Political Drama, Rate Normalization, and a Bull Run – What's Next?

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Executive Summary

- *There is little doubt that the global political environment will remain a meaningful source of market uncertainty for the remainder of the year.*
- *With limited prospects for harmful inflation and solid global economic underpinnings, the Federal Reserve may find itself in a fortunate position of being able to normalize monetary policy through rate increases without threatening the near-term growth trajectory for the U.S. economy.*
- *While current U.S. equity valuations are elevated, they do not flash red of speculative excesses seen in prior bull market episodes.*
- *Prudence in investment selection and risk management remains of utmost importance in all environments.*

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The first quarter of 2017 delivered plenty of drama and a wide array of issues for investors to contemplate. Investor worries over global political discord were offset by continued strength in the U.S. economy, a strengthening global economy, and follow through on healthy fourth quarter corporate earnings expectations. With turmoil in Washington D.C., a Federal Reserve on the move, and an extended bull market run in stocks, investors are wondering what twists may lie ahead.

No other story dominated the headlines and capital market performance more than Donald Trump's nascent presidency. Early quarter market excitement over the President's pro-growth agenda centered on tax reform, regulatory relief, and infrastructure spending propelled equities higher and bonds lower on higher growth and inflation expectations. This excitement waned late in the quarter after the U.S. Congress failed to repeal and replace the Affordable Care Act (ACA). The failure to repeal the ACA indicates stiff resistance not only from Democrats but also from deficit hawks and the more conservative arm of the Republican Party and casts doubt on the Administration's ability to execute its legislative agenda. Overseas, the political environment remains no less uncertain and fluid. 2017 elections in France and Germany are pitting anti-European Union (EU) candidates against the pro-EU establishment. In March, the Netherlands voted in favor of the incumbent pro-EU Prime Minister over his anti-EU rival. It is too early to tell if this outcome is an indicator for the French and German elections but if recent history is any guide, there may be some surprises along the way. British Prime Minister

Theresa May formally began the process of withdrawal from the EU, a process expected to drag on for at least two years. Did we mention South Korea, the eleventh largest economy in the world, impeached and arrested its sitting President on corruption charges during the quarter? With this backdrop, there is little doubt that the political environment will remain a meaningful source of market uncertainty for the remainder of the year.

Despite the political turmoil, the outlook for global economic growth has improved. The U.S. remains on solid footing bolstered by healthy labor and housing markets, surging consumer and business confidence and improving expectations for manufacturing. It remains to be seen if surging confidence translates into a meaningfully higher GDP growth rate, but the U.S. should continue to grow in 2017. The Federal Reserve remains on a path to tighten monetary policy through a slow, data dependent process. With limited prospects for harmful inflation and solid global economic underpinnings, the Federal Reserve may find itself in a fortunate position of being able to normalize monetary policy through rate increases without threatening the near-term growth trajectory for the U.S. economy. Will other global economies contribute to accelerating economic growth in 2017? This is possible considering the fact that developed international and emerging markets are at an earlier stage in the business cycle relative to the U.S. and recent data suggests improving economic conditions. In its January 2017 report, the International Monetary Fund (IMF) forecasts accelerating global economic growth with 3.4% growth in 2017 and 3.6% in 2018 following an estimated 3.1% for 2016. Commensurate and leading economic statistics from around the world are consistent with accelerating growth.

While the stock market's surge early in the first quarter was strongly influenced by the Trump Administration's pro-growth initiatives, strong S&P 500 earnings results also served as a positive contributor. Full year 2016 S&P 500 earnings results rebounded strongly from the 2015 "earnings recession" as the

Equity Market Index Returns

As of March 31, 2017

Asset Class	Index	1Q 2017 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	6.07	17.18	10.37	13.30	7.51
	Russell 1000 Large Growth Index	8.91	15.77	11.28	13.33	9.14
	Russell 1000 Large Value Index	3.26	19.20	8.66	13.12	5.93
	DJ US Select Dividend Index	3.93	15.64	11.50	14.39	6.89
Mid Cap U.S.	S&P 400 Mid Cap Index	3.93	20.91	9.36	13.32	8.97
Small Cap U.S.	S&P 600 Small Cap Index	1.06	24.59	9.45	14.25	8.81
Developed International	MSCI EAFE Index	7.24	11.67	0.50	5.83	1.05
Emerging Markets	MSCI Emerging Market Index	11.44	17.22	1.18	0.80	2.72
Commodities	Bloomberg Commodity Total Return Index	-2.32	8.72	-13.91	-9.54	-6.22
Real Estate	NAREIT Equity Index	1.15	3.54	10.25	9.98	4.84
Global Market Cap Weighted	MSCI World Index*	6.37	14.74	5.51	9.36	4.21

