SIGNATUREFD

Spring 2017

MARKET SENSE:
Synchronized Global Growth vs. Global Risks

The equity market rally of the second half of 2016 continued into the first quarter of this year as data showed growth and confidence accelerating in most regions globally. Leadership within the U.S. market and between geographies shifted however, with many 2H16 outperformers lagging in 1Q17. Domestically, the S&P 500 rose 6% while smaller companies, which returned nearly double that of the S&P 500 last year, gained only 2.5%. Similarly, international equity markets outperformed U.S. markets with the MSCI All-Country World Index excluding U.S. stocks (ACWI ex-U.S.) gaining roughly 8% versus the S&P 500's 6%.

Global bond yields were mixed during quarter with U.S. rates down modestly and global rates flat to slightly higher, showing some stabilization after the sharp rise following the U.S. election in November. As a result, fixed income market returns firmed with U.S. and global bond benchmarks posting 0.8% and 1.8% returns, respectively. The Federal Reserve increased its benchmark interest rate by one-quarter of a percent in March, breaking the annual pace of rate hikes seen in 2015 and 2016 and defying market expectations coming into the year.

Before turning to a forward look on the economy and markets please take a minute to review the table below which shows major market benchmark data over the quarter and one-year time periods.

MOST ECONOMIC DATA HAS BEEN EXCEEDING EXPECTATIONS SINCE LATE LAST YEAR. IN FACT, THE CITIGROUP ECONOMIC SURPRISE INDEX HIT A FOUR-YEAR HIGH IN THE FIRST QUARTER.

	1st Quarter	52 Weeks
S&P 500	6.07	17.17
Dow Jones Industrial Average	5.19	19.91
MSCI EAFE (International)	7.25	11.67
MSCI EM (Emerging Markets)	11.45	17.22
Bloomberg Commodity Index	-2.33	8.71
Barclays Global Aggregate Bond Index (Global Bonds)	1.76	-1.90
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	0.82	0.44
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	1.90	0.35
HFRI Fund of Funds Composite Index	2.04	5.85

ECONOMIC UPDATE

One of our favorite pastimes outside the office is cooking, and some of you may agree that the best meals are cooked low and slow – think bar-b-que or marinara sauce. Recent data would suggest that the economy is currently operating at a nice steady simmer. Just as it leads to satisfying outcomes in cooking, this backdrop could prove positive for investors. The economic cycle is nearing its eighth anniversary, and the stock market crossed this threshold in March. Both cycles are thus longer than normal, but an economy that doesn't suffer from overheating should allow for steady forward progress.

Most economic data has been exceeding expectations since late last year. In fact, the Citigroup Economic Surprise Index hit a four-year high in the first quarter. But even this news is not enough to satisfy everyone. The biggest debate we heard over recent months was about the importance of "soft" vs. "hard" data. First, let's define these concepts: economists gather soft data, mostly via surveys such as confidence questionnaires or manufacturing outlooks in order to have predictive information. This is

in contrast to hard data which is historic based information such as retail sales, industrial production, or labor data. Clearly, hard data needs to follow soft data over time for there to be meaningful results that feed into corporate earnings and therefore market gains. While the gap between the two is large right now, it is possible that the business and investor confidence surge after the events of late last year – the Brexit vote and U.S. elections – will fade in coming months. But this may be the differ-ence between a slow simmer and pot boiling over. As we will touch on in the next section, at this stage of the economic cycle too much acceleration could trigger an aggressive Federal Reserve that could pull forward the potential for a policy induced slowdown.

In the U.S., some evidence does support the view that the economic recovery is aging. Recent data on automobile sales show that further improvement in that sector could be limited. Even with business optimism up, bank lending remains low, showing that companies remain cautious. Finally, the March employment reports showed disappointing new job creation even while the unemployment rate declined, showing that the pool of available workers very well could be running dry. Thus, too much growth at this stage could push wages, and consequently inflation, higher. As we mentioned in our newsletter last quarter, we believe the global economic recovery is as synchronized as it has been since 2011, and even without fiscal spending or tax reform, recession is unlikely over the next several quarters. Even with early disappointments for the new administration the markets have held up relatively well in recent weeks. We suspect that the realization that a slow simmer could be as good, or even better, than a full boil could be the reason why.

CAN THE FED STICK THE LANDING?

The team at one of our key research partners, Strategas, has questioned whether the Federal Reserve could stick the landing as the final phase to the technically difficult series of events they orchestrated since financial crisis. This remains an open question almost four years after the so-called taper tantrum that began the Fed's normalization process. But as evidenced by the calm market reactions to the well communicated December rate increase, the quicker to develop March increase, and the recent conversations about reducing the size of the Fed's bond holdings, we would suggest that the Fed has regained control of the process after a few difficult years. Why does this matter? We view the two biggest sources of risk that currently exist both reside with the Fed - first that they move to slowly, and second that they move too quickly.

