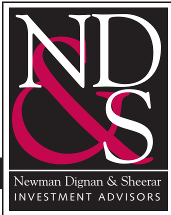


ECONOMIC & CAPITAL

MARKETS REVIEW

NEWMAN DIGNAN & SHEERAR, INC.

Mostly Sunny … *chance of showers*

2nd Quarter 2017

ECONOMY & MARKETS

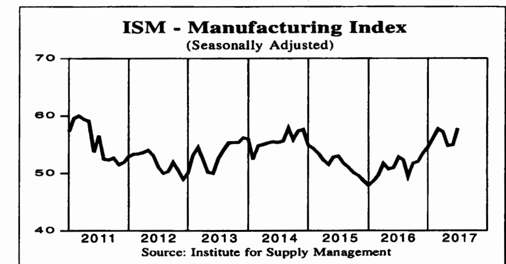
Markets continued to push higher during the second quarter as investors focused on the gradually improving economic picture. As has been the case for several years now, investors seemed to blocked-out any negative headline news. So for now, the forecast is *Mostly Sunny with a chance of showers*.

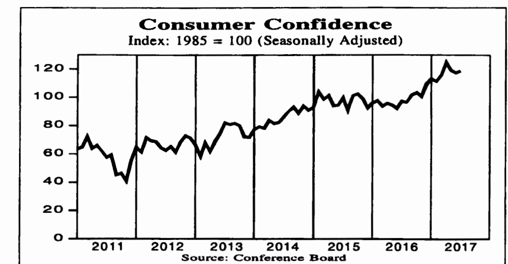
Patience and staying the course have once again proven beneficial to long-term investors. Yes, some "showers" may be on the way, but trying to time the markets by going to cash and waiting out each "crisis" is simply too difficult to do with any consistency. There will be a correction in the markets when least expected, but it will most certainly be followed by a recovery … as always. For now, let's enjoy the fruits of an improving global economy.

For the second quarter of 2017, the **DJIA** moved higher by 3.3% while the **S&P** posted a gain of 2.6%. The tech-heavy **NASDAQ** closed ahead by 3.9%. International markets continued their move higher as the **EAFE** Index jumped 5.0% for the quarter. The appetite for bonds continues to grow despite today's paltry yields. Bonds posted decent gains on a more dovish outlook from the Fed. For the quarter, the BBgBarc Aggregate **Bond Index** gained 1.5%. The benchmark 10 year US treasury closed at a meager yield of 2.31% … down from 2.39% at the end of the first quarter.

U.S. equities finished the first-half of 2017 in good shape. For the year-to-date period, the **DJIA** is up 8.0% while the **S&P 500** is ahead by 8.2%. The tech-heavy **NASDAQ** is higher by 14.1%, and the **EAFE** index gained a solid 11.8% for the year-to-date period (*it is about time …*). Bonds are having a decent year as the BBgBarc Aggregate **Bond Index** is positive by 2.3% for the year through June. Bonds continue to confound most investors, but it is quite clear that the medium to long-term trend for rates is higher with central banks around the world in tightening mode.

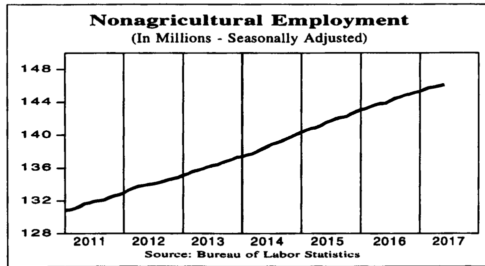
Most economic conditions continue to paint a gradually improving economic backdrop (we keep repeating this mantra …). Among the positives lately are: strong **job growth** and declining **unemployment**, sustained **low energy prices**, moderate **wage gains**, a narrowing **trade deficit**, increasing **household net worth**, declining **foreclosures**, rising **equity values** in homes, improving **manufacturing** data (~15% of GDP) *(see below)*, decent **auto sales**, improving industrial production and **leading economic indicators**. Of course, all of this has led to improving **consumer confidence** – June's index rose to 118.9, up nicely from May's 117.9 level *(see below).*





We have mentioned many times that in order to get sustained economic growth we need to see better labor market conditions (not just smoke and mirrors) … we are now finally seeing signs of sustainability in job growth *(see next page)*. June's **unemployment rate** came in at 4.4%. Continued job growth will likely lead to stronger wage growth which will, in turn, lead to better consumption growth. Fortunately, fairly benign inflation/input costs are helping employers offset creeping wage pressures.

