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Stocks March Higher—But for How Long?

March Market Update—April 6, 2017

Stocks continued their post-election bounce, with the S&P 500 index adding another 6% in the first quarter, on top of the strong returns for November and December. There was a shift among favored areas of the stock market during the quarter, with areas that were particularly strong right after the election, including small-cap stocks, and industrial, energy and financial companies, taking a back seat to foreign, technology and health-care companies (areas that had lagged last year).

Other asset classes started the year fairly subdued. High quality bonds barely managed any gains, with the Barclays Aggregate bond index only up 1% for the quarter. High yield bonds rose 3%. Commodities were a mixed bag as gold rose over 8%, while oil plunged 9%.

This rather strong movement for the first quarter—the third strongest quarter since 2000—is even more impressive considering the headwinds faced by investors in 2017.

For one thing, the Federal Reserve raised interest rates for a third time during the quarter. Investors generally get nervous whenever the Fed begins to push up short-term interest rates because rising rates often lead to recession down the road. Some analysts argue, however, that with interest rates as low as they are now, we don’t have anything to worry about for quite some time.

In addition, despite President Donald Trump’s promise to repeal and replace “Obamacare,” congressional Republicans were unable to do so in their first attempt. This has created concerns about prospects for other elements of the Trump agenda, including tax reform and infrastructure spending. Given the strong rally in many areas of the equity markets, were investors perhaps a bit too optimistic about how much could actually get done in Washington?

In spite of these potential stumbling blocks, stocks forged higher. Overall, investors seemed complacent as we started the new year. The S&P 500 index went 109 days without a 1% daily move in either direction, the longest stretch of its kind in nearly 22 years according to Ned Davis Research. Investors appear to be taking recent developments in stride and have not reacted strongly. It will be interesting to see if that behavior continues into the second half of the year.

What Lies Ahead?

From our big picture technical perspective (looking at price trends of various indices), stock trends look to be fairly consistent. For this reason, FSA’s overall asset allocation now reflects low money market levels and relatively high allocations to stock-oriented funds (including high yield bond funds). That said, we recognize that the current bull market in stocks has run pretty long (it's been more than eight years since the bottom of the last bear market and nearly six years since the last significant correction). Moreover, we see some signs that the upward momentum in stocks is beginning to wane here in the United States. Some of the most popular stocks (Apple, Amazon, Facebook) have fared the best so far this year, while the stocks of many small companies are languishing. As a result, we are not pushing the risk in our portfolios too high right now. We are content to ride the current wave, but stand poised to take action if market conditions deteriorate.

The trend looks more anemic for the high-quality bond market, in which prices have not recovered from a post-election decline. With the Federal Reserve in a tightening mode (looking to raise short-term interest rates as the economy strengthens), it's hard to get excited about prospects for bonds of this type.

<u>Portfolio Review</u>
Below, we review first quarter results in FSA's six broad investment strategies. Keep in mind that because we manage clients' portfolios individually, the results for your particular account may differ somewhat from the averages.

Income (Strategy 1)
The Income strategy outperformed the Barclays bond index thanks to high yield and emerging markets bond funds, which achieved better returns during the quarter. The floating rate funds had modest gains; these funds are included in the portfolio mix to provide a lift if interest rates continue to rise. Currently, the portfolio is nearly fully invested, with a money market allocation below 5%.

Income & Growth (Strategy 2)
This balanced strategy (with a high focus on consistent returns and low volatility) posted gains in line with its conservative nature. During the quarter, we increased the equity allocation to its upper range of 50%, while the bond allocation remained at 45% (in high yield and floating rate funds). These portfolios have a money market allocation below 5%.

Conservative Growth (Strategy 3)
Conservative Growth accounts participated in the first quarter rally even though the more conservative equity income funds could not match the pace of the S&P 500 index. During the quarter, we increased the equity allocation from 50% to 60%, while adding a high yield municipal fund to most taxable accounts. The bond allocation is between 35% and 40%, with the money-market allocation at 5%.

Core Equity (Strategy 4)
Because portfolios in this strategy held roughly 90% in equities during the first quarter, these accounts benefited from the rally and are well positioned to increase those gains if the uptrend

continues. The 15% allocation to small-cap stocks hampered returns, though the effect was countered by help from the industrials and consumer discretionary sector funds. During the quarter, we sold the MLP and telecom funds we purchased in the first half of last year. We also trimmed back our small-cap stock position, and added a health-care and a gold fund.

Tactical Growth (Strategy 5)
This eclectic strategy posted solid gains, helped by the technology sector funds and the emerging markets fund. During the quarter, we increased the weighting in the emerging markets fund, and added a biotechnology fund. Our foray into long-term government bonds was short lived as interest rates languished after our purchase. Overall, accounts in this strategy hold 60% to 75% in equities, 15% to 20% in high yield bonds, and 10% to 20% in money market funds.

Sector Rotation (Strategy 6)
After a challenging 2016, this equity strategy has made a nice rebound, thanks to solid returns from the financial, technology and leisure sectors. The most recent monthly rotation left portfolios in this strategy holding three technology-oriented funds, along with investments in leisure, consumer staples, and health care.

We welcome the opportunity to answer any questions you have about markets, general economic conditions and what they may mean for you. Please remember to inform us of any changes in your life that could affect your investment objectives. We will always do our best work when we're closely aligned with you.

FSA Investment Team