MARKET COMMENTARY & OUTLOOK

First Quarter, 2017

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For now, it appears their priority is to keep a sizeable level of assets to help maintain accommodative financial conditions.

As expected, the Federal Reserve Open Market Committee (Fed) increased the target range for the federal funds rate in March. This is the second increase in three months. The new target range is 0.75% to 1.00%. The effective federal funds rate is 0.91 as of 3/31/17. Committee members did not change their projections for 2017 and 2018, so the median effective federal funds rate by the end of 2017 remains at 1.40%. Therefore, assuming the economic data continues to show strength in the economy, the Fed is expected to increase the target another 50 bps.

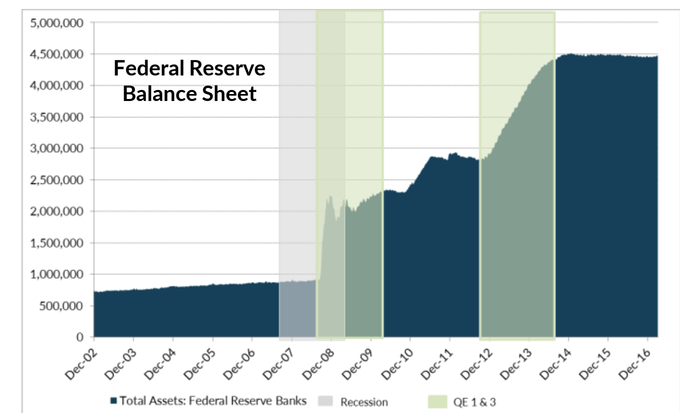
Brian Wesbury, Chief Economist for First Trust, recently discussed in his blog a significant component to the Fed's monetary policy that has not been frequently discussed by the mainstream media. Wesbury believes the Federal Reserve needs to shrink the assets on its balance sheet in order to more effectively manage monetary policy. Until the Fed reduces the size of the balance sheet, further increases in the federal funds target will have diminished effectiveness curtailing inflation risk because those excess reserves remain in the system. His belief is that as long as excessive reserves are in the financial system, banks will continue to lend those excess reserves, putting upward pressure on inflation.

Over the last 8+ years, with three rounds of quantitative easing (QE), the total assets at the Federal Reserve increased by more than 100%. At the end of the first quarter, the assets on the Fed's balance sheet totaled $4.47 trillion.

As a refresher, QE involved the Fed purchasing fixed income securities. Those securities were added to the Fed balance sheet with the intent that the cash used to purchase the fixed income securities would provide further liquidity to the economy and spur additional economic activity. These actions were in addition to traditional policy measures of lowering the target for short-term interest rates, which they ultimately set between 0.0% to 0.25%. The first round of QE began in November 2008 with the purchase $600 billion of mortgage-backed securities (MBS) per month. The last phase of asset purchases ended in 2014. Even though the Fed has not targeted a level of bond purchases in more than two years, it has been re-investing proceeds from maturities and the interest received. As a result, the balance sheet has only declined marginally (*see chart below*).

Minutes from the Fed's March meeting indicate the size of the Fed's balance sheet was an agenda item. After discussing several factors that must be considered in reducing the balance sheet, the Committee decided to discuss the topic further in upcoming meetings. I see an image in my mind of a can getting kicked down a road. However, the Committee appears to believe it is important to maintain the existing policy of reinvesting principal payments from the holdings of agency MBS and rolling over maturing Treasury securities until the "*normalization of the level of the federal funds rate is well underway*." For now, it appears their priority is to keep a sizeable level of assets to help maintain accommodative financial conditions.

Subsequent to Wesbury's blog, Bloomberg posted an article titled "Markets Start to Ponder the $13 Trillion Gorilla in the Room." The authors discuss how the Fed, European Central Bank, and Bank of Japan will transition from "*unchartered*" quantitative easing to "*uncharted*" quantitative tightening. How will the market react when the Fed's announces a detailed plan to reduce the balance sheet? Will there be another "*taper tantrum*" similar to or worse than the one in June 2013 when the 10-Year Treasury yield jumped approximately 100 bps or will the market react in a muted fashion similar to China's reduced purchases of Treasuries over the last few years? Fed Vice Chairman Fischer's view is that "*[w]e appear less likely to face major market disturbances now than we did in the case of the taper tantrum*". Despite the fact that the Fed has not provided much information on a change in the reinvestment policy, he believes the markets muted response so far to the Fed's discussion is an indication that the markets will not get 'disturbed'. Let's hope he is right and the muted response is not another example of investor complacency that seems to be enveloping the markets.



