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Market Overview, July 2017

The first half of 2017 continued the trend leading us out of the earnings recession we experienced in 2015 and 2016. Markets responded across sectors and across countries. The S&P500 increased 3.1% for the quarter and 9.1% for the year. International markets as measured by the EFA index were up 6.4% for the quarter and 14.7% for the year. Of the 30 major indexes representing the world's biggest stock markets, 26 are up year to date. For reasons discussed a bit later, international markets will likely play an important role in total return going forward.

While economic growth has returned to a positive trend, continued growth domestically is likely constrained in the short run by the pent up demand in the auto and home sectors being met for the most part. Longer term, economic growth is constrained by population growth and productivity. In other words, you can grow your economy if you have more workers and/or they are more productive than they were last year. The number of workers you have is determined by people born 16 years ago, and those retiring. This number is hard to change in the short term. Productivity growth has been quite low over the past 10 years vs. history, and given that demographics are not going to help us out going forward, we will need to see improvements in productivity to achieve a 2% real growth rate or better in the economy.

Corporate profits should follow with a modest growth rate going forward. Earnings growth of companies with foreign sales could be helped in the near term by a weakening dollar which seems likely over the next 18 months.

I have mentioned before that the valuation of the domestic markets seems a bit stretched, and it remains so. Earnings growth can help (as can a declining market). One source of earnings growth for companies (and potentially economic growth) is reform in corporate taxes. Because of the modest level of market overvaluation and two sources of potential earnings gains (real GDP growth and corporate tax reform), I am comfortable with current market exposure (but don't forget that some level of volatility is normal).

After underperforming the U.S. market for years, international markets should continue responding to stronger economic growth across many countries. During the second quarter of 2017, global manufacturing growth seemed to be stronger than it has been in six years. This stronger growth is also reinforced by better global services indices. And the strength extends across both developed and emerging economies.

It would help if international companies would take advantage of better economic growth by improving their earnings during the period. In other words, well managed companies should be able to take advantage of a growing economy by improving their earnings. This is not always the case. In June, however, I had conversations with two teams that manage emerging market portfolios that suggest this is happening. One team discussed their research that ROE's of emerging market companies were improving for the first time since 2006. What does that mean in plain English?

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Return on Equity is the return that companies make on the equity invested in the business. If returns are improving, then stock prices are likely going up. You can break the Return on Equity measure into components to dig down and evaluate if a company is getting better at what they do, or if they are doing worse, and why.

The important take away from the statement that ROE's are improving is that 1) Emerging market companies are even paying attention to such a measure, and 2) that when you break ROE down into its components, generally companies are improving in those areas that are sustainable and reflect better corporate management.

Of course, as with any period of time in history, there are factors that represent risk to calm and growing economies and markets. Central Banks' involvement in markets across the world is one such factor. Their actions since 2008 could have caused massive inflation by some accounts, yet that has not materialized. One could argue that since we have recovered from 2008, Central Bank involvement in markets has been successful. Predictions were difficult to make since their involvement both in terms of size and scope were unprecedented in history. The challenge today is that as their entry into markets was unprecedented, so too is their withdrawal. This process will also provide uncertainty to markets as to the impact on prices and volatility. We will remain diversified and attentive.

Please call with any questions or concerns.

Regards,

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