The Ten Themes of 1Q 2017

Anyone who has been watching has likely noticed that global stocks posted solid gains during the first three months of 2017. In the U.S., small cap stocks rose +2.12%[i] and large cap stocks rose +5.53%[ii]. While the stock gains were good in the U.S., foreign markets faired even better as indicated by the gains posted in Developed International Markets (+7.90%)[iii], with the best gains coming from Emerging Markets (+12.51%)[iv]. Yet, this strong start does have some concerned the gains will not be able to last.

A consensus view to begin the year expected there would be a Great Rotation out of bonds into stocks. Well, stocks have held up their end of the bargain; however, bonds have not, as global investors were reluctant to get rid of them. The yield on a 10-year U.S. treasury started 2017 off at 2.45%. Wall Street widely expected that yield to rise above 3%. Instead, the yield on a 10-year U.S. note fell to 2.40% by the end of the first quarter.[v]

There are many reasons why investors have not been willing to sell their “safer” bonds. One of the reasons demand for U.S. bonds has remained high is because of their relative attractiveness compared to other countries. The U.S. is widely recognized as a “safe” investment for global bond investors due to its almost zero chance of defaulting on its debt obligations. Yet, much weaker countries than the U.S. have lower bond yields, which makes little sense.

Most global investors understand it is better to purchase a 10-year U.S. bond that offers a yield of 2.40% than to buy a Spanish 10-year bond that offers +1.66%. German 10-year bonds only yield 0.32%, and even worse than that is Japan with a mere +0.07% yield. Therefore, so long as global interest rates remain low, it will be very challenging for the U.S. to see long-term interest rates rise. This will make the Fed’s job of hiking short-term interest rates that much more difficult because, if rates on the long-end of the curve do not rise commensurately, the narrowed spreads will lead to lower bank profits.[vi]

There is still plenty of hope that Donald Trump will be able to stimulate the world’s largest economy with less regulation, lower corporate taxes and increased infrastructure spending. The additional hope is this will cause the global economy to pick up and international investors will then rotate out of their bonds (i.e. sending their yields higher) into stocks.

Hope is not a sound investment strategy. Our internal research continues to measure that overall S&P 500 earnings growth expectations have been coming down for 1Q 2017 through 4Q 2017. With stock prices rising in the first quarter as overall 2017 EPS estimate went lower, it means you are now paying more for less. For this reason, we continue to believe it is prudent to be slightly cautious in the current market environment. Stay tuned throughout the year as we objectively measure and analyze the data for any changes that could alter our opinion. In the meantime, **here are the ten themes** we believe **impacted financial markets the most in 1Q 2017**

1. Trump bump continued
2. Growth is accelerating
3. Fed hiked rates
4. Slumping commodities
5. Falling long-term yields
6. Corporate earnings expectations
7. Obama Care remains law
8. Soft vs. Hard economic data
9. Paying more for less
10. Global stock market performance

Trump bump continued

Since Donald Trump was elected, stocks have been on an amazing run. If the new administration reduces regulations, lowers corporate taxes and increases infrastructure spending, it is very difficult to argue that the direction of stock prices should not be higher. Our problem, though, remains just how much higher stock prices should rise absent details of what the fiscal stimulus will be and how it will be implemented. We have already seen Trump's attempt to repeal and replace Obama Care fail. Will his tax reform pass? Better yet, what are the details of the tax plan? Without detail of what the fiscal stimulus will be, modeling the current value of stocks is challenging right now. We hope that the new administration will be highly successful. However, as already stated, hope is not a sound investment strategy. For that reason, our research indicates a more cautious stance on stocks is prudent given current market prices.