The Economy

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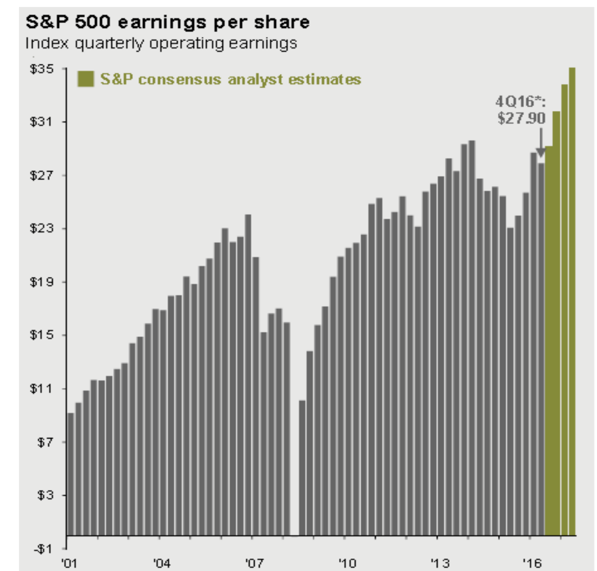
As has been the case for much of the economic recovery, economic statistics have shown gradual but consistent improvement, yet the resulting growth in Gross Domestic Product ("GDP) has been muted.

- The Citigroup Economic Surprise Index remains in positive territory through March, continuing the trend from the end of 2016. A positive reading indicates recent economic data has exceeded expectations. The index for the US, the Euro-Zone, the UK and Emerging Markets reached some of the highest readings in the last three years in February.
- Manufacturing activity levels, as measured by the Purchasing Managers Index (PMI), indicate expansion. A PMI reading above 50 represents expansion. As of March 31st, the Global PMI level was 53.0 and the PMI for the United States, Canada, United Kingdom, Euro Area, Japan, and China were above 51. Moreover, in January, the International Monetary Fund (IMF) reported a higher projected economic growth for advanced as well as emerging and developing economies. Advanced economies are expected to grow 1.9% in 2017 and 2.0% in 2018, with positive revisions for the United States, Germany, Japan, Spain, and the United Kingdom.
- The Conference Board's Leading and Coincident Indicators also provide optimism. The coincident index, which measures the current state of the economy, continues to move higher. The Leading Index, which includes 10 components, indicates positive economic momentum; for three consecutive months, the index for the US shows positive change with a +1.51% increase since December.
- Despite a drop in non-farm payrolls for March, the job market continues to be a positive component for positive economic growth. In the first three months of this year, the increase in non-farm payrolls is 533,000 and the monthly average change is +177,700. The percentage change in non-farm payrolls for the trailing twelve months is 1.52%. While there is a declining trend in the year-over-year change for the last two quarters, the rate of change is significantly greater than the 0.4% JPMorgan indicates is the growth in workers during the 10-year period from 2007 to 2016.
- US Corporate profits, as measured by the Bureau of Economic Analysis release, are improving. After declining in each quarter in 2014 and in the second quarter of 2016, corporate profits have increased for two consecutive quarters as of the end of the fourth quarter.

Even though there have been general improvements in the economic data globally, economic growth in the United States slowed in the fourth quarter of 2016. In the report released at the end of March, the Bureau of Economic Analysis indicated the annualized quarterly change in the GDP increased 2.1% compared to +3.5% for the third quarter. The year-over-year change for the fourth quarter is 1.2%. However, if economic growth is positive in the first quarter, it will mark the 93rd month of expansion in the current business cycle. Currently, the GDPNow forecast from the Atlanta Fed is estimating a +0.4% GDP growth. While there is hope that the impact of the new administration's policies will stimulate growth, US economic growth remains slow, but steady, for the time being.

Economic Statistics	Current	One Year Ago
Real GDP Growth (Year-over-Year)	1.20%	-1.40%
Unemployment Rate	4.70%	4.90%
Labor Force Participation Rate	63.00%	62.90%
Core CPI (Year-Over-Year)	2.22%	2.33%
Real Personal Income Growth (Year-over-Year)	2.40%	2.57%
10 Year Treasury Rate	2.42%	1.78%

Data Source: Federal Reserve



Data Source: JP Morgan

US Equity Market

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Investors have openly embraced risk since President Trump was elected and this appetite for risk has favored equities. A majority of the US equity indexes posted positive returns for the quarter, with several of those indexes hitting new all-time highs.

