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1ST QUARTER 2017

The bull market, which began in March 2009, trudged on methodically during the first quarter of 2017. The limited volatility was evidenced by the fact that when the S&P 500 index fell by 1.2% on March 21st, it marked the only day during the entire quarter that the index fell by more than 1%, and it was the first such fall in five months. The last time the market went that long without a 1% lower close was during 1993. The lack of volatility was remarkable considering that Donald Trump was inaugurated on January 20th, and the new administration had moments of unevenness.

The S&P 500 index was up 6.07% for the quarter. It is up an impressive 17.17% for the 12 months ended March 31, 2017. Small cap stocks, which were on a tear during much of 2016, lost some luster in the first quarter, as the Russell 2000 index was up only 2.47%. For a change, international stock markets generally outperformed the U.S., with emerging markets especially strong.

The broader bond market managed to eke out a positive return. The Barclays U.S. aggregate bond index was up .82% for the quarter. Not a robust performance to be sure, but the increase indicates that predictions of significantly higher interest rates amid stronger economic growth were over blown. The fact is that although the Federal Reserve (the Fed) has raised the discount rate by .25% in both December and March, intermediate and long-term interest rates have not increased commensurately. The steepening of the yield curve, that has for so long been coveted by the banking sector, has still not materialized.

Post-election confidence about an ignition for the economy began to wane as the quarter drew to a close. The failure by the Trump administration to deliver on its promise to scuttle the Affordable Health Care Act served as a reminder of the challenges in shepherding legislation not just past a divided congress, but a split Republican Party. Meaningful tax reform now looks more like a possibility, not a probability. One of the factors that fueled the so-called Trump rally was the anticipation that a pro-business president and a Republican-controlled Congress would be able to reform the tax code, repatriate offshore corporate profits and reduce taxes, thus stimulating the economy and boosting the stock market. That optimism was dealt a blow when the first major initiative of the new administration, the repeal of Obamacare, was presented in such a haphazard manner, only to be later withdrawn, due to a lack of support from members of both parties.

This bull market, however, is no stranger to political gridlock. Yet the challenge to higher U.S. stock prices is that the price to earnings ratio is well above the long-term average. The market is priced for a rebound in earnings so if the acceleration of earnings does not develop, the stock market may be vulnerable. This is especially the case as tax reform, to a large extent, is already reflected in stock prices.

And then there's the Fed. Its goal is the normalization of interest rates, which means a departure from a long-standing accommodative stance. The Fed began unwinding a bond portfolio of trillions of dollars acquired during three quantitative easing programs. The timing for this is vital. Yellen has indicated the Fed's intention to continue a series of small discount rate hikes. Two more this year? Perhaps three in 2018, assuming the economy does not dip? Nevertheless, higher rates are ultimately inevitable (and necessary). For now, and perhaps even after several rate hikes, equities can prevail in the battle against bonds for income. If, however, money market rates and bond yields return to 3-5%, investors may shift from stocks. Once the forward looking stock market is able to more confidently identify this "crossover" point, the aging bull market will be ready to take its place in history.

As investment advisors and financial planners our focus remains unchanged. Given the fact that recent corrections have been relatively painless and of short duration, the process of assessing risk tolerance is made more difficult. Our job is to help our clients remember that all bull markets come to an end. Consequently, portfolios should be appropriately diversified and in line with the goals and desires of our clients.

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