2017 SPRING INVESTMENT OUTLOOK

The post-election stock market rally has continued through the late winter months of 2017 as President Trump began the complex process of building his administration while setting a new agenda and policy direction. The psychology and aftermath of the Trump win over Secretary Clinton has taken precedence over the normal flow of economic and corporate news and assumed a life of its own. The vitriolic relations between the Republican and Democratic parties, which dominated the election season, have continued with fierce opposition mounted against many Trump appointees requiring Senate confirmation. The President has generally continued the harsh rhetoric of the campaign trail and issued a number of executive orders reversing many policies of the Obama administration. This has added to the rancor of today's political debate.

The underlying fundamental data remains essentially unchanged from recent quarters. Real GDP growth continues at a substandard rate in the area of 2%, corporate profits are expanding in the mid-single digit range, the strong dollar is reducing foreign earnings when converted to US dollars, and organic volume growth is very hard to come by in either domestic or foreign markets. The unemployment rate has come down and remains at a low rate although many have left the labor force and a good number of new jobs are often at lower wage rates than jobs previously lost. Inflation has moved higher with the annual CPI index now over 2% on both a total and ex-energy and food basis.

The economic data was considered sufficiently strong by the Federal Reserve Board to raise short term interest rates by one quarter point in December and then by a second quarter point in mid-March. The December increase was exactly one year after the first one quarter point rise following eight plus years of a very accommodating monetary policy. Today's interest rates, both short and long maturity, remain very low by historical standards and Fed watchers believe several more quarter point increases will be forthcoming by year end.

President Trump's late winter address to a joint session of Congress struck a tone of unification and conciliation not heard before and inspired a 300 point market rally in the Dow 30 on March 1st and carried the popular stock indices to new highs early in the month. Year to date results are as follows while gains since the November election day roughly double these figures.

Equity Markets – 3/20/17

	Index Price Level	2017 YTD Total Return
Dow 30 Industrials	20,906	6.4%
S&P 500	2,373	6.5%
NASDAQ Composite	5,902	9.9%
MSCI All Country World Index ex-USA	266	8.3%

Outlook

The so called "Trump Rally" has surprised many observers and merits discussion. The simple and most often heard explanation is that market participants believe the President's message of lower taxes, a repatriation holiday for foreign earnings, less regulation, and return of more matters to the states will enhance economic growth, corporate profits, and hence stock prices. There are other factors to be considered, however.

First, there is a broad based movement by investors away from actively managed funds to low cost passively managed index funds and exchange traded funds (ETF's) which track one or more indices. According to Morningstar, nearly $400 billion has flowed in this direction over the last year. Hence popular indices such as the Dow 30 and S&P 500 would be expected to move higher given strong cash inflows.

Secondly, many large institutional investors have followed consultant recommended asset allocation models calling for a low 10-20% ratio in American common stocks, preferring international stocks and a variety of alternative equity investments including hedge funds, long-short funds, real estate, and private equity vehicles. While a few seasoned alternative investments have lived up to expectations, the majority have not. The National Association of College and University Business Officers (NACUBO) tracks endowment performance for 805 colleges and universities totaling $515 billion and reports a one year negative total return of -1.9% (the largest university endowment reported a -2.0% negative return) for the fiscal year ending last June 30th while the S&P 500 index earned a positive 4.0% total return. Ten year results show a 5% total return for the group as compared with 7.4% for the S&P 500 and 6.9% for a blended 60/40 stock/bond index. The poor collegiate results reflect low domestic equity and bond allocations of 16% and 8% respectively and high allocations of international equity and alternative investments of 19% and 53% respectively.

Significant policy changes are underway in endowment management and while there will be no hard data until months after this June 30th, it is reasonable to assume that the percentage of American equities is being increased from previously low levels. A number of large pension funds including the California State Pension System are making similar changes by reducing their exposure to alternatives (hedge funds in particular) and increasing the weighting in more traditional domestic market investments. The size and relative safety of the American economy and marketplace make this a logical development.

The policy changes being proposed by the Trump administration are a more problematic matter. Fiscal policy adjustments are critical as the federal deficit is growing and will top $600 billion this year and move ever higher in ensuing years without changes to put it on a lower growth trajectory. The early months of the new administration have been noteworthy for unrestrained criticism of many opponents as opposed to typical new administrations (if there is such of a thing) when bridges are mended and goodwill engendered in anticipation of the forthcoming legislative agenda. Reforming the Affordable Care Act is the first major piece of legislation proposed and it has been met with more than major skepticism from both sides of the aisle. Failure to produce a compromise solution that can become law on this issue would be a major setback and likely make legislation on other equally important issues even more difficult to accomplish. We are assuming that compromise is attained and the legislative agenda can then move to other high priority items including tax reform, infrastructure, and immigration. There will also be heated debate over the proposed budget which favors defense and cuts many domestic and foreign aid allotments.

A brief look at history suggests important new legislation coincides with moral leadership by the party in power, and a broad popular mandate to enact change. Examples include Theodore Roosevelt (notably befriended the press corps) and his Fair Deal, Franklin D. Roosevelt and his New Deal, Lyndon Johnson and his Great Society, and Ronald Regan's (made very good friends with two leading Democratic opponents) Regan Revolution. The art of using Presidential power to take the moral high ground, lead one's party, make friends and build bridges with political foes does not seem a strong suit of the new administration and imperils tax reform legislation which the stock market is baking in.

It is difficult if not impossible to make probable economic projections in this environment so we will fall back on the status quo until more is known. Real GDP growth remains uninspiring and may be closer to 1% than 2% this quarter. Consumer spending is positive but traditional retailers continue to suffer at the hands of online competitors. Car sales seem to have peaked with inventory now growing and housing is positive but well below previous periods. Manufacturers in general are holding lean inventories awaiting better demand. The strong dollar has imports growing faster than exports and pushed the trade deficit to $50 billion in January, the highest in four years. Spending for plant and equipment is advancing slowly and far less than the bulls on Wall Street are anticipating.

One positive for the long term is today's savings rate of some 5%, nearly double that of eight years ago, as the economy entered the financial crisis and great recession. A higher savings rate is to be anticipated, however, as easy money by the Federal Reserve cost savers and investors some $1 trillion in lost interest in the 2008-2015 period. According to Senator Bob Corker of Tennessee, seniors were "thrown under the bus" in this period. The Fed has raised short term interest rates, but the current ten year US Treasury rate of 2.5% remains below its yield of 2.9% eight years ago when the stock market reached its recession low. Rates are likely to go higher but perhaps not materially if fiscal policy changes fall short and leave the Fed as the sole caretaker of the country's economic wellbeing.

The US economy enjoys cyclical periods of expansion (this one almost eight years old) and shorter periods of contraction or recession. While there is nothing immediately on the horizon which would lead one to believe recession clouds are gathering, a major geo-political event or shock to confidence through an unexpected series of events could trigger the next recession and accompanying economic downturn. On balance, corporate profits may expand in the mid-single digit area in 2017.

Foreign economies remain subdued with Europe, led by Germany, achieving limited progress with weak results continuing in the Mediterranean nations. The United Kingdom is doing better than first thought following Brexit and negotiations on the new relationship to be established with Europe are moving forward. The populist movement that won victory at the polls for Brexit and Trump did not elect the candidate of this nature in the Netherlands and upcoming French elections may remain in the center as well. The Emerging BRIC economies (Brazil, Russia, India, and China) are uninspiring with recessions continuing in Brazil and Russia and a transition to a lower growth rate in China. India is the one bright spot as growth is improving thanks to able political leadership and recent currency reforms. Oil producing economies (OPEC and others) remain subdued and oil prices appear in a narrow trading range of $45-$60, well beneath peak levels of several years ago.

Geopolitics in the Middle East remain in flux and stability is far from being attained. The same can be said for the Korean Peninsula where the dictatorial state of North Korea remains a danger to the region as well as to North America as it presses ahead with its ballistic missile program. Militarization of shoals in the South China Sea is another challenge with which the new administration must deal.

Common stock valuations remain high and, in too many cases, are priced for perfection. The broad market is valued at a price earnings ratio of some 18x forward earnings, the dividend yield on the S&P 500 and Dow 30 are close to 2% and sectors including the financial and capital goods companies have advanced dramatically in anticipation of benefits from proposed Washington policies. Other sectors including health care and biotech have been held back by populist comments coming from Washington.

This firm's approach, practiced since its founding, is to deal exclusively with the facts rather than speculation and make long term equity investments in companies across industry and market capitalizations which stick to a business model giving them a competitive advantage. Pricing at moment of entry is critical to long term success and relatively few opportunities exist in today's very fully priced market environment. The opposite of course was true eight years ago as the precipitous bear market of 2008-2009 wound down.

Investment Conclusion

The challenges outlined above leave the firm in a capital protection mode as regards investment portfolios. While a diversified portfolio of common stocks continues to account for a majority of client assets, solid cash reserves are being maintained to cover short term liquidity needs and act as a stock buying reserve. Investment grade short term bonds comprise the bond portfolio to prevent capital depreciation as interest rates continue to rise. These are likely to be reinvested at higher rates upon maturity and will enhance cash earnings along with a growing stream of dividend income.

March 21, 2017

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