AMB Newsletter
2nd Quarter 2017

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1st Quarter 2017 Review

The first quarter of 2017 was another strong quarter for the financial markets. Domestic equities continued to improve off last year's performance, with the market, measured by the S&P 500, earning 6.1%. This performance was led by three sectors: Technology +12.6%, Health Care +8.4%, and Consumer Discretionary +8.5%. Asset allocation continues to be important as the top producing sectors have outperformed the bottom contributors by 10%+ over the past three quarters. Reminiscent of 2016, certain investment styles outperformed other styles significantly. While growth and value stocks had relative parallel performance in 2016, the two reversed that trend with value stocks underperforming their growth oriented counterparts in the first quarter of 2017. Similarly, small and mid-cap stocks underperformed the larger capitalized corporations. This has not occurred in nearly a year. International equities have taken a positive turn with the MSCI-EAFE posting a return of 7.1%.

Interest rates performed within market assumptions during the first quarter with fixed income rebounding from the poor fourth quarter 2016 performance. The short end of the yield curve, measured by the 3-month treasury, moved up 25 basis points with the Federal Reserve's latest rate hike. However, the intermediate part of the yield curve, measured by the 10-Year Treasury, and the longer end of the curve, measured by the 30– year Treasury, both moved six basis points lower. As expected, the bond markets posted positive returns for the first quarter. The longer dated portfolios outperformed the shorter dated portfolios by a wide margin. High Yield once again outpaced investment grade debt, following equity prices higher.

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Economy - Economic growth in the US and other developed nations remains feeble. Fourth quarter 2016 GDP came in at 2.1%, pushing the 2016 annual GDP growth rate up to 1.6%. Currently, GDP for the first quarter of 2017 is tracking between .5-1.5%. This is another example of the slow pace of growth we have seen since the financial crisis. Inflation is rampant in certain sectors of the economy, such as healthcare and housing. Per capita Healthcare costs have increased over 800% since 2005, while wages have only increased 12%. This unsustainable trend places a tremendous burden on the average American family. Reform is needed in the healthcare system, or it is going to continue to fail.

Wages remain our main economic indicator for growth and inflation. In our view, they both remain below the level necessary for increased economic growth. Since the election of President Trump, soft data (surveys) continued to improve while hard data (actual output) has not. We need to see a shift if growth is expected to increase. An example of a report was the addition of 90,000 jobs in the March Non-Farm Payroll, which despite all the strong "soft" data going into the report, the result is hard evidence that not all is well. In our view, US growth and inflation prospects will continue to track wages and business spending. Although proposed policies from the new administration will most likely drive growth and inflation, we believe such policies will take significantly longer to implement than what the administration was proposing earlier in the year. The current economic data is suggesting that 2017 will continue to show slow gains in economic growth.

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Federal Reserve – The Federal Reserve has captured headlines since 2009 because of their deployment of unconventional monetary policy tools to spur economic growth. The accommodative policies implemented over the past few years have included Quantitative Easing (outright buying of bonds) and ZIRP (Zero Interest Rate Policies). These programs have moved rates lower and driven money out of fixed income investments and into riskier assets. Recently, the Federal Reserve's stance has shifted to a less accommodative approach. In March, the Federal Reserve initiated its 3rd rate hike in two years and has indicated reducing the bank's $4 trillion balance sheet. The recent rate hike was implemented at a time when U.S. GDP growth was tracking below 1%, per the Atlanta Fed GDP forecast. This was the weakest growth rate for an interest rate hike cycle in decades, which could cause a setback in economic growth.

In the Fed's statement accompanying the March rate decision, the Committee said the risks to the economy remain balanced. They also signaled there could be additional rate hikes over the course of 2017. This no longer seems as certain because recent hard data on the U.S. economy shows vulnerability. The slack in the labor market continue to be a bigger issue than the Fed would like to admit. The unemployment rate has become a meaningless metric due to the way it is calculated because more and more individuals are dropping out of the workforce, skewing the calculation. Instead, we are more focused on labor participation and wage growth, both of which have deteriorated this year. The interest rate futures market is currently implying two additional increases before 2018. This could certainly happen, but it is too aggressive in our view.

