Newman Dignan & Sheerar
INVESTMENT ADVISORS

ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.

Great Expectations

1st Quarter 2017

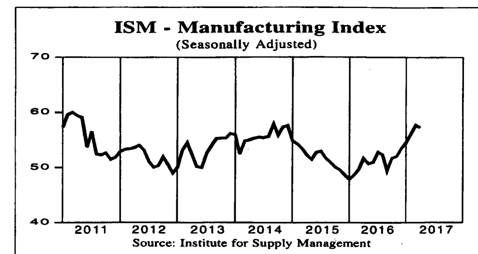
ECONOMY & MARKETS

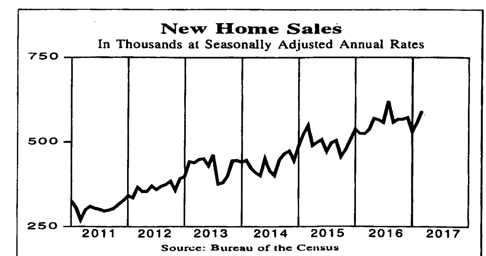
Markets moved higher in the first quarter on great expectations of a continuing bump from the so-called Trump agenda. Investors seem to believe that a Republican-controlled congress can goose the U.S. economy out of its current anemic growth mode (the weakest recovery in GDP growth since the great depression). Congress' initial inability to repeal and replace the affordable care act could put the Trump agenda in jeopardy (especially corporate tax reform), but the market's optimism of the pro-growth Trump agenda remains … at least for now.

Perhaps President Trump is the unknown/unheralded benefactor to this recent market advance, but the real benefactor may simply be an economy that continues to plod along on its own strength. In Charles Dickens' nineteenth century novel – *Great Expectations* – Pip, the protagonist, is shocked when he finds out the identity of his benefactor who has expectations for Pip … rather than the wealthy spinster, Miss Havisham, it is actually the convict Abel Magwitch. Hmm … the current situation could be somewhat similar if President Trump turns out to be the market's benefactor.

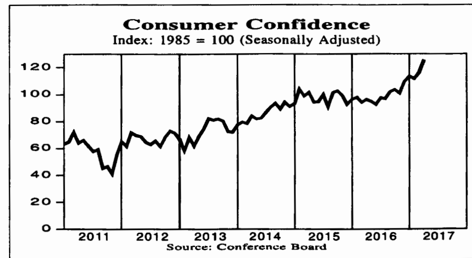
Despite imbedded high expectations and continuing geopolitical challenges from around the world, markets found a way to appreciate over the course of the quarter. For the first quarter of 2017, the **DJIA** moved higher by 4.6% while the **S&P** advanced 5.5%. The **NASDAQ** finished nicely ahead by 9.8%. International markets outperformed most domestic markets during the quarter as the **EAFE** Index gained 6.5%. Bond returns were decent as the Barclay's Aggregate **Bond Index** finished higher by 0.8% for the quarter.

Spring is finally in the air, and investors have a few things to cheer about. Economic data released over the first quarter seem to indicate that the economy continues to gradually improve. Among the improving signs are: solid U.S. **non-farm payrolls** *(a coincident indicator)*, a 10-year low of 4.5% in the **unemployment rate**, improving new orders for **durable goods**, renewed strength in **factory orders** and the **ISM Manufacturing Index** *(see chart below)*, improving U.S. **trade gap** (as exports rise faster-than-expected), better-than-expected **small business confidence**, moderate **inflation** *(so far)*, low **interest rates** *(at least for the next few quarters or so)*, solid **productivity** numbers, improving **CEO confidence** *(leads to pick-up in capital spending)*, **dividend increases** that are outpacing wage gains, and 1st quarter **earnings** that are expected to be quite reasonable. **Housing**, a key indicator of the strength of the consumer and the economy, remains resilient *(see chart below)*. Home prices rose in January at the fastest pace in 31 months.