Country	Stock Index	Gains since Trump was elected
Italy	MIB	21.86%
Germany	DAX	17.46%
Spain	IBEX	17.07%
Turkey	BIST 30	16.77%
U.S. Small Cap	Russell 2000	15.96%
France	CAC	14.42%
Greece	ASE	14.40%
U.S. Large Cap	S&P 500	10.43%
Japan	Nikkei 225	10.12%
Portugal	PSI	9.77%

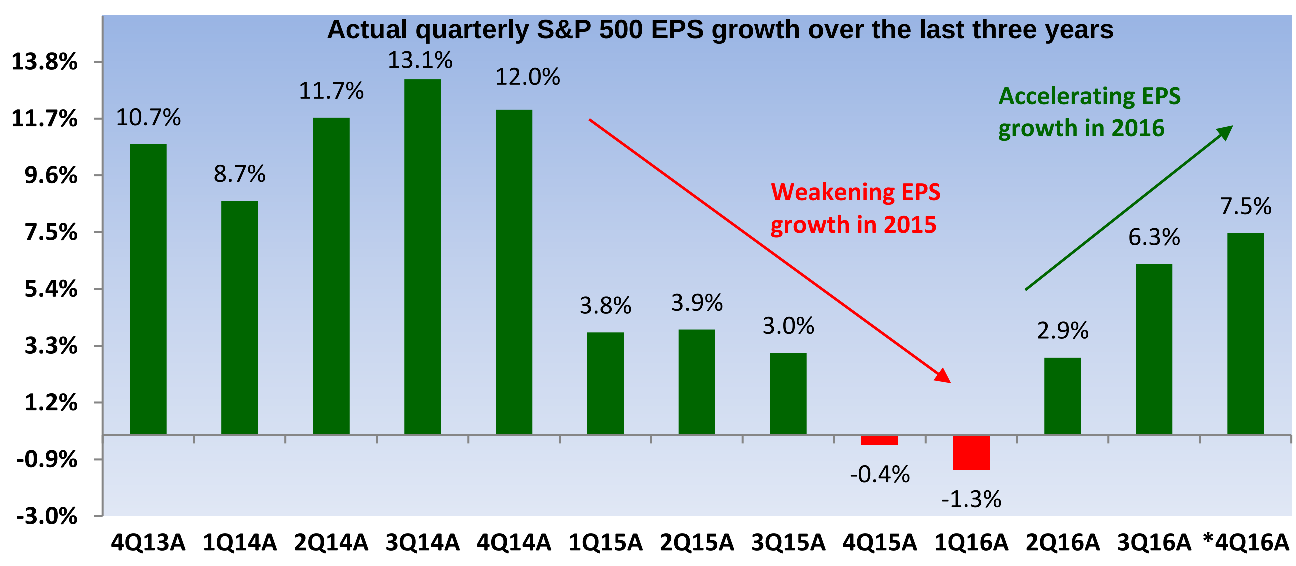
Source: Bloomberg
As of March 31, 2017

U.S. Industry	Gains since Trump was elected
Semiconductor Equipment	30.67%
Casinos & Gaming	30.45%
Trading Companies & Distributors	28.81%
Technology Hardware Storage & Peripherals	28.38%
Tires & Rubber	28.21%
Real Estate Services	28.00%
Hotels, Resorts & Cruise Lines	26.92%
Human Resource & Employment Services	26.38%
Investment Banking & Brokerage	26.35%
Diversified Banks	25.76%

