MARKET
Insights

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Trumped Up Markets?

Trends to think about

The first quarter delivered solid results for equity-oriented investors. The S&P 500 continued its upward march and gained +6.1%. International markets also continued to rally, with the MSCI EAFE and Emerging Markets indexes up +6.5% and +11.1% respectively. After taking a beating in November and December, fixed income markets settled down. The Barclays U.S. Aggregate Bond index was virtually flat, down -0.1%. The yield on the benchmark ten-year Treasury note ended the quarter at 2.39%, down -9 basis points from where it stood at 2.48% at the end of 2016.

Role reversals

On the surface, markets seemed to be content and following the "Trump trade" rally that began after the presidential election. However, such a cursory reading is misleading – there were significant reversals between various sectors and geographies during the first quarter. U.S. large cap equities significantly outperformed small cap stocks, after losing to them in 2016. Growth stocks outran value stocks. The U.S. stock market lagged international markets, after several years of U.S. outperformance. Emerging markets continued to rally and significantly outperformed stocks in the developed world. Oil prices slumped after last year's recovery, with crude oil ending the quarter at $50 per barrel, down from last year's peak of $54 on December 28.

	2016	2017 Q1
S&P 500 (large)	9.5%	**6.1%**
Russell 2000 (small)	**19.5%**	2.5%
Winner	**Small Caps**	**Large Caps**
NASDAQ (growth)	7.5%	**10.1%**
DJIA (value)	**13.4%**	5.2%
Winner	**Value Stocks**	**Growth Stocks**
MSCI World ex U.S. (world)	7.0%	**6.5%**
S&P 500 (U.S.)	**9.5%**	6.1%
Winner	**U.S. Stocks**	**Rest of World**
MSCI EM (emerging)	**10.1%**	**11.1%**
MSCI World (developed)	9.7%	5.9%
Winner	**Emerging (barely)**	**Emerging (decisively)**

Source: FactSet Data

Equities –Stay the course with less smooth sailing ahead

The stock market's close on March 21 was a reality check for equity investors. U.S. markets fell more than -1%, ending a record 109 day streak without a decline of that much. The past several months have been characterized by little volatility in the stock market. This might have allowed investors to become complacent and forget how much normal daily results can move. Declines or advances of 1% or more are not uncommon. Since 1928, the average year has seen 60 days in which the S&P 500 Index changed by 1% in either direction. On average, 29 days fell more than -1% and 31 days rose more than +1%. Based on this long-term experience, and with 250 trading days per year, we should expect the market to move by at least +/-1% about every four days.

Days of S&P 500 Moves +/- 1% or More

	-1% Down	+1% Up
Yearly Average 1928-2016	29	31
Most Volatile Year: 1932	95	86
Least Volatile Year: 1964	3	0
2017 Q1	1	1

Source: www.pensionpartners.com

We anticipate more volatility this year, and investors would be wise to stay the course. Normally a market decline of -5% of more occurs at least three times per year, so investors shouldn't be shaken up by the next garden-variety correction. A downturn may provide valuable rebalancing entry points, as both U.S. and global growth fundamentals remain intact. International stocks are becoming more attractive, as economic activity picks up in Europe and Japan while those countries' central banks maintain low interest rates. We plan to increase exposure to international stocks in client portfolios in the near future. We also continue to maintain an overweight in financial, technology and industrial companies in our clients' core U.S. large cap equity holdings. We are avoiding utilities, telecom and consumer staples, which are sensitive to increases in interest rates.

Fixed income – Take a hike

In our Fixed Income positioning we are focused on real returns, not just relative value among fixed income sectors. The yield on the U.S. Treasury ten-year note remains below current annual CPI inflation of 2.7%. The Federal Reserve raised its target for the overnight Fed Funds rate on March 15 from 0.75% to 1.0%. It remains well below inflation and the economy's nominal growth of +4.2%. The market expects two more +0.25% rate hikes by the end of this year, as indicated by Fed Funds pricing. These are small, well-anticipated short-term increases and won't derail the economy.

The recent rally in fixed income that followed the March 15 FOMC meeting may be short-lived. Inflation already is at the Federal Reserve's target level of 2% — its preferred inflation measure, the PCE deflator, currently registers +2.1%. High-yield bond credit spreads (their additional yield over U.S. government bonds) remain less than 4%, well below the long-term average of incremental yields for non-investment grade bonds. At such low absolute and relative yields, any upside surprises in interest rates or inflation would demolish the meager year-to-date returns of fixed income securities. Key risks continue to be greater economic expansion and employment growth, a more aggressive Fed tightening schedule and restrictive trade laws or regulations from the Trump administration.

Rate hikes = equity spikes

Typically, equity markets outperform following periods when central banks hike interest rates. The Fed has conducted only four hiking campaigns since it began targeting the overnight Fed Funds rates in the late 1980s. The subsequent 12-month S&P 500 returns following those hiking periods were +39% in 1995, +42% in 1997, -10% in 2001 and +21% in 2007.

Hiking Campaigns

Rate Hike Period	Fed Funds Rate Increase	Next 12-month S&P 500 Total Return
Feb 1994-Feb 1995	3.00%	+39%
March 1997	0.25%	+42%
June 2000-May 2001	1.75%	-10%
June 2004-June 2006	4.00%	+21%
Dec 2015-March 2017	0.75%	?

Source: Federal Reserve, FactSet Data

Summing It Up — What does it mean for investors?

CAPITALIZE ON RECENT TRENDS

Recent equity market results have been excellent for investors. In 2017 the leading sectors and geographies have been those that lagged last year – large caps, international and growth stocks. We believe these trends will continue and are positioning portfolios accordingly.

BE MINDFUL OF SECTOR SELECTIONS

Consider overweighting in financial, technology and industrial companies. Consider avoiding utilities, telecom and consumer staples which are sensitive to increases in interest rates.

STAY THE COURSE WITH POTENTIAL MARKET MOVES

We expect greater volatility than what the past several months have delivered. Daily stock market moves of +/-1% are normal and a correction of -5% or more is well within the realm of annual outcomes. We encourage clients to look past such volatility and, if it occurs, to view it as an opportunity to add to core U.S. equity positions when their prices are "on sale."

STRATEGICALLY ALLOCATE FIXED INCOME IN LIGHT OF INCREASED INTEREST RATES

The trajectory of interest rates is upward and will hamper traditional fixed income returns. Investors should look past the recent rally in bonds and position portfolios by shortening duration, adding floating rate and inflation-indexed debt and seeking additional return from credit markets with higher yields, such as emerging market U.S.-dollar debt.

CONSIDER MARKET OPPORTUNITIES WITH TIGHTENING INTEREST RATE CYCLE

The Fed's current interest rate tightening cycle is not likely to derail economic trends. The next interest rate moves are small and well-anticipated. Historically, the ends of tightening cycles have been followed by significant positive stock market returns over the following 12 months.

TO VIEW A MORE DETAILED DESCRIPTION AND ANALYSIS OF THESE INSIGHTS, VISIT WWW.WEBSTERBANK.COM/PB.

Source for charts: FactSet 03/31/17

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