1st Quarter 2017: Attitude Adjustment

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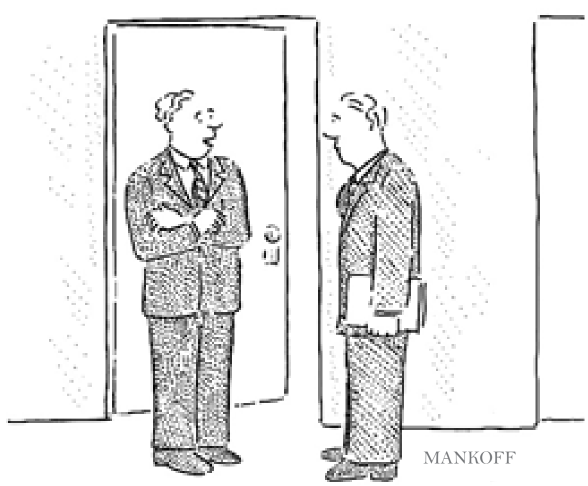
Stocks got off to a strong start during the first quarter of 2017, albeit with a new cohort of leaders. As a reminder, cyclical stocks were the best performers during last year's fourth quarter. Following the astonishing-to-most outcome of the Presidential election, capital rushed into the shares of companies which were perceived to be the biggest beneficiaries of President-elect Trump's proposals to grow U.S. jobs, lower tax rates and slash regulations. Markets are dancing to a different tune so far this year. Breaking stride with the late-2016 pattern, the leaders in early 2017 have been growth companies in the Technology, Health Care and Consumer Discretionary sectors. Energy companies have slumped along with a pullback in oil prices, and the commodity-heavy Materials sector has also lagged the broader market in recent weeks.

Part of the market's "attitude adjustment" in 2017 can be ascribed to the collision between rhetoric and reality in Washington DC. President Trump's ambitious policy agenda is now beginning to be bogged down in the morass of partisan politics in Washington. Crafting and passing transformative legislation is - and always has been - a messy business, even when a single party controls both houses of Congress and the Oval Office. Although the President chose to attack healthcare reform first, it turned out his bill was not able to garner enough votes to ensure passage through Congress. Now that his plans to "repeal and replace" the Affordable Care Act have gone back to the drawing board, Trump has decided to pivot to restructuring corporate and individual tax rates. We expect that these negotiations on tax reform will be contentious, and that they will likely drag on into the fall of 2017. In our opinion, the main investment takeaway from all of this is that the Trump Administration's policy changes will take more time to execute than many investors expected (hoped) before Inauguration Day.

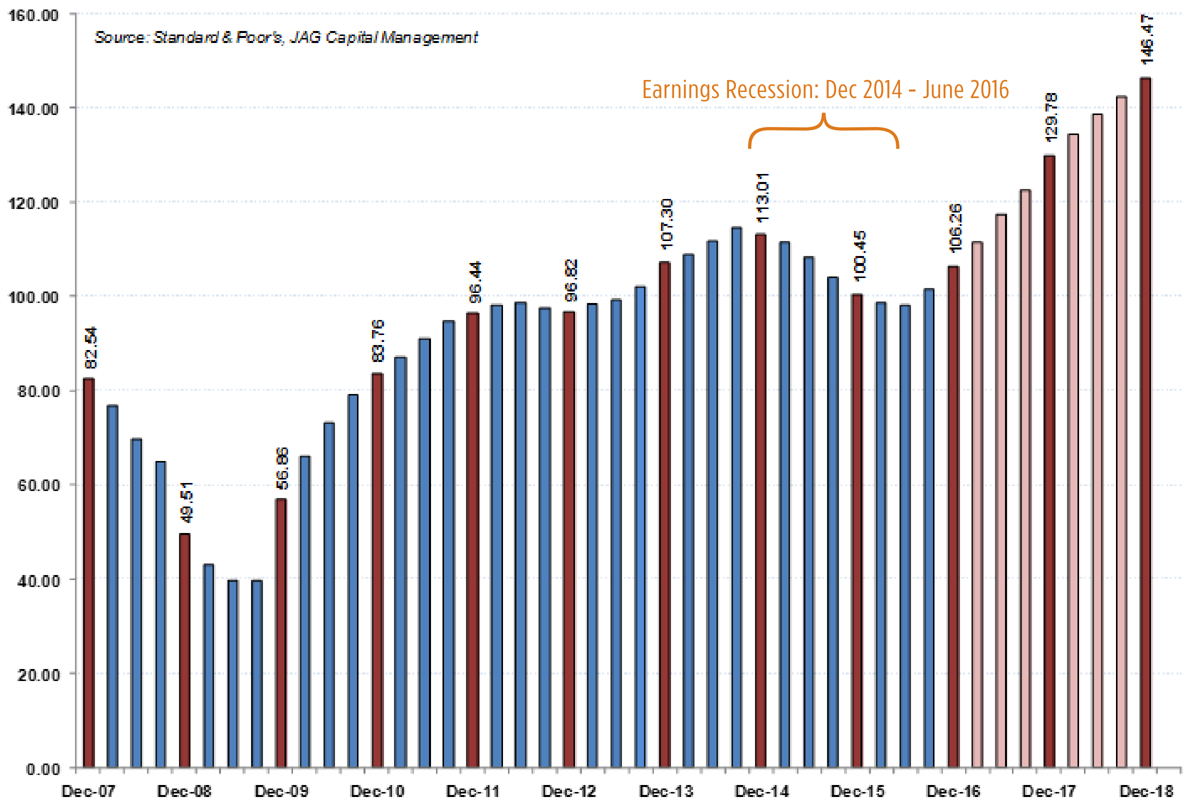
Stocks are not cheap, but this has been the case for several years. The S&P 500 has returned almost 37% over the past three years, despite the fact that corporate earnings are roughly flat over that time span.