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of March 31, 2017

Fixed Income Market Index Returns

As of March 31, 2017

Asset Class	Index	1Q 2017 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	0.82	0.44	2.68	2.34	4.28
	BC Intermediate Government Credit	0.78	0.42	2.01	1.88	3.76
	BC US Intermediate Credit	1.14	2.11	2.74	3.02	4.69
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	1.90	0.35	2.03	2.06	3.84
International Bonds	Citigroup Non-US Government Bond	2.02	-4.79	-2.56	-1.50	2.64

All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of March 31, 2017

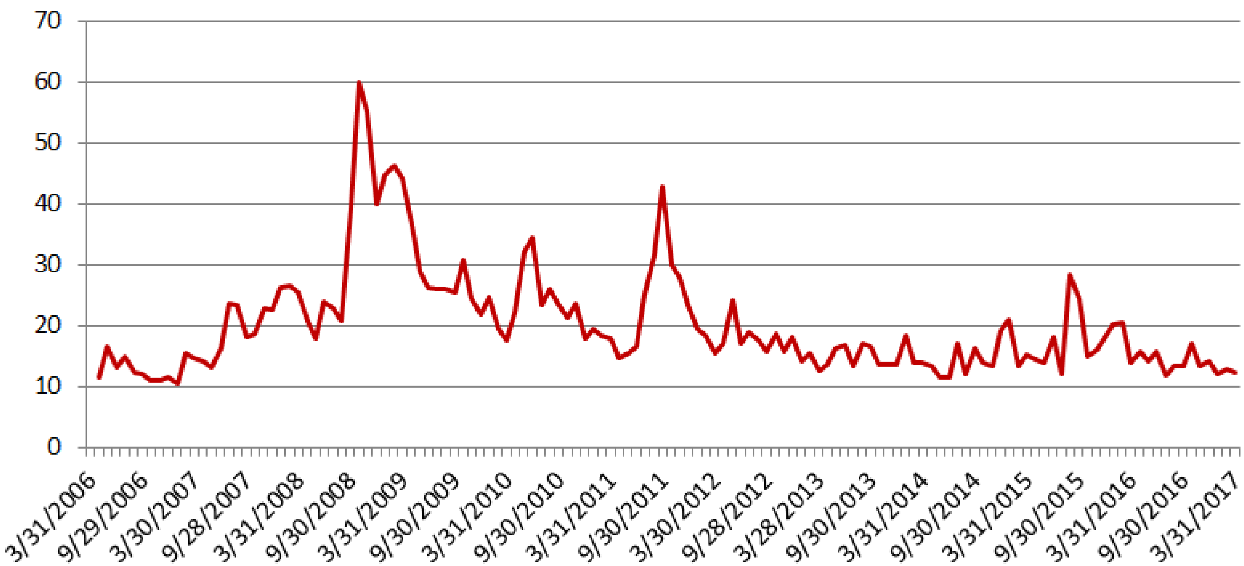
sustained recovery in oil prices and the slowing pace of the U.S. Dollar's appreciation provided strong earnings tailwinds. For the quarter, U.S. small and mid-cap stocks yielded their recent leadership back to U.S. large cap stocks. Strong performance by the technology and healthcare sectors led growth oriented strategies to outperform their value counterparts. Europe outpaced the U.S. market, despite its seemingly never ending barrage of bureaucratic issues and flash points. Data suggests Europe is improving on several fronts including unemployment, the outlook for manufacturing, GDP growth and corporate earnings. Emerging markets, cyclical beneficiaries of resurgent global economic growth, outpaced the U.S. and international developed markets by a wide margin and posted an 11.5% return for the quarter. What's new in the bond market? During the quarter, the U.S. yield curve flattened as the Fed's second rate hike in three months influenced short term yields to rise and lower long-term inflation expectations caused longer dated bond yields to decrease slightly. The broad measure of U.S. investment grade bonds, the Barclays Aggregate Bond Index, produced a 0.8% total return for the quarter. True to the "risk on" nature of the first quarter's script, the riskier corners of the fixed income market outpaced their more conservative counterparts.

