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Market Outlook

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Fears of a market correction resurfaced in the minds of investors last week as political tension in Washington was heightened by the appointment of former FBI Director Robert Mueller as Special Counsel to lead the Justice Department investigation into possible collusion between Russian officials and the Trump campaign. Though the market reaction was limited to a one day drop of 379 points on the Dow (-1.76%), it served as a not so gentle reminder, amidst an environment of largely bullish sentiment, that markets can indeed move in both directions. Such a sharp reaction is always enough to get our attention, but is not that surprising given that volatility has been at a low level for an unusually long period of several months at this point. A combination of solid corporate earnings growth, a measured Federal Reserve and the expectation for positive economic initiatives from a new administration have fueled strong market returns since the election while allowing complacency to find its way into the market's psychology. With increasing political uncertainty concerning the pace at which the administration can pursue its legislative agenda, earnings expectations may be tempered somewhat in the coming weeks. This coupled with a strong probability of another Fed rate hike in June suggest that we should allow for the possibility that the market will adjust to some degree in the near term.

While the current political landscape suggests some choppiness may be in store and has stirred some sleeping bears, that doesn't necessarily mean that we are on the precipice of a major market shift. The reasons for this are that the economic fundamentals are still solid and the Fed continues to be more than deliberate in its approach to raising interest rates. Low levels of unemployment, solid consumer metrics and improved global activity suggest that the long term bullish trend remains in place. However, given the rising political concerns, it is important for us to recognize that corrections can take shape and present themselves in forms other than a sharp price decline. One way that this can occur is for markets to move sideways for an extended period of time. This is what happened throughout 2015 as there was uncertainty about the Fed transition away from an accommodative posture while the underlying economic fundamentals continued to show progress. The market's pause gave earnings a chance to catch up to valuations and created a foundation for the subsequent continuation of the advance absent a price decline that would qualify as a bear market. This also seems to be what is happening over the last few months as investors are catching their breath a little bit in the wake of a big run up. The other way that we can get a correction without encountering the bear is to get a rotational market where certain sectors have bear markets within them while others do reasonably well. We have already seen some examples of this in the last couple of years as the Energy sector has suffered a steep decline and there has been some uncertainty in Health Care tied to possible changes in the Affordable Care Act that have triggered industry and company specific reactions. These situations present unique risks and opportunities at the sector and security levels, but they do not require a dramatic shift in asset allocation to become more defensive as their impact is limited. The effect is not sufficient to trigger a sharp drop into bear territory, but can restrain the upward movement in prices for a period of time.

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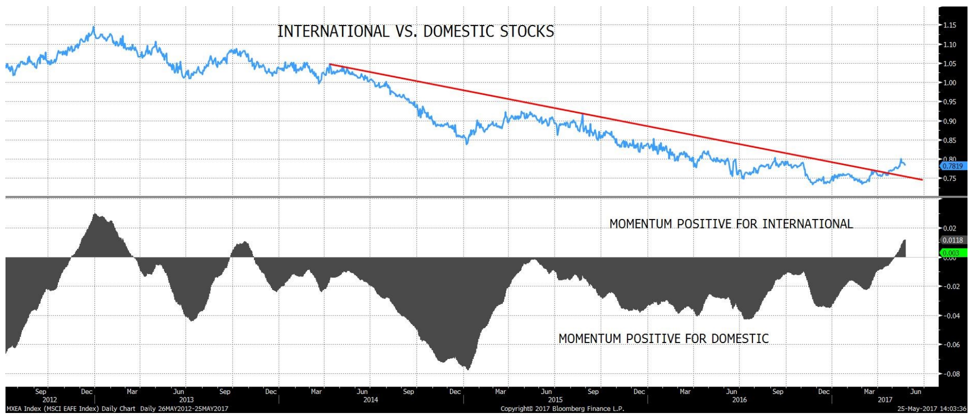

As the market has spent the last few months digesting the post election rally, we have begun to see some signs of shifting leadership and rotation which is action that is typically found in late cycle bull markets. The first of these is that the average stock has not kept up with the S&P 500 so far this year. We recognize that the S&P 500 Index is weighted by company size so when we compare this to an equal weighted S&P 500 it highlights any divergences in performance. To date in 2017, we see an equal weighted index that is up +5.40% versus +7.25% for the S&P 500 itself. The reason for this is the strong performance of the larger companies in the technology sector lead by names like Google, Apple, Facebook, Microsoft and Amazon. There are several reasons not to be overly concerned by this for the moment, the first of which is that stock performance has been broadly positive with an economic landscape that has continued to expand. The second is that the current divergence is not that significant to this point when compared to much more striking examples of narrowing leadership that we witnessed ahead of important market tops in 2000 and 2007. Also, we would be more concerned if the market was not freshly coming off of new all time highs and was struggling to break higher through resistance levels.

The other noteworthy shift that has been underway of late is that money has started to move into international stocks for the first time in almost a decade as we have seen the MSCI EAFE Index rise +13.8% year to date while the MSCI Emerging Markets Index is up +16.1%. This is due to a combination of factors in our view that include a pick up in global demand, more modest valuations overseas, and an asset class where many institutional investors are underexposed because of weak relative performance that has persisted for several years. Beyond this, it is possible that investors are looking at the political situation in Washington with an eye toward the additional diversification that a higher weighting in global stocks would provide as a hedge against potential uncertainty. It is interesting that while market leadership here in the U.S. has narrowed somewhat, global markets have moved more broadly higher suggesting that there is still enough demand out there for stocks to generate productive returns for investors even if a near term pullback is in the cards.