Making Sense of Finance

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First Quarter 2017 Review

STOCK MARKET

The post-election market rally continued into the first quarter of 2017 as all major U.S. stock indices rose, particularly in the first two months. The S & P 500 increased 5.5%, the Dow Jones Industrial average gained 4.6% and the Nasdaq Composite saw the largest increase, 9.8%. The Dow rose above the 20,000 mark without too much fanfare, closing out the quarter at 20,663 after having surpassed the 21,000 mark at one point in the quarter. All this took place in an atmosphere of very little volatility. The widely tracked CBOE Volatility index actually declined 11.9% last quarter. While the stock market continues to rise, concerns about valuations also persist. However, the S & P 500 dividend yield still holds at around 2%. Of all U.S. traded equities, 881 issuers increased their dividend in the first quarter, with an average increase of 10%. This is good news to shareholders as income from most fixed income securities languish. If there is an opportunity for multi-national companies to repatriate their foreign held cash back to the United States at a lower tax rate, which last happened in 2004, then we still may see even more substantial increases in both dividends and stock buybacks, which was the case last time.

Financial stocks lost some momentum in the first quarter after their significant gains last year. The technology sector was one of the best performing last quarter, as reflected in the Nasdaq Composite's almost double-digit percentage gain. In particular, hardware, software and internet related stocks did well. Consumer discretionary stocks such as home builders and home improvement retailers also did better than the market averages, as the Consumer Confidence Index, measured by the Conference Board by Nielsen, reached its highest level since December 2000. Oil and gas, coal and retail REITs (real estate investment trusts) stocks were among the laggards in the first quarter. The latter was a reaction to the numerous retail store closing announcements (about 2,800) made so far this year.

Most foreign stock markets did as well or better than domestic stock indexes in the first quarter. The MSCI EAFE index which measures developed markets in U.S. dollar terms rose 6.5% last quarter. Some of the better performing indexes were in Spain, Austria and Germany. The Japanese Nikkei Stock index was one of the few international markets posting a loss in the first three months of 2017. However, stocks in the riskier emerging markets had even better results

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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last quarter than developed markets. The MSCI Emerging Market Index increased 11.1% in the first quarter. India, Argentina, Singapore, Chile, and Turkey were among the areas where the local stock markets had gains of greater than 10%. In particular those countries that are dependent on base metals mining fared well as those commodities continued to increase in price as they did in 2016, based on renewed interest in U.S. infrastructure spending.

BOND MARKET

The first quarter of 2017 saw a reversal in bond prices from the previous quarter. Across all sectors bond prices increased (yields declined). In polar opposite fashion to the previous quarter, the longer the maturity of the bond the better it performed this quarter. Preferred securities, whose maturities are very long term or infinite, were the best performing fixed income category on a total return basis. Below investment grade bonds were the next best performers, as not only interest rates declined but the spread (premium) of what below investment grade bonds pay versus higher quality bonds became smaller. The Barclays Aggregate Bond Index, a measure of a blend of investment grade domestic bonds, had a total return of 0.8% in the first quarter.

Municipal bonds, after posting one of their worst quarters in a long time at the end of 2016, performed better than most bond sectors in the first three months of this year. Perhaps investors are now starting to doubt the reality of lower tax rates, therefore making tax-free bonds more attractive again. After more than $26 billion was withdrawn from municipal bond funds in the fourth quarter of 2016, the first quarter of 2017 saw an inflow of over $5 billion which contributed to the increase in prices.

The Federal Reserve raised the Fed Fund target rate another 0.25%, which was not a surprise. In fact, the Fed has indicated to the markets that it plans on three rate hikes this year, however there is no certainty of that happening. This increase in short term rates, while long term rates have decreased, has led to a flattening of the yield curve. Since the end of 2016, the yield on a three month Treasury bill has increased from 0.51% to 0.94%, while the yield on a ten year Treasury has actually fallen from 2.45% to 2.34%. Yields on money market funds should eventually reflect this increase in short rates, while mortgage rates should remain somewhat constrained. This flattening of the yield curve is something that banks usually do not like, since their net interest income depends on the difference between short and long rates.

MARKET OUTLOOK

If you have been reading this newsletter for the past six years, you will see that we always seem optimistic and the past six years has proven us correct. The markets have continued to have mini corrections but mostly been on an upward trajectory. There is no hard rule that says the stock market must have a negative return every three years or that the business cycle can't last more than five years. Our argument for the past few years has been that the anemic growth, though constant, could be maintained for more than an average business cycle. Interestingly, investors are sitting on the side lines when in fact the economy seems to have some positive momentum behind it. Valuations of stocks seem reasonable, as well. If you recall the past two years, any mention of rate hikes caused the markets to get skittish; now investors are recognizing this as a non- event or possibly even a positive. Our bottoms-up method focuses on company fundamentals not whether Putin or Kim Jong-un makes saber-rattling remarks. We think our method is more in tune with reality rather than speculation from the press that was created to sell newspapers and advertising and are often unfounded.

Our view on fixed income remains the same. A gradual and predictable rate hike could be good for investors, particularly for retirees who count on a decent return with lower volatility. Real estate will probably continue to have headwinds but still do better than bonds, in our opinion. Its most valuable characteristic is that it is understandable to the lay person and is a good inflation hedge. As mentioned earlier in this newsletter, commodities will likely strengthen with more upside in industrial production around the world. Even with good appreciation potential, we still favor equities, real estate, and even bonds, simply because these are assets that can pay the investor while you wait for a turnaround. Overall, we would get nervous about the market if everything seemed perfect. That is something we know could not last for long.