In a reversal from much of 2016, large cap equity outperformed small cap equity by a large margin. The large cap Russell Top 200 Index returned +6.4% and the small cap Russell 2000 Index returned +2.5%. In another reversal from 2016, growth outperformed value across all three market capitalizations.

Market breadth, which helps determine whether the market is being driven by a select group of stocks (narrow) or a larger number of securities (broad), was decidedly narrow in the first quarter. An easy method to measure the breadth of the market is to compare the performance of a cap-weighted index to an equal-weighted index. While breadth improved in March, the Russell 3000 Index outperformed the Russell 3000 Equal Weighted Index by 300 bps for the quarter. Another way to measure market breadth is to compare the median return for the index to the overall return for the index. This method also confirms the narrow breadth; the median return for the Russell 3000, as measured by the performance of each constituent in the iShares Russell 3000 ETF, is significantly less than the index return (+1.5% vs. +5.7%).

As the equity markets trended higher, volatility trended lower. The CBOE Volatility Index (VIX) for the S&P 500 declined 11.89% during the quarter from 14.04 to 12.37 and the Russell 2000 Volatility Index experienced a 16.8% decline. While not at their all-time lows, each finished the quarter nearly one standard deviation below the 10-year average. Another measure of volatility is the number of days the index moved more than +/- 1%. Out of the 74 trading days, there were only 5 days in which the S&P 500 Index moved by more than 1%. The index gained more than 1% in 3 days and declined more than -1% in two days; the best and worst daily returns were essentially cancelled each other (i.e., +1.46% and -1.43%). As expected, the small cap Russell 2000 Index was more volatile and there were 23 days in which the index moved more than +/-1% and the range of daily returns was greater than the large cap index (+2.57% to -3.23%). It is important to remember that low volatility does not equate to low risk. In our opinion, this represents a level of complacency in the markets, which is concerning. While the base case still reflects steady but lower returns in equities, the probability for a bad case scenario is higher than normal and, based on these volatility statistics, is not being contemplated by investors.

As the chart to the right illustrates, Information Technology was the best performing sector (+11.8%) in the Russell 3000 Index for the first quarter. Apple, Facebook, and Amazon were the top 3 contributors to the index return. In aggregate, the three stocks accounted for 20.2% (or 1.16% points) of the Russell 3000 Index's +5.74% return.

Major Market Averages	Q1, 2017	1 Year	2016	3 Year
Russell 3000 Index	5.74%	18.07%	12.74%	9.76%
FTSE RAFI US 3000 Index	3.15%	19.58%	18.09%	9.05%
Russell 3000 Equal Weighted Index	2.75%	25.70%	21.58%	6.53%
S&P 500 Index	6.07%	17.17%	20.00%	10.37%
Russell Mid Cap Index	5.15%	17.03%	13.80%	8.48%
Russell 2000 Index	2.47%	26.22%	21.31%	7.22%

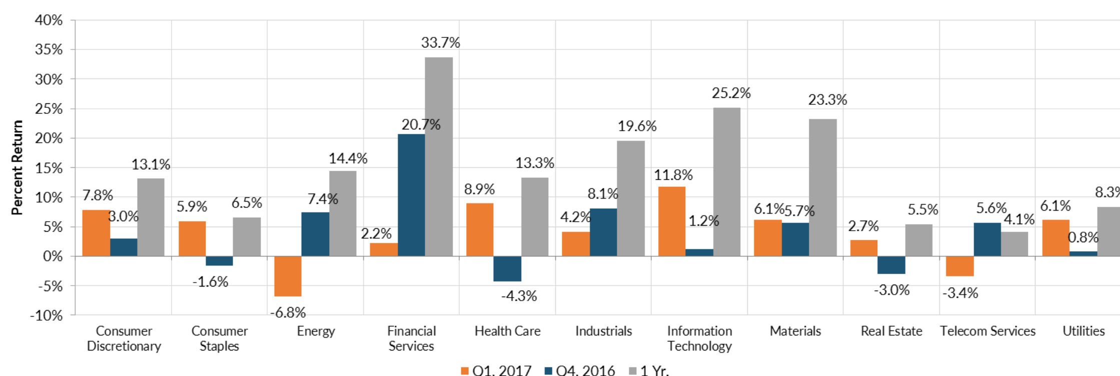
Data Source: Morningstar

Russell 3000 Style & Cap Summary

	Mo.	Qtr	Value		Core		Growth	
Large	Jan		0.27%		1.85%		3.38%	
	Feb	Q1	3.96%	3.05%	4.29%	6.38%	4.60%	9.61%
	Mar		-1.15%		0.15%		1.36%	
Mid	Jan		1.68%		2.41%		3.33%	
	Feb	Q1	2.79%	3.76%	2.83%	5.15%	2.88%	6.89%
	Mar		-0.73%		-0.16%		0.55%	
Small	Jan		-0.71%		0.39%		1.62%	
	Feb	Q1	1.45%	-0.13%	1.93%	2.47%	2.45%	5.35%
	Mar		-0.85%		0.13%		1.18%	

Data Source: Morningstar Direct. Market capitalization represented by Russell Top 200, Russell Mid Cap, and Russell 2000 indexes.

Russell 3000 Sector Performance



US Equity Market (as measured by the Russell 3000 Index)

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Return By Dividend Yield	Avg. Weight %	Return %	Contribution to Return %
Dividend Yield %TTM [2.89 - 17.32]	23.6%	2.0%	0.5%
Dividend Yield %TTM [2.06 - 2.89)	23.3%	4.9%	1.2%
Dividend Yield %TTM [0.86 - 2.06)	25.1%	7.6%	1.9%
Dividend Yield %TTM [0.00 - 0.86)	27.7%	8.0%	2.2%
Attribution Total	**99.7%**		**5.70%**

*Dividend Yield is for the trailing twelve months

Return By Market Cap	Avg. Weight %	Return %	Contribution to Return %
Mega Cap (>$100 Billion)	36.3%	6.8%	2.5%
Large Cap ($20 Billion < x <$100 Billion)	34.5%	5.4%	1.9%
Mid-Large Cap ($10 Billion < x <$20 Billion)	10.0%	6.6%	0.7%
Mid Cap ($5 Billion < x <$10 Billion)	8.0%	5.3%	0.4%
Small-Mid Cap ($2 Billion < x <$5 Billion)	6.8%	3.4%	0.2%
Small Cap ($500 Million < x <$2 Billion)	3.5%	1.9%	0.1%
Micro Cap (< $500 Million)	0.6%	0.3%	0.0%
Total	**100.0%**		**5.70%**

Average weight and return data for Q1, 2017.

Data Source for all data in tables: Morningstar Direct and iShare Russell 3000 ETF.

Top Weights	Weight	Return	Contribution
Apple Inc	2.95%	24.57%	0.67%
Microsoft Corp	2.00%	6.63%	0.13%
Exxon Mobil Corp	1.44%	-8.30%	-0.13%
Johnson & Johnson	1.35%	8.81%	0.12%
Amazon.com Inc	1.33%	18.23%	0.23%
JPMorgan Chase & Co	1.32%	2.36%	0.03%
Berkshire Hathaway Inc B	1.30%	2.27%	0.03%
Facebook Inc A	1.23%	23.47%	0.26%
General Electric Co	1.15%	-4.94%	-0.06%
Wells Fargo & Co	1.07%	1.68%	0.02%

Top Contributors	Weight	Return	Contribution
Apple Inc	2.95%	24.57%	0.67%
Facebook Inc A	1.23%	23.47%	0.26%
Amazon.com Inc	1.33%	18.23%	0.23%
Philip Morris International Inc	0.65%	24.53%	0.15%
Microsoft Corp	2.00%	6.63%	0.13%
Johnson & Johnson	1.35%	8.81%	0.12%
Visa Inc Class A	0.67%	14.12%	0.09%
Cisco Systems Inc	0.67%	12.81%	0.08%
Oracle Corp	0.51%	16.47%	0.08%
Alphabet Inc C	1.00%	7.48%	0.07%

Top Detractors	Weight	Return	Contribution
Exxon Mobil Corp	1.44%	-8.30%	-0.13%
Chevron Corp	0.87%	-7.90%	-0.07%
Verizon Communications Inc	0.85%	-7.68%	-0.07%
General Electric Co	1.15%	-4.94%	-0.06%
Qualcomm Inc	0.35%	-11.23%	-0.05%
Target Corp	0.15%	-22.88%	-0.04%
Schlumberger Ltd	0.47%	-6.40%	-0.03%
Bristol-Myers Squibb Company	0.38%	-6.33%	-0.03%
Occidental Petroleum Corp	0.21%	-9.96%	-0.02%
The Kroger Co	0.13%	-14.24%	-0.02%

US Equity Market Valuations

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It has been well documented, by many market observers, that valuations for equity and other assets are high.