Good job #s



A few **strong headwinds** continue to temper enthusiasm for the markets (which is a good thing …). North Korea, President Trump's unpredictable tweets, political bickering and logjams in Washington, federal debt approaching $20 trillion (yes, trillion), peaking auto and home sales (still fairly strong), central banks around the world in tightening mode (although not as hawkish as previously thought), and a market that has gone quite a while without a pullback/correction.

OUTLOOK

Bottom Line –A good first half to the year for the markets will likely be followed by a late summer sell-off before moving ever-so-slightly higher into year-end. We don't expect to look for "mattresses" (safe houses/defensive positions as mentioned in *The Godfather* by Clemenza) over the next few months, but we do have a penchant for perhaps trimming some positions that have run quite a bit. President Trump and his early morning tweets will continue to dominate headline news, but investors will likely look through the noise and focus on the economy. Headlines news is often a bit alarming – especially in its attempt to establish truth not by rational/objective standards but by perpetual repetition. Be prudent, but ignore the headline news just as the market seems to be doing. An interesting tidbit – according to The Wall Street Journal, the S&P 500's average daily swing was just 0.3% for the second quarter, the lowest in over 50 years. Lest an investor get lulled into a false sense of complacency we feel compelled to repeat this fact – the average intra-year decline in the markets since 1980 has been roughly 14%. The good news – every decline has been temporary. We don't see a Minsky Moment developing quite yet.

Stop the tweets!

Market valuations are still higher-than-average as the S&P 500 is trading at a forward P/E of 18.8X *(next 12 months EPS of $129)*. The 25-year average is approximately 15.9X. No doubt, low inflation and low interest rates help to mitigate and partially explain today's valuation levels. Interestingly, the average yield on the 10-year treasury, over the 25 years when the forward 12 month P/E averaged 15.9, was nearly 4.5%. The 10-year treasury yield today is only 2.3% so equities are worth more today, relative to bonds, than they were over the past 25 years. Higher valuations (both equities *and* bonds), however, will temper future gains … history is quite clear.

Bond prices should move a bit lower over the next few quarters as today's ultra-low yields give way to some profit taking. Of course, geopolitical challenges could temporarily move bond prices higher and yields lower on a flight-to-safety (we've seen this before!).

We remain constructive on equities even as the risk-reward calculus for equities is diminishing a bit. With interest rates so low the oft-heard rallying cry seems to be TINA – *There Is No Alternative*. *Small and mid-cap equities* still add value to an overall asset allocation strategy, especially as they have lagged their larger-cap brethren this year. We plan to add to small-cap on weakness. We continue to be sanguine on *international equities* – both *developed* and *developing,* as their valuations remain relatively attractive. Developing markets have had a nice year-to-date run, and we will look to trim positions with the intention of adding at lower prices. *Large-cap domestic equities* - particularly those with higher quality attributes and increasing dividends - remain a core position in client portfolios. *Commodities* remain under pressure due to ongoing bouts of deflation. *Alternative assets* should provide good risk-management for portfolios – particularly during times of volatility (they will eventually come …).

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

Happy Summer!

Smarter and Stronger US Banks

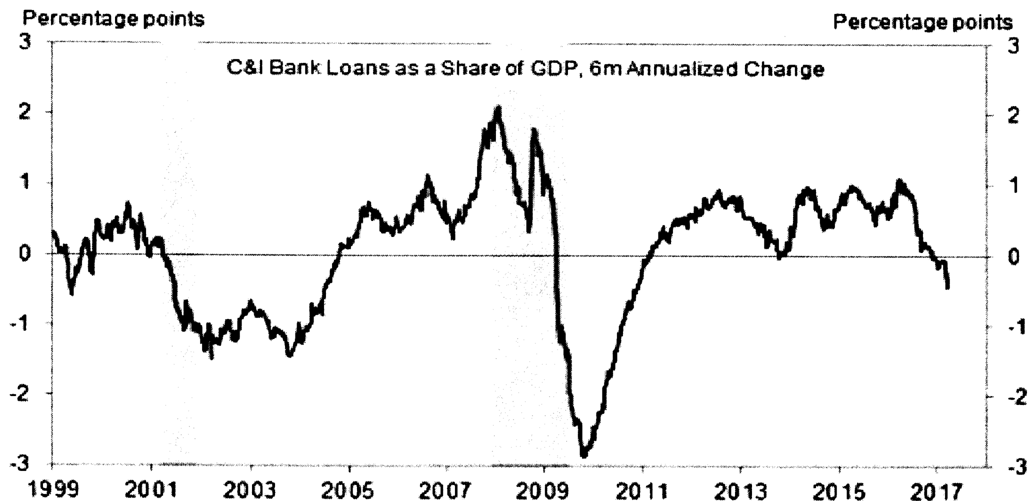
It's now almost ten years since the nadir of the financial crisis. The environment for US banks has been improving and a healthy banking system is so vitally important to strengthening our economy. Regulatory reform is on the political agenda, and with regulators being chosen by the Trump Administration (tongue in cheek) and not Congress, relief is on the way. All of the major banks, for the first time, have passed the Federal Reserve's stress tests with flying colors.