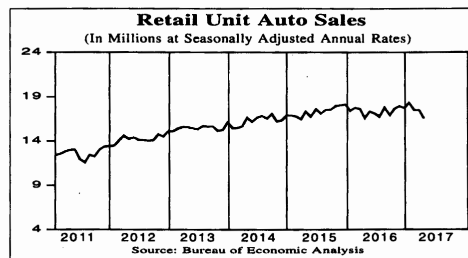




The **U.S. March Consumer Confidence Index** *(see chart top of next page)* hit its highest level since December 2000 as the Conference Board's Index rose to 125.6 from 116.1 in February. Consumers, of course, are a key component to economic growth (roughly 2/3rds of our GDP). Rising consumer confidence should lead to increased real consumption in the months ahead.



Before we get carried away … in parsing the economic data and political landscape, one is able to identify a fair number of headwinds. Among the economic headwinds are: a more **hawkish Fed**, early signs of a potential **peak in auto sales** *(see chart below)*, ongoing **tepid consumer spending** (despite rising consumer confidence), and a disappointing **March jobs report**. The **geopolitical environment** remains challenged, at best. Heightened risks in North Korea, Syria, Russia and Afghanistan could derail markets in the short-term. The global **political landscape** is certainly unsettled at the moment. Nothing good can be said about our **federal debt** approaching $20 trillion … certainly a hindrance to future economic growth (especially since the U.S. collected a record $3.3 trillion in taxes in 2016). Should we also address the $1.3 trillion in **student debt**?



The above chart could be signaling a tired consumer. One thing we do know is that new car owners are saddled with more debt.

OUTLOOK

Let's continue to call our outlook as **cautiously optimistic**. An overly giddy and confident market seems vulnerable to a short-term pullback. Volatility during most of the quarter was fairly low as the S&P 500 only had one daily drop of more than 1% during the quarter. However, recent signs (increasing VIX and some larger intra-day moves in the market) point to some uneasiness ahead. Let's remember that pullbacks are normal and that one is overdue. The good news is that the risks of a cyclical peak remain low as the economy is simply too strong to dictate a long lasting correction (perhaps that comes in 2019 …).

Market valuations are not particularly cheap with the S&P 500 trading at 18.3X 2017 earnings of $129. However, given fairly low inflation and low interest rates, market valuations are not overly stretched. First quarter S&P 500 operating income should increase around 9% - this would mark the third consecutive quarter of year-over-year earnings growth (and the fastest pace since the fourth quarter of 2011). We would not be surprised to see the markets down a bit over the summer months, but a pause in the market's advance is not such a bad thing … fairly normal, in fact.

Bond yields moved lower in the first quarter on increasing geopolitical risk and moderate inflation (as we predicted at year-end). We see bonds as fairly valued, at best. Despite the recent drop in yields we see bond yields moving gradually higher as the year advances. We anticipate keeping average durations in the short-to-intermediate range … we are not willing to take on much interest rate risk given the likelihood of more Fed increases. *Strategic Income Funds* ought to provide diversification benefits to a core bond portfolio.

Small and mid-cap equities still add value to an overall asset allocation strategy as a stronger U.S. dollar and protectionist policies play to their strength. We are more sanguine on *international equities* – both *developed* and *developing,* and we've been adding to positions this year as their valuation gap to U.S. equities warrants action. Again, we believe that *large-cap companies with higher quality attributes* should continue to provide better-than-market returns. *Commodities* offer investors some protection from potential inflation and dollar weakness, but those scenarios do not seem likely for the next few quarters or so. *Alternative assets* will continue to provide good risk-management for portfolios.

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance.

Happy Spring!

25 years!

Twenty-Five Years and Counting!

It is with great pleasure that Newman Dignan & Sheerar, Inc. announces our 25th anniversary! ND&S was formed by Paul Dignan and Bill Newman on April 2, 1992 with the express purpose of providing top-notch, professional fee-based investment advisory services to a select group of clients. Bill and Paul had been portfolio managers at Bank Boston/Hospital Trust. John Sheerar joined the firm in 1997 (this is his 20 year anniversary!) to add his estate planning, investment and client relationship expertise to the team. A few years later we were fortunate enough to have three investments pros – Dave Mulanaphy, Ed Buxton and Bill Jennings - join ND&S. Bill Weiland, our analyst and director of research, joined us not long after that, and he remains in that role today. Our most recent addition is Erik Manchester. Erik serves as a junior portfolio manager, and we are excited about all that Erik will add to the firm and our clients in the years ahead. Rounding out the team is Dawn Carlson, Ann Keating and Isabel Blakely … three team members who are indispensable to the ongoing success of ND&S. Al Sebastian serves as a research consultant to ND&S, and his 33 years of investment experience add nicely to the depth of our investment process. Sadly, two dear friends - Paul Dignan and Dave Mulanaphy - passed away and left us way too soon. We plan on highlighting Paul and Dave in our next quarterly newsletter.

