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Investment and Financial Consultants

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FIRST QUARTER 2017 ECONOMIC AND FINANCIAL MARKETS REVIEW

The stock market began 2017 in a much different manner than 2016. Last year started with a significant market decline due mostly to concerns regarding deflation, the potential for rising interest rates, sharply declining oil prices, and a slowing global economy. By contrast, 2017 began with a series of record highs for the major U.S. stock market averages, as the positive outlook for economic and corporate earnings growth has continued since the November election. Despite political divisiveness, investors are now optimistic that the new administration's desire to lower personal and corporate income taxes, spend a significant amount of money on improving infrastructure, and deregulate various industries will lead to a stronger economy going forward. As a result of this investor enthusiasm, the S&P 500 Index ended the first quarter up 5.5%, while the Dow Jones Industrial Average finished up 4.6%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index gained 0.78% during the first quarter of this year.*

While our outlook for stocks remains positive over the long-term, investors now have very high expectations that new government stimuli will lead to strong corporate profits and economic growth, justifying higher stock prices. However, despite the current administration and Congress both being Republican-controlled, President Trump's economic agenda may prove difficult and take time to enact. If the political promises of lower taxes, increased government spending, and deregulation do not materialize as expected, investors may become disappointed, leading to a market sell-off.

If the economy does grow more rapidly this year, this acceleration, coupled with the potential for protectionist trade policies, may lead to meaningful inflation for the first time in a while. Inflation, or the rise in prices of goods, services, and wages, is a natural consequence of a fast-growing economy. However, its presence may force the Federal Reserve Board to raise interest rates more regularly or dramatically than investors currently expect. If the economy or inflation grows too quickly, the Fed's mandate is to raise interest rates to slow the amount of money entering the economy. When interest rates rise, risk-averse investors who invest in CDs, bonds, or money market funds can benefit by obtaining higher yields on new fixed-income investments. Conversely, existing fixed-income investments may decline in value if interest rates rise, because there will be a better supply of newly- issued fixed-income investments that pay higher yields.

Stock prices may also decline if interest rates rise too rapidly, as investors will likely reallocate money from the stock market back to fixed-income investments that now earn a higher rate of interest. Additionally, corporations may be forced to pay a higher interest rate on the money they borrow, leading to lower corporate profits. Likewise, if individuals borrow money going forward, they will incur a higher cost. For example, the economy and the stock market would be adversely affected if rising mortgage rates, auto loan rates, and student loan rates negatively impact consumer spending and the housing market.

We will continue to monitor stock and bond prices to see how they react as new fiscal policies make their way through Congress. We will also continue to monitor inflation and monetary policy changes throughout this year. Gradually accelerating economic growth without rapidly rising inflation would be preferable and would give the Federal Reserve Board flexibility to raise interest rates slowly without harming the economy and financial markets. We continue to favor short-term bonds over long-term bonds because short-term bonds tend to hold their value more than long-term bonds if interest rates rise. We still favor large company U.S. stocks, although we have become more bullish on smaller-size companies recently. If inflation does become a problem for the global economy, we may begin to look to commodities as an inflation hedge.

In the meantime, please call us if you have any questions or concerns regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays Indices on April 1, 2017.*

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