US stocks had their best first quarter in four years. US stocks generally outperformed most the other major asset classes during the first quarter, despite a flat total return during the month of March. US stocks continue to be the best performing asset class over the past 10 year period ending March 31, 2017 according to Merrill Lynch. Total return (price change plus reinvested dividends) for the S&P 500 rose +6.1% for the 2017 first quarter and the Dow Jones Industrial Average increased +5.2%. These returns followed the beginning of the "Trump Rally" which produced total returns during the 2016 fourth quarter alone for the S&P 500 of +3.8% and the Dow Jones of +8.7% The equally weighted S&P 500 price Index (excluding dividends) rose +5.2%. The S&P 500 outperformed most other asset classes during the 2017 first quarter with the exception of gold (+8.6%). The other major asset classes had returns as follows: 3 month US Treasury Bills (+0.1%); long term US Treasury Bonds (+1.4%); and Investment Grade Corporate Bonds (+1.4%) for the first quarter. The highest quality stocks (ranked B+ or better by Merrill Lynch[1]) advanced slightly less for the quarter (+4.3% vs. +5.0%) compared to the lower quality stocks (ranked B or worse). We saw a major shift during the March as the higher quality growth companies substantially underperformed the lower quality companies. The A+ rated companies actually declined -0.7%, while the C & D rated companies actually increased +1.3%. This was primarily the result of the higher beta stocks responding to expectations of better global economic growth. The equal-weighted Nifty Fifty (S&P 500 largest companies) recorded a positive return of +4.6% compared to +4.7% for the other 450 stocks in the S&P 500 for the quarter.

The MSCI AC World Equity Index (Ex. US) rose +5.3% in local currency, underperforming US equities. In US dollars, the MSCI AC World Index rose just 8% reflecting the substantial appreciation of the US dollar during 2017 first quarter. The MSCI Emerging Markets Index (local currency) increased +7.8% for the quarter. Many of the emerging economies are highly dependent upon commodities, which experienced some price rebound during the quarter. The US consumer price index (CPI) rose +0.9% for 2017 through February.

The first quarter was marked by optimism regarding legislative changes that would enhance US economic and corporate profit growth. These included: (1) lower corporate and individual income tax rates; (2) a reduced regulatory environment; (3) more US based manufacturing; (4) lower cost for companies and individuals for healthcare costs: and (5) higher governmental spending on infrastructure and defense.

The best performing equity sectors during first quarter 2017 were primarily focused on industries that were positively impacted by improving economic growth, governmental regulations and generally stocks with the highest betas. The best performing sector was Technology (+12.2%). The second best performing sector was Consumer Discretionary (+8.1%). The third best performing sector was the Healthcare (+7.9%). Correspondingly, the two worst performing sectors for the quarter were Energy (-7.3%) and Telecommunications (-5.1%). Energy suffered from lower crude oil prices and telecommunications reflected increased competition.

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[1] Merrill Lynch rates the quality of companies from a high of A+ to a low of C based upon company fundamentals.

While US GDP growth is subpar as compared to prior economic recoveries, the US economy is still showing signs of moderate growth. However, with the 2017 change in administration, the likelihood of (1) lower income taxes for companies and individuals; (2) less regulatory requirements; and (3) higher spending on infrastructure should provide a more positive environment for economic growth over the next few years. As long as employment grows and real wages can experience some improvement, the US economy should advance in 2017, despite the difficulty in other world economies. Dearborn Partners envisions 2017 US GDP growth to be in the area of 2.5%, despite the prospects of a slower growth rate to be announced for the first quarter.

On the positive side, corporate earnings are doing reasonably well even though revenue growth continues to be moderate for most industries. Corporate margins remain near record highs. Productivity improvement and share repurchases by corporations have been an important contributor to the advance in earnings per share growth. Federal Reserve policy is still very accommodative, despite the recent rise in short term interest rates. US employment is rising and the unemployment rate is about 4.7%. Inflation continues to run about 2%. Low energy prices should continue to increase disposable income for most families. Housing prices continue to show signs of improvement in most regions of the country. The housing affordability index is still attractive due to low mortgage rates.

On the negative side, weakness in foreign economies along with the strength in the US dollar should slow export demand and curtail the growth in reported foreign revenues/earnings of US based corporations. The impact of these factors may also limit US employment growth. US employment participation rate (62.6%) remains low. There is a shortage of skilled labor in a number of key industries. The energy industry, which has been an important sector for employment growth, is still experiencing layoffs due to the sharp decline in energy prices. Finally, as a result of the new healthcare law, income tax rates have increased in 2015 for higher income earners placing additional pressure on disposable income. The top federal income tax rate is now 39.6% before the impact of Alternative Minimum Tax.

In general, the higher quality companies that dominate our portfolios continue to generate improving free cash flow with earnings/dividends advancing at a faster pace than inflation. Balance sheets are the best condition that we have seen in years due to higher capital positions, lower cost of carrying debt, as well as reduced overall debt levels. Productivity remains high and profit margins reflect management's focus on cost containment. We continue to closely watch the trend in revenue and earnings growth for 2017.

Please contact me if you have any questions and/or would like to discuss your portfolio or market dynamics in further detail.
