KLS Professional Advisors Group, LLC
Complete Financial Management

The Good, The Cautionary, and The Precarious

Domestic equity markets continued their rise during the first 60 days of the year, ultimately gaining 7.0%, in anticipation of stimulative policies expected to be enacted by the new administration. Thereafter, however, as political realities and polarization markedly slowed the Trump agenda, equity markets gave up some earlier gains and have seemingly been confined to a narrower trading range, subject to a reversal of policy deadlock, earnings and economic data not currently reflected in share prices, and geopolitical developments.

At the close of the first quarter, the S&P 500 was trading at 20x price earnings ratio based upon 2016 annual operating earnings and an 18.2 price-earnings ratio based on 2017 estimated operating earnings. We note the disconnect with the equity market multiple implied by Baa corporate bond of approximately 25x equating to a yield of approximately 4%. Analysts presently estimate 10% S&P 500 earnings growth for 2017, down from estimates at the close of the prior year. Multiples for mid- and small-cap companies are higher. We note that earnings growth estimates for the first quarter as compared to first quarter of 2016 reflect a recovery in oil prices which significantly contribute to analyst projections of a 9% year-over-year increase for S&P 500 first-quarter profits.

Interest rates varied moderately throughout the quarter with maturities of a year or longer remaining within a narrow range, but ultimately slightly declining for 5 and 10 year treasury maturities. Shorter-term interest rates rose significantly during the quarter. Gold made substantial gains. The performance of both bonds and gold notwithstanding, the Federal Reserve's articulated policy and first action step in raising interest rates underscores the uncertainties confronting investors. Below we summarize factors that we believe have impacted the markets thus far this year and are likely to continue in the coming quarter.

The Good

- A positive outlook for growth in corporate earnings, domestically and in Europe.
- A rise in all oil prices, possibly signaling stronger economic activity as the supply and demand mismatch has been tempered by OPEC production cuts. Nonetheless, a recent rise in the domestic supply reserves is cautionary.
- Increased capital spending by corporations in anticipation of continued economic growth.
- Inflation and economic growth supporting the Federal Reserve's decision to increase interest rates, coupled with positive consumer sentiment.
- Modest inflation and economic gains in Europe.
- Preliminary activity in pursuit of lessening regulatory burdens on businesses.
- Modest domestic employment gains (although averaging less than 200,000 jobs created per month during the first quarter); declining (though relatively high) unemployment levels in Europe.
- Interest rates remain relatively low, supporting corporate earnings and share valuation.
- Global momentum in both developed and emerging market economies.

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The Cautionary

- Policy uncertainties continue to weigh on companies and investors alike.
- The Federal Reserve has increasingly signaled that it may commence reduction of its balance sheet in the not too distant future. While we anticipate that this will be gradual, it may spur a decline in bond prices and a corresponding increase in interest rates. With regard to the ECB, once tapering begins with respect to ECB purchases of corporate bonds, credit spreads may widen and corporate bond prices decline.
- The domestic bond market continues to signal a tentative investor outlook for equities as demand for longer-term bonds remains strong. Investor thirst for yield has tightened credit spreads for investment grade and sub investment grade bonds.
- Political deadlock and polarization portend further delay in enacting and implementing healthcare reform, tax reform, and infrastructure spending.
- Technology gains continue to dampen employment gains but may nonetheless be supportive of corporate earnings.
- Thus far, trade rhetoric from the administration has not resulted in aggressive actions which may unsettle markets. The recent presidential meetings with China did not give immediate concern that protectionist trade policies would ensue. Investors are still cautious, however, that the administration's aggressive rhetoric may have negative economic consequences that impact corporate earnings and consumers.
- As public comments regarding Mexico's border and trade with the United States have subsided, government officials have sought common ground. The Mexican currency and stock market rose as a result.
- As China employs a tighter monetary policy in order to address its pervasive leverage issues, economic activity and perhaps demand for oil and other commodities may moderate. Higher interest rates also pressure corporate profits.
- While euro zone activity has improved significantly, the ECB believes that it is premature to reduce stimulus, evidencing continuing concern regarding deflation and GDP growth.
- As reported in the Wall Street Journal, some analysts believe that a contributor to the recent low volatility in the equity markets is the sale of portfolio insurance (and volatility protection) by equity portfolio managers, and the purchase of such by financial institutions who may then offset their exposure by purchasing equities or future contracts. Should markets have a strong reaction to data or an event, dislocation of positions as parties react may in fact magnify losses and volatility.
- A strong investor interest in gold and strength in the bond market during the quarter (low interest rates) are evidence of investor caution and uncertainties.

