Introduction

In the first quarter of 2017, investors ignored a hike in interest rates by the Federal Reserve, low levels of economic growth, and political headline risk to extend last year's rally in stocks and, with it, the continuation of an 8 year-old bull market.

Large-cap US stocks, as measured by the S&P 500 Index, rose 6.1% in the first 3 months of the year, led by technology stocks, which were up 12%. The outperformance of this particular sector appears to represent a shift in sentiment from the immediate post-election beneficiaries, banks and infrastructure stocks, and a bet that a resurgence in economic growth will benefit these companies. On the flip side, a drop in the price of oil resulted in energy stocks dropping 6.7%, the worst performing sector so far this year. After last year's solid outperformance, the more volatile Russell 2000 Index of small-cap stocks underperformed its large-cap brethren, up only 2.5% for the period. Stocks of companies in overseas markets provided some of the strongest returns due to the potential for earnings growth as well as valuations that are more reasonable than for US stocks.

Despite the interest rate increase, as well as inflation finally creeping above the Fed's 2% target rate for the first time since 2012, bonds managed to eke out a 0.82% quarterly gain, as measured by the Bloomberg Barclays US Aggregate Index. The Bloomberg Commodity Index dropped 2.5%, mainly due to a drop in the price of oil of nearly 6% but mitigated somewhat by gold rising almost 9%.

Looking ahead, we are encouraged by continued wage and job gains, as well as manufacturing activity, as catalysts for economic growth. However, the current political environment lowers the probability that much-needed tax reform and infrastructure spending will be enacted quickly or easily and will spur more robust growth, as markets had anticipated over the last several months.

1st Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 3/31/17

	1Q 2017	YTD Return	Price / Value
Dow Jones Industrial Average	5.2%	5.2%	20,663
S&P 500 Index	6.1	6.1	2,363
Russell 2000 Index	2.5	2.5	1,386
MSCI EAFE Index	7.4	7.4	6,954
MSCI EM (Emerging Markets)	11.5	11.5	2,041
Bloomberg Barclay's US Aggregate	0.8	0.8	103
Bloomberg Barclay's Municipal Bond	1.6	1.6	107
Gold – Continuous Contract	8.6	8.6	$1,251
Light Crude Oil – Continuous Contract	-5.8	-5.8	$51

Source: Factset

Economy

The animal spirits which drove equity markets to record highs failed to impact economic activity to the same degree during the first quarter. Despite numerous positive signs, it appears the economy did not improve upon the fourth quarter's 2.1% annual pace of growth. In fact, the Atlanta Fed's well-regarded GDP tracker projects first quarter growth of less than 1%, far below the most pessimistic forecasts by Wall Street economists, as well as our own.

While the epic failure to repeal and replace the Affordable Care Act likely dented confidence, consumer spending had faded well before that. Cautious consumer behavior is somewhat of a surprise given near record-high confidence surveys. Sentiment, likewise, was buoyed by the solid hiring seen in the January and February payroll reports. In addition to an aggregate 473,000 jobs created in the two months, data showed the unemployment rate dropped to 4.7%, which is close to the Fed's definition of full employment. Also, voluntary quits, which reflect confidence in individuals' labor prospects, continue to rise, while layoffs remain muted, with initial jobless claims residing at the lowest levels since 1973. The healthy labor environment allowed wages to build on the modest, mid-2% rate of increase that has prevailed much of the past two years. Meanwhile, manufacturing activity surged during the quarter as new orders swelled along with backlogs, which should keep factories humming into the summer.

We expect many of these favorable trends to continue, although we look ahead with significant concerns as well. Last year's auto-driven rise in consumption may be difficult to replicate with the Fed determined to raise rates. Auto loans yielding near 0% likely pulled activity forward, and it seems that dealer incentives will not be as attractive as the interest rate cycle matures. Housing activity, likewise, may slow in sympathy with higher mortgage rates. Given encouraging trends in household formation and firming wage growth, we expect housing to contribute this year, however. Mortgage rates remain low versus historical norms, and potential buyers may jump off the fence to get ahead of rising rates, especially if the mortgage interest deduction is threatened by potential tax reform proposals.

