due to the popularity of anti-EU candidate Marine Le Pen. Though she is tied for first in most polls, the general consensus is that her main opponent is better positioned to win once some of the less popular candidates drop out and stop diluting his base. Still, the developed world has been surprised twice already in the past twelve months with "underdog" victories from the anti-establishment, so nothing should be taken for granted. Away from the headline political risk, valuations in Europe are attractive and many of the core economies seem to be moving in a positive direction. With inflation stabilizing, the European Central Bank may consider backing off its stimulus program.

Geopolitical tensions are rising, and with them the possibility of a market-moving crisis. At the center of the uncertainty is President Trump and his view on the U.S.' role in the world. His rhetoric has been critical of U.S. interventionism while at the same time striking a heavily militaristic tone. Shortly after quarter end, Trump made remarkably aggressive comments with respect to North Korea and he took concrete military action against the Russian-allied regime in Syria. While both developments were spurred on by catalysts—his upcoming meeting with China's president and the Syrian regime's chemical weapons attack—there is a risk that Trump may attempt to strengthen his image by continued military confrontation. It is common for leaders to take military action when dealing with unpopularity at home, as Trump has been. Additionally, Trump may begin to gravitate more toward the foreign policy realm, where he can act much more unilaterally than he can when focusing on passing domestic policy legislation. In such an environment, the risk of an international crisis that impacts the markets will increase.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure that it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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