PERSPECTIVES AND POSITIONS

By James F. Dykstal, CFA, Portfolio Manager *May 2017*

This is a summary of our views on the economy and markets as shared with discretionary clients.

ECONOMIC OUTLOOK

- We see growth modestly improving in 2017 as the prospects of fiscal stimulus, such as tax cuts and infrastructure spending, gain momentum.
- The Federal Reserve will continue interest rate hikes into 2017; we expect two more rate hikes totaling 50 basis points, to end the year at 1.50%.
- Headline inflation will begin to trend above 2% for 2017, due to the improvement in commodity prices and wage growth. A growing economy will continue to put upward pressure on prices.
- Wage growth will increase slightly with a tighter labor market. Job creation will be stable with the unemployment rate remaining below 5%. Labor force participation will increase slightly.
- The U.S. dollar will remain relatively strong, but stable, versus other currencies. The recent surge in strength resulting from the Fed rate hike and the U.S. election will consolidate into a new stable trading range for 2017.

STRATEGIC MARKET OUTLOOK AND TACTICAL ALLOCATIONS

Fixed Income: The Federal Reserve will remain vigilant. The outlook is for increasing rates in 2017, due to improved economic activity and inflation pressures.

- High yield struggled somewhat in the first quarter of 2017, due to slightly widening credit spreads. During 2016, high yield bonds exhibited great performance as credit spreads tightened dramatically following the energy scare of February 2016. However, high coupon yields in this sector provide attractive income in a low rate environment. We view high yield to be fully valued and will use it as source of funds to bolster other positions.
- We continue to overweight credit versus Treasuries, with duration tilted shorter than benchmarks.
- Emerging market debt denominated in U.S. dollars provides diversification and yield potential. Stability in global growth will further entice yield investors to add to these positions.
- Commercial real estate continues to provide positive returns. Queues can delay additions to positions, and an increase in interest rates could dampen valuation improvements. Value added or opportunistic strategies can be a complement to a core real estate exposure.

CONT. STRATEGIC MARKET OUTLOOK AND TACTICAL ALLOCATIONS

Equities: The domestic large cap stock market appears to be fully valued and has priced in an earnings rebound. The negative impacts on earnings of a strong dollar and energy price rebound will fade in 2017. The year-over-year comparisons will become easier.

- Small cap stocks are over weighted versus targets in portfolios. Small cap stocks, while more inherently volatile, will benefit from fiscal stimulus. Also, small cap stocks are relatively undervalued to large cap stocks.
- International stocks are equally weighted versus targets. The quantitative easing programs in Europe and Japan should provide tailwinds to stocks. The relative dollar weakening in the quarter added to returns on foreign stocks.
- Emerging markets stocks are over weighted versus targets as they are comparatively attractive, due to their low relative P/E multiples. Asian stocks are preferred, as consumer demographic trends favor that part of the globe.
- The dollar weakened slightly in the first quarter, retracing from strong performance in the fourth quarter of 2016. The dollar will remain range-bound, given the expectation of positive global economic data. The currency headwind of the stronger dollar on future expected returns should be modest.