

Economic & Market Quarterly

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Macroeconomics: The Good, the Bad, and the Potentially Ugly

The growth scare that the global economy endured in early 2016 is becoming a distant memory as we progress through 2017. In the United States, while reported data has not been indicative of an economy that is rapidly expanding, a contraction does not appear to be in the offing, either – at least in the near term, barring any major geopolitical shock or unanticipated shift in central bank monetary policy.

On the positive side, global economic survey data, such as Purchasing Managers indices, are signaling an expansion. In addition, the Organisation for Economic Co-operation and Development's (OECD's) Composite of Leading Indicators (CLIs) are showing positive readings across most countries and regions that are examined.

Focusing on the United States, The Conference Board Leading Economic Index has recently strengthened, after declining over an 18-month period that ended in June 2016 (see the chart below).

The Conference Board Leading Economic Index (YoY%)
15 Years Ending 3/31/2017



Source: FactSet, Inc.

While no econometric model can perfectly forecast economic growth rates, the recent acceleration in a variety of leading indicators has been encouraging and has positively impacted economically sensitive asset prices over the last several months.

Since the beginning of March, key economic data, such as retail sales, employment, inflation, and auto sales, has softened. While one month does not signify a trend, continued weakness would be concerning.

Another potential headwind for the markets would be if government officials do not implement the tax reform, deregulation, and fiscal spending policies that investors have been anticipating. Confidence could wane very quickly if political gridlock persists.

Recent events in Syria and North Korea have been disconcerting on many fronts, and they could be another source of market volatility going forward.

However, a potentially bigger risk to the financial markets would be if more countries, such as France, decided to leave the European Union (EU). The angst surrounding last June's Brexit vote in the UK and last November's presidential election in the United States failed to depress asset prices the way many pundits had anticipated. The upcoming runoff in the French presidential election could turn out to be a non-event for the markets, but if the far-right populist movement takes hold in France, there could be long-term ramifications in terms of the viability of the EU.

Post-Election Bounce Stalls in March

Equity markets continued their post-election rally during January and February. The S&P 500 Index advanced 5.94%. The rise in prices appeared to be based mostly on the premise that a lessened regulatory burden, coupled with pro-growth policies, would stimulate the U.S. economy and, in turn, corporate profits.

In late March, expectations and reality collided, when an attempt to repeal and replace the Affordable Care Act, or "Obamacare," fell apart. This was the first major policy initiative put forth by the Trump administration, and it was expected that tax reform would follow shortly thereafter. Interestingly, the move toward a new health care plan was derailed not by opposition from the Democratic party, but by dissent from within the Republican ranks.

With the hope for any quick policy action fading by the day, equities marked time in March, finishing the month just above breakeven at +0.12%. However, for the first three months of 2017, the S&P was higher by a full 6.07%.

The Russell 2000 Index of smaller cap stocks, which had performed particularly well in late 2016, rising 13.84% between Election Day on

Nov. 8 and year-end, followed a similar path. During the first two months of the new year, this Index posted a meaningful gain of +2.33%, before advancing just +0.13% in March. For the first quarter of 2017, the Russell 2000 was higher by a more modest +2.47%.

Conversely, non-U.S. equities marched steadily higher throughout the first three months of 2017, with the MSCI EAFE Index posting a return for the quarter of 7.25%. The results for emerging markets equities were even better, with the MSCI EM Index returning 11.45% for the same time period.

As we have noted in the past, while early, if the two non-U.S. indices (MSCI EAFE and MSCI EM) continue to track favorably to the S&P 500 for the balance of the year, it would be the first time since 2012 that the return on domestic equities has come in under these international benchmarks.

Fixed Income Markets Post a Gain in the Quarter

The U.S. fixed income markets squeezed out a gain in the first quarter of 2017, driven by continued investor demand for higher yields embedded in corporate bonds. The Bloomberg Barclays U.S. Intermediate Government Credit Index returned 78 basis points (+0.78%). Corporate bonds, which continued to benefit from multiple years of slow but steady U.S. economic growth, outperformed U.S. government securities.

During the period, the yield curve flattened by 13 basis points (0.13%). The two-year U.S. Treasury yield jumped seven basis points (+0.07%) during the quarter, while the ten-year U.S. Treasury yield dropped six basis points (-0.06%). These two U.S. Treasury benchmarks ended the quarter yielding 1.26% and 2.39%, respectively.

A flatter yield curve has been created by a continued shift in U.S. monetary policy (impacting the short end of the curve) and comments by members of the Federal Open Market Committee who support higher short-term yields, accompanied by geopolitical uncertainty coinciding with investor doubts regarding the Trump administration’s ambitious pro-growth agenda, which have kept a lid on yields further out on the yield curve.

Regarding monetary policy, the U.S. Federal Reserve (the Fed) raised its range for the Fed Funds target rate by 25 basis points (+0.25%) in March to 0.75% - 1.00%, and maintained its bias for two more rate hikes before the end of the year.

The additional chatter surrounding the Fed’s plan to reduce its balance sheet and curtail its bond reinvestment program added upward pressure to short-term bond yields.

**Federal Reserve Balance Sheet
1/1/2008 – 3/31/2017**



Source: Bloomberg Finance L.P.

On the fiscal side, investors dialed back their expectations for fiscal stimulus this year either through tax reform or government spending. Although consensus remains that some form of fiscal reform is on the horizon, investors questioned the impact such policies would have on U.S. economic growth and overall inflation. Longer-term bond yields fell during the first quarter due to reduced inflationary concerns by investors.

Investors have sought the safety associated with longer-term U.S. government securities, due to concerns related to geopolitical risks, such as the ongoing tensions in North Korea and Syria, and talk of the possible departure of France from the EU, or “Frexit,” a potential outcome of the French presidential election.

During the first quarter of 2017, the yield spread between 10-year German and French government bonds increased 17 basis points (+0.17%), an indication that concerns are growing.

In the municipal bond arena, investors shrugged off concerns regarding potential tax reform (lower personal income tax rates) and its impact on tax-free bonds and yields. Investor demand during the first quarter remained very healthy, with the focus on the short to intermediate part of the yield curve. Underfunded pension obligations were a factor weighing on investor demand for longer-dated bonds. Overall, the Bloomberg Barclays Municipal Bond Index was up 1.58% during the quarter.

Where Do We Go from Here?

Asset prices have risen in large part based on the hope that the Trump administration’s “pro-growth” agenda will cause an acceleration in economic growth and corporate profits. However, the recent dichotomy of results between “hard” data and “soft” data has called into question the durability of this expansion. In addition, the bond market may be signaling doubt as to whether economic growth and fiscal measures will be enacted in a timely fashion.

We believe it is imperative that U.S. Gross Domestic Product (GDP), which grew at a torpid 1.6% pace in 2016, expand at a faster pace to promote margin expansion at the corporate level and thus support equity prices on a sustained basis. Going forward, we will be closely

watching the administration's ability to implement the policies intended to stimulate the economy.

Our view is that the U.S. equity market is fully valued relative to future earnings expectations, although it remains attractively valued relative to the yield on the ten-year U.S. Treasury bond. We will be monitoring earnings closely to determine whether current valuations are sustainable, given the gap between price growth and earnings growth of stocks that has widened over the last several quarters.

Credit and duration are the primary risks impacting fixed income securities. On the fixed income side, we believe that a portfolio of higher quality, investment grade issuers is appropriate at this stage of the business cycle. Given the continued low-yielding environment, limiting duration risk and positioning for potentially higher interest rates down the road is, in our view, the prudent course of action.

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