Bill Gross, a tenured and successful bond manager with Janus, discussed valuations in his April investment outlook: *"Equity markets are priced for too much hope, high-yield bond markets for too much growth, and all asset prices elevated to artificial levels that only a model-driven, historically biased investor would believe could lead to returns resembling the past six years, or the decades predating Lehman. High rates of growth, and the productivity that drives it, are likely distant memories from a bygone era."*

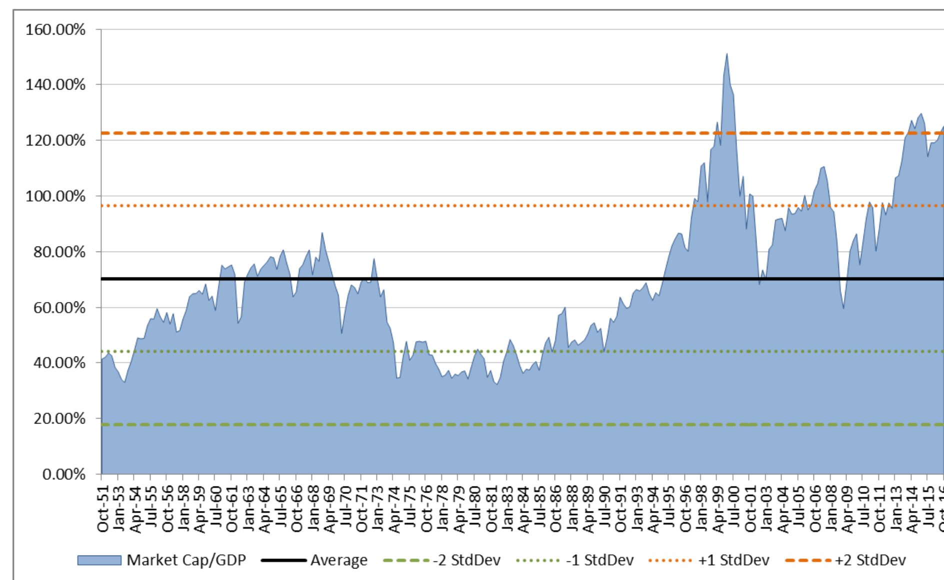
In general, the discussion of valuation in the media tends to be framed in the context of triggering a bear market or a market correction. In our previous commentary, we included a chart from JP Morgan that summarizes that only 2 of the last 10 equity market corrections/bear markets were solely triggered by excessive valuations.

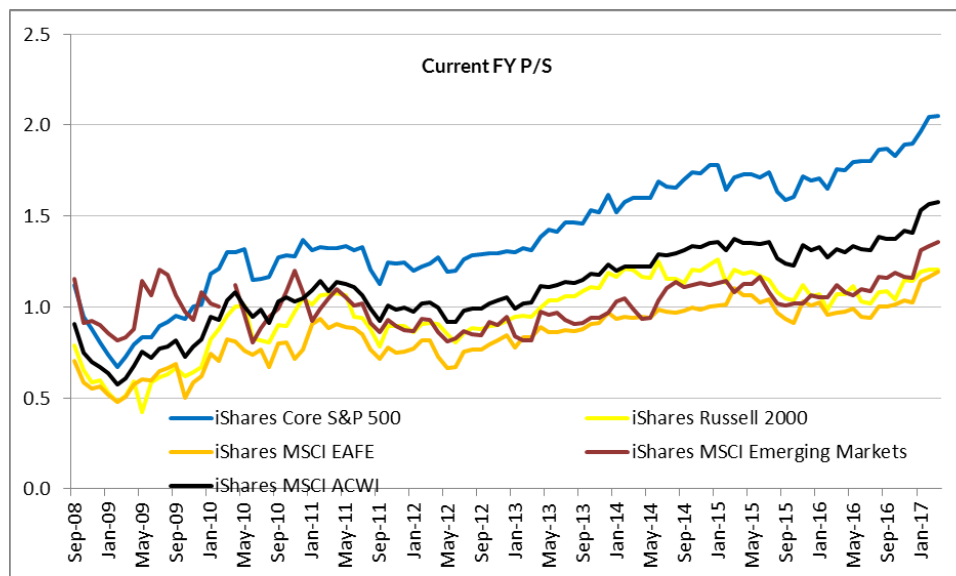
Compared to foreign equity indexes, US equity valuations are higher. In relation to the broad MSCI All Country World index, the S&P 500 has consistently been priced more expensively based on current fiscal year sales.