Early this year it seemed that the Fed could be falling behind in normalization. With economic data surging and only one rate increase during 2016, the glacial pace of change seemed like it could get overwhelmed by a new administration intent on injecting major fiscal stimulus in the form of increased spending and major tax cuts at a time the economy arguably doesn't need either. The potential for surging economic growth seemed at odds with short-term interest rates that remained near historic lows and many inflation indicators starting to flash. If investors feared the Federal Reserve was acting too timidly then inflation expectations could move higher while long-term interest rates rise to the point of slowing down economic activity and acting as an alternative to richly valued equities.

A STABLE U.S. ENVIRONMENT WILL ALLOW THE BURGEONING RECOVERY IN OTHER ECONOMIES AROUND THE WORLD TO REINFORCE THE SYNCHRONIZED GROWTH.

Alternatively, if the Fed reacts to forward looking inflation data, and were to make anticipatory rate increases based on the potential for fiscal stimulus at a pace faster than the 2 or 3 additional increases that are expected by investors then confidence could quickly erode. The Fed is seriously challenged in the current environment not having clarity on the level of rates that would serve as an equilibrium in the economy – not too hot, not too cold. Given the lag effect of monetary policy, serious damage could occur to the economy if they move too quickly and exceed this equilibrium rate.

This brings us back to the steady simmer. A slower developing backdrop works to the investor's advantage currently as it reduces the risk that the Fed makes a mistake in either direction. If interest rates rise slowly then asset values can be supported. A stable U.S. environment will allow the burgeoning recovery in other economies around the world to reinforce the synchronized growth. Of course this environment can't last forever, and we will have further to write about 2018 and 2019 in future updates.

MARKET OUTLOOK

In recent meeting and travels around the country we still feel the biggest surprise to investors would be a stock market that appreciates significantly between now and year-end. We aren't predicting this, but merely making the observation that investors remain skeptical after eight years of market gains. The old adage that the market has to climb a wall of worry seems especially appropriate at this point. Even after a swift and strong move higher late in 2016, the market has yet to suffer an even 5% correction in the face of several negative headlines in recent weeks. With political and economic expectations now reset lower it just seems the market wants to move higher on any good news. When comparing recent evidence to that seen in 2000 and 2007, the market continues to show a lack of signs of traditional exuberance, and thus we believe it can still move higher before a more serious downturn becomes likely.

Of course, as time goes on, and as valuations rise, our clients pay us to grow increasingly nervous. But we don't see evidence yet that it is time to run for cover. The U.S. is the most expensive major stock market in the world, but without an interest rate surge, valuations can be defended. Outside the U.S. we believe valuations are more attractive, and improving economic data has been underappreciated. Investors remain underweight Europe and Japan, even while these markets are beginning to catch-up, or even exceed the U.S. over the past three and six month time periods. As an example of the faith that investors are putting in U.S. companies think about the following. Currently, the U.S. represents over half the entire universe of global public companies based on size. Further a full one-half of the US market is comprised of just 20 companies. That means that 25% of the global equity market is comprised of just 20 companies that are based in the U.S. Of course these are some great, great businesses, many of which have deep operations outside the U.S. But we would suggest that the source of much future innovation and economic dynamism may very well come from the 75% of production and consumer spending and by the 95% of human beings that live outside the U.S.

Our portfolio themes remain largely consistent with last quarter. We are cautious on fixed income. Portfolios typically have lower than normal bond exposure and the positions we hold are tilted toward short-term investments. Within equities, our portfolios remain largely in-line with global benchmarks, but compared to many U.S. based investors have relatively high allocations to Europe, Japan, and emerging markets. As mentioned above, this is due partly to valuations and partly based on a belief that investors are largely under-allocated and will have to follow the improving trends. Over the past year, our portfolio shifts did cause an increase in exposures to financials, industrials, and energy stocks which could continue to benefit from a strengthening economy.

In summary, we think the reflationary trends that started early in 2016 have further to run. Global synchronized growth should be particularly supportive of international markets. This should benefit stocks generally, and sectors like financials and energy, specifically. Interest rates are likely at the beginning of a long, but gradual cycle of rising, thus limiting the return potential and the risk mitigation typically provided from this asset class. Too much or too little action by the Fed could derail our thesis, but currently they are acting in a way that supports a slowly simmering economy that can last at least into 2018.

As always, we thank you for the confidence you have placed in our team. We remain available to discuss this letter, or any other questions you may have on your portfolio.