Despite these concerns, we are not forecasting a recession, which can result from aggressive interest rate increases by the Fed to head off inflation. While the Fed is tightening monetary policy, we would hardly categorize a 25 basis point/quarter pace as aggressive, and we believe they would stop raising rates should any signs of trouble arise. While long-dormant inflation has begun to move higher, we do not see prices accelerating to a degree that meaningfully damages consumer demand. Gas and energy prices are rising off a low base, and plentiful oil inventories and idle rigs should cap large moves. Similarly, wages are finally growing after years of stagnation, and while we may be near full employment, the recent increase in the labor participation rate offers an encouraging sign of idle workers chasing opportunities.

Should the economy falter, it likely would be because of the chaotic political environment, which could destroy confidence and dampen the optimism in the confidence surveys. The failure of ACA repeal demonstrated that Republican majorities do not guarantee the smooth execution of President Trump's agenda. The wasted political capital on health care reform will make it harder to overhaul the tax code. Robust tax reform (as opposed to ephemeral tax cuts) is needed to justify the current optimism, especially within the equity markets. Globally-competitive corporate tax rates and the subsequent repatriation of corporate profits held abroad are integral to nurturing the corporate investment and capital expenditures that are expected to drive domestic growth, as well as provide funding for fiscal initiatives such as the promised infrastructure buildout. Likewise, confusion over issues such as the border adjustment tax could negatively impact trade, especially in an environment of hostile rhetoric towards trading partners such as China and Mexico. While we expect some progress, it seems likely that disappointments will materialize regarding the timing and magnitude of tax reform. As a result, we are forecasting a somewhat less optimistic growth outlook and see the prevailing 2% pace of growth as the most likely scenario for the coming year.

Equities

The enthusiasm and momentum from 2016 spilled over into the first quarter of 2017. Large-cap stocks led the US market; the S&P 500 returned 6.1% as sector leadership rotated from financials and industrials to healthcare and technology. Small-cap stocks, the darlings of 2016, returned 2.5%. Outside the US, developed country markets returned 4.7% in local currencies and 7.4% when measured in USD as the dollar declined during the quarter. Emerging markets topped the list with a 7.8% local currency return and 11.5% in USD.

March 6th marked the eight-year anniversary of the current US equity bull market as defined by a continuous period without a 20% decline. It is the second-longest bull market in US history but still well short of the record that lasted from December 1987 until March of 2000. However, the current advance is one of the most unloved and least trusted bull markets of all time, and it is this skepticism that allows the advance to continue.

This is due, in large part, to the memory of the financial crisis that weighs heavily on many investors' minds. Baby boomers were particularly hard hit, as the crisis struck when retirement plans were clearly on their radar screens. This shock has led to many years of trepidation and a propensity to favor fixed income alternatives over equities, behavior that clearly is visible by analyzing the flow of cash out of US equity funds and into fixed income funds (Chart 1). While some of these investors may never come back to the stock market, others have reallocated money to equities, creating new demand, which has pushed stock prices and valuations higher.