Source: Bloomberg
As of March 31, 2017

Growth is accelerating

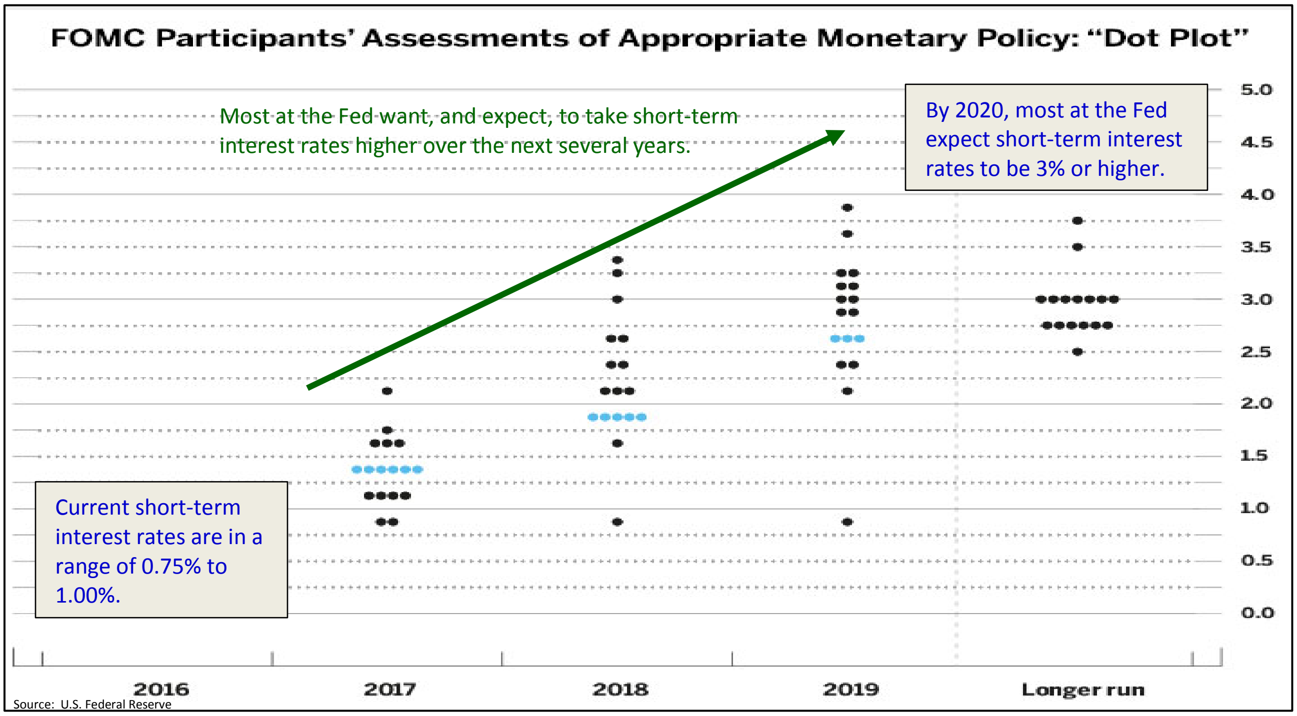
We are continuing to measure that actual earnings and sales growth among S&P 500 companies have accelerated every quarter off their 1Q 2016 bottom. Sadly, many investors have only recently begun to recognize growth has been improving and are becoming bullish on stocks near their all time highs. Our research suggests to us that stock prices have been accounting for improved growth ever since mid-February 2016. That improved growth environment adds justification to the rally in stocks last year. It does not necessarily mean stock prices should continue to rise in 2017. Stock prices discount what is expected to happen in the future, and this is why we focus on the direction of corporate earnings 6 months to 2 years out.



Source: The Earnings Scout

Fed hiked rates

With 2016 growth re-accelerating into 1Q 2017, stocks rallying and Wall Street sentiment on Trump very high, the Fed decided to raise interest rates, again, in mid-March 2017 by +0.25%. The Fed has raised rates twice now in the last six months. Normally, this would contribute to the value of the U.S. dollar strengthening, however, it has weakened during the first three months of the year. Another development that runs contrary to normal expectations is that long-term interest rates are not rising with short-term rates. If these trends persist, the Fed's "dot plot" below (the dot plot is where members of the Fed "guess" where they think interest rates will be in the future) may not play out.