"Oh, can't complain, but I do."

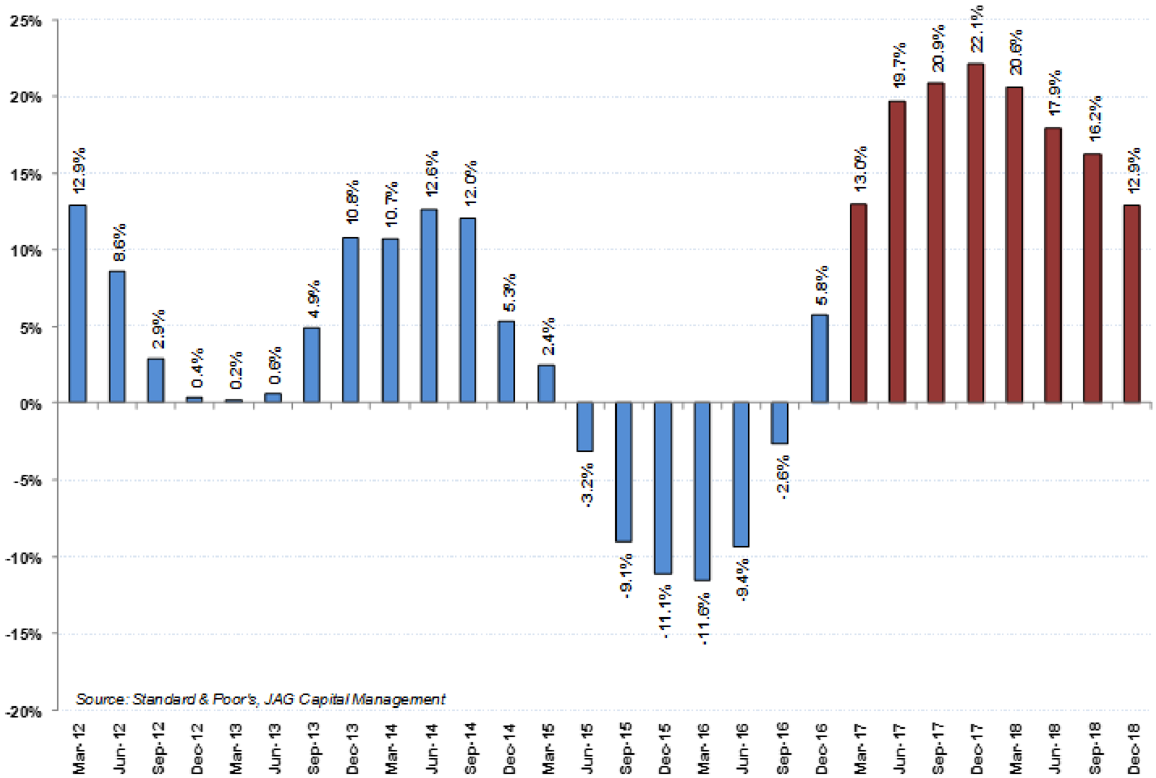
> "In the short run, the market is a voting machine but in the long run, it is a weighing machine."
>
> \- Benjamin Graham

Actual (blue) and Estimated (pink) S&P 500 TTM Operating Earnings as of 3/30/2017



This means that multiple expansion, rather than actual earnings growth, has been the key driver of stock price appreciation since early 2014. In fact, corporate earnings have actually been contracting for most of the past few years. After peaking at $114.51 in September 2014, S&P 500 operating earnings slumped all the way to $98.17 in June 2016. To paraphrase Benjamin Graham, investors have been "voting" in favor of the higher stock prices for years, even in the absence of corporate earnings growth. But over the long term, the stock market "weighs" earnings heavily. We think the markets voting mechanism is reaching the end of its rope, so we do not expect much further expansion in valuation multiples. Given the political landscape referenced earlier, we also doubt that big policy changes are forthcoming in the near term. If we are right on either or both of those counts, the onus will be on earnings to drive continuation of the bull market in 2017.

Actual (blue) **and Estimated** (red) **Year-Over-Year Percentage Change in TTM S&P 500 Operating EPS as of 3/30/2017**



Happily, last summer appears to have marked the bottom of the so-called earnings recession, and profits have improved over the last two quarters. December 2016 operating earnings came in at $106.26, a 5.8% year-over-year increase and the first year-over-year gain in quarterly earnings since March 2015. Analysts expect further good earnings news in the just-completed first quarter of 2017. Consensus estimates currently call for operating earnings to increase 13% year-over-year. If the analysts are correct, we see room for stocks to generate solid returns throughout the remainder of the year.

Longer-term, we think investors should continue to be constructive. Although policy changes are likely to take longer to implement and be less impactful than some Trump fans had hoped, make no mistake that the tone out of Washington will be different in the coming few years. Love the President or hate him, his election gave him a mandate that will eventually result in at least incremental adjustments to the government's stance on taxes and regulations. Generally, we can expect less regulatory pressure on businesses and somewhat lower personal and corporate income tax rates. All else being equal, we are probably entering a more market-friendly several years for investors.

Meanwhile, there are a variety of quietly disruptive revolutions occurring in the economy and the markets, many of which could pay off handsomely for selective growth-oriented investors. These include major breakthroughs in cancer treatments and surgical procedures, semi- and fully-autonomous vehicles, clean energy, 5G wireless technology, augmented and virtual reality, and cloud-based computing. Thanks to these and other developments, the pace of technological improvements to our daily lives is accelerating. As always, we will do our best to make sure our clients participate in the fruits of sustainable and transformative innovation.

> "Attitude is a little thing that makes a big difference."
>
> \- Winston Churchill

Disclosures

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