# *Wealth Advisory Group – Review and Outlook – Q1 2017*

## Economic and Market Review

**Economy** – Indicators during the first quarter of 2017 continued pointing towards an economy which is growing slowly. Interestingly, soft indicators measuring sentiment are registering strong gains, while hard data tends to show a more moderate level of economic activity. Consumer confidence, business sentiment, stock markets and even employment measures all point towards an ebullient economic mood. Statistics focused on actual economic activity, like industrial production and lending, have generally been positive but paint a more tepid picture. Thus, begs the question, will actual economic activity catch up with expectations or will there be disappointments, leading to potential market difficulties.

The political landscape continues to confound as well. The new president has broadly outlined several major initiatives, including fixing health care, tax reform and infrastructure rebuilding. However, a divided electorate, polarized political factions and a click driven news cycle seem to be positioned to derail any meaningful consensus on significant legislation. Through executive order, the president has acted to reduce a variety of regulation, which has been well received by the business community. The markets have seemingly ignored the political circus with equity markets near all-time highs, low volatility and a stabilization of interest rates albeit at slightly higher levels. Just as with the dichotomy in economic indicators, there seems to be a disconnect between expectations and reality in the markets regarding political events. How this rift resolves will have important implications for investors.

**Interest rates** – After a significant rise in interest rates during the second half of 2016, interest rates traded in a relatively narrow range during the first quarter. The Federal Reserve continues to signal a desire to “normalize” rates with a series of interest rate hikes in 2017 and made good on that promise with a 0.25% hike in March. Inflation has shown signs of perking up while remaining relatively tame. The fading threat of deflation has enabled the Fed to continue on the path of returning interest rates back to more normal levels.

**Equity Markets** – US equity markets started the year off well with the S&P 500 up over 6% as the post-election rally continued. Growth outperformed Value and larger stocks bested their smaller counterparts. The major contributor to S&P 500 performance was Apple Inc., the largest company in the index, which posted a return of nearly 25% for the quarter. Overseas both the developed and emerging market posted solid returns for the quarter and outperformed U.S. stocks. Stocks were lifted in the first quarter by relative strong earnings announcements and upward revisions to future earnings estimates. Despite the good earnings news, U.S. stocks remain fully valued placing greater significance on results over the coming quarters.

**Commodities** – The first quarter continued the relatively tight trading range that Crude Oil has experienced over the last 12 months. After starting the year in the mid $50 per barrel range, oil prices fell in below $50 in early March as a supply glut rattled the market. The price of Oil then recovered and finished the quarter around $50/barrel. Gold saw a modest rally during the quarter and finished around $1,250 per ounce. The U.S. Dollar continued to remain strong, largely driven by favorable interest rate differentials with much of the world.

## Outlook

**Economy** – The underlying economy continues to grind along in one of the longest, yet least inspiring recoveries. This Goldilocks recovery (not too hot, not too cold) has been nursed along by extraordinary monetary policy accommodations by the Fed, which now appears ready to take the training wheels off and let the economy stand on its own. So far, the modest increase in interest rates and specter of future rate increases has not had a meaningful impact on the more interest rate sensitive areas of the economy, like housing. Clearly the Fed is moving away from a stance geared to preventing deflation and towards policies oriented to a more normal economic environment. Looking into the future, one can envision conditions where the Fed may move to cool the economy as the labor markets tighten and inflation makes a comeback. While still a way off, we are monitoring economic signals and Fed actions to anticipate tightening monetary policy, which would have important investment implications.

As we outlined earlier, the economy, the political environment and the market valuations are all exhibiting a meaningful gap between current readings and future expectations. Therefore, several areas exist for potential disappointment, which leads to increased potential risks for investors. Markets can tolerate some uncertainty, but need direction and stability to thrive. We are looking for some answers on health care and tax policy, follow through on economic expectations and continued strong earnings results to justify the positive outlooks across the economy and markets.

**Equity Markets** – Market valuations in the U.S. are at the high end of historic ranges which clearly has implications for long term total returns. While we see no specific catalysts on the immediate horizon, market corrections are more common than investors care to remember. Only 12 months ago the market was recovering from an 11% decline, which is the norm for most years. Similar to last quarter, the US equity markets are stretched from a valuation standpoint so we see lowered long term expectations for equity returns and potential for a correction. Foreign markets, developed and emerging, continue to offer attractive valuations after years of underperforming the US markets and have begun to show signs of coming out of the doldrums.

**Fixed Income** – Although interest rates were reasonably stable during the first quarter, the Fed has clearly signaled their intentions to raise rates over the remainder of 2017 and into 2018. So, while fixed income investors are beginning to receive more meaningful yields, they still need to be vigilant for potential risk to principal as rates continue to rise. We continue to advocate for short durations to preserve principal to be reinvested in the future at higher rates.

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