A dovish ECB

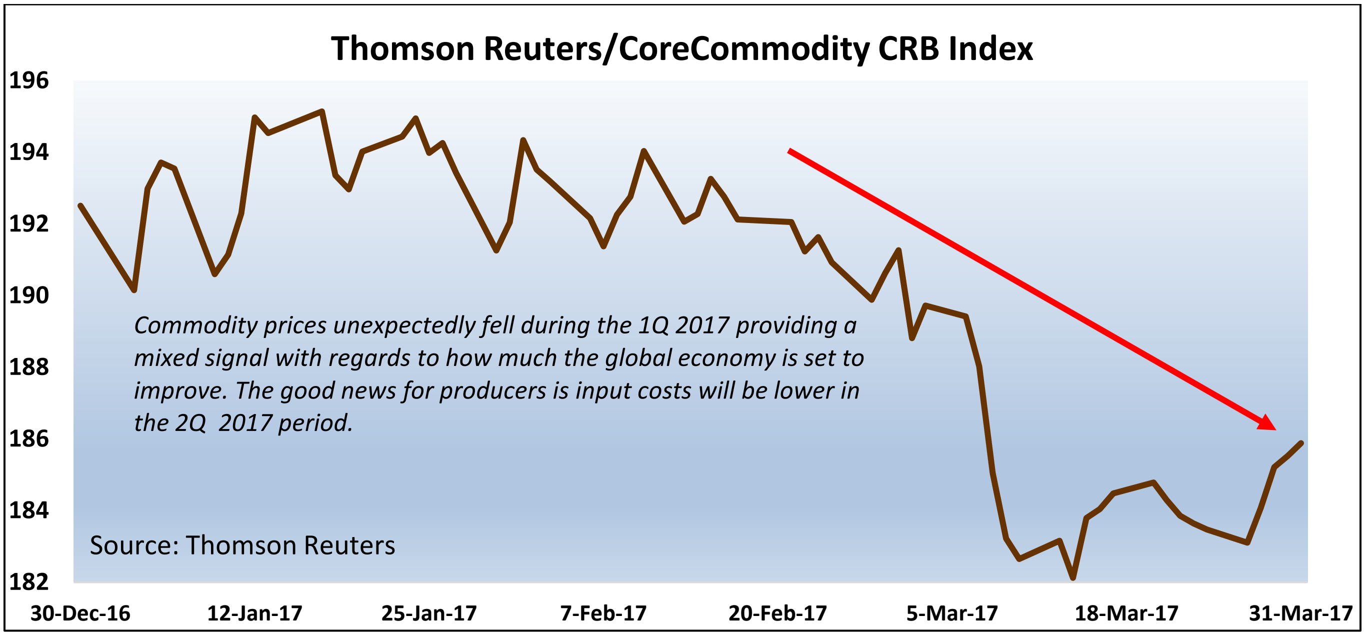
Due to some cool inflation readings across the Eurozone last month, the European Central Bank (ECB) became more dovish and the prospects of it raising interest rates this year quickly diminished. This has caused European sovereign debt yields to fall offering global investors significantly less yield than what they can get in the U.S. In other words, would you really own a Spanish 10-year bond with a yield of 1.66% over a comparable U.S. bond offering 2.40%? Worse, you could let the German government borrow from you at 0.32% over the next 10 years. Since it is all relative, the demand for U.S. treasuries should remain high so long as Eurozone yields remain low.

The implication: If long-term U.S. interest rates do not start rising, it will make the Fed's plans of gradually raising short-term interest rates that much more of a challenge.

Mario Draghi, head of the European Central Bank, might keep dishing out stimulus longer than expected. But why would he keep pumping in stimulus if the global economy is recovering?

Slumping commodities

As we stated, the ECB had to turn dovish (i.e. not raise interest rates) because inflation readings were mostly below expectations across the Eurozone in March. One of the reasons why inflation was contained was because of declining prices of many commodities. Similar to long-term interest rates, falling commodity prices were not widely anticipated this year. Why? If the economy is really set to improve more than what is currently forecasted, you would typically see commodity prices rise with increased global demand. Check out below how the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities, from crude oil to orange juice, declined in the first three months of the year.



Falling long-term yields

The yield on a 10-year U.S. treasury fell during the 1Q 2017 period by five basis points to 2.40%. With the Fed raising short-term interest rates, and the hope that the new administration's pro-business policies will help lift economic expectations, long-term interest rates were supposed to rise -- NOT fall. The real issue is that, as rates fell on the long end of the curve, shorter-term rates, like the yield on the 2-year note, have risen. The difference between the 2-year and 10-year yield is referred to as the yield curve. When the spread widens between "2's and 10's", it is widely regarded as good for economic growth. When the spread narrows, it is regarded as less good, and when it inverts (i.e. rates on 2-year notes are higher than rates for the 10-year notes), it usually indicates a recession. During the 1Q 2017 period, the yield curve flattened. A flattening yield curve does not help banks because they make less "spread" when issuing loans. Check out how interest rates moved during the first quarter. Notice how the yield has narrowed based on the spread between 2- and 10-year yields compressing 10 basis points to 1.13% by the end of the quarter.