The strength of the US economy has allowed the Federal Reserve to raise its policy rate three times in the last seven months. The Fed feels confident that it will be able to reduce its massive $4 trillion balance sheet. Both of these announcements should lift anemic interest rates and provide a more favorable environment for expanding bank net interest margins.

Excellent Stress Test Results

US banks have been pulling back on lending which has contributed to a lengthened economic recovery. The immediate response to the passing stress tests' grades has been announcements by the US Banks that they will increase their dividends and buy back stock. The big five banks, on average, raised their dividend 40%, bringing their average yield to 2.24% above the S&P 500's yield of 1.9%. Hurrah! Not so fast, we need banks to begin prudently lending money and not just to reward starving shareholders.

Widening interest margins, where banks make 50% of their income, should greatly help bank profitability. Thoughtful easing of bank regulations from Dodd Frank, the Fed, FDIC, Comptroller of the Currency, SEC, etc., will also provide a better appetite for commercial lending from both the borrower and lender's stand point.



Source: Federal Reserve System, Goldman Sachs Global Investment Research

Talk About Parity

Major League Baseball has done a good job of creating parity among its leagues (not the case in the NBA ...). After the most recent All-Star Game, both the American League and the National League have each won 43games (two ended in ties) and scored exactly 361 runs apiece ... if only the markets were that predictable!

2nd QUARTER 2017 SCOREBOARD

Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	21349.6	3.3	8.0
S&P 500	2423.4	2.6	8.2
NASDAQ	6140.4	3.9	14.1
Russell 2000	1415.4	2.1	4.3
MSCI EAFE	1883.2	5.0	11.8

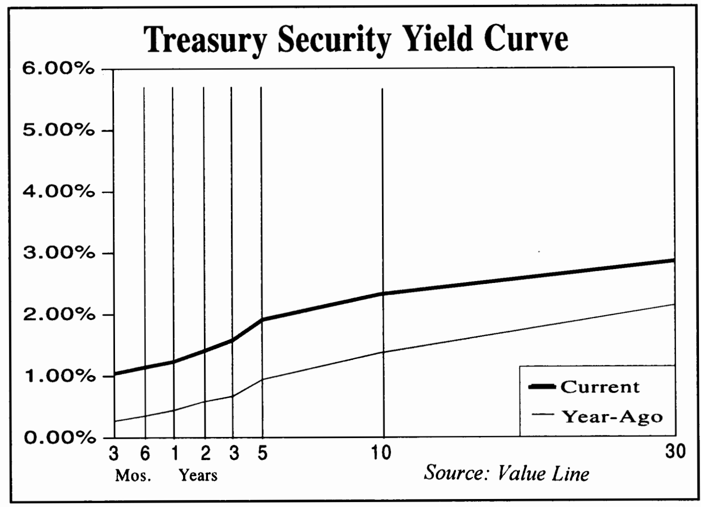
3 Month T-Bill	1.03%	Fed Funds Rate	1.00% - 1.25%
5 Year T-Note	1.89%	Prime Rate	4.25%
10 Year T-Note	2.31%	Gold	$1240.70
30 Year T-Note	2.84%	Oil	$46.04

Index returns are price only

Oil is down over 14% this year ... great for consumers and businesses!

Good time to re-fi!

Trend is higher... ever so slowly.



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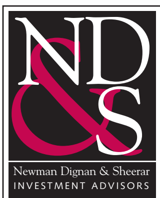

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