MARKET
PERSPECTIVES

STC Investment Committee

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Global markets remained resilient as positive economic news around the world and encouraging European political developments offset deteriorating optimism in the US about the degree and speed to which tax reform, deregulation and infrastructure spending initiatives will be achieved.

Global equities gained 1.6% in March, with non-US stocks gaining 3.1%. Not surprisingly given its run of outperformance, the US equity market's 0.2% return paled against international markets. Gains were restrained by uncertainly surrounding the Federal Reserve Board's (Fed's) likely pace of tightening and the administration's failure to replace the Affordable Care Act (ACA). The latter was important as both a central campaign promise and a precursor to tax reform. For the quarter, world markets gained 6.9%, with US stocks up 5.7% and foreign stocks up 8.0%, led by an 11.65% emerging-market return.

While much has (justifiably) been made of the quantitative difference between hard and soft (more survey-based) economic data, global growth hit post-Great Financial Crisis high levels. In the US, March consumer confidence had its highest reading since the peak of the tech bubble. With the economy at full employment, labor market optimism hit 35-year highs in terms of people expecting more jobs to be available, while manufacturing numbers were consistent with gross domestic product growth closer to 3%.

The economic background remained so supportive that investors were probably beginning to anticipate some disappointments as often happens after both economic surprise indices remain at elevated levels for a number of months. Auto sales were one such disappointment, as a general sign of consumer spending fatigue, with unit sales declining from annualized rates of 17.6 million to 16.5 million. Of greater concern is that bank lending growth has inexplicably decelerated, a trend seemingly at odds with a potential near-term spike in economic growth.

US equities had their quietest quarter in more than 50 years, with predicted market volatility declining to its lowest level ever. March saw US equities little changed, although the tech-heavy NASDAQ gained 1.6%. Growth, boosted by technology (large-cap tech up 2.7%), continued to outperform value, which declined 1%. Financial service stocks (-2.1%) and energy were the weakest sectors. Overall, quality and growth factors did well, while value, momentum and beta lagged.

International equity returns were strong, but variable, in both developed and emerging markets. Eurozone shares gained 6.1%. Political news was supportive, despite the UK's formal announcement to start Brexit negotiations. Dutch voters rejected the extremist right-way party and French polls showed an increasing likelihood of a market-friendly outcome (Macron ultimately defeating Le Pen). Spain gained nearly 10% as its budget deficit came in below expectations, giving room for fiscal stimulus. Strong economic releases continued unabated, with unemployment near an 8-year low of 9.5% (Germany's falling to 25-year lows) and UK growth holding up despite Brexit fears. Elsewhere, Japan was modestly negative due to disappointingly low core inflation (0.1% year-over-year) and a stronger yen.

The emerging-market rally continued, tacking on a 2.5% gain, despite the headwinds of the Fed rate hike and lower commodity prices. India gained 6% as the economy recovered from a liquidity squeeze with a strong purchasing manager's index and an important state election validating Prime Minister Modi's policies. China was higher despite increasing borrowing costs and rising domestic inflation. Despite the lower oil prices, Russia equities were higher due to rating agency upgrades, favorable inflation news and an interest rate cut. Brazil fell 3.6% on weaker than expected growth and a tainted-meat issue which caused many countries to halt imports from Brazil.

Continued on next page.

Despite the Fed raising its target rate by 25 basis points in March, bond market performance was muted. The Fed chose to guide only two additional rate hikes in 2017, surprising many investors who were expecting three. Treasury and investment-grade bonds were modestly lower over the month, with long corporates declining the most at -0.75%. High-yield bonds declined for only the second time in the past 12 months while issuance hit multi-year highs. Once again, the strength was in emerging market debt, as local-currency bonds returned 1.5% and yields fell 20 basis points to 6.55%.

The dollar ended modestly weaker across the board, retreating once the timeframe for a US fiscal stimulus was pushed back. Emerging-market currencies gained more than 1%, but ranged from -2% in South Africa (on the dismissal of a popular finance minister) to +7% in Mexico (after its central bank raised interest rates yet again and the Trump administration suggested it would not withdraw from NAFTA).

Despite the weaker dollar, commodity indices fell 3-4%, as oil prices plunged 7% on surging shale production and the limited impact thus far of OPEC's late 2016 production cut on US oil inventories. Natural gas bounced 16% on increasing exports and unseasonably cold weather. Gold recovered from intra-month 4% losses on the weaker dollar after the failure to replace the ACA.

April Developments

Through April 18, markets have seen a continuation of a retracement of the reflation trade that started in mid-March with the Republican's failure to replace the ACA, casting doubts on the Trump Administration's ability to push through its ambitious economic agenda. This retracement has been reinforced by increasing geo-political concerns surrounding North Korea, Syria and the French elections. Finally, investors have pulled back their forecast of future Fed rate hikes due to these factors, benign inflation and new qualitative guidance from the Fed (and President Trump).

Not surprisingly given these factors, the Treasury market has rallied strongly in April, with intermediate Treasuries up 1.25% and long bonds up over 2%. Investment-grade corporates outperformed high-yield bonds by 100 basis points despite a 4% recovery in oil prices as growth expectations have been challenged. Global equities are little changed, but volatility has picked up. The US equity market has seen a continued rotation into quality and defensive interest-rate-sensitive stocks. Consumer staples, utilities and real estate are up 2% and financials are down 2-3%. International equities are modestly outperforming the US, but Eurozone stocks are down 2%, with Italy particularly weak (-5%) as we approached the April 23 French vote. The binary risk is diminished with the results of the first round in and the markets are optimistic now, with the center-left and center-right rallying for Macron against Le Pen. Fed officials took pains to introduce the prospect of beginning a sell-down of the Fed's balance sheet by the end of this year. This quantitative "un-easing" was presented as a substitute for future interest rate hikes. At the same time, President Trump opined as to the benefit of a lower value for the dollar and low interest rates and his appreciation for the work of Fed Chair Yellen. Investors listened and marked down their forecast US interest-rate-hike trajectory, with the odds of a June increase being less than 50%. Not surprisingly, the dollar was weaker (except for metals-based currencies and Korea, which fell 2%). Gold rallied 3% on the fall in the dollar and increased geopolitical tension.

Despite these developments, there is little change to my economic outlook, so any change in our positioning will primarily reflect recent market movements. If anything, a concern could be that my optimistic view of global growth with surprises to the upside has become increasingly the consensus. In fact, this week the International Monetary Fund has upgraded its forecast of global growth for the first time since 2011. In addition, the Brookings-Financial Times Tiger Index suggests that growth has picked up sharply in both developed and emerging countries in recent months, with above-trend growth in advanced economies and emerging-market growth the highest since early 2013, as China's growth has surprised to the upside.

With the caveat that all bets are off if there is a massive reversal in the French polls, or worse – another terrorist attack, I would take profits in Europe on any post-election market surge as European equity valuations already reflect an economic recovery. Fixed income investors should sell the rally, as US fiscal stimulus is not needed for interest rates and inflation to rise. The Fed's apparent decision to pare down its bloated balance sheet makes a steeper yield curve even more likely. Municipal bonds are especially vulnerable at this time due to poor value in benchmark Treasuries; poor relative value to Treasuries; and the extension risk should the yields go up and the municipal curve steepens (plus tax reform risks).

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