Market & Economic Outlook

March 2017
Market/Economic Review and Outlook

In a month that historically exhibits muted returns, particularly in years with a first term president, risk assets ended February in strong positive territory. Equity markets were surrounded by relatively little market noise and continued to rally throughout the month. The Fed provided more hawkish rhetoric during the FOMC February meeting, alluding to a strong possibility of an interest rate hike during the first half of 2017. Economic data was positive with low unemployment data, positive earnings reports and continued uptrends in housing data. However, investor sentiment ticked down and disorder surrounded the new Trump administration as details around pro-growth policies have been slow to emerge. Inflation expectations also continued to climb but still remain well below levels of concern.

The S&P 500 Index was up 4.0% and sector performance was mixed. Healthcare was the best performing sector, up 6.4% in February, a reversal from 2016 negative performance. Conversely energy was down -2.2% for the month and -5.7% for the year. Growth slightly outperformed value and leads, year to date by a large margin. Small cap lagged both large and mid cap but all were positive.

Developed international equity was up 1.5% in February. Economic data in the European Union leaned positive with signs of decreasing inflation and positive GDP growth. However, political uncertainty and a rise in populism continued to cast a shadow of uncertainty on the region. Likewise, Japan experienced an uptrend in growth as business confidence rose and a weaker Yen helped drive export growth. Emerging markets were up 3.1% due to improving fundamentals and stabilizing oil prices.

The Bloomberg Barclays US Aggregate Index finished the month up 0.7% with all fixed income sectors posting positive returns.

Despite some mid-month volatility, the 10 year Treasury yield was relatively unchanged and finished the month at 2.4%. High yield credit spreads contracted an additional 25 basis points in February, spurring a positive return of 1.5% in the sector. Municipals were positive, performing in line with taxable counterparts.

We remain positive on risk assets over the intermediate-term, although we acknowledge we are in the later innings of the bull market and the second half of the business cycle. While our macro outlook is biased in favor of the positives and recession is not our base case, especially considering the potential of reflationary policies from the new administration, the risks must not be ignored.

Reflationary fiscal policies: With the new administration and an all-Republican government, we expect fiscal policy expansion in 2017, including tax cuts, repatriation of foreign sourced profits, increased infrastructure and defense spending, and a more benign regulatory environment.

Global growth improving: U.S. economic growth is ticking higher and there are signs growth outside of the U.S., in both developed and emerging markets, are improving.

Global monetary policy remains accommodative: The Federal Reserve is taking a careful approach to policy normalization. ECB and Bank of Japan balance sheets expanded in 2016 and central banks remain supportive of growth.

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However, risks facing the economy and markets remain, including:

Administration unknowns: While the upcoming administration's policies are currently being viewed favorably, uncertainties remain. The market may be too optimistic that all of the pro-growth policies anticipated will come to fruition. We are unsure how Trump's trade policies will develop, and there is the possibility for geopolitical missteps.

Risk of policy mistake: The Federal Reserve has begun to slowly normalize monetary policy, but the future path of rates is still unclear. Should inflation move significantly higher, there is also the risk that the Fed falls behind the curve. The ECB and the Bank of Japan could also disappoint market participants, bringing the credibility of central banks into question.

The technical backdrop of the market is favorable, credit conditions are supportive, and we have started to see some acceleration in economic growth. So far Trump's policies are being seen as pro-growth, and investor confidence has improved. We expect higher volatility to continue as we digest the onset of new policies under the Trump administration and the actions of central banks, but our view on risk assets remains positive over the intermediate term. Higher volatility can lead to attractive pockets of opportunity we can take advantage of as active managers.