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A Podcast Series by Kayne Anderson Rudnick

Episode 48

A Market Review of the First Quarter of 2017, and an Outlook for the Rest of the Year

Douglas S. Foreman, CFA
Chief Investment Officer

Is the Trump Bump Becoming the Trump Dump?

Well, stocks are off to a terrific start so far in 2017, with the S&P 500 Index advancing 6.07 percent in the first quarter, international markets up 7.25 percent and emerging markets even stronger at 11.44 percent. A style rotation continued during the quarter, with growth benchmarks outperforming value indexes and large stocks outperforming small stocks—the exact opposite of what happened in 2016. The asset classes and equity sectors that benefited the most from Donald Trump's surprise election cooled off and have lagged materially so far this year.

Bonds reversed course in the first quarter after a difficult fall. The broad U.S. bond market advanced 0.82 percent, California muni bonds returned 1.57 percent, high yield was up 2.71 percent and emerging-market debt increased 3.9 percent. Importantly, the yield curve flattened during the first quarter, with the U.S. Federal Reserve raising short-term interest rates one quarter of a point, but longer term rates barely budged. The 10-Year U.S. Treasury yield actually fell from 2.44 percent a quarter earlier to 2.39 percent, as did the 30-year rate which fell from 3.07 percent to 3.01 percent. Investors are now grappling with how much of Trump's agenda will actually make its way into law and when will this occur.

The Trump Bump

The failure of the Obamacare repeal and passage of a suitable replacement has led to questions about how much of President Trump's agenda will actually be enacted by Congress. Even though the Trump administration has already pivoted towards tax reform, the market doesn't seem to have much confidence that the agenda will be accomplished any time soon. Since the middle of December, companies with high tax rates have actually been materially underperforming companies with low tax rates, suggesting the market doesn't believe the likelihood of tax reform anytime soon.

Cyclical stocks, which have the most to gain from the passage of Trump's agenda, have lagged defensive stocks so far this year. So why then are stock prices continuing to perform well overall? Well, since last summer, improving energy prices and economic growth in many foreign markets has been driving a steadily improving U.S. economy. In addition, corporate earnings have actually stopped declining (after two years of being in decline), and are actually starting to accelerate. Also contributing to the climb of the stock market is the fact that CEO and small business optimism has soared now that the uncertainty of the presidential election is behind us and investors see Trump's administration as more pro-business. Such optimism is more likely the result of investors believing that the election of a Republican majority in Congress and the White House will spell the end of increasing regulation and taxes rather than investor confidence in the ability of President Trump and Congress to work together to pass the legislation.

One of the largest question marks of Trump's presidency as he entered office was how his administration would deal with our trading partners. So far, it appears his stance on trading with Mexico (NAFTA) and China, in particular, has softened from his campaign rhetoric. Despite the fact that the Trump administration frequently garners negative headlines, the stock market has tended to focus on improving domestic and foreign profits, as well as the rampant innovation and disruption at the corporate level.

For the 2017 Outlook, we believe the stock market and business activity are off to a good start. Globally, corporate sentiment and the business environment seem to be improving, which is quite a change from the last several years. Trump's policy agenda is becoming clearer than it was during the election. However, it is still too early to declare that we have all the details of his agenda for trade policies and foreign affairs.

We believe improving business sentiment will translate into improved growth, assuming the price of crude oil stabilizes in the 45 to 60 dollar range. We expect GDP growth to be in the 2.5 to 3.5 percent range and S&P 500 earnings-per-share growth, which we estimate will be in the high single digits, to pick up over the remainder of the year and into 2018. In the fixed income market, we still believe there will be some modest upward pressure on longer-term bond yields as the year unfolds. Corrections in the equity market may occur at any time, but conditions for a more meaningful bear market do not seem to be present. Our patience in not overreacting to last fall's Trump rally has been rewarded. We'll adjust our portfolios if Trump's actual initiatives become reality, rather than just speculation and random proposals. From a stock selection perspective, we'll continue to focus on quality companies with protective moats that can do well in both good and bad economic times.

Thank you for your trust and confidence.