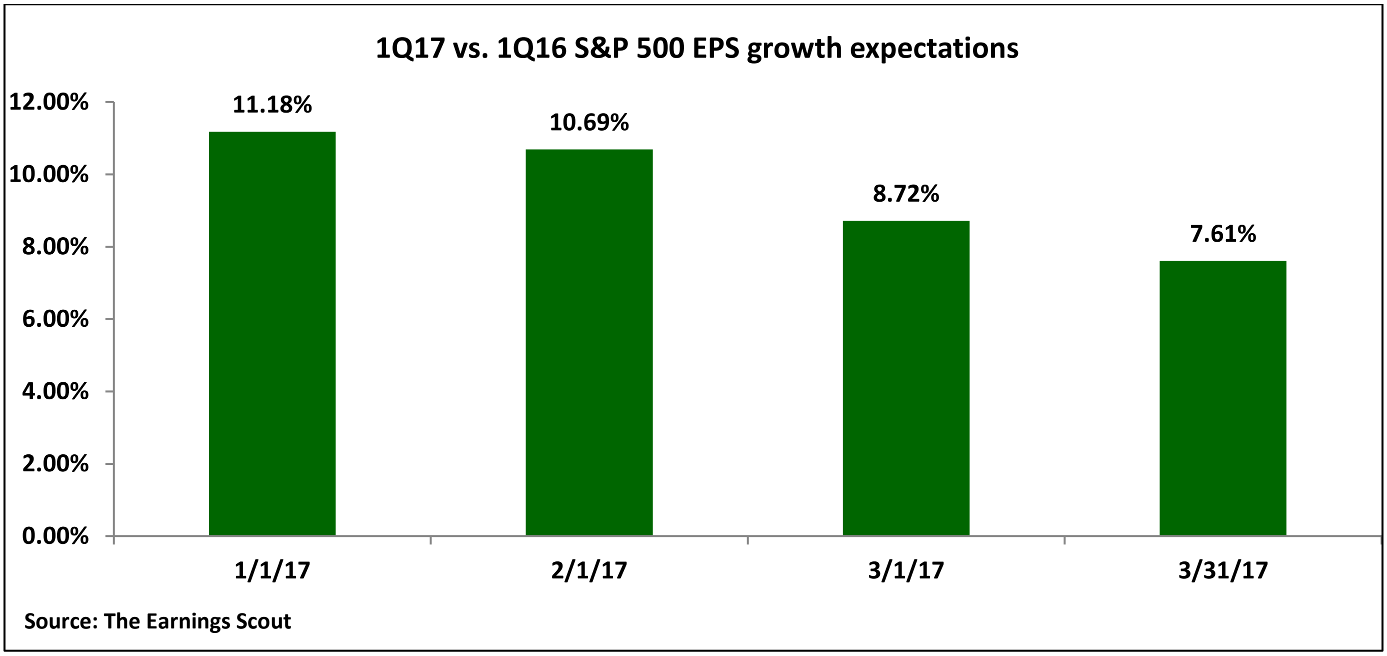
Date	1 Mth U.S. yield	2 Yr yield	10 Yr yield	1 Month - 10 Year Spread	2 Year - 10 Year Spread
1/3/2017	0.52%	1.22%	2.45%	1.93%	1.23%
3/31/2017	0.74%	1.27%	2.40%	1.66%	1.13%

Source: U.S. Treasury Department

Short-term interest rates can't keep rising as long-term rates fall. Otherwise, it will derail the plans for the Fed to keep raising short-term rates without adverse consequences for the economy.

