WAITING…WAITING…WAITING…

In contrast to ambitious campaign agendas and the prospect of productive single-party control following the 2016 U.S. elections, political news in 2017 has largely brought delays and uncertainty. Amid the unusually slow appointment of cabinet members, the ongoing investigation of Russian election involvement, intra-party debates over healthcare reform, the Republican Party's failure, as yet, to pass the American Health Care Act, and a lack of substantive progress towards any other legislative measures, the stock market's optimistic expectation for that economically-stimulating tax reform has begun to wane. House Republicans are now working on a revenue-neutral tax plan. This will eliminate the broad tax cuts investors had widely expected, further reducing the likelihood of meaningful fiscal stimulus. Investors thus face not only the usual uncertainty of the markets, but a rising concern about the capability of the U.S. political system to support economic growth.

In addition to their political frustrations, investors are impatiently waiting for economic data to tell a cohesive story about the condition of the economy. "Soft" economic data, including The Conference Board's Consumer Confidence Index and the National Federation of Small Business's Small Business Optimism Index, remain elevated compared to pre-election data, but have weakened since the first quarter. Likewise, "hard" economic data, such as consumer spending, capital spending, construction spending, and retail sales, continue to come in below expectations. The unemployment rate reached a sixteen-year low in June, but wage growth is still sluggish, and capacity utilization is still well below pre-crisis levels.

Given these conditions, divergence in equity performance by sector during the second quarter is not surprising. Without compelling reasons for equity markets overall to advance or retreat, investors have focused on which sectors may secure relative benefits from changing conditions. Any changes achieved within a revenue-neutral tax plan, for example, will necessarily generate winners and losers, which investors race to anticipate.

With this background of policy uncertainty, diverging data, continuing structural economic headwinds, and recently heightened threats from North Korea, we maintain our neutral allocation toward equities and our slightly defensive sector allocation.

STRUCTURAL ECONOMIC HEADWINDS.

Long term sustainable economic growth is constrained by growth in the labor force and increased productivity of workers. With the unemployment rate at pre-recession lows, and demographic trends reflecting very slow growth in the working-age population, we see little potential for the first half of this equation to support continued GDP growth above 2%. Meanwhile, limited investments in labor-enhancing capital equipment over the past decade have led to very slow productivity growth, which has averaged just 0.6% over the past five years. Thus, we believe that even if Republicans were to overcome current divisions to pass a substantial tax reform bill, or to enact a substantial infrastructure spending bill, these would have limited potential to sustainably raise the rate of real GDP growth. We are therefore highly skeptical of investment outlooks dependent on U.S. GDP growth rates over 2.5%.

The Federal Reserve continues to increase interest rates gradually, balancing its response to persistently low inflation rates and a tightening labor market. While market movements indicate a belief by some investors that rates are increasing too quickly in relation to weak inflation, we believe that the Fed is appropriately addressing the distinct risk of an overheating labor market. The Fed has also announced its intention to begin unwinding its extraordinarily large balance sheet, reducing the holdings of both government bonds and mortgage-backed securities which it acquired through Quantitative Easing to support economic growth in the wake of the financial crisis. While the strength of the interest rate effects will depend on the Fed's pace of action, both of these measures have significant potential to tighten financial markets. Meanwhile, European central banks have expressed similar intentions and outlooks. By raising the cost of capital globally, this harmonized tightening of financial markets poses a headwind to long-term international economic growth.

Review of Second Quarter Performance. Equity markets continued to climb higher in the second quarter, as investors adjust to a shifting political landscape while also trying to understand the implications of the Federal Reserve's gradual reduction in monetary stimulus. The Republicans struggled with moving their plan to repeal and replace the Affordable Care Act through the House and Senate, which pushed plans to address tax reform further into the future. While consumer confidence is still at the high levels it reached post-election, it has been gradually fading. Mixed economic data led to the outperformance of defensive themes, as in the first quarter. This performance differential in favor of large-capitalization growth stocks reflects prolonged policy uncertainty, structural economic headwinds, and concerns about potentially softening economic growth.

The large-cap S&P 500 stock index returned 3.1% for the quarter, while the smaller-cap Russell 2000 index returned 2.5%. U.S. sector-by-sector returns reflected cross-cutting currents in the market. Energy stocks lost -6.4%, after a -9.0% decline in the price of oil, while telecom sector stocks dropped -7.1%, reacting to upheaval in the cellular market caused by the entry of cable provider Comcast into the wireless phone market. Healthcare, a defensive sector, rose 7.1%, while Industrial stocks rose by 4.7% for the quarter, as the declining dollar improved prospects for foreign sales. After decreasing by 3.1% in the First Quarter, the U.S. Trade-Weighted dollar decreased an additional -1.6% in the Second Quarter. A weaker dollar contributed to the performance of non-U.S. stocks from the perspective of a U.S. investor, with the MSCI All-Country World Index excluding the U.S. up 6.0% for the quarter.

Bonds returns picked up slightly. The Bloomberg Barclays Intermediate U.S. Government/Credit Bond Index returned +0.9% for the quarter. Investor fear that comprehensive tax reform might eliminate the tax-exemption for interest payments on state and local debt faded, boosting the return on the Barclays Municipal Bond Index to +2.0%, making up some ground lost in the past two quarters. The effect of 0.75% in cumulated Federal Reserve increases in the Federal Funds rate showed in the total returns for both the U.S. Government/Credit Intermediate and the Municipal Bond index, which were negative for the past twelve months, at -0.21% and -0.49%, respectively.

Valuation and Positioning. With the economic headwinds addressed above, we continue to anticipate sluggish economic growth in the near future. Current valuations for U.S. and international stocks look somewhat expensive relative to this outlook, especially after gains in the first half of the year. Currently, the S&P 500 index is at 17.5 times expected earnings for the next twelve months, slightly over the 25 year average of 16.0 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 30.1 times earnings, 2.0 standard deviations above the average since 1881, but just 0.6 standard deviations over the 25 year average of 26.2 times earnings. Compared to the current S&P 500 earnings yield of 5.4%, the yield on the 10 Year Treasury Inflation Protected Security is just 0.5%, indicating that stocks should return about 4.9% more than bonds. Despite this potential for higher returns, we believe that current valuations and economic conditions also present significant risks. As the expectations of investors and consumers adjust to the reality of sluggish economic growth and unrealized policy opportunities, we believe that soft data is likely to decline further, presenting downside risk to equity markets. As a result, we continue to maintain a neutral equity exposure for clients where we have the ability to allocate between stocks and bonds, as well as a risk-neutral positioning in our equity strategies. We anticipate that our portfolio companies, which we select based on their strong balance sheets, financial flexibility, strategic leadership in their products and markets, and strong environmental, social, and governance policies, will have the leadership wisdom to navigate choppy and volatile economic conditions. We also continue our active corporate engagement and policy work to encourage companies to address important structural issues such as climate change, the gender pay gap, and the need to pay a living wage.