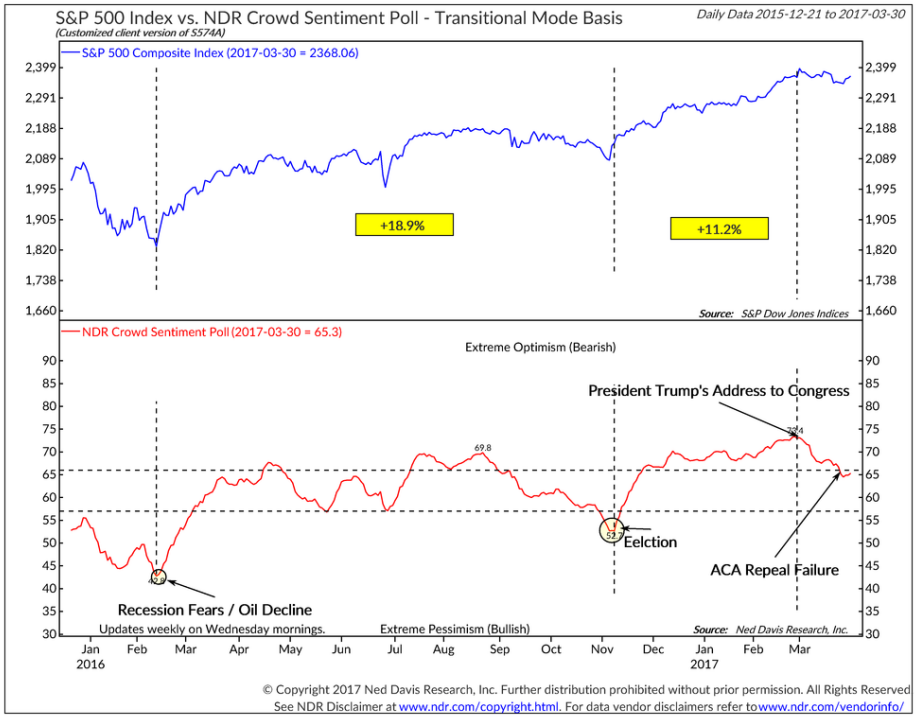
Investor sentiment swooned going into the 2016 election but proceeded to rise through President Trump's address to the joint session of Congress on February 28th. The S&P 500 returned 11.2% from the election until the speech. Subsequently, sentiment has waned as the administration has had to fight off various concerns and, ultimately, failed to repeal the ACA on March 24th (Chart 2). Surprisingly, equity markets have not declined during this period of political confusion.

Chart 1

Net Flows into Mutual Funds + ETFs ($BN)								
	Domestic Equity			International Equity				
Year	MF	ETF	TOTAL	MF	ETF	TOTAL	Bond	Money Market
2009	-27.6	30.9	3.3	29.6	39.6	69.2	417.2	-539.1
2010	-81.1	46.7	-34.4	56.7	41.5	98.2	262.0	-525.1
2011	-133.3	47.3	-86.0	4.1	24.3	28.4	163.7	-124.1
2012	-159.1	80.9	-78.2	6.4	51.9	58.3	358.5	-0.2
2013	18.1	104.1	122.2	141.4	62.8	204.2	-59.0	15.0
2014	-60.2	141.5	81.3	85.4	46.6	132.0	94.5	6.2
2015	-170.8	65.4	-105.4	93.9	109.7	203.6	29.4	21.5
2016	-235.4	167.6	-67.8	-24.5	20.1	-4.4	190.1	-30.3
2017 YTD	-11.1	16.0	4.9	2.5	12.4	14.9	35.5	-48.1
TOTAL	**-860.4**	**700.4**	**-160.0**	**395.5**	**408.9**	**804.4**	**1,491.9**	**-1,224.2**

Source: Strategas Research Partners

Chart 2



Our financial services analyst, Chris Perry, met recently with over 40 regional bank management teams. They were generally upbeat about business trends but reported that many business owners were holding back on capital investment decisions until better clarity was available on health care and tax policy. For the US markets to move higher, we believe tangible progress on deregulation and corporate tax reform is necessary.

Our positive outlook for the US economy supports our domestic equity outlook. With this perspective, we are focused on sectors and companies that benefit from this expansion, including industrials and financials. As always, we are committed to investing in businesses with talented management teams that are able to grow cash flows and earnings over many years.

Fixed Income

With yields and spreads mostly range-bound in the first quarter, the Bloomberg Barclays Aggregate Index posted a meager return of 0.82%. The higher returns generated by BBB-rated securities and those maturing in 10+ years clearly support

a more risk-on bias, but not overwhelmingly so. Since year-end, the 10-year Treasury yield has climbed to just above 2.62% before falling again to below 2.35% due to increased demand.

