MANAGED ASSET PORTFOLIOS

MAP VIEWS
Second Quarter 2017

The first quarter of 2017 can best be summed up by the old Wall Street adage “A Bull Market Climbs a Wall of Worry.” In the first quarter of 2017, there was no shortage of concerns for the perpetually concerned to lose sleep over. The Fed raised interest rates in March, following December’s increase; geo-political tensions throughout the globe grew; and questions were raised about how much of President Trump’s political agenda will become law in today’s surprisingly complex political environment; these were just a few worries that the bear-hearted were pointing to when justifying their beliefs..

Despite these headwinds, the S&P 500 posted its largest quarterly gain since the end of 2015. During the quarter, the S&P 500 gained 5.5%, hitting several new records along the way. Globally, performance was stronger, with the MSCI ACWI up 7%, including dividends. Of note was the change of sector leadership that took place during the quarter. Immediately following the election, financial and infrastructure stocks soared on hopes that the new administration would drive economic growth by lessening regulations. Recall that we commented in last quarter’s edition of MAP Views that we thought the rally in shares of the “Trump-bump” beneficiaries (namely financials and infrastructure companies) was overdone. During 2017’s first quarter, technology stocks led the pack, surging 12%, while financials and infrastructure stocks lagged. The dollar, which soared in the weeks after the election, gave up some ground to most foreign currencies. The Mexican peso versus the U.S. Dollar declined substantially in the weeks after the election as Trump’s comments about “the wall” spooked investors. Interestingly, the peso has made up nearly all its post-election losses as investors are beginning to doubt the President’s ability to accomplish everything on his campaign agenda.

The inability of Congress and the President to easily pass a reformed health-care bill has raised questions about their ability to execute on other campaign promises such as tax reform, reduced regulations and increased infrastructure spending. We will be the first to agree that lower taxes and deregulation are positives for the stock market; however, we are growing concerned that the market is beginning to price in perfection. As seasoned investors know, utopia in the financial markets does not exist. Stock market valuations have expanded on expectations that lower taxes and fewer regulations will boost corporate earnings. As we enter the beginning of earnings season, we would not be surprised to see a pullback in the equity markets as investors’ lofty expectations are not met.

Most Wall Street forecasters are calling for three more rate hikes in 2017. We believe those forecasts to be a bit aggressive and think one or two more hikes are in the cards. It appears that the great bull market in bonds that began in 1980 (with long-term Treasuries yielding 13% and money market accounts earning near 20%) ended last summer when the 10-year bond yield touched 1.4% and negative rates were common in many countries. Going forward, while we predict rates will increase gradually, we do not expect rates to roar higher; tepid global economic growth simply does not support substantially higher interest rates.

One of the primary economic challenges facing the U.S. and many other developed countries is the shift toward lower paying jobs. This shift constrains many consumers' discretionary income. Further, the rampant adoption of technology has significantly impacted total employment. Of the manufacturing job losses experienced in recent years, it is estimated that only 15% have gone offshore. The remaining 85% is attributable to technology and automation. We anticipate the rate of technology and automation adoption in the workplace will accelerate in the future, as the following news events highlight: Wendy's to install 1,000 ordering kiosks; Domino's using robots to deliver pizzas in Australia and Europe; Driverless truck made its first delivery. Even Adidas, the German sports apparel company, is moving a shoe factory from China to a robotic plant in Germany, because robots offer the most cost effective option. As a result, we believe the shift toward automation will carry many challenges, both economic as well as social.

2017 is shaping up to be a year where what you do not own will be more important than what you do own. Over recent years, many investors have embraced passive investing. We believe the move toward indexing will come back to haunt many investors during the next market correction. Clearly there are good companies and bad companies, cheap stocks and expensive ones. With indexing, all stocks are comingled. Unlike purposeful active investing, indexing does not discriminate between good and bad stocks. As much as this strategy seemingly works in rising markets, many indexers, who have become complacent in the bull market of the last 10 years, will be disappointed during the next market correction. Indexers' comfort is partly driven by the fact that volatility has remained low this year despite uncertainties in the U.S. and abroad. The CBOE's Volatility Index (popularly referred to as the "fear" index) averaged 11.7 in the quarter, which was the lowest ever recorded for any first quarter. When investors become this complacent, it is usually prudent to be cautious.

With the rise in the equity markets, valuations have become stretched and finding investable value stocks has become a less obvious task than it was a few years ago. With that being said, we believe value can still be found in specific geographies and in select names. In particular, we are finding opportunities in Europe. Recent economic data suggest that the European economic landscape is improving and this factor should lead to better corporate earnings. Our macro views of the economy have not changed since our last update. Accordingly, we remain overweight those sectors of the stock market that are not directly tied to a strong economy (e.g. Consumer Staples- whose products people have to buy regardless of how much they have in the bank). If we thought the economy could grow at 3-4%, we would have a substantially different portfolio composition. However, after 7.5 years of one of the feeblest recoveries in history, now is not the time to get excited about strong economic growth.

Thank you for allowing us to service your investment needs. It is a responsibility we do not take lightly. We work diligently every day to deliver the best risk-adjusted returns for our clients.

Happy Spring!!!

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