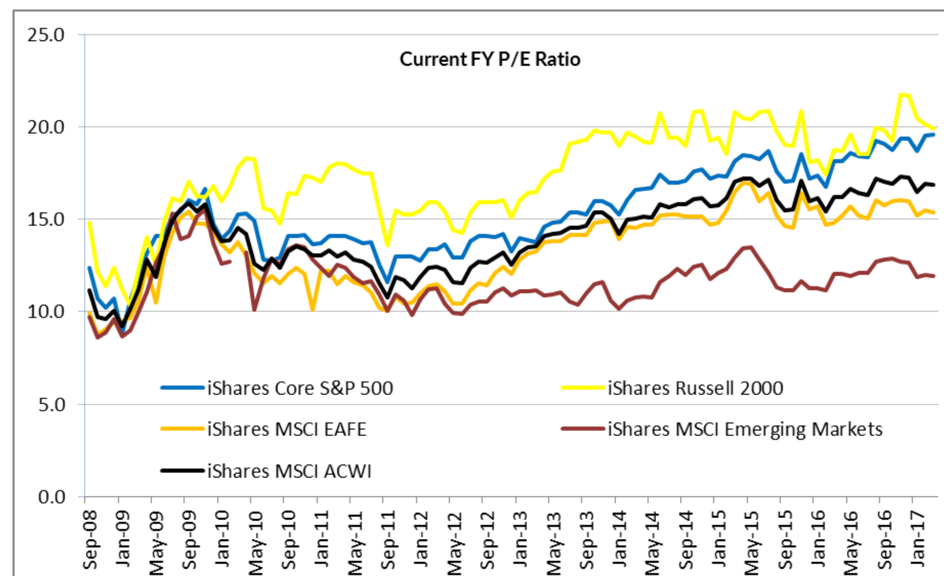
Our view on equity valuations has not changed. In previous commentaries we have summarized that risk assets with higher valuations are more susceptible to larger pull backs and lower prospective returns. To mitigate some of the risk, we believe lower beta and long/short equity strategies are prudent allocations at this stage of the investment cycle.

Buffet Indicator

The Buffett Indicator, made popular by Warren Buffett, compares the market cap of the US equity market to US Gross Domestic Product. The numerator for the equation is the Market Value of Equities Outstanding as reported by the Federal Reserve. The denominator is Nominal Quarterly GDP.







Source: Morningstar Direct; iShares

International Equity

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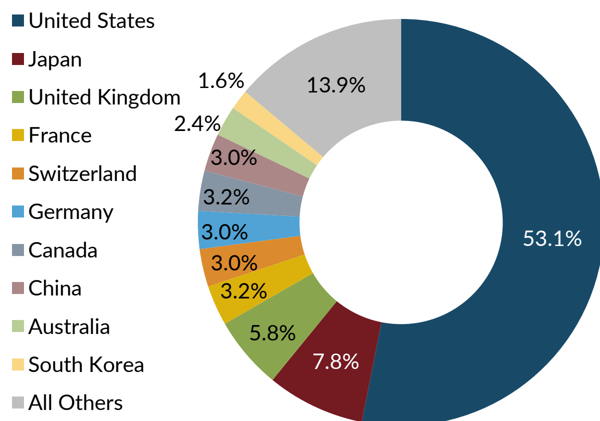
One of the most significant contributors to foreign equity performance in the first quarter was the decline of the US Dollar. With the exception of China, the US dollar declined versus major global currencies, providing a tailwind for US investors in foreign equity markets (Note: Foreign returns buy more US dollars as the dollar weakens). The currency impact from the depreciation ranged from 57 bps (Canada) to 602 bps (Russia). Even without this tailwind, the majority of the foreign equity markets outperformed the US markets. Improved economic data and attractive valuations provide support for the improved performance. With the US Federal Reserve focused on raising rates, the accommodative stance still being followed by many foreign central banks is likely to provide continued support for those markets.

Developing markets, which have underperformed developed markets over recent years, outperformed developed markets by 4.10 percentage points. (+11.5% vs. +7.4%) in dollar terms.

