On April 1, 2016, the Dow Jones Industrial Average was 17,792. One year later, the Dow passed the 20,000 point threshold to stand at 20,663, a 16% increase. The U.S. and world economies have continued to improve, aided at least in part by the Trump election. The last twelve months have seen strongly positive performance in almost all markets.

**Stock Returns Strong Across Globe**

As of March 31, 2017, all major stock indices ended both the twelve-month and three-month periods with positive performance. The S&P 500 index finished the first quarter of 2017 up 6.1%, just short of the record high it registered in January. The index was up 17.2% for the twelve-month period. In the U.S., “value” outperformed “growth” for the year, but lagged in the first quarter of 2017. Smaller companies outperformed the big ones for the year, but not in the most recent quarter. The Russell 2000 was up 27.6% over the last twelve months, but was up only slightly in Q1.

Economic recovery in the rest of the world is currently where the U.S. recovery was about five years ago. Profits are growing again, investor optimism is slowly on the rise, and valuations appear attractive—especially in light of the ultra-low bond yields prevailing in Europe and Japan. Global developed markets, as measured by MSCI Europe Australia Far East Index (EAFE), were up 7.4% in the first quarter of 2017. The index rose 12.2% over the twelve-month period.

Meanwhile, emerging market (EM) equities had a torrid start to the year. Investors have taken advantage of the relatively low prices associated with EM equities while these markets have begun to recover from weakened currencies and falling commodity prices. The MSCI Emerging Market Index finished the first quarter up 11.5%, contributing mightily to the twelve-month return of 17.6%. India, China, Latin America, and much of Asia all produced strong returns, particularly in Q1.
Bond Returns Low, But Stable

The U.S. bond market has largely stabilized. For most bond sectors, the returns achieved were roughly equal to bond yields (since bond prices experienced little change during the year). The Federal Reserve raised its key rate in March. This action was spurred by steady U.S. economic growth, strong job gains and confidence that the inflation rate is approaching the central bank's inflation target. The 10-year Treasury yield, a key indicator for the bond market, stood at 2.4% at the end of the quarter. The 1-year Treasury yield was at a low of 1.0%. As can be seen in the ‘treasury return’ charts below, short and intermediate-term bond yields are still well below their averages of the past 50-plus years.

Treasury Returns 1962 - 2016

As we enter the second quarter, both consumer and business confidence continue to rise in the U.S. Job creation remains strong and wage growth has been picking up in many sectors. All of these trends seem to bode well for the financial markets over the near term. The fact that these measures have continued to improve despite the turmoil in Washington and elsewhere reflects the strong economic fundamentals of the U.S. economy.

GDP Forecast

The U.S. gross domestic product (the broad measure of the goods and services produced across the economy), expanded at an inflation and seasonally-adjusted annual rate of 1.9% in the fourth quarter of 2016. This was broadly in line with an economy that has, through its ups and downs, settled at a roughly 2% growth pace since the 2009 recession ended (you can note the recent trend line indicated by the lower blue horizontal line on the ‘Real GDP’ chart).

The current economic expansion has continued for more than seven years now, but the pace of this particular recovery has been the weakest in the post-WWII period. The new presidential administration has set a goal of generating 4% annual U.S. economic growth. The administration intends to achieve this goal with promises of major tax reform, reductions in federal regulations, and major infrastructure investments.

These possibilities have helped boost confidence among both consumers and businesses. Consumer confidence data for the month of March indicates that consumers are feeling more optimistic about the current and future economic environment. This may well translate into stronger real consumer spending growth beyond the first quarter.
Employment

Jobs continue to be added at a healthy pace. As a result, the rate of U.S. unemployment continues to fall and worker pay has been rising at a rate greater than the rate of inflation.

Housing

The national average home price has finally surpassed the previous peak achieved in late 2005 ($286,100 versus $275,938). Demand for housing continues to rise while borrowing costs remain relatively low. Mortgage rates, though higher than a few months ago, are still attractive at 4.21% for a 30-year fixed rate mortgage.

Inflation

The U.S. economy reached an important milestone in February when consumer inflation (2.7% in February 2017) exceeded the Federal Reserve’s target of 2% for the first time in five years.

