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Market Update: February 2017

Stocks advanced for the fourth straight month, with U.S. and foreign markets returning 3.72% and 1.59%, respectively. **In fact, the S&P 500 blue-chip index saw 12 consecutive days of record closings during the month.** Year-to-date returns are already in excess of 5%, as investors anticipate pro-growth policies that will bring regulatory relief, reduce taxes, and increase infrastructure spending.

U.S. corporate earnings for the fourth quarter of 2016 are expected to increase 4.6% from the same period a year ago. This will mark the second consecutive quarterly advance … before that, earnings had contracted for five consecutive quarters.

> **Lost in the speculation about the Trump administration's expected business-friendly policies were better-than-expected corporate earnings. More good news is expected in coming quarters, too.**
>
> **Steven Russolillo – WSJ 2/23/17**

The 10-year U.S. Treasury now yields 2.358%, which is slightly lower than the 2.451% rate at the end of January. This was the first monthly decline since the record lows that were reached in early July of last year. The yield had reached 2.6% in mid-December.

Remember, **bond values increase when interest rates decline … so stocks and bonds are again moving in the same direction.** This is quite a change from the *reflation trade* of late last year, which saw investors buy stocks and sell bonds in expectation of accelerating growth and higher inflation.

So, what exactly does that mean? If bonds are considered a *safe-haven* for investors, are rising bond prices a warning that stock valuations are too high? Or, will improving economic fundamentals and rising corporate earnings support higher stock prices?

> **At some point the stock and bond markets need to be reconciled.**
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> **Julien Scholnick, Western Asset Management – WSJ 2/27/17**

The demand for U.S. Treasuries could also be attributed to lower comparative yields in foreign markets, as well as political risks in Europe. The 10-year German and Japanese government bonds currently yield only 0.2% and 0.05%, respectively.

The French presidential election takes place this spring. Some investors are selling French government debt over concerns that Marine Le Pen could be elected president. Ms. Le Pen has promised to take France out of the Eurozone. Polling suggests that Ms. Le Pen will not be elected … but, haven't we heard that somewhere before?

> **If France was to leave, the viability of the remaining euro would be very difficult to justify.**
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> **Neville Hill, Credit Suisse – WSJ 2/21/17**

In a related note, the European Union's statistics agency confirmed that consumer prices in the currency area increased 1.8% from a year earlier. This is close to the 2% target set by the European Central Bank. **January marked the first time in nearly four years that none of the 19 member Eurozone economies were in deflation.**

Emerging markets have returned in excess of 8% during the first two months of 2017. Initial concerns over trade and currency rhetoric following the surprise Trump election are apparently diminishing. **More importantly, emerging market stocks are a bargain.** The MSCI Emerging Markets Index is trading at approximately 12 times expected earnings over the next 12 months … well below U.S. valuations.

As you all probably know, the Dow Industrials exploded through the 21,000 barrier on the first day of March … yet another in a string of milestones eclipsed. So, let's look at the latest valuation metrics:

- The S&P 500 now trades at about 18 times expected earnings, which is a 12-year high.
- At the end of 2016, the total value of the U.S. stock market was estimated at 169% of gross domestic product. That compares with 85% at the end of 2008, and it is close to the 177% level reached just before the technology bubble burst in 2000.
- According to the cyclically adjusted measure used by Yale's Robert Shiller, the markets are valued in the 96th percentile of all observations in the past 135 years.

Since 2009, Shiller's cyclically adjusted earnings per share growth was calculated at 5.3% annualized. Without corporate stock buy-backs, however, this rate of growth would have been cut in half. Put another way, most of the stock market's return since the great recession has come from *valuation* as opposed to real earnings growth and inflation.

Low interest rates should lead to higher valuations, and profit margins are supported by cheap debt. Still, stocks appear to be pricing in strong forward earnings and significant corporate tax cuts.

> **The point is that since it is incredibly difficult to know which events are likely to occur, and when, it is also difficult to determine what exactly is priced into market expectations. Reasonable people can agree that something substantial is priced into a range of securities, but there is far less consensus about exactly what that something is. That means that the market has been rallying on what it doesn't know.**
>
> **Steve Sosnick – Barron's 2/27/17**

Generally, investors look to balance the risks associated with inflation and volatility. **An investor's time horizon will usually determine which risk (inflation or volatility) is of greater importance.** The only way to properly determine *time horizon* is by establishing and updating an overall financial planning framework. Simply put, when it comes to investing only 3 things matter … timeframe, timeframe & timeframe.

This is a great time to rebalance investment portfolios and replenish cash levels. Above all, stay disciplined and humble … if not slightly defensive.

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