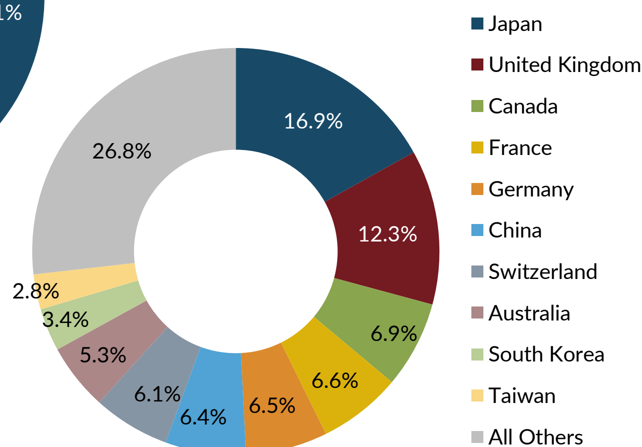
Japan, which represents nearly 24% of the MSCI EAFE Index, contributed 1.1% to the MSCI EAFE's 7.4% return (a 15.1% contribution). The best performing country in the MSCI EAFE Index was Singapore (+15.0%). Conversely, the largest country in the MSCI Emerging Markets Index (China) contributed 3.50% to that index's return (a 30.4% contribution). Given the country's significant weight in the index, we expect any change in sentiment toward China to have a meaningful impact on index performance.

After trailing the value index by 970 bps in the fourth quarter of last year, the MSCI EAFE Growth Index return exceeded the value index by 2.40 percentage points (+8.6% vs. +6.2%). In general, companies in the EAFE Index with higher valuations, based on earnings and book value, outperformed.

MSCI ACWI - Country Weights



MSCI ACWI ex USA – Country Weights



Data Source: Morningstar and iShares ETFs as the representative index proxies. Weights are average for Q1.

Major Market Averages

	Q1, 2017	1 Year	2016
MSCI EAFE	7.4%	12.2%	1.5%
MSCI EAFE Value	6.2%	16.7%	5.7%
MSCI EAFE Growth	8.6%	7.9%	-2.7%
MSCI EM	11.5%	17.7%	11.6%
MSCI ACWI Ex. USA.	8.0%	13.7%	5.0%

Data Source: Morningstar

Regional & Country Performance

	Local	USD	Impact Of US Dollar [(a)]
MSCI ACWI Ex USA	5.33%	7.98%	2.66%
MSCI Europe	6.18%	7.61%	1.43%
MSCI Europe Ex UK	7.11%	8.64%	1.53%
MSCI United Kingdom	3.82%	5.06%	1.24%
MSCI Pacific Ex Japan	7.95%	11.79%	3.83%
MSCI Japan	-0.03%	4.64%	4.67%
MSCI France	5.86%	7.35%	1.49%
MSCI Switzerland	7.18%	8.83%	1.65%
MSCI Germany	7.02%	8.52%	1.50%
MSCI Canada	2.12%	2.68%	0.57%
MSCI China	13.13%	12.93%	-0.21%
MSCI India	12.06%	17.12%	5.06%
MSCI Brazil	7.73%	10.43%	2.71%
MSCI Russia	-10.63%	-4.61%	6.02%

Assumes Gross Reinvestment Of Dividends

Data Source: Morningstar

(a) Impact of Dollar: A strengthening dollar (represented as a negative return) has a negative impact on foreign returns as those returns are converted from foreign currency to US dollars. A weakening currency (represented by a positive return) has the opposite effect.

Fixed Income

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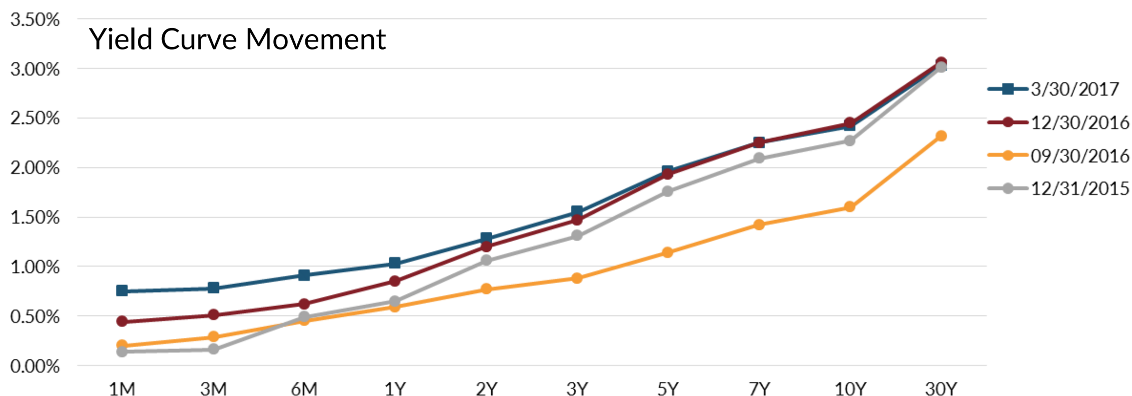
While inflation expectations continued to increase during the quarter, the Treasury yield curve did not shift higher for longer maturities. However, higher yields in shorter maturities due in large part to the Federal Reserve's decision to raise the short term federal funds rate by .25%, caused the yield curve to flatten. During the quarter, the 5-Year Forward Inflation Expectation Rate Index increased another 5.34% after increasing 17.71% in the fourth quarter of 2016. Despite the increase in inflation risk, the 5-year Treasury yield only increased 3 bps. With long maturity yields basically unchanged during the quarter, long duration outperformed. For example, the Bloomberg Barclays US Treasury 20+ Index underperformed the Bloomberg Barclays US Treasury 1-3 Year Index by 114 bps (+1.41% vs. +0.27%). We believe the yields on longer maturities will remain under pressure. Longer interest rates on foreign government bonds have been muted by their easier monetary policies. Should interest rates rise in US bonds, the likely result will be increased demand from those seeking higher yields. This increased demand will result in higher prices for those bonds which, in turn will cause yields to decline. Therefore, short of significant inflationary pressure, we expect longer term rates to remain under pressure until global monetary policies are in sync.

