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WEALTH MANAGEMENT

First Quarter 2017 Market Commentary

The S&P 500 posted its biggest quarterly gain since 2015, lifted by a brightening economic outlook and rising confidence among businesses and consumers.

Stocks extended their postelection climb in the first three months of the year, adding to fourth-quarter gains. However, the leading sectors shifted in 2017 to companies that tend to gain in times of economic growth from companies expected to benefit from changing US policy following the presidential election. Financial services and industrial companies lost some of their so-called "Trump trade" luster, while businesses that tend to grow with the economy – like technology and internet companies – came into favor.

Significantly, the Dow Jones Industrial Average crossed the 20,000 threshold for the first time in history during the quarter. The Dow recorded 12 straight record closes in February – the longest streak of this type since 1987 – but then recorded 8 straight down days in March – the longest losing streak for the index since 2011.

The bond market recorded very modest positive returns for the first quarter. The yield curve – which plots bond yields for different maturities – flattened during the quarter, with short-term rates rising and 10- and 30-year yields declining. The Federal Reserve's March meeting, during which the central bank raised interest rates for only the third time in the past decade, was an impetus for the bond market movement. Investors are keenly watching the Fed to see if there will be a total of three or four rate increases in 2017.

The stock market rally was a global one during the quarter, with international developed and emerging markets also posting strong results. China, in particular, appears to have reversed course over the past year. At that time, investors were fearing a "hard landing" for the economy, and a potential currency devaluation. But last month, China experienced net inflows of capital for the first time in three years. Some market observers are still expressing concerns about China over the longer-term, as a transition from an export-led economy to one based on domestic consumption is seen as the key to moving from a middle income base to a high income one.

Benchmark Returns
For comparative purposes, the S&P 500 index (a proxy for large US stocks) returned +14.7% for the twelve months to March 31, and rose +5.5% in the first quarter.

The Russell 2000 (a proxy for small US stocks) returned +26.2% for the twelve months to March 31, and rose +2.5% in the fourth quarter.

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The Wilshire 5000 index (a proxy for the broad US stock market) returned +18.5% for the twelve months to March 31, and rose +5.7% in the first quarter.

The MCSI EAFE index (a proxy for large international stocks) returned +8.5% for the twelve months to March 31, and rose +6.5% in the first quarter, as measured in USD. Measured in Euros, the performance was better: +15.6% for the year and +5.0% for the first quarter.

Finally, the MSCI Emerging markets index returned +14.5% for the twelve months to March 31, and rose +11.1% in the first quarter.

In the fixed income segment, the Bloomberg Barclays US Aggregate Bond Index returned +0.5% for the twelve months to March 31 and +0.8% for the first quarter.

Looking Forward

As we noted last quarter, meaningful risk-free income is still not available, and the "safest" stocks – US large caps – are trading at all-time high valuations. The S&P 500 is currently trading at about 18x estimated earnings, compared to a long-term average of 15x.

Robert Shiller's "CAPE Ratio" is a well-known valuation measure applied to the S&P 500 index. The ratio divides the index's inflation-adjusted price by its 10-year average inflation-adjusted earnings. Historically, when the CAPE ratio is low, subsequent 10-year returns tend to be good. And when the CAPE ratio is high, subsequent 10-year returns tend to be low. According to Shiller, the ratio is currently at 30. It has only been higher in 1929, when it was at 33, and in the years around 2000, when it was at 44. While a high CAPE ratio suggests we can expect low market returns going forward, it does not guarantee them nor indicate when they might occur.

Investors should continue to be able to generate higher returns over time by "tilting" their portfolios to capture the premiums offered by the small cap and value factors. However, those unwilling or unable to accept low- to mid-single digit returns on a balanced portfolio may have to reconcile their risk aversion with their long-term investment growth needs.

At Springwater, we continue to advocate a prudent, proven investment approach that is focused on controlling what can be controlled – asset allocation, diversification, taxes, expenses and, most importantly, emotions. Over the long-term, investors have historically been rewarded for taking stock market risk with higher returns. We see no reason to expect that this will not continue.

As always, we remain available to answer any questions or comments you may have, and committed to helping you navigate the periodically choppy seas of successful long-term investing.

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