KayneCast

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Episode 51

A Market Review of the Second Quarter of 2017, and an Outlook for the Rest of the Year

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This is our second quarter of 2017's market review, and once again we have the question of has Trump been dumped?

In terms of first-half performance, as we closed out the first half of the year, stocks continued their steady march forward. For example, U.S. large-cap equities, as measured by the S&P 500, advanced 9.34 percent, year-to-date through June 30th; international stocks, as measured by the MSCI EAFE Index, were up 13.81 percent; and emerging markets stocks were even stronger, as measured by the MSCI Emerging Markets Index, up 18.43 percent. Growth stocks and large-cap stocks continued to outpace value and small-cap stocks in the first half of this year—the exact opposite of what occurred in 2016. The Russell 1000 Growth Index was up 13.99 percent, year-to-date, versus the Russell 1000 Value Index, which was only up 4.66 percent. Small-cap stocks, as measured by the Russell 2000 Index, were up 4.99 percent—about half the return of the S&P 500 year-to-date. As usual, corporate earnings were a key factor driving stock market returns. First quarter 2017 results were up double-digit and earnings-per-share growth is improving, globally, for the first time in many years.

Bonds continued to perform well, with the Bloomberg Barclays U.S. Agg Bond Index up 2.27 percent. California municipal bonds advanced 3.64 percent; high yield bonds, as measured by the Bank of America Merrill Lynch U.S. High Yield Bond Index, returned 4.91 percent; and emerging market debt, as measured by the JPMorgan Emerging Markets Bond Index Global, was up 6.2 percent for the first half of the year. Credit spreads continued to tighten overall in the second quarter. The 10-Year Treasury yield actually fell from 2.44 percent at the start of the year to 2.3 percent as of June 30th. The 30-Year Treasury also fell from 3.07 to 2.83 percent at the end of the quarter. The decline in longer-term rates occurred despite the fact that the U.S. Federal Reserve continued to raise short-term interest rates for the second time this year. Given that the yield curve has continued to flatten, we believe this will make any further short-term rate increases more difficult to achieve. Inflation is still below the Fed's long-term target, which is having a positive impact on lower long-term interest rates.

Since last fall's election, equity indexes have appeared very calm relative to history. However, underneath the broad stock indexes has been a lot of rotation and change in individual industries and stocks. A recent example of this has been Amazon's announced purchase of Whole Foods. Amazon has already disrupted many retailers' business models and now seems poised to potentially disrupt the traditional grocery business. Retail and grocery stock prices have been negatively impacted due to this threat. So despite the very calm macroeconomic and overall index performance, there continues to be significant disruption, innovation and change at the industry and stock level. This is providing excellent opportunities for fundamentally based active stock pickers to add value.

Many market participants have observed that much of this year's stock market return have been driven by a select few mega-cap technology stocks. And, while these stocks have certainly outperformed in the first half of this year, this focus fails to acknowledge that many of these mega-cap tech stocks performed poorly last year (particularly after President Trump's surprise election in November). This poor stock performance last year occurred despite the fact that many of these companies' cash flow and earnings

grew very robustly last year. This concentration of returns among the top 10 mega caps doesn't appear to be too unusual by historical standards. We would argue that the strong first-half performance of these stocks simply reflects catch up for their strong corporate performance that was not rewarded in 2016.

What about the Trump affect? In looking at the data, the stock market doesn't believe that any of President Trump's agenda will be passed into law, as the sectors which have benefited the most last fall from his election have now all materially lagged the market this year. Energy, financials, materials and many industrials have performed very poorly this year, causing the value indexes to lag the growth indexes by a wide margin. Given the inability to pass any health care legislation thus far, investors are understandably skeptical about the ability to pass other meaningful legislation. The good news is that stocks are priced for no tax reform. Therefore, if tax reform ever does really occur, it could represent further upside for the stock market. A fair amount of merger and acquisition activity is being deferred in many industries as corporate boards await further clarity on the tax reform plans.

What's the outlook for the second half? Well, even in a mediocre GDP outlook environment, corporate earnings should continue to look very solid over the next 6-12 months. As a result, stocks should continue to generate positive returns (although we may experience a correction along the way). Despite the yield curve flattening materially, it is still not inverted and the Federal Reserve may feel less pressure to continue with another rate increase in the second half of the year. A meaningful increase in the price of crude oil, or major progress by the Trump Administration on tax reform and/or an infrastructure bill could cause longer-term bond yields to rise over the next 6-12 months. And this would give the Fed a lot more wiggle room with respect to short-term interest rates than what they currently have available. But the key takeaway for clients in this environment is to remember to focus on their real, longer-term objectives and not get caught up in the day-to-day vagaries of the stock market. Time can be our strongest ally in achieving our long-term positive return goals.

As always, we will continue to focus on high-quality businesses that can perform well in both good and bad times, that have sustainable competitive advantages. We thank you for your trust and confidence in managing your assets.

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