Corporate earnings expectations

The good news on the earnings front is that 2017 will be a better year for corporate bottom lines than last year. The bad news is that markets are a discounting mechanism and already know this. As such, 2017 S&P 500 earnings growth expectations are the highest we are measuring in over two years. Because 2017 growth expectations are so high, though, we have seen earnings estimates for 1Q 2017 through 4Q 2017 consistently edge lower during the first quarter. Once again, this was not expected by the crowd. After all, stock prices have rallied since election night on the expectations of improving economic growth. Will it improve? Yes. However, will it improve more than what markets already expect? Our research indicates not likely.



Obama Care remains the law

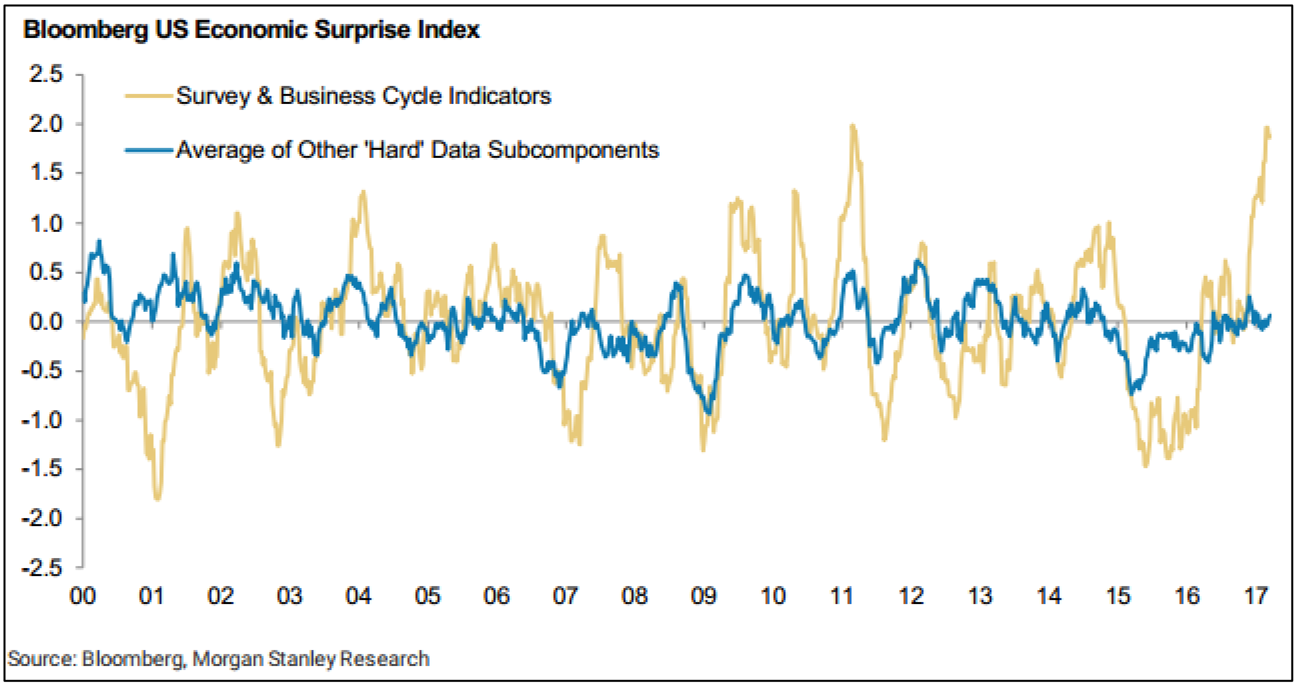
After failing to pass the America Health Care Act (AHCA), House Speaker Paul Ryan affirmed that "Obama Care is the law of the land." The failure was most definitely a black eye for Speaker Ryan and a setback for the new administration; however, global financial markets shook off this event fairly well and remain optimistic that Trump will move past Health Care and get to more of what Wall Street really wants: lower taxes and less regulation!

