Market Commentary
April 2017

Introduction

The momentum from 2016 spilled over into 2017 with most markets continuing their upward trend. Aside from pro-business policies in the new administration's pipeline, economic data has also been supportive of global financial markets. There has been modest growth in the U.S. with the annual GDP growth rate as of Q4 2016 being revised up to 2.1%. The unemployment rate remains low in the U.S. at 4.5% (as of March), indicating a healthy labor market, while the consumer appears to be growing as well, with increases in both personal income and consumer spending as of the latest readings from February. Given these more positive signs, along with increases in headline and core inflation measures, the Federal Reserve decided to raise the Fed Funds rate by a quarter of a point during their March meeting to keep the economy in check and ensure it would not become overheated. Overall, equities remain attractive as long as earnings continue to improve and the economy remains in a mild growth mode.

Domestic Equities

U.S. stocks continued to appreciate in 2017, as the S&P 500 returned 6.07% from the start of the year through March 31st. The question is whether this has been a "Trump bump" as a result of optimism surrounding the potential future economic environment or actually due to improving corporate earnings and the continued strength of the U.S relative to globe. Further, consumer confidence hit its highest level since December 2000 as the Conference Board Consumer Confidence Index finished at a level of 125.6 in March. Smaller sized stocks appear to have taken a pause from their breakout performance experienced last year, as investors patiently wait to see if Trump's pro-growth policies, such as tax reduction, will in fact be implemented as planned. This would disproportionately benefit smaller size companies who have higher tax rates and generate a larger portion of their revenues domestically compared to large U.S. corporations. After an 8-year bull market and while we are overweight equities in our portfolios, we continue to closely monitor valuations to make sure the market is pricing stocks within reasonable range.

International Equities

International equities outperformed domestic equities for the quarter as the MSCI EAFE index returned 7.25%, however, political volatility persists in Europe. The United Kingdom officially started the process of leaving the European Union in March, which caused only a slight sell off since the event was already widely expected to occur. However, uncertainty surrounding other political elections in the region, questionable consistency of economic growth as well as the negotiations with the United Kingdom, create reasons for concern. Thus far the accommodative monetary policy has been supportive for the region but with continuing political headwinds in the area, we remain cautious for the near to intermediate term.

Emerging markets (EM) outperformed other asset classes for the first quarter, as the MSCI EM index returned 11.45%. This was based on expectations that stronger global economic momentum should support more robust trade activity in EM countries, and improving commodity prices should help drive growth. From a long-term perspective, a growing middle-class population will dictate stronger consumer spending power and economic growth. However, the asset class has historically been susceptible to speculation and political instability. We believe the fundamentals of EM countries have turned more favorable but this asset class will still experience significant volatility due to their high correlation to commodity prices.

Fixed Income

The fixed-income market was volatile in the first quarter. Despite a Fed rate hike of 25 basis points, the U.S. 10-year Treasury yield peaked at 2.63% and finished the quarter at 2.39%, 6 basis points lower than where it started the quarter. The Fed reiterated its target of three rate hikes in 2017, which should push short term interest rates higher. However, since U.S. debt has higher yields than most other countries, there is demand for Treasuries amongst foreign investors, which should constrain rates. Since it will be hard to predict each force's magnitude of impact on the fixed-income market, we believe the asset class will continue to experience volatility in 2017.

Based on this current environment, we favor corporate bonds over government bonds, supported by the Bloomberg Barclays US Credit index finishing the quarter up 1.30%, outperforming its government counterpart (Bloomberg Barclays US Government index) by 62 basis points. We expect the credit sector to continue to outperform as they are less rate sensitive than Treasuries, rendering them more attractive in a rising rate environment. We are also allocated to riskier fixed income asset classes such as high yield, emerging market debt and international bonds which help to diversify the portfolio.

Alternatives

Risk-reducing alternatives took a backseat to traditional return producers during the first quarter's early post-election equity rally, but they provided valuable downside protection when equities began to cool off as the quarter drew to a close, ending with the Deutsche Bank Hedge Fund index returning 0.95% for the quarter. Oil prices slipped during the quarter due to concerns over OPEC members' commitment to the agreed upon supply cuts, beginning the quarter at $54.81/per barrel WTI, and ending at $50.60/per barrel WTI. Moving forward, hedged-equity, long/short, and market neutral alternatives will continue to play a key role in downside protection and reducing volatility within a portfolio by maintaining low correlation to equity and fixed income markets.

Real Estate

The housing market should remain a positive contributor to the economy as credit standards in the mortgage market become looser, wages increase, and home ownership rates rebound from historical lows. This should create plenty of potential home buyers for the future as the economy strengthens. Recent data has been positive, with new single-family home sales increasing 6.1% in February, up 12.8% from a year ago, and housing starts increasing 3.0% in February, up 6.2% versus a year ago. Though the outlook remains positive in the long term, rising interest rates present a headwind for real estate moving forward.

Conclusion

When we think about the current economic environment, we are reminded of the familiar tale of "Goldilocks" – are we too hot, too cold or just right? With modest GDP growth, mild inflation and slowly expanding corporate earnings, the U.S. economy is not too hot, but with unemployment far below historical averages and high consumer confidence, we are not too cold. Therefore the economy should be just right yet, there are still many questions that lie ahead such as the timing of policy changes domestically, how elections will play out overseas and decisions to be made by the Federal Reserve. Given the current state of the economy, we are keeping a positive outlook for financial markets but acknowledge the fact that a new catalyst would be needed to send the economy higher.