As stated in our last letter, *"We believe the Federal Reserve's policies will continue to have a lesser impact on the market. This seems to be the consensus even within the Central Banks themselves. However, with the US Congress in deadlock and the EU implementing austerity reforms, the burden of spurring growth has been on the shoulders of Central Banks; however, their ability to move markets is waning. The market's response to President-Elect Trump's promises of infrastructure spending, tax and healthcare reform even without actual specifics shows the readiness for a different approach."* It will be interesting to see the market's reaction to extending the time horizon of President Trump's proposed reforms.

Equity Market – The first quarter of 2017 has appeared to be a continuation of 2016, while equity markets push to new record highs. AMB believes that the stability of credit markets in the beginning of the year helped to steadily propel the markets to new highs in an environment of low volatility. Positive, forward looking outlooks also helped the market soar to new highs; this could also be seen in the soft survey data throughout the first quarter. The month of March however, produced signs of pause as hard data began to weaken and the administration began to comprehend the difficulty of policy reform. President Trump's health care reform was met with dissatisfaction from both parties, and it is now back to the drawing board. This has delayed further policy moves, which could cause weakness in the equity markets going forward.

As we move further into 2017, AMB expects the equity markets to cool off for multiple reasons. To begin, valuations in the equity markets are currently elevated according to nearly every metric available. Additionally, the Trump administration's first major reform effort was rejected by both parties, which will stall further major legislation in Congress for some time. The issue with the failure to reform healthcare is how it affects tax reform. The two do not seem to be mutually exclusive to the Trump administration as savings from health care reform are needed to make up for reduced tax receipts. We are also seeing first quarter GDP track below 1%., while the employment situation in March came in well below expectations. Moreover, our favorite indicator (wage growth) reversed their end of year gains., and geopolitical tensions are at the highest levels in decades as the U.S. continues to dispute with other world powers, such as Russia and China. It is evident that there is more than enough justification for an intermission to this rally. Furthermore, even with the expectations of a pullback, we do not anticipate any corrective type activity to exceed 10% and would view any drawdown as a buying opportunity.

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Equity Market - As written in our two previous letters, AMB continues to believe the higher yielding sectors of the market remain overvalued. In the first quarter of 2017, information technology, health care and consumer cyclical were the major contributors to the S&P 500's performance with returns of 12.6%, 8.5% and 8.4%. AMB continues to position ourselves away from the defensive sectors and into the sectors we feel are undervalued. As prices continue to move higher, it will be increasingly important to focus on bottom-up analysis: investing in companies we deem to be undervalued based on a multitude of factors.

Fixed Income– Coming into 2017, it appeared rates would continue their upward trajectory as they had since the election. This move in interest rates was massive on a percentage scale, and it was being pushed by the promise of growth-simulative policies from the new administration. The Federal Reserve took steps to increase rates over the last year, most recently with a rate hike in March. This continues the divergence in global central bank policy from that of the U.S. Central Bank. AMB maintains that central banks abroad will continue to provide liquidity to markets in the coming years.

During 2017, AMB expects moderate to slow growth in the U.S. with inflation remaining subdued. Wage growth is our main indicator of future growth and domestic inflation, and until the market sees that increase, we expect rates to remain low. AMB's range for the 10-year Treasury Note has not changed, and it remains between 1.8%-2.7%; however, we believe if it breaks above the 2.7% level, then 3.0%-3.5% is possible. As previously said, AMB expects the shorter end of the yield curve to move higher, due to monetary policy changes. The longer end of the yield curve remains subdued because it is driven by actual growth and longer term inflation expectations, not by monetary policy. For these reasons, we will continue to position client portfolios in intermediate and longer dated bond issues.

Even with rates at historic lows we must remember why we invest in fixed income. It is not the growth engine of our portfolios, but instead brings stability and predictability. Operating within a buy and hold strategy, interest rate movements are irrelevant because one is investing in a stream of cash flows, knowing that principal will be repaid upon maturity as long as the bond is credit worthy. Fixed income brings diversification to portfolios along with a reduction in overall volatility and in our view has a place in every portfolio. Pundits that speak to fixed income being riskier than the stock market are making a generalized, simplistic statement that we feel is not accurate.

Conclusion- With the conclusion of a strong first quarter, the remainder of 2017 will be highly influenced by the Fed's further tightening of monetary policy, the progress of the Trump administration's proposed reforms, and the hard data that will result from the Fed and the President's actions. Asset allocation along with a bottom-up selection approach will play increasingly important roles in managing ones portfolio as the market awaits additional rate hikes from the Fed and President Trump's proposed reforms on healthcare, Dodd-Frank, and most importantly, taxes.