Ryan has said this about the stunning defeat, "Yes, it does make tax reform more difficult, but not in any way impossible." Regardless, some doubt has set in….Will Trump get lower taxes? Probably. But, will it be as much as he wants? Maybe not. Another question is will tax reform happen this year or be delayed? Without more detail on the plans, all one can do is speculate. Stocks have rallied and speculated in favor of Trump ultimately getting his pro-business agenda(s) through. Time will tell if, and when, that happens.

Soft vs. Hard Economic Data

There is a record gap between soft and hard economic data. Let us explain economic vernacular here. Soft economic data is based on sentiment and surveys. Currently, that is running at extremely optimistic levels based on the hopes that fiscal policy from Trump will dramatically boost economic activity. Then you have the hard, or real, data, such as our measurement of actual earnings estimate revisions from corporations that are showing some signs of weakness and do not support the amount of optimism that the surveys indicate.

Will the hard economic data eventually begin to reflect the optimism that we see in the soft economic data? Or, are the surveys going to show that too many people are overly optimistic and doomed to be eventually disappointed? These are the key questions that will soon need to be answered. The only way we get those answers comes when details and implementations of Trump's actual economic agenda materialize. Through the end of the first quarter, stocks have rallied following the soft economic data, while the bond market has been more cautious following the hard economic data. We prefer to follow the hard data when making decisions regarding our investment strategies.



Paying more for less

As stock prices have risen on the mounting hope(s) the economy picks up more steam, the hard economic data (i.e. real EPS estimate revision data) is not showing any real improvement in macroeconomic expectations, which has caused P/E multiples on the market to rise. The P/E multiple is a valuation metric that represents just how much you pay for every dollar of expected earnings.

One year ago, you had to pay a multiple of 15.82x for every dollar of future earnings. Since price has risen as EPS estimates have fallen, today you have to pay 18.09x. As such, stocks have become modestly more expensive as investors have to pay a little more for a little less in 2017.

Date	*P/E ratio based on next 12 months EPS Estimate
3/31/2016	15.82x
1/1/2017	16.86x
3/31/2017	18.09x

As a rule of thumb, the higher the P/E ratio, the more expensive the overall stock market. The long-term historical P/E ratio for the S&P 500 (i.e. the market) is 15x.

