GLOBAL STOCKS RALLY, LED BY EMERGING MARKETS
The Trump rally in stocks that began after November’s elections continued into the first quarter of 2017 and went global. International developed and emerging market stocks played catch-up and outperformed U.S. stocks. The MSCI World Index of stocks rose 6.9 percent in the first quarter. Emerging market stocks were up 11.4 percent with large countries like China, India, and Brazil doing even better. Only Russian stocks fell, dipping due to lower oil prices.

U.S. stocks rose by 6.2 percent. Improving economic data, positive corporate earnings growth after five quarters of earnings recession, and the prospect of tax and regulatory reform were catalysts for the rally. However, market internals suggest that investors are beginning to lose faith that the Trump agenda will get through Congress. Failure to pass the American Health Care Act and poor execution of some of the executive orders did not help investor confidence. Small market capitalization companies, which would benefit the most from Trump’s promised corporate tax cuts, underperformed. The Russell 2000 Index rose just 2.5 percent while the Standard & Poor’s 500 Index of large company stocks was up 6.1 percent. Similarly, financial stocks which would benefit from regulatory reform, lower taxes, and higher interest rates, underperformed the broader market, rising just 2.5 percent. Slowing loan growth also weighed on stocks of financial services companies.

From a sector perspective, technology was the performance leader, rising 12.6 percent on strong showings from bellwethers like Apple, Facebook, and Oracle. Technology stocks benefited from strong earnings growth, a positive outlook for 2017 and beyond, and continued market share gain/expansion. Failure to pass the American Health Care Act lifted the cloud of uncertainty over health care companies. Health care was the second best performing sector in the first quarter. Energy, down 6.7 percent, was the worst performing sector as oil prices fell 5.8 percent due to increased production and inventories in the U.S.

Emerging market returns were driven by stable-to-rising commodity prices, a fragile but sustained global recovery, stronger earnings, and a lack of overtly negative U.S. policy action. A weaker dollar also helped emerging markets easily absorb a 25 basis point hike in the federal funds rate despite investor anxiety leading up to the announcement. The developed international markets, mainly in the Eurozone, delivered a robust 7.4 percent gain. An economic turnaround, improving earnings picture and receding political worries following a win for the center-right in the Dutch elections helped fuel the rally.

BONDS: REBOUND AFTER POST-ELECTION SLUMP
Following Trump’s election, bonds had their worst quarterly performance since 1987. Trump had won the election proposing a pro-growth, inflationary agenda. Following his inauguration,
Trump began moderating his anti-trade positions, failed to get his health care reform bill through Congress, and realized that tax reform would take much longer and be more modest. Bond markets began to adjust to this new reality in the first quarter and despite the fact that the Federal Reserve raised rates by 25 basis points in March, the bond market offered positive returns to investors.

The Barclays U.S. Aggregate bond index returned 0.8 percent along with all major fixed income sectors which also posted positive returns for the quarter. Despite improving economic fundamentals, longer interest rates (two years and out) were little changed because of solid demand. The 10 Year Treasury ended the quarter 5 basis points lower than where it began, yielding 2.4 percent at the end of the quarter. Option-adjusted spreads for U.S. agency mortgage-backed securities widened 12 basis points as the Fed began talking about reducing its balance sheet. Both investment grade and high-yield corporate bonds outperformed government bonds as investors bet on an improving global economy and strong demand for yield. High-yield bonds returned a solid 2.7 percent for the quarter.

The Treasury yield curve flattened during the first quarter, an indicator that investors were losing faith that Trump’s pro-growth and inflationary agenda could be implemented in 2017. The 10 Year U.S. Treasury yield, which is driven by economic growth and inflation, fell, while the 2 Year yield, which is influenced by monetary policy, rose. As a result the spread between the 10-year note and the 2 Year note fell to 1.107 percent, the lowest since the election. A flattening yield curve is usually a sign of a slowdown in economic growth.

The Barclays Municipal index returned 1.6 percent this quarter. New municipal supply fell 30 percent from one year ago levels due to lower refunding volumes, contributing to strong performance. The potential for tax reform had caused investor concerns earlier in the quarter. However, these concerns faded once the market realized that tax reform was politically more complicated than health care reform, which failed in Congress. Flows into the municipal market strengthened as the quarter progressed.

OUTLOOK 2017: STORM CLOUDS GATHERING
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. There are many factors driving this, chief among them is the potential for Marine Le Pen to be elected President of France in May. Ms. Le Pen is the leader of the National Front, a far-right party that wants to take France out of the Eurozone.

The failure to repeal and replace Obamacare raises questions in investor minds about whether Trump will be able to get the rest of his pro-growth agenda through Congress. Of special interest is passage of tax reform and the subsequent improvement in growth and corporate earnings. With Obamacare in place, it is also very likely that proposed corporate and personal tax rates 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 stable dollar, and oil prices.

We expect the Federal Reserve to raise rates two more times in 2017, by 25 basis points each time. By the end of the year the Federal Reserve may also start laying out its plans to reduce its $4.5 trillion balance sheet including scaling back reinvestments in treasuries and mortgage-backed securities. 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. We expect credit and high-yield sectors to outperform government bonds.

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 – a potential upset in the French elections in May