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The first quarter of 2017 saw a continuation of the market's move higher, a move that began in the fourth quarter of last year. Year to date, the S&P500 appreciated 6% while small stocks lagged, with the Russell 2000 gaining 2.5%. International markets fared better, with the MSCI EAFE index gaining 7.4%. The outperformance of international markets is a change from recent past, and one that we expect to continue. Bonds, as measured by the Barclay's U.S. Aggregate index gained only 0.8%.

Where do we go from here? If forced to guess, we believe that there will be more volatility this year than we have seen in a while, and that domestic markets will end the year slightly higher than today. International markets will continue to outperform domestic.

Why might there be more volatility this year? Markets remain expensive, making them more susceptible to downdrafts when unexpected events increase fear and uncertainty. The market, at current prices, is trading on hopes and expectations of certain actions occurring (like tax reform). What this means is when events call into question either the timing or the probability of these actions occurring, there can be a downdraft in the market as valuations are suddenly called into question. Geopolitical events can also cause concern. When things go bump in the night while the market is at high valuations, market declines are more likely.

While I believe that the market remains susceptible to these downdrafts, it is also important to note that underpinning a portion of the market's gains is actual improvement in corporate earnings. The earnings recovery is real, and there is reason to believe that it will continue. While the market's rally began after the election in November, the change in corporate earnings from a declining trend to a positive trend began in October. During the first quarter of this year, there were positive economic data points that supported the argument for a domestic economy that would continue to improve.

There is also evidence that global economic growth is improving. Given the lower valuations overseas, we suspect that international markets will outperform domestic this year for the first time in several years.

We seem to be left with two trends that can offset one another. It is hard to bet against stronger earnings, but higher valuations should temper returns given stronger earnings. Another way to think about this is that if earnings increase 20% over the next 24 months, but the markets only increase 10%, then valuations will decrease by about 10%, bringing levels back close to historical norms.

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There is another reason to believe that domestic returns might be tempered over the rest of this year. March consumer confidence increased to its highest level since December 2000. This sounds great, and can also boost real consumption levels. Consider, though, that J.P. Morgan has research that looks at market returns over the 12 months following peaks and troughs in consumer confidence. After peaks, returns for the following 12 months were muted. A good time to invest for double digit returns is when consumer confidence troughs. Of course, it can be difficult to invest new money when everyone feels miserable. The research does not conclude that returns will be negative after peaks in confidence, just muted.

Our expectation is that gains in domestic equity markets will be constrained for the rest of this year because of current valuations. Also, the market is susceptible to downdrafts stemming from delays in anticipated policy actions or geopolitical events that cause concern. International markets will likely outperform domestic. Continued improvement in corporate earnings will provide a path for markets to recover from declines, if and when they happen.

Please call with any questions or concerns.

Regards,

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