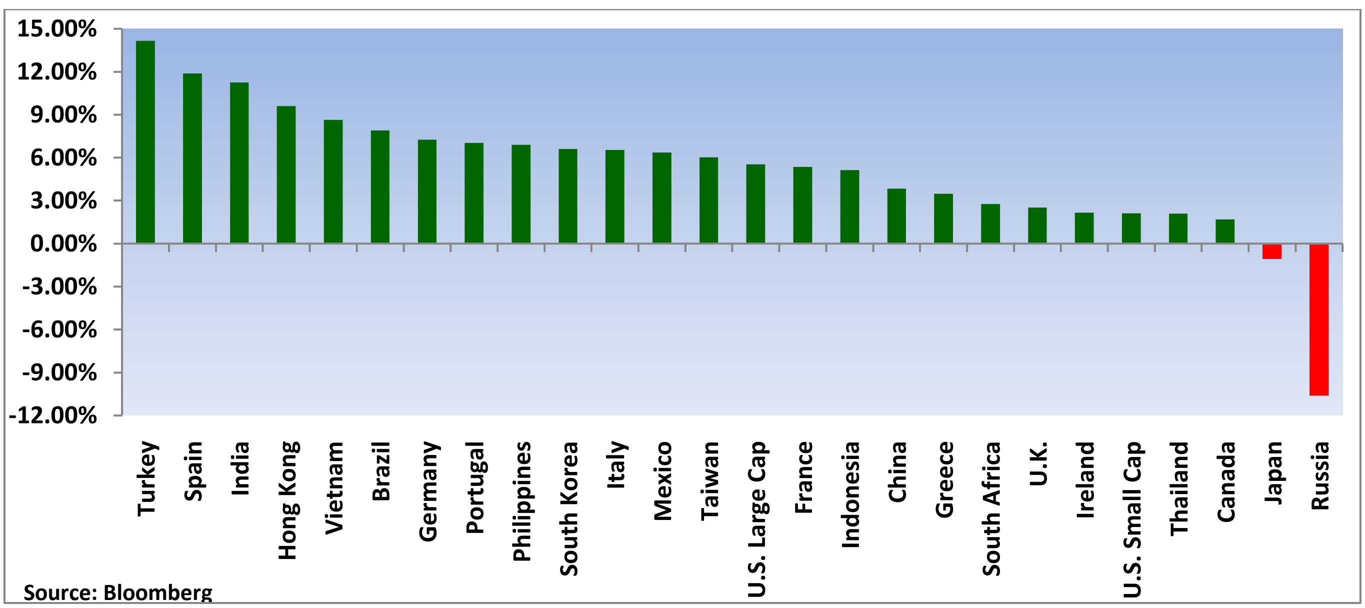
Source: The Earnings Scout

Global stock market performance in 2017

Country	Stock Index	1Q 2017 Return	Post U.S. election (Trump Trade)
Turkey	BIST 30	14.15%	16.77%
Spain	IBEX	11.88%	17.07%
India	SENSEX	11.24%	7.36%
Hong Kong	Hang Seng	9.60%	5.25%
Vietnam	Ho Chi Minh	8.64%	6.78%
Brazil	Ibovespa	7.90%	1.29%
Germany	DAX	7.25%	17.46%
Portugal	PSI	7.02%	9.77%
Philippines	PSEi	6.89%	0.05%
South Korea	KOSPI	6.60%	7.83%
Italy	MIB	6.54%	21.86%
Mexico	Bolsa IPC	6.35%	0.15%
Taiwan	TSE	6.03%	6.45%
U.S. Large Cap	S&P 500	5.53%	10.43%
France	CAC	5.35%	14.42%
Indonesia	JSE Composite	5.12%	1.78%
China	Shanghai Composite	3.83%	2.37%
Greece	ASE	3.48%	14.40%
South Africa	FTSE/JSE All Share	2.77%	2.67%
U.K.	FTSE	2.52%	7.01%
Ireland	ISE	2.17%	9.39%
U.S. Small Cap	Russell 2000 Index	2.12%	15.96%
Thailand	SET Index	2.08%	4.32%
Canada	TSX Composite	1.70%	6.08%
Japan	Nikkei 225	-1.07%	10.12%
Russia	MICEX	-10.61%	1.42%

Source: Bloomberg

Global stock market performance in 2017



Conclusion

Our overall view on financial markets as we enter the 2Q 2017 period is unchanged from the beginning of the year. While our research indicates the rise in stock prices over the past year has been justified, the rally could soon come to an end when the positive effects from central bank policy start to fade. In fact, it may get worse if the central banks start making monetary policy even more restrictive for growth. The U.S. Fed has taken steps to do so with its rate hikes in December and March. Of course, the difference this year is Donald Trump. If his plans to lower taxes, soften regulation and increase infrastructure spending finally play out as he wants them, the economy and stock prices could be off to the races. Yet, we must remember, many of those policies will not impact corporate bottom lines for years to come.

We will not speculate and just hope Trump's policies work. To become more constructive on stocks, we need to measure improvement in expected macroeconomic data (i.e. the hard economic data). Our biggest concern with the post-Trump rally has been that Wall Street has had to justify current stock prices by discounting earnings three to five years into the future (i.e. when some of Trump's policies would kick in). In doing so, the market has become more speculative in nature. For that reason, we are hoping for the best, but maintaining a slightly more cautious stance than we had one year ago.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Scott Hohman, CFP®, AIF®

Mark Klopfenstein, AIF®

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Erin Zylka, MBA

[i] Small cap stocks are measured by the Russell 2000 Index
[ii] Large cap stocks are measured by the S&P 500 Index
[iii] Developed International Markets are measured by the iShares MSCI EAFE Index Fund
[iv] Emerging Markets are measured by the iShares MSCI Emerging Markets Index Fund
[v] Interest rate data related to U.S. Treasuries obtained from the U.S. Treasury Department
[vi] Source: Bloomberg