Looking forward, the S&P 500's consensus first quarter annual earnings growth estimate is a somewhat lofty 9.1%. The S&P 500's forward Price to Earnings (P/E) ratio is 17.5x while its 25-year average P/E is 15.9x. The Fed has signaled its intention to raise rates two more times in 2017. U.S. stock market volatility, as evidenced by the CBOE Volatility Index (a measure of market expectations of near-term volatility known as the VIX Index) has been remarkably low for an extended period and closed the quarter at its lowest average since 2006 (see chart on page 4). The political backdrop remains uncertain. These facts raise a few questions. Are equities overvalued? How will Fed policy affect my portfolio of stocks and bonds? Have investors become lulled into a sense of complacency with stock market exposure following a multi-year bull market run supported by unconventional Fed policy? How will events in Washington D.C. affect my investments?

While current U.S. equity valuations are elevated, they do not flash red of speculative excesses seen in prior bull market episodes. A continuation of low, albeit rising, interest rates and an expectation for solid future earnings growth explain some of the premium valuation. While elevated valuation levels increase the likelihood of market corrections, the timing of

U.S. Stock Market Volatility Remarkably Low

CBOE Volatility Index as of March 31, 2017



Source: FactSet as of March 31, 2017

market corrections is impossible to predict. We remain steadfast in our belief that high quality U.S. equities offer long-term growth potential in excess of inflation and recommend careful adherence to client specific equity allocations calibrated appropriately to reflect an individual's risk tolerance. The relative calm in the equity market is likely reflective of a well-balanced and stable economy, the Fed's incremental, well telegraphed and data dependent approach towards normalizing monetary policy and positive expectations for corporate earnings. However, relative calm can be quickly disrupted by exogenous events outside of our line of sight. As such, prudence in investment selection and risk management remains of utmost importance in all environments. In our view, the Fed is in the very early innings of an extended rising rate cycle and is far from increasing interest rates to a level that will negatively impact equity market performance. Fed policy is likely to impact bond performance but the low global yield environment and low inflation expectations will likely prevent a severe spike in interest rates. Politics will continue to be a wild card. Washington's failure to repeal the ACA may accelerate efforts on corporate tax reform and infrastructure spending. While there will undoubtedly be resistance to these initiatives, both will have more bipartisan support relative to healthcare reform and would boost corporate earnings. We believe U.S. centered strategic equity exposure remains prudent given the U.S.'s diversified, highly innovative and globally important economy. While the U.S. remains the centerpiece of our equity exposure, we believe maintaining a global equity orientation is good practice from both a risk and return perspective and therefore feel comfortable maintaining exposures in both international developed and emerging markets. Following a multi-year period of underperformance, relative valuations compared to the broad U.S. stock market appear attractive. The continuation of positive economic and earnings trends and performance leadership of international equity markets is debatable but continued follow through could unlock value obfuscated by well documented issues.

Rising interest rates will serve as a headwind to bond market performance but will allow the opportunity to reinvest bond maturities at higher yields increasing cash flow and offsetting, at least partially, any drop in return from unrealized bond price declines. Following a 30-year bull market, long-term return expectations for investment grade bonds have diminished. However, their critical roles of generating stable cash flow, mitigating investment risk and diversification has not.

Complacency, overconfidence, and risk avoidance are well known investment villains that can damage financial outcomes stealthily over time or more quickly and in spectacular fashion. Effective wealth management combines the development and execution of comprehensive plans tailored to your family's unique challenges, goals and aspirations with a disciplined investment management process designed to mitigate behavioral investment errors. Paying careful attention to the "return of capital" before the "return on capital" is important for security selection regardless of our current position in the market cycle. While day to day market gyrations may keep us on the edge of our seats at times, a thoughtful, comprehensive approach to wealth management coupled with a carefully calibrated, risk managed investment process gives us confidence to go on with the show. ■