INTERNATIONAL STOCKS CONTINUE WHERE THEY LEFT OFF

The superior performance of international stocks relative to U.S. stocks, which began in the first quarter, continued into the second quarter of 2017. The MSCI ACWI Ex-US returned 5.9 percent during the quarter compared to the Standard & Poor's 500 Index's 3.1 percent gain. Within international markets, emerging market stocks rose 6.3 percent, slightly outperforming their developed market counterparts, which gained 6.1 percent. Within developed markets, Eurozone equities benefited from reduced political risk due in part to the defeat of far right candidate Marine le Pen. Eurozone stocks also benefited from improving economic data, though concerns about central banks initiating tighter monetary policies later in the quarter partially offset this benefit. France and Italy outperformed global stocks. Emerging market returns were driven by a fragile but sustained global recovery, stronger earnings, lack of overtly negative U.S. policy action, and a weaker dollar somewhat negated by the decline in oil prices hurting commodity-dependent markets like Russia.

U.S. equity markets provided positive returns during the second quarter of 2017 on the back of mixed but improving economic data and double-digit solid corporate earnings growth. But the positivity was somewhat tempered by political uncertainty over the Trump administration's ability to successfully implement its fiscally expansive policies. For the quarter, health care stocks rallied 7.1 percent as concerns about drug pricing legislation faded and investors discounted the prospects of repeal and replacement of the Affordable Care Act. The industrial sector returned 4.7 percent due to continued strength in machinery, aerospace, defense, and building products. Technology stocks continued their rally from the first quarter as investors rewarded secular growth, cloud-related business inflection, and continued market share gains.

Energy stocks continued their weak performance for the year, declining 6.4 percent in the second quarter as oil prices fell 9 percent. Oil prices were hurt due to persistent oversupply from U.S. onshore production. The telecommunications sector was also weak, declining 7 percent due to intensifying competition resulting in subscriber losses and pricing pressure at the major wireless operators.

Stocks of small market capitalization companies once again underperformed large companies, while growth stocks continued their relative outperformance over value stocks. Investors continue to favor large companies as there is skepticism around the successful implementation of the administration’s growth/reform agenda and comprehensive tax reform. Growth stocks tend to outperform their value counterparts during the later stages of an economic cycle.

BONDS: FED PLANS BALANCE SHEET REDUCTION DESPITE LOW INFLATION

Core inflation, which strips out food and energy, slipped from a high of 1.8 percent in February to 1.4 percent in May. This was a surprise...
to those who believed in Trump's pro-growth and inflationary agenda of lower taxes and reduced regulation. Following his inauguration, Trump began moderating his anti-trade positions, has failed to get his health care reform bill through Congress, and has realized that tax reform is likely to take much longer and might be more modest than his original proposals. Bond markets began to adjust to this new reality, and despite the fact that the Federal Reserve raised rates by 25 basis points in June, bonds offered positive returns this quarter. The yield on the 10-year Treasury note fell from a high of 2.61 percent in March to end the quarter at 2.3 percent.

The Barclays U.S. Aggregate Bond Index returned 1.45 percent for the second quarter of 2017. All major fixed income sectors also posted positive returns for the quarter with credit outperforming other sectors. The Bloomberg Barclays U.S. Credit Index returned 2.35 percent for the second quarter. Investment grade credit spreads started the quarter at +126 basis points and then tightened to +115 by the end of the quarter. BBB credits outperformed AA credits by 150 bps. Strong demand for yield and better first quarter corporate earnings both supported the investment grade credit sector. The Bloomberg Barclays High Yield Index returned 2.77 percent for the quarter. Option-adjusted spread started the quarter at +386 basis points and tightened to +364 at quarter end. Similar to investment grade credit this sector benefited from strong investor demand in search for yield. A fall in oil prices weighed down prices in the high yield energy sector.

The Federal Reserve increased the fed funds rate target range by 25 basis points to between 1.00 percent and 1.25 percent on June 14, 2017. Despite that, the 2-10 year spread tightened from 113 to 92 basis points during second quarter resulting in a flatter yield curve. Low inflation and strong demand for fixed income securities further out on the yield curve kept longer interest rates low even as the Fed pushed up the short end. Despite low inflation, the Federal Reserve has expressed confidence in the long-term path of the U.S. economy and has started to lay out its plans to reduce its $4.5 trillion balance sheet. This includes scaling back re-investments in Treasurys and mortgage-backed securities beginning with $10 billion fewer purchases per month and increasing every three months until it reaches a cap of $50 billion per month.

OUTLOOK 2017: RISING POLITICAL RISKS IN THE U.S.
Global stock markets have delivered strong returns since the election of President Trump. However, we believe that the probability of a correction in equity markets is rising as Trump’s pro-growth agenda remains stalled in Congress. The failure to repeal and replace the Affordable Care Act raises questions in investor minds about whether Trump will be able to pass the rest of his agenda. Of special interest to investors is passage of tax reform and the subsequent improvement in growth and corporate earnings. It is also very likely that the proposed corporate and personal tax rate cuts are likely to be more modest to account for the tax revenue that flows to the government from the Affordable Care Act.

On the positive side, investors are not expecting a major shift in U.S. trade policy, as Mr. Trump’s rhetoric has become more mainstream. This should boost emerging market stocks, currencies, debt, and also benefit multinational U.S. companies. Mr. Trump had promised to introduce higher tariffs on China and Mexico and investors were expecting retaliatory actions from those governments. Also positive for global equity markets are improving economic fundamentals in Europe, a weaker dollar, and stable oil prices. At Alerus, we are overweight global equities in our long-term portfolios.

We expect the Federal Reserve to raise interest rates by 25 basis points one more time in 2017. The Fed has also started to lay out its plans to reduce its $4.5 trillion balance sheet by scaling back reinvestments in Treasurys and mortgage-backed securities. We expect the Fed to begin this process as early as September of 2017. The central bank accumulated its balance sheet during three rounds of purchases known as quantitative easing. As this additional supply comes into the market, long-term rates have the potential to rise. At Alerus, we are overweight fixed-income in our portfolios. Within fixed-income, we expect credit and high-yield sectors to outperform government bonds.

As we see further improvements in European economies, the European Central Bank is also expected to scale back its bond purchases beginning early 2018. Political risks in Europe appear to be fading too. We expect the euro, which has rebounded this year, to continue to outperform the dollar.

KEY RISKS:
U.S. Policies – failure to pass Trump’s pro-growth agenda
Geopolitics – Russia, Syria, ISIS, and North Korea are back in the headlines
Federal Reserve – tightening at a rate that is faster than what the market expects
Europe – upcoming elections in Italy