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## Second Quarter 2017



Fig. 1 – S&P 500



Fig. 2 – iShares Emerging Markets Index

In the second quarter, stocks again posted solid gains. The large cap S&P 500 index (**Figure 1**) posted a total return of +3.1%, and is now up 9.3% for the year. In contrast, the Russell 2000 Small Cap index rose 2.5%, as smaller company stocks continued to trail their large cap peers. Foreign markets outperformed for the second straight quarter. Emerging markets rose +5.5% while developed economies outside the U.S. were up +5.0%.

First quarter earnings growth for S&P 500 companies was much stronger than forecast. According to Zacks Investment Research, reported earnings grew 13.3%, double the +6.6% expected. This acceleration in earnings growth helped fuel the stock market's strong first half performance. 72% of reporting companies topped analyst estimates, a proportion comparable to recent quarters. However, revenue results were much stronger than expected, with 65% of companies beating analyst estimates, versus 53% in the prior quarter. This was particularly bullish, because top line growth has been limited in much of this economic expansion.

Looking ahead, earnings estimates for the second quarter have risen for cyclical sectors including transports, construction and other industrials. While aggregate growth is likely to be lower than last quarter, any improvement on the current expectation of +7.9% will be supportive of higher stock prices.

The U.S. economy expanded 1.4% in the first quarter of 2017, and growth of 2.6% is forecast for the second quarter. Unemployment has remained low, supported by new job openings and few layoffs. Manufacturing and service industry surveys indicated slower activity in April and May, but were much stronger at the end of June. New orders readings were very strong, supporting future growth. New home sales were also solid, and home prices continued to rise, boosted by steady demand and a lack of sellers. At the same time, inflation remains tame, allowing the Federal Reserve to raise interest rates very gradually. These data points indicate continued growth for the U.S. economy.

Overseas stock markets continued to rise in the second quarter. As noted in our previous letter, growth in both developed and emerging economies (**Figure 2**) has stabilized or accelerated. In a sign of confidence, the European

Central Bank has finally hinted at removing some of its bond buying stimulus. In China, purchasing manager surveys and exports have also strengthened, due to improving global demand. International equities appear to offer reasonable valuations, and those markets may continue to lead in the months ahead.

Most U.S. bond sectors rewarded investors again in the second quarter. The Bloomberg Barclays U.S. Aggregate Bond index is +2.4% year-to-date, and riskier segments including investment grade corporate bonds, high yield debt, and preferred stocks, have all been stronger. However, with the 10-year Treasury yield (**Figure 3**) at 2.3%, bond returns are likely to be close to flat for the remainder of the year. We note that asset allocation between stocks and bonds is generally investor-specific. Investors who require a balanced asset allocation should continue to hold bonds, to manage the potential volatility in their portfolio.

In the U.S., traditional growth sectors including technology and health care continued to lead equities higher. Health care stocks were particularly strong in the second quarter. Fears over price controls and major changes to health care laws, which depressed these stocks in 2016, have largely abated, and investors have returned to these relatively steady growers.

Financial stocks, while generally up for the year, have lagged the broader indexes. Bank earnings were very strong in the first quarter, and this is likely to continue in the coming earnings season. The banking sector appears to be on solid footing, with low loan delinquencies and high capital ratios. Recently, all major banks received passing grades in the Federal Reserve's stress tests, allowing them to increase share purchase plans and dividend payouts. As the Fed starts to shrink its balance sheet later this year, longer term yields should inch higher. This should help both bank and insurance company margins and support higher share prices.



**Fig. 3 – U.S. 10 Year Treasury Yield**



**Fig. 4 –iShares Financials Index Fund**

We hope you are enjoying a beautiful summer and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA