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First Quarter 2017

Fig. 1 – S&P 500

Fig. 2 – US Dollar Index

In the first quarter, stocks continued to rise, building on the gains at the end of 2016. The large cap S&P 500 index (**Figure 1**) posted a total return of +6.2%. After a very strong 2016, smaller company stocks lagged: the Russell 2000 Small Cap Index rose +2.5%. Foreign markets posted broad gains, helped by a weaker U.S. dollar. The developed world outside the U.S., including Europe and Japan gained +7.2% in the quarter and emerging markets were up +11.2%. The dollar decline (**Figure 2**) was a major factor. In local currencies, the non-U.S. developed world was +5.3% and emerging markets +7.5%.

In the fourth quarter of 2016, S&P 500 companies reported earnings growth for the second straight quarter. This stands in contrast to the five previous quarters in which earnings contracted. According to research firm Factset, earnings grew 4.9%, a modest acceleration over the 3.1% growth logged in the third quarter of 2016, and better than the 3.1% increase that was projected at the start of the last earnings season. 72% of reporting companies topped analyst earnings expectations, but only 53% beat sales estimates, as top line growth remains challenging for many. Traditional growth industries including information technology and health care were among the top earnings performers, while defensive groups such as utilities and telecoms logged the most disappointments.

The forward price-to-earnings (PE) ratio of the S&P 500, which looks at future earnings, currently stands at about 18, higher than the 5-year average of 15.3. This is one sign that the market may be overvalued. However, earnings for the first quarter are projected to grow 7.2%, an improvement over last quarter's growth of 4.9%. If this acceleration continues in future quarters, the market's valuation may be sustained, and shares may continue their gains.

The U.S. economy expanded 2.1% in the fourth quarter of 2016, slightly better than early forecasts. The employment picture remained strong with consistent job creation and historically low layoffs. Purchasing manager surveys in both the manufacturing and services sectors continued to signal future growth, although some readings ticked down at the end of the quarter. Consumer spending was solid, although many traditional retailers struggled with declining sales. Also, domestic March vehicle sales were weaker than expected. Spending on construction grew, particularly in the residential multi-family area, while non-residential construction was stagnant. There have been few signs of the promised infrastructure spending as of this writing.

Index returns taken from Morningstar.com and MSCI.com

U.S. bonds posted positive returns in the first quarter on steady cash flow and slight price gains. The 10-Year Treasury yield stabilized and declined slightly by the end of the quarter, after rising sharply in late 2016 (**Figure 3**). In March, the Federal Reserve raised short-term lending rates another 0.25% on widespread economic strength. However, inflation remains lower than the Fed's target of 2%. Longer maturity bond yields are unlikely to move higher rapidly unless U.S. inflation appears to be accelerating beyond that 2% marker. At the same time, interest rates are historically low, and the direction appears to be up. High quality bond returns (i.e., treasuries, investment grade corporate bonds) are likely to be positive in most quarters, but modest, particularly in quarters when equities rise. Bonds will still be an important portfolio weighting for many who do not want the full volatility of the stock market in their portfolios.

Fig. 3 – U.S. 10 Year Treasury Yield

Fig. 4 – Eurozone iShares Index Fund

The recent advance by foreign markets has surprised some investors. After several years of lagging U.S. indices, foreign shares appear relatively inexpensive, and foreign economies may be strengthening. This is true in emerging markets, where Brazil has exited recession, and India continues its rapid growth. It is also the case in Europe (**Figure 4**). In the first quarter, European business and investor optimism improved, and manufacturing surveys suggested future strength. In addition, European large cap companies posted 11% earnings growth for the fourth quarter of 2016, more than double the 4.9% growth of S&P 500 companies. After years of stagnation and unconventional central bank stimulus, the Eurozone may be attractive to equity investors. We will continue to look across the globe for the investments that help our clients meet their financial objectives.

As always, we look forward to speaking with you soon, and encourage you to contact us at any time.

Sincerely,

Kenneth M. Bernard, CFA