INVESTMENT OUTLOOK

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SECOND QUARTER 2017: EVERYTHING'S COMING UP ROSES

Honey, everything's coming up roses and daffodils!
Everything's coming up sunshine and Santa Claus!
Everything's gonna be bright lights and lollipops!
Everything's coming up roses for me and for you!
-Stephen Sondheim

In the classic Broadway show *Gypsy*, the lead character and ultimate stage mother Rose, always only a step away from the next calamity—and financial ruin—does her level best to maintain a veneer of maximum optimism. That declaration of a bright future, notwithstanding a fragile and uncertain present, is expressed with unbridled exuberance in the iconic song, "Everything's Coming up Roses."

In the second quarter, markets of all kinds were aping Ethel Merman, belting out their own version of the upbeat show tune. Equities large and small, domestic and international, posted solid returns, as did real estate. Bonds generated healthy appreciation, as interest rates fell, and even cash has—ever so gradually—started to yield a little bit more income. Only commodities experienced weakness, though it should be noted that lower energy and other commodity prices are a boon to both businesses and consumers.

Asset Class	Index	2nd Q Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	3.1%	9.3%
US Small Cap Stocks	Russell 2000	2.5%	5.0%
International Developed Stocks	MSCI EAFE	6.1%	13.8%
Emerging Markets Stocks	MSCI EM	6.3%	18.4%
Real Estate	MSCI US Real Estate	1.7%	2.7%
Commodities	Bloomberg Commodity	-3.2%	-5.6%
Bonds	Barclays US Aggregate	1.5%	2.3%
Cash	Citigroup 3 month UST Bill	0.2%	0.3%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, BLOOMBERG

Year to date returns are even more encouraging, led by strong appreciation in developed and emerging international markets. US equities have also advanced smartly; gains for real estate and bonds were more modest but still healthy. Only commodities, weighed down by an oversupplied oil market, lost ground. Returns on cash, while still extraordinarily low, have finally begun to rise.

In this bright world reminiscent of the carnival barker's come-on—"everybody's a winner"—rough rice appreciated 22.9%, South Korea's Kospi Composite stock market index rose 18.0%, and the Polish zloty was up 13.1%. The median Manhattan apartment set a record at $1.2 million, up 9% in the past year; sales of apartments priced over $4 million grew 41%.

And the losers? Mostly commodities—orange juice off 31.6%, sugar down 29.2%, crude oil off by 14.3%. Also, retail space—stores comprising 49 million square feet have been closed in the first four months of this year, according to Credit Suisse. (Of course, there's a big winner behind this loser…)

TRUMP BUMP OR TRUMP SLUMP?

Now's your inning. Stand the world on its ear!
Set it spinning! That'll be just the beginning!
-Stephen Sondheim

What's behind these better than good numbers? Considerable ink has been spilled trying to ascertain the extent to which market rallies can be attributed to a positive reception for the Trump policy agenda.

The perceived pro-growth initiatives cluster around three policy prescriptions:

- Less regulation/de-regulation: The business community, chafing from eight years of pro-consumer regulation seeking to stamp out the prior decade's excesses, has welcomed the new Administration's focus on reducing or eliminating regulations that raise costs and may curtail job growth. On this issue, concrete advances have already occurred, through executive orders, changes in enforcement postures, and agency and Cabinet appointments.
- Tax reform: Statutory corporate tax rates in the US compare unfavorably with many developed nations' tax rates. More generally, the US tax code is infamously complex, ridden with sops to special interest groups, and almost universally disliked. Prospects for reform, however, are in doubt. Due to arcane Senate rules, the initial focus has been on repealing and replacing the Affordable Care Act, in order to reduce government outflows for insurance subsidies. However, to the surprise of some, health care reform has proved to be, er, challenging, so the narrative may soon shift. That said, comprehensive tax reform in an era of both intra- and inter-party fractiousness is a large ask. A more modest package of lower corporate tax rates and a tax holiday on repatriation of corporate cash held overseas may prove more achievable.
- Higher fiscal spending: Hopes remain for higher fiscal spending in two areas: military defense and infrastructure. Pentagon spending has already been lifted in the current budget year, and we think it likely to be raised again in the 2018 budget. There is broad consensus on the need to upgrade our infrastructure but more questions than answers on how to pay for it. The extended planning cycle for infrastructure projects suggests that even once funding issues are resolved it will take some time before any economic and financial impacts are achieved.

With limited early progress on the Trump agenda, it seems a stretch to attribute markets' advances to the new administration. That said, enthusiasm remains at elevated levels. Surveys of small business owners, consumers and CEOs all evidence strong optimism for economic growth. It is difficult to quantify that positive sentiment, in terms of its possible contribution to stock market movements, but things that cannot be measured do exist.

THE NOT YET Y-U-G-E ECONOMY

Curtain up! Light the lights!
We got nothing to hit but the heights!
I can tell, wait and see.
There's the bell! Follow me!
-Stephen Sondheim

Markets—and sentiment—are at record heights. But what we can measure—what economists refer to as "hard data"—is at some variance from the soft sentiment surveys of participants' feelings. What economic actors are actually doing—spending and investing activities—remains tepid.

Treasury Secretary Steven Mnuchin advocates for the administration's tax reform plan as a means to achieve a 3% targeted growth rate (note the unacknowledged slippage from a 4% target around Inauguration Day). But US GDP during the long, slow recovery from the Great Recession has barely managed to grow 2% on average over the past eight years.

The labor market has the best data set. Job growth continues to run at a 200,000 monthly rate, and measured unemployment is down to 4.4%. These are strong numbers, but we still have too many under-employed and discouraged workers, too low an employment participation rate (the percentage of working age population actually in the labor force), and wage growth that only slightly exceeds inflation.

