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SECOND QUARTER 2017 ECONOMIC AND FINANCIAL MARKETS REVIEW

The first half of 2017 was largely positive for stocks. These gains were fueled mostly by promises of new fiscal stimulus emanating from Washington. If these fiscal policies become law, they would provide catalysts for improving economic growth and larger profits for U.S. corporations. In addition, economic conditions in foreign countries have been strengthening lately, leading to rising corporate profits overseas. Although some sectors of the stock market have not participated in this year's market rally, the S&P 500 Index ended the first half of this year up 8.2%, while the Dow Jones Industrial Average finished up 8.0%. Unfortunately, returns for fixed-income investments continue to remain relatively low, as the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index gained only 1.84% during the first half of this year.*

Since the November election, stock investors have been enthusiastic about pledges made by the new administration to lower personal and corporate income taxes, spend a significant amount of money improving the nation's infrastructure, and deregulate various industries. Each of these policies would likely stimulate U.S. economic growth. Lowering corporate income taxes is particularly exciting for stock investors, as this would immediately lower companies' expenses, providing a direct boost to corporate earnings on which stock prices are based. Moreover, one of the proposals being discussed in Washington is to allow U.S. multinational corporations to repatriate money to the U.S. at a lower tax rate. If this additional money is spent in the U.S. by corporations on hiring, new investment, and research and development, it could be very beneficial for the U.S. economy as well.

In addition to this potential new fiscal stimulus in the U.S., foreign economic conditions appear to be improving. The economic growth rates in India and China have stabilized, and the European and Japanese economies are growing faster than at this time last year. This economic recovery overseas not only bodes well for foreign stock investing, but it also benefits U.S. corporations that generate a large portion of their revenues in foreign countries. For example, the technology sector is known for generating a significant amount of its sales globally, and stock prices for large U.S. technology companies have been very strong lately. Companies like Facebook, Amazon, Netflix, Google, and Apple have been significantly outperforming stocks in many other industries. This is reminiscent of the late 1990s technology boom, when a small group of large technology stocks led the market indices higher.

For the stock market to continue to appreciate, stocks in more industries need to participate in the current uptrend. For instance, the banking, energy, telecommunications, and retail sectors have underperformed. Furthermore, Washington must deliver on its promises to avoid disappointing investors. Political partisanship, party infighting, and controversy surrounding the White House have become significant distractions that risk hindering the rollout of the promised fiscal policies that have helped the overall stock market to appreciate over the last eight months. Investors could soon adjust their outlook regarding the positive impact that these proposed fiscal policies will have on the economy and stock prices if it appears less likely that they will be implemented as expected this year.

The good news is that stock market declines that occur due to concerns over political issues are typically not as bad as stock market declines that are based on structural problems with the economy or the financial system. Throughout history, economic problems such as inflation or deflation, soaring interest rates, currency issues, and global recessions have created much larger stock market declines than bad news that is not related to the economy. Therefore, as long as the economy continues to grow modestly, and interest rates do not rise too rapidly, we do not expect the next stock market decline to be as severe as the type of bear markets that occurred from 2000-2002 or 2007-2009. In fact, if the next stock market decline is due to political or geopolitical issues and the global economy is still improving, we may recommend investing a bit more in equities for risk-tolerant investors. We may also allocate additional funds to additional asset classes such as small-company stocks, emerging markets stocks, and gold, rather than mainly investing in large-company U.S. stocks.

Despite the Fed raising short-term interest rates three times since December, interest rates in the bond market remain relatively low due to concerns that the fiscal stimulus may not get implemented this year and political uncertainty will continue. That said, we still believe that interest rates in the bond market will rise gradually in the future, so we continue to recommend short-term bonds rather than more interest-rate-sensitive long-term bonds.

We will continue to monitor developments during the second half of this year. 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 July 1, 2017.*

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