Eideard Group
GUARDIANS OF PROSPERITY

Market Commentary **Spring 2017**

Post-Election Optimism Wanes

As we suspected might soon become reality, the momentous "Trump effect" - which drove the stock market to its year-end high and bond prices to multi-year lows over the post-election period through December - began to retreat as the first quarter wore on. The most conspicuous signs of the gathering headwinds were the immediate judicial challenges to Trump's proposed immigration initiatives and the administration's failure to replace the Affordable Care Act in late March. Then, of course, we saw early shifts on policy promises. On trade, it was the reported reversal on the dumping of NAFTA. On China, it was silence over currency manipulation and on NATO it was the sudden revelation that the organization was no longer obsolete - though thankfully its member nations will still be pressed to pay up! Whatever your position on these headline issues, most would agree that never before has there been such intense media scrutiny of executive action or inaction in any President's first 60 days much less any administration's first 100 days. Nonetheless, for students of the financial markets, the first quarter proffered a quick and dramatic change across the US equity markets, while the bond market vindicated our forecast that bonds were simply not about to enter the "dark shadows" of a secular bear market, at least not for now.

As to the US stock market, the first quarter witnessed a sizeable shift in performance leadership in investment style and capitalization. Whereas value investing had sizzled relative to growth during most of 2016 and similarly small cap stocks significantly outpaced large caps, most if not all of this leadership was upended by the close of the first quarter. Notwithstanding the change, the broad US equity market delivered a solid +6% return on the quarter. Under the hood, growth investing across all capitalizations responded with a vengeance to resume its leadership over value. In large cap stocks, growth outperformed value by +5.6%; while in mid and small cap stocks it was +3.1% and +5.5% respectively. Having witnessed this very rapid shift brings to mind the notion of "reversion to the mean" and no better example can be found than in this first quarter. What goes up too quickly must take a breather and so value found its rest stop in this first stanza of 2017. This is precisely why we believe equity diversification - both in terms of market cap and investment style - is so critical to long term investment success!

Meanwhile, as we here in the US were focused on the seismic shifts in new Presidential policy, the international markets were making a performance statement of their own. The developed international market as measured by the MSCI EAFE index posted a solid +7.4% return to outpace US stocks for the first time in recent memory. Even more surprising was the emerging equity markets' return which registered a whopping +11.5% on the quarter. But, as we've come to experience over the last few years, longer term international performance has been difficult to achieve and can certainly be fleeting. On the downside, we do know that Brexit is still a contentious issue on the EU horizon and several member countries including France are - or will soon be - in the midst of national elections where growing nationalist sentiment threatens to undermine the Union itself. On the upside, we know the ECB's QE programs have finally become effective and, politically speaking, once all of the elections' ballots are finally tallied our bet is that pro EU forces will have prevailed…so we hope!

Turning to the bond markets, the benchmark 10 year treasury - which stood at 1.78% just before the Presidential election - spiked to over 2.60% by mid-first quarter chilling, as we all know, the bond world. Since then however, its yield has moderated on the back of a myriad of growing concerns. First, there is a waning enthusiasm that Trump's platform may not materialize as quickly or be as expansive as anticipated. Secondly, the first quarter's initial estimate of .70% in GDP growth appears to reinforce the notion that we remain mired in continued slow growth. And third, there are increasing geopolitical clouds forming including the administration's most recent saber rattling over North Korea's missile program which has sparked a modest safe-haven treasury rally. Despite this backdrop which has also included two post-election Fed rate hikes and a Fed announcement that it will begin to lighten up on its balance sheet QE-driven bond holdings, the bond markets have continued to weather the news rather nicely. On the tax exempt side of things, the Barclay's benchmark 10 year municipal bond index posted a +1.8% return while on the taxable side; higher yielding bonds and investment grade issues registered +1.66% and +.82% respectively.

Finally - as to the energy sector- it is clear things continue to normalize and progress for the fossil fuel industry after what was one of the fiercest downturns in years. First quarter earnings suggest a solid revenue comeback across the sector including most of the oil majors, the upstream exploration and production firms and the midstream infrastructure firms providing transportation and storage. This good news comes on the heels of a definite shift in business activity modeled around the concept of base-line production that is intensely focused on oil and gas prices. Additionally, most energy firms have by necessity trimmed away their excess costs to become lean and intensely focused on those drilling and haul away activities that offer certainty of return. Clearly OPEC's continuing agreement to cap production and alleviate excess inventory has been a modest boon for the industry but it also poses the threat of overproduction by nimble US shale oil producers who appear to be increasing rig count and production levels at or beyond 9.3 million bbl/day. We suspect that if West Texas crude remains within the current band of $47-58 per bbl the normalization process should continue unabated. Hopefully, the US as a swing producer, will recognize and heed the need for an equilibrium that will benefit all. For that, we will simply wait and see.