Other measures of economic growth fall well short of upbeat sentiment. Consumer spending is meh, as consumers divert income to higher healthcare costs and increase their savings rates; the US Department of Commerce reported that consumer spending rose a scant 0.1% in May 2017. Business capital investment remains subpar; new orders in May for nonmilitary equipment excluding aircraft, a proxy for business investment, dropped 0.2%, as did shipments of finished goods. Housing construction remains well shy of previous cyclical highs, and automobile sales are falling from last year's peak levels.

The gap between sentiment and real world economic data is large and unsustainable. It will be particularly important to observe closely the action in Washington, not for its entertainment value but because it will ultimately yield the answer to whether sentiment will fall or economic activity will rise, to close the distance between them. Much rests on whether the economic agenda of the new administration can be successfully legislated into action.

EARNINGS GROWTH AND THE TRIUMPH OF GLOBALISM

You can do it, all you need is a hand.
We can do it, Mama is gonna see to it!
-Stephen Sondheim

The post-election euphoria was driven by a consensus view that the US economy would experience accelerated growth and, therefore, that domestically focused companies would fare best. This translated to smaller cap companies, financial stocks, utilities and telecoms.

Sometimes it pays, however, to be a contrarian with regard to the consensus. More than any Trump bump, markets have moved up on solid fundamentals—that is to say, on strong profit growth. And that strong profit growth has been driven by strong sales growth (a much superior source of higher profits than cost cutting). And strong sales growth, in turn, has been driven by strong international growth.

Although inconvenient, the facts are that economic growth today is faster in Europe than in the US, faster in Japan than in the US, and faster in emerging markets than in the US. Europe, so much slower to adopt pro-growth and market-clearing policies following the Great Recession, is at last emerging from economic malaise. It is also benefiting from highly accommodative central bank monetary policy and from a notable decrease in political disharmony. Elections this year in the Netherlands, Austria, and France have beaten back far right/nationalist parties and reaffirmed the European Union, notwithstanding Brexit. In Japan, aggressive monetary policy has fueled better economic growth. And emerging markets have demonstrated surprising resilience, even in the face of a weak commodities environment.

The biggest corporate beneficiaries of this improved, synchronized global growth story are multinational companies. Overall, revenues rose 8% and corporate profits 15% in the first quarter. Such robust results provide sound support for rising equity prices, and expectations for the remainder of the year are constructive, although year-over-year comparisons will become more challenging. And it is likely that international operations—that hand that we need—will continue to be the driver making American corporate profits great again.

ALLOCATING ASSETS: THE WHOLE WORLD ON A PLATE

Clear the decks! Clear the tracks!
You've got nothing to do but relax.
Blow a kiss. Take a bow.
Honey, everything's coming up roses!
-Stephen Sondheim

We are pleased to have participated fully in this year's market appreciation. Increased international exposure has been timely and additive to returns. More generally, it has been rewarding to be fully invested in the face of ongoing political and economic uncertainty. From an asset allocation perspective, our largest tactical over-weights, to US Large Cap and International Equities, have been constructive, as have under-weights in real estate and commodities. Modest fixed income under-weighting has also helped portfolio returns.

From a sector perspective, our largest over-weight has been information technology. Underlying such positioning is a focus on secular growth stories, which we continue to believe cluster around the technology group. We are adding to health care exposures, in part to take advantage of discounts attributable to legislative uncertainty affecting the sector. Long term demographics, globally, are supportive, as are scientific advances. On balance, we are coming around to the view that the legislative and regulatory environment is unlikely to harm industry profits. We are neutral on financials, as a more favorable regulatory climate and lower capital requirements are offset by slower loan growth, pressure on net interest margins and muted capital markets activity. Under-weighted sectors include telecommunications, where price competition and unlimited data plans are crimping profits, and energy, which remains over-supplied amid modest demand growth and increasing disruption from alternative energy sources—wind and solar—notwithstanding a potential US withdrawal from the Paris climate change accord.

In the fixed income arena, the Fed has raised rates two times this year and, absent a reversal in the economy, seems likely to continue on a gradual path to higher rates. We applaud the movement away from emergency interest rate policies. The Fed is also on a path to reduce its extraordinarily high level--$4.5 trillion!—of fixed income securities holdings. We think this, too, is a necessary and appropriate reset. That said, securities markets have for years been buoyed by coordinated global central bank policies of easy money and quantitative easing. Even as rate increases are executed off of ultra-low levels, the effect nonetheless is tightening, and this support for higher equity and bond prices is being slowly eroded. Until the economy evidences a substantial downshift, the fixed income investment implication is to be cautious about longer term bond investments.

As we move into midsummer, our garden confirms that everything is, indeed, coming up roses. But as any experienced gardener knows, it's a time to be active and anticipatory, to watch for and guard against rust spot and black spot, against aphids and Japanese beetles.

In investment terms, it means that even as we enjoy elevated portfolio values, we remember economist Hyman Minsky's observation that stability is inherently destabilizing. A long period of exceptionally low market volatility has left investors relaxed, not to say complacent. Rising portfolio values may tempt market participants to take a bow, but we would caution against any self-congratulatory impulse.

Rather than blowing a kiss, better to hunker down, clear the decks and focus on fundamentals. Recall that at the end of *Gypsy*, Rose's dreams collapse and she breaks down. Better to live in the real world, as free of illusion as possible. After all, we live in an era of geopolitical risks, partisan divisiveness, elevated debt loads, vast income inequality, waning global central bank accommodation, elevated valuations, and disruptive technologies. We focus on hard economic data, on real earnings, on solid balance sheets, on high quality companies with sustainable competitive advantages. Asset allocation and security selection are the talents we need to nail this performance.

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