Equity Market Update

As of March 31, 2017 / Volume 6, Issue 1 / FFTAM.COM

The first quarter was a successful one for stocks. Investors pushed equities higher on increased optimism about growth in the overall economy. Hopes of lower taxes, less government regulation, and fiscal stimulus from the Trump Administration remain in the market; however, sentiment was dented in March on the failure to pass health care reform. Stocks have risen five consecutive months on a total return basis. Almost all equity indexes are sitting at all-time highs.

The S&P 500 jumped 6.07% for the quarter. This was its best quarterly showing since the 4th quarter of 2015. The Dow Jones Industrial Average lagged with a 5.19% total return. The NASDAQ Composite Index zoomed 10.13% on strong moves from the technology sector.

Stock leadership changed during the 1st quarter. In the final months of 2016, investors pushed the market higher by pouring money into the financials, energy, and materials sectors. This group became known as the "Trump trade." In 2017, this group has lagged the overall market as investors shifted their interest to growth stocks that do well when the economy broadly improves.

The new market leaders are tech companies. The technology sector spiked 12.57% in the quarter, led by Apple's 24.57% return. Tech accounted for nearly 50% of the S&P's return. The leadership was so narrow that five companies—Apple, Facebook, Amazon, Alphabet and Phillip Morris International—represented over 30% of all gains in the S&P 500.

Mid and small-sized companies did not perform as well as their large cap peers in the quarter. The S&P 400 Mid-Cap Index increased 3.94%, while the S&P 600 Small-Cap Index improved 1.05%. The Republicans' failure to pass a health care bill to replace the Affordable Care Act weighed on these stocks as investors began to question the Trump administration's ability to get other parts of their growth agenda passed.

The strongest gains were seen in International stocks. The MSCI EAFE Index advanced 7.39%, while the MSCI Emerging Markets Index jumped an impressive 11.45%. Investor excitement about improving economic conditions in China and Europe, along with increased appetite for risk and attractive relative valuations versus US stocks, pushed up international indexes.

Last month, we wrote about retail investors being a driving force behind recent gains. In early March, *The Wall Street Journal* reported mom and pop investors were responsible for 85% of the $124 billion poured into ETFs. Meanwhile, institutional investors have been relatively quiet with their trading as they await details from President Trump's economic policies. Finally, the most recent data released by the NYSE shows margin debt has risen to a record $528.2 billion. Collectively, these conditions resulted in a calm and steady environment for stocks. Two weeks ago, we concluded 109 consecutive trading sessions without a 1% decline for equities—one of the longest stretches in history. The VIX Index, which measures investor fear, experienced its second lowest quarterly average on record.

The stock market's success has caused valuations to expand. Currently, the S&P 500 trades at 18.28x 2017 EPS estimates. This is above the historical average of 15.47x. The trailing PE is 21.66. That is the highest PE for non-recessionary conditions since 2004. Analysts are forecasting earnings to grow 18.5% this year. Much of the rise is due to improvements in earnings from energy companies.

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We believe stocks deserve to trade at a premium. The economy continues to improve. The most recent PCE data—the Fed's preferred measure of inflation—was over 2% for the first time in five years. Small business optimism and consumer confidence are at their highest levels in 12 years and 17 years, respectively. Finally, President Trump says corporate tax relief and regulatory reform will be addressed by August. Despite these good readings, we believe most of it is already priced into equities. This makes the market vulnerable to a short-term pullback given all the bullish rhetoric previously cited.

Interest rates remain low compared to historical standards, thus providing stocks another reason to trade at a premium. However, this window is beginning to slowly close as the Fed raised rates by another 25 basis points in March. They plan to raise rates three times in 2017 and four times in 2018. Despite the Fed's pace, higher interest rates will serve as a headwind for stock PE multiples.

Collectively, we remain positive on the economy and equities, but we would wait for a short-term pullback before deploying additional capital. Our internal economic checklist indicates the economy is still in the latter stages of the mid-cycle, which supports an overweight in cyclical sectors. We maintain a cyclical tilt in our equity portfolios relative to their benchmarks.

Among cyclical sectors, we are overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare and telecommunications given their attractive valuation paired with underweights in consumer staples and utilities.

On the global scale, we remain overweight US stocks with an underweight in developed international countries and an inline weight to emerging markets. Inside the US, we have maintained our overweight to mid and small-sized companies since they stand to benefit the most from Trump's pro-growth economic agenda.

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