The World Economy

Since the Great Recession, the U.S. economy has grown by 2% per year. While relatively modest by longer-term U.S. standards, such growth would have been a welcome achievement for the euro zone or Japan. Recently, the euro zone’s economic trends have beaten expectations. In an effort to perpetuate these trends, the European Central Bank (ECB) remains committed to maintaining its easy monetary policy. Leading indicators have ticked up even in Japan, where growth has long failed to gain much traction given demographic and regulatory challenges. Despite the economic struggles of the past few years, the emerging markets economies enjoyed positive growth in 2016 and have experienced a tremendous start to 2017. Recent indicators show faster-than-expected improvement in emerging economies ranging from China to India to Brazil.

Euro Area

The euro zone economy expanded by 1.7% in 2016 while its unemployment rate fell to 9.5%. The formal declaration of Britain’s exit from the EU and the upcoming elections in the European Union’s two largest economies (France and Germany) will contribute to continued uncertainty in the developed world in 2017. However, stronger economic numbers demonstrate the euro zone’s resilience in the face of repeated shocks to confidence. The zone’s inflation rate of 1.5% is still running below the European Central Bank’s target. This will allow the ECB to keep the economic stimulus in place (the ECB has been attempting to stimulate the euro zone economy with negative interest rates and a bond-buying program).

Japan

Japan’s gross domestic product expanded by 1.2% in 2016. This long-hoped-for growth has been modest and mostly driven by exports. Domestic Japanese consumption remains soft. The Japanese economy remains one of the weakest in the Asian region. An aging population, a stronger yen, along with stubbornly low inflation (currently at 0.1%) and wage growth, leave the overall outlook in Japan somewhat downbeat.

China

China is the world’s second-largest economy. Its growth rate has been slowing. Last year, China’s economy expanded at an annual rate of 6.7%. This is in line with the government’s full-year GDP growth target of around 6.5%. And while many indicators of economic activity look increasingly healthy, the challenge will be to manage the high levels of debt in an environment of higher interest rates. China’s debt-to-GDP ratio rose to a worrisome 277% at the end of 2016. In many cases, an increasing share of new credit is being used to service existing debt. There are also concerns about the future of the U.S.-China trade relationship as the new Trump administration has threatened to reevaluate the existing relationship between the world’s two largest economies.

Elsewhere

An improving economic picture in the developed markets, coupled with improving commodity prices have helped emerging market economies—many of which have struggled in recent years. Recent indicators show faster-than-expected improvement in emerging economies ranging from Latin America to Asia.

Investments

U.S. Equities

The S&P 500 Index hit an all-time high in July 2016 and has regularly been making new highs ever since. All three major U.S. market indices established new all-time records during the first quarter of 2017. The S&P 500 Index rose 6.1% for the quarter and was up 17.2% year-over-year. Other than energy, all major sectors of the economy posted positive quarterly returns. The technology sector was the strongest, gaining 12.6% for the quarter. Including dividends, the S&P 500 index has now risen more than 314% from its March 2009 lows, and at year-end was 85.5% above its prior peak achieved in October 2007.
From a market valuation perspective, using the forward P/E (current stock price divided by estimated future earning over the next twelve months), the S&P 500 is now priced at 17.5 times forecasted earnings, slightly above the index’s twenty-year average of 16.0. All else being equal, a higher-than-average forward P/E ratio suggests that market prices are a bit on the high side and thus have less room to rise. Historically, the higher the P/E ratio, on average, the lower are subsequent market returns. The current dividend yield for the S&P 500 stands at 2.1%.

**International Equities**

Helped by a weakening dollar, international markets fared even better than U.S. markets during the first quarter. For example, the MSCI EAFE index, the most widely-used international index, was up 4.9% for the quarter in local currency, while U.S. investors enjoyed gains of 7.4%. Japan was unchanged for local investors but posted a 4.6% gain in dollar terms. European markets posted gains of 8.6% in U.S. currency. In dollar terms, the MSCI EAFE index rose 12.2% for U.S. investors over the last twelve months vs. 17.2% for the S&P 500.

The MSCI Emerging Markets Index also showed a strong performance in Q1, gaining 11.5% during the first quarter and 17.6% for the year. Emerging markets finally showed signs of revival after several quarters of lackluster growth. Of the BRIC countries (Brazil, Russia, India, and China), only Russia was negative for the quarter, while Brazil, India, and China posted strong double-digit dollar denominated returns.

**Bonds**

Given its ample advance warning, the Federal Reserve’s announcement to raise interest rates by another 0.25% in March was something of a non-event. There was no significant reaction in the fixed income markets as the investors had already priced in future Fed interest rate hikes. The Barclays Capital U.S. Bond market index posted gains of 8.6% in the first quarter, while the same index that tracks bonds in local currencies rose 12.2% for the year. The yield on ten-year Treasuries stayed pretty much unchanged at 2.4%, producing a return of 0.79% for the quarter.