After taking a breather, investors' appetite for credit risk re-emerged. Not only did credit bonds outperform less risky government debt, but lower credit (i.e., high yield) outperformed investment grade credit. The net result is tighter credit spreads, as measured by option-adjusted spreads (OAS). Investment grade spreads decreased 5 bps, while the OAS for the Bloomberg Barclays US High Yield declined 26 bps. As summarized in the tables to the right, the investment grade (IG) corporate index beat the Treasury index by 55 bps and the high yield corporate index easily beat the return for the IG index by 148 bps. For the fifth consecutive quarter, the index representing the lowest quality high yield credit rating posted a positive return; the Bloomberg Barclays US High Yield Ca-to-D returned +8.9% for the quarter and returned +90.5% for the trailing four quarters. Similarly, within IG credit, the lowest quality rating outperformed the highest rated (1.48% vs. +0.84%).

In other areas of the bond market, Treasury Inflation Protected Securities (TIPs), which adjust upward to increases in consumer prices, outperformed nominal Treasury securities (1.26% vs. 0.67%). The Bloomberg Barclays Municipal Index returned +1.58% for the quarter. Steady demand along with a light new supply contributed to higher prices across the AAA municipal yield curve.



Data Source: Federal Reserve

Major Market Averages	Q1, 2017	1 Year	2016
BofAML US Treasury Bill 3 Mon	0.10%	0.36%	0.33%
Bloomberg Barclays US Govt/Credit 1-3 Yr	0.41%	0.71%	1.28%
Bloomberg Barclays US Govt Interm	0.54%	-0.67%	1.05%
Bloomberg Barclays US Govt/Credit Interm	0.78%	0.42%	2.08%
Bloomberg Barclays US Govt/Credit	0.96%	0.54%	3.05%
Bloomberg Barclays US Agg Interm	0.68%	0.35%	1.97%
Bloomberg Barclays US Agg Bond	0.82%	0.44%	2.65%
Bloomberg Barclays Global Agg Bond	1.76%	-1.90%	2.09%
Bloomberg Barclays US Treasury	0.67%	-1.44%	1.04%
Bloomberg Barclays US Treasury US TIPS	1.26%	1.48%	4.68%
Bloomberg Barclays US Corporate IG	1.22%	3.31%	6.11%
Bloomberg Barclays High Yield Corporate	2.70%	16.39%	17.13%
Bloomberg Barclays Municipal	1.58%	0.15%	0.25%
Bloomberg Barclays Municipal 7 Yr 6-8	1.95%	-0.06%	-0.50%

Credit Quality

Credit Quality			
Bloomberg Barclays US Corporate Aaa	0.84%	-0.39%	3.39%
Bloomberg Barclays US Corporate Aa	0.93%	0.94%	3.60%
Bloomberg Barclays US Corporate A	1.00%	1.74%	4.65%
Bloomberg Barclays US Corps Baa	1.48%	5.30%	8.04%
Bloomberg Barclays US High Yield Ba	2.06%	10.82%	12.78%
Bloomberg Barclays US High Yield B	2.53%	15.89%	15.81%
Bloomberg Barclays US High Yield Caa	4.66%	32.60%	31.46%
Bloomberg Barclays US High Yield Ca-to-D	8.87%	90.47%	83.14%

Data Source: Morningstar

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