We are grateful to our many clients and friends who have partnered with us over the past twenty-five years, and we look forward to the next twenty-five years with the same level of excitement and enthusiasm. ***We greatly appreciate your trust.***

Don't Forget!

Don't Forget Tax Form 8606!

The advantage of accumulating after-tax assets in a retirement account is that the earnings are tax deferred and nondeductible contributions are distributed tax free. However, this benefit is realized only if the proper steps are taken. For anyone making non-deductible contributions to a traditional IRA, that person should be filing Form 8606 along with their Form 1040. Your IRA custodian is not responsible for keeping track of the after-tax balance of your IRA. For those who have made after-tax contributions to a retirement plan, one should reach out to their plan administrator to make sure their contributions are coded properly.

Good news for those who haven't filed Form 8606 in the past, the IRS will process a late-filed Form 8606 – even if after the normal three-year statute of limitations. You will need to file one Form 8606 for each year you made a non-deductible contribution (you might be subject to a $50 late-filing penalty for each year). Form 8606 will help you and the IRS track the basis for which your retirement assets will be taxed when taking a distribution or converting a traditional IRA to a Roth IRA.

Distributions from IRAs with after-tax amounts are generally taxed on a pro-rata basis (you cannot simply take after-tax contributions). To find the tax-free amount of your distributions you take the balance of all your after-tax contributions and divide it by the total balance of *all* of your IRAs. That result is the percent of your distributions that are tax free for that year. Filing Form 8606 will help you to avoid paying income taxes on your after-tax IRA contributions … ***so don't forget to file!***

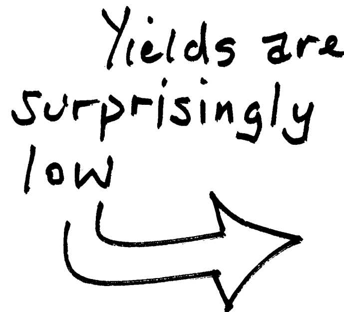
1st QUARTER 2017 SCOREBOARD

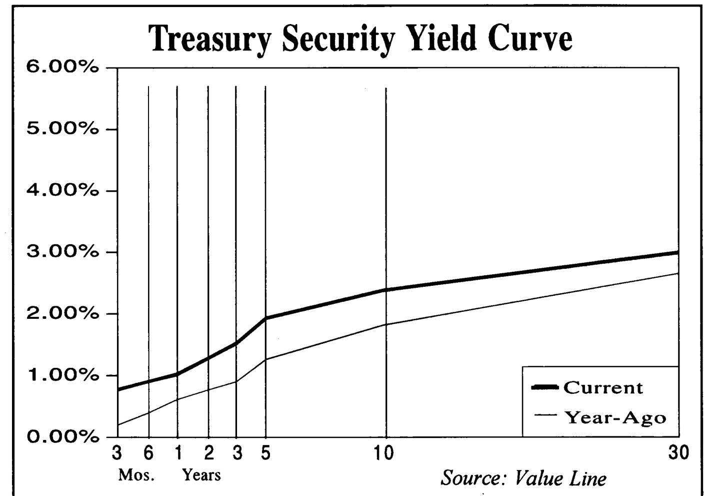
Index	Close	1st Quarter % Change	Year-to-Date % Change
DJIA	20663.2	4.6	4.6
S&P 500	2363.7	5.5	5.5
NASDAQ	5911.7	9.8	9.8
Russell 2000	1385.9	2.1	2.1
MSCI EAFE	1792.9	6.5	6.5

3 Month T-Bill	0.76%	Fed Funds Rate	0.75% - 1.00%
5 Year T-Note	1.92%	Prime Rate	4.00%
10 Year T-Note	2.39%	Gold	$1247.30
30 Year T-Note	3.01%	Oil	$50.60

Index returns are price only

Oil prices were down 5.8% for the quarter.





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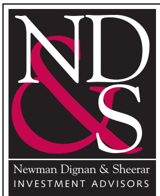

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