The Precarious (i.e., "the politics")

- The ever present domestic political dysfunction has weighed on investors and effectively become a fundamental factor in analyzing the risks and rewards in the capital markets.
- The litigation over executive orders addressing travel, security and immigration policy gave investors pause as to the ability of the administration to timely effect its policies and goals.

- The defeat of the healthcare bill not only further highlighted polarization between political parties, but also polarization among factions within the Republican Party. This defeat caused further concern regarding the ability to enact tax reform and infrastructure stimulus.
- The continuing distraction of congressional and law enforcement investigations into Russian intervention in U.S. elections also raises concerns regarding the efficacy of administration efforts to move forward on policy matters in addition to the substance of the matter being investigated.
- Protectionist/populist sentiment in member countries of the European Union and euro zone could be disruptive in the event that separatist governments are elected and could have consequence for European banks, interest rates, and equity markets.
- This month Congress must pass a spending bill to continue to fund the government. There is concern that political posturing may be an impediment. Longer lasting concern over increasing budget deficits attributable to higher interest rates also weighs on a budget deal.
- Political disagreements continue to dominate headlines as the confirmation vote for the administration's Supreme Court nominee was filibustered and then subsequently overridden by a unilateral change in the Senate rule allowing a simple majority to confirm the Supreme Court justice. This "nuclear" option, as it has been described, has permeated the American psyche and has caused grave concerns over enactment of economic policies as well as social policies. Ultimately, the nominee was confirmed.
- The capital markets took the geopolitical events (the missile attack on the Syrian base in response to Syria's use of chemical weapons against civilians) of the last week in stride. Oil prices gained shortly thereafter. As post-strike tensions with Russia escalated, capital market volatility increased.
- In the aftermath of the missile strike in Syria, the administration made clear that the United States will respond and enact the price for similar war crimes committed in contravention of international law and agreements.
- Finally, missile tests in North Korea, discussions between the Chinese and U.S. presidents regarding North Korea and the subsequent statements indicating the prospects of unilateral action by the United States also create additional uncertainty for U.S. allies and U.S. foreign policy. Recent U.S. Navy deployment reflects these increased tensions.

Market Performance, Outlook and Portfolio Construction

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index each finished the first quarter of 2017 in positive territory, (5.19%, 6.07%, 6.03% and 5.61%, 3.94% respectively). The Russell 2000 Small Cap Index rose 2.46%. The NASDAQ gained 10.13% as technology shares set the pace.

International equity markets gained. The MSCI Emerging Markets Index rose 11.45%, the MSCI All Country World Index 6.91% and the MSCI European Equity Index 7.44%.

Although the policy uncertainties and political dysfunction in place at the close of 2016 continue to eclipse the financial landscape, a stable and growing domestic economy, anticipated growth in corporate earnings, stabilization of commodity prices, a lower unemployment environment, an inflation rate approaching the Federal Reserve's target rate and Europe's improving prospects all support meaningful participation in equity markets notwithstanding that policy developments and geopolitical events could quickly elevate risks. While capital market risk cannot and should not be eliminated from an investment portfolio, we seek to strike the right balance of risk and reward through diversification by and within asset class. To this end we maintain a diversified fixed income exposure for most client accounts as well an equity position that is diversified by sector, market capitalization, and specific issues.

As always, we will use our best judgment to adapt to changes in the investing environment as they develop.

April 11, 2017

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.