Though the focus may have shifted to domestic and global politics, central banks are not entirely out of the picture, at least not in the US. While the Fed has indicated that 3 hikes in 2017 may be appropriate, the market continues to see the situation differently and is pricing in only one more hike this year. The recent failure of healthcare reform has dampened hopes for more stimulative fiscal policies and reignited a rally in Treasuries. Globally, the additional risk from the upcoming French elections also puts downward pressure on Treasury yields, as another populist win would likely keep a lid on rates. Our current stance is for all points along the curve to move higher; thus, we are continuing with a more laddered approach.

Corporate issuance in January came in at record levels and was met with solid demand, as flows into mutual funds and ETFs continue to be positive. As we have previously mentioned, we do not believe that those dynamics will dominate the rest of the year. While spreads are at relatively tight levels, credit fundamentals remain sound, and technical conditions are supportive of further narrowing, albeit modest. Given our expectation for positive GDP growth and a decrease in supply, we will maintain the overweight to corporate bonds as we have for some time. Any tax reform or infrastructure spending would certainly be positive for the high-grade sector, but the level of uncertainty makes it difficult to depend on legislation getting passed.

In the municipal bond market, the post-election meltdown gave way to a period of surprising strength during the first quarter. The Bloomberg Barclays Municipal Bond Index surged 1.58% as interest rates fell sharply from the multi-year highs that prevailed after the election, supported by firming demand from mutual funds and lower levels of new issuance. Even a modest increase in demand will push the market higher if there are fewer bonds from which to choose.

Higher borrowing costs coming into 2017, combined with the March quarter-point rise in rates, served to shelve numerous rate-sensitive refunding deals. The fate of the ACA also impacted borrowing behavior as alterations in Medicaid reimbursement would impact both hospital and municipal revenue streams, and embarking on a large municipal capital project in advance of policy clarity would be risky. Likewise, the Administration's initiatives on climate could foster a wait-and-see strategy in the public power sector. Proposed draconian budget cuts to certain programs such as public housing, which is a large sector within the municipal bond market, coming at a time when states are already reducing estimates for income tax and sales tax revenues, furthered the cautious tone.

As Congress and the Trump administration turn their attention to tax reform, uncertainties surrounding the proposed funding of $1 trillion of infrastructure projects will take center stage. While suggestions of tax credits and private investment seem plausible, we still expect traditional bond issuance to carry much of the load. Thankfully, talk of eliminating the tax exemption on tax-free bonds seems to have little support. However, lower marginal tax rates have the potential to negatively impact the municipal bond market somewhat as do lower corporate tax rates, which shift the behavior of big muni buyers such as insurance companies towards taxable debt.

In our opinion, the biggest factor for absolute tax-free bond returns continues to be the general path of Treasury yields, which we forecast will move higher (in an orderly fashion) over the balance of the year. Inflation and wages were already accelerating prior to the election, and the Fed is clearly more comfortable raising interest rates in response. Compared to recent experience, government policies look to be additive to growth, inflation and municipal bond issuance. As a result, we remain somewhat defensive but will use any material sell-offs to augment the income streams in portfolios where appropriate.

Conclusion

Our view from the beginning of 2017 has not changed: we continue to expect lackluster economic growth and the potential for volatile markets. Much of this is due to the contentious political environment that makes infrastructure spending and tax reform less certain. Despite relatively high valuations, we remain biased to stocks over bonds and believe markets overseas may continue to benefit from more reasonable valuations. Fixed income markets likely will be challenged in an environment of rate hikes and high valuations, although we believe the probability of a sharp, sustainable rise in yields is low. Our outlook is for at least two additional rate hikes in 2017 and a year-end 10-year Treasury yield of 3.25%, with growth remaining quite low at around 2%.