

# JRM Investment Counsel

An Independent Registered Investment Advisor Firm

## Market Commentary First Quarter 2017

During the first two months of the quarter, stocks moved steadily higher on the enthusiasm and expectations of stronger economic growth, lower corporate income taxes, higher government spending on infrastructure and a more business friendly regulatory environment. The stock market reaction reflected instant success of the Trump pro-growth agenda without any regard to potential adverse unintended consequences or the possibility that some of these initiatives may not be implemented.

The S&P 500 set 12 all time highs during the quarter, the most recent on March 1 at 2,396. Since then, the S&P 500 has slowly drifted lower and ended the quarter at 2,363, for a return of 6.1%. Technology was the best performing sector during the quarter, up 12.6% and energy was the worst, down 6.7%. Overall, growth did better than value, and large cap did better than small cap during the quarter.

The domestic equity market valuation is much higher than its historical average. Based on trailing 12 months GAAP (generally accepted accounting principles) earnings, the S&P 500 is valued at 25 times earnings. The average historical earnings ratio is about 16 times. Further, investor sentiment became more bullish during the quarter, which is often a contrarian indicator. A recent survey indicated many investors believe the market is overvalued *and* returns will be positive during the next 12 months, which seems somewhat inconsistent. If the majority of the pro-growth Trump agenda is not implemented, it is doubtful the market valuations are sustainable.

The S&P 500 has had positive returns 28 of the last 37 years in spite of an *average intra-year* decline of 14%. The intra-year decline has been below average during each of the last five years. Current valuations, investor optimism, and political uncertainty are all factors which may contribute to a market correction later this year. Consequently, we have modest expectations for domestic equity investment returns in the near term.

The best performing asset categories during the first quarter were foreign equities, with emerging markets equity and developed markets international equity, up 11.5% and 7.3%, respectively. These asset categories have underperformed domestic equity for the last 10 years and their respective valuations remain considerably below the domestic equity market.

On March 15, the Federal Reserve Open Market Committee (FOMC) increased its target short-term interest rate to 0.75-1%, the third increase during the last fifteen months. In addition, the FOMC is projecting two more interest rate increases this year. In spite of the increase in short-term interest rates, the yield curve “flattened” with long-term interest rates declining during the quarter. Short-term interest rates are determined by the FOMC and long-term interest rates are

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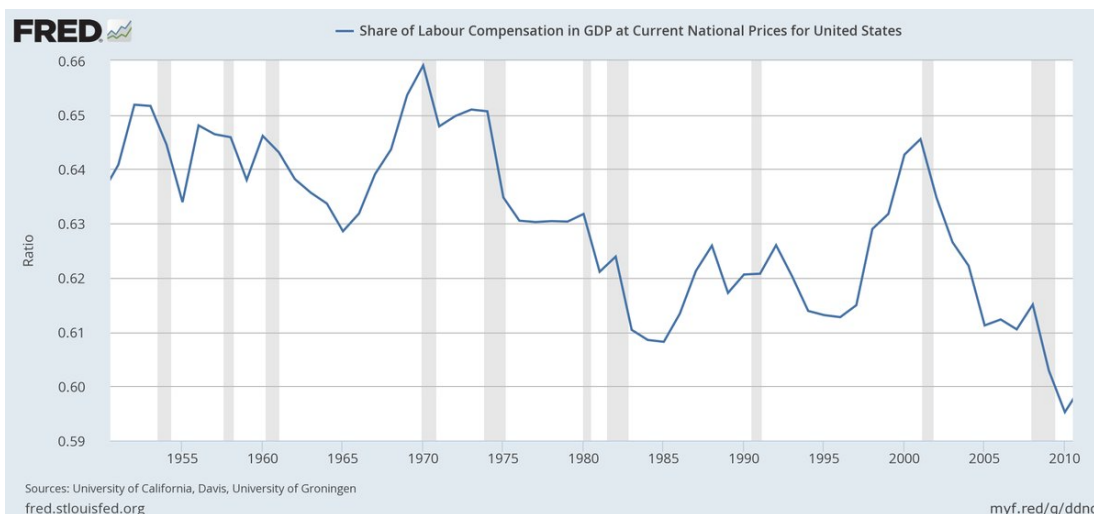
determined by investors' views on inflation and economic growth. Based on current long-term interest rates, the market is suggesting it is unlikely economic growth or inflation will accelerate significantly.

The Trump administration believes economic growth will increase to 3-4% if its legislative agenda is approved. By comparison, the Federal Reserve's estimate of long run growth is about 2%. Policies that restrict global trade or immigration or increase debt will have an adverse effect on growth. Reducing corporate tax rates will not automatically cause a significant increase in capital investment, employment or GDP unless they are offset by other government spending reductions or revenue sources. Regardless, the inability to repeal and replace the Affordable Care Act suggests it may be challenging to implement much of the "pro-growth" Trump agenda. We believe continued slow and steady economic growth is a more likely scenario.

The total amount of credit outstanding in the United States is about \$70 trillion, or 350% of GDP. Of this amount, federal debt is about 30% of the total, or 105% of GDP. Approximately \$20 trillion of this debt will have its interest rate reset during the next two years. Interest rates are about 1% higher since last summer, and although it does not sound like much of an increase, it amounts to \$200 billion annually, which will place additional pressure on consumer spending, the federal deficit, and economic growth.

Historically, periods of high GDP growth have occurred following periods of economic weakness and high unemployment. This higher growth was driven by an increasing labor force, higher productivity and rising wages. Today, we are dealing with the opposite: the economy has been growing (although at a modest rate) for the last eight years, unemployment is a low 4.5%, the labor force participation rate is declining, and productivity and wage growth are not robust.

The U.S. Bureau of Labor Statistics projection of growth in the labor force is 0.3% per year for the next seven years. In addition, labor's share of GDP, as noted in the chart below, has been



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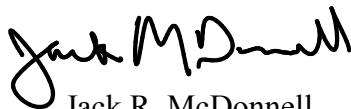
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declining for the better part of the last decade. This does not bode well for consumer spending, which represents 68% of GDP.

If economic growth remains steady or stalls, it is unlikely current domestic equity valuations are sustainable or that interest rates will increase significantly. Although we have modest expectations for investment returns, we do not believe in attempting to time the market simply because it does not work. The allocations to fixed income and preferred stocks should perform better than equities when (not if) we see a market correction. These income producing securities provide important balance to multiple asset class portfolios.

If you would enjoy a thorough review of your portfolio, or if we can be of greater service to you, please do not hesitate to reach out to us.

Thanks again for your trust and confidence.



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