Treasury Inflation-Protected Securities (TIPS) reflect investor expectations about future inflation trends. Given the stable inflationary environment in the U.S., TIPS were up 1.26% for the quarter and are up 1.48% year-over-year. The yield on ten-year Treasuries stayed pretty much unchanged at 2.4%, producing a return of 0.79% for the quarter.

The real action in fixed-income markets took place overseas. Concerns about the upcoming election in

**Market Returns**

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>YTD</th>
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</thead>
<tbody>
<tr>
<td>Int’l Sm</td>
<td>9.94</td>
<td>BDCs</td>
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<td>MLP</td>
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<tr>
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<td>Small US</td>
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<td>Timber</td>
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<tr>
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<td>Gbl Bds</td>
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<tr>
<td>REITs</td>
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</tr>
<tr>
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<tr>
<td>EM Bonds</td>
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<td>EM</td>
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</tr>
<tr>
<td>Mrgr Arb</td>
<td>(0.8)</td>
<td>Global Bonds</td>
<td>(0.17)</td>
</tr>
</tbody>
</table>

France have driven up French bond yields to their highest levels, compared to their German counterparts. But more generally, the relatively low yields of European and Japanese debt continues to make international developed market bonds one of the less attractive investment categories for bond investors.

In contrast, emerging market bonds have rallied impressively since the beginning of the year. Returns on local debt have been greatly bolstered by both the 3%–10% appreciation in EM currencies relative to the U.S. dollar and by an improving global economic outlook. The JP Morgan Emerging Markets Bond Index (which tracks bonds issued in dollars) was up 3.9% during the first quarter, while the same index that tracks bonds in local currencies rose 6.5%.

**Real Estate and Alternatives**

Most alternative holdings produced solid returns in the first quarter:

- Global real estate, represented by the NAREIT Real Global Index, was up 3.4% over the quarter but grew only 2.9% year-over-year.
• The Alerian Master Limited Partnership Infrastructure Index, which tracks energy transportation and storage facilities gained 4.1% for the quarter, but enjoyed a spectacular 31.2% for the twelve-month period.

• MultiAlternative, as measured by the Credit Suisse Hedge Fund Index, was up 2% for the quarter, and had a 1.3% gain for 2016.

• Managed futures, as measured by SG Trend Index, which represents this category, posted 0.9% loss for the quarter and is down 9.8% year-over-year.

**Conclusion**

The last twelve months have produced strongly positive investment returns, globally. Following the difficult markets we experienced in mid-2014 and continuing into early 2016, the strength of this market “rebound” has been heartening.

Earnings for companies that make up the S&P 500 Index have recovered significantly from their 2014-15 swoon and are expected to continue growing. This, more than the election, explains the rise in the markets over the twelve-month period ending in March 2017. With rising employment, consumers have some money to spend and they are feeling more optimistic about their future than they have in a while. Companies have plenty of cash and earnings are growing. Overseas, on a host of economic measures, conditions have improved and are better than they have been in a number of years. It makes for a good picture.

Still, there are certainly risks on the horizon. What impact will a Trump presidency have? How will Brexit play out? What will happen in the upcoming French and German elections? Will conditions in the Middle East improve or deteriorate? Can Japan’s economy finally emerge from its nearly twenty-five year malaise? How will U.S. policy respond to developments with China, Russia and other global players? None of us know the answers. We do believe a well-diversified portfolio is the best protection from any of this.

The market has enjoyed an almost unbroken upward trend since coming out of the Great Recession beginning in March 2009. This run won’t continue forever. History suggests that it takes several years to recover and stabilize from serious economic problems like those we faced from 2007 to 2009. The U.S. has reached a healthy point and most of the world seems prepared to move forward. If markets take a turn for the worse in this environment, we believe it will be a temporary setback—more likely because investors became tired and lost interest than because a new disaster arose (with Trump being a distinct wildcard here).

While markets today are a bit high by historical standards, we don’t think that is a reason to fear them. Assuming the world economies grow, it is highly likely that markets will be higher in the future. Traditionally, markets tend to reflect investor expectations about the future of the economy, and economic growth has been reflected in rising market indices. We strongly believe this relationship will continue to hold true going forward.

Thank you for allowing us to be of service to you. Please get in touch with feedback or questions.