January 2017

Market Index	January Return
Standard & Poor's 500	1.9%
Dow Jones Industrial Average	0.6%
NASDAQ	4.3%
Russell 2000 (small company)	0.4%
MSCI EAFE (international)	2.9%
Barclays Aggregate Bond Index	0.2%

Monthly Update

2017 got off to a positive start as the post-election rally carried over into the New Year. Worldwide, attention was focused on Washington as the new government leadership took office. The financial markets took the transition in stride, even as the Trump administration quickly moved on several controversial campaign promises. U.S. stocks advanced, particularly in the technology, materials, and consumer discretionary sectors. Sector and industry behavior continues to reflect investor expectations about the impact of potential Trump policies. It will take time for the actual impact of policy changes to be clearly understood, and there are still many more questions than answers. Investing during these politically-heated seasons requires a focus on the key drivers of the economy and the markets. Government and central bank policy certainly affect both, but sifting the noise from the substance is an important and helpful exercise.

As the nation transitions to a new administration, the economy continues to expand, albeit slowly. The recovery began in June 2009, and since then GDP has grown by 2.1% per year. This growth rate is roughly half the normal rate during the expansion phase of the economic cycle. This slow pace of growth has allowed the economy to expand for longer. The 91-month expansion is one of the longest since 1950. At the same time, U.S. stocks have gained much ground. Through January, the S&P 500 Index has gained 20.9% on an annualized basis since the market bottom of March 2009. Will the economy continue to grow? Will stocks extend higher? Over the long term the answers to these questions will depend only in part on what happens in Washington, but political developments will be a key driver of markets in the short term.

The post-election rally in stocks was partly driven by optimism about fiscal policy driving an accelerated economy. But not all policy proposals would necessarily boost growth. There are three proposals under consideration that are typically viewed as pro-growth: tax cuts, regulatory reform, and infrastructure spending. Two other policy proposals are also under consideration which could be a damper on growth: trade limitations and immigration reform. Geopolitical turmoil is a separate concern that could indirectly impact the economy in a negative way. Limitations to fiscal policy and the uncertain timing of implementation could mean that the actual impact is muted relative to expectations. In addition, some in Congress may be hesitant to aggressively pursue reforms that would expand budget deficits and add to already-high government debt levels.

Meanwhile, global economic growth is finally showing signs of life. For several years many of the world's larger economies have lagged the U.S. rate of growth (with the notable exception of China). This has been most apparent in Europe and Japan, where demographic issues and political turmoil have kept a lid on growth. This has been the case despite extreme

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levels of central bank assistance. After years of little to no growth, the recent pickup in activity has been encouraging. A strengthening economy abroad could help offset any letdown if policy changes in the U.S. fail to spur faster growth. The recent pickup in growth has enhanced the appeal of international stocks, which are attractive given their diversification benefits, attractive valuations, and improving fundamentals.

Above-average valuations of U.S. stocks likely reduce their return potential over the intermediate to long term. Stronger growth of both earnings and dividends will likely be necessary for the market to go higher from the current record-high levels. Company earnings estimates that have baked in generous assumptions about policy changes, particularly lower corporate taxes, may need to come down if Trump's proposals aren't fully adopted.

The Federal Reserve has been somewhat lost in the recent political shuffle. But the Fed could make a mark on the economy as 2017 progresses as it considers additional rate hikes. After its most-recent meeting it indicated that it might raise rates two or three times in 2017. Inflation has been low during most of the economic expansion but has picked up recently in the U.S. and around the world. Any acceleration in the economy or inflation is likely to be met with tighter Fed policy.

Tighter Fed policy leading to higher interest rates does not necessarily spell trouble for the economy or bond prices. In the short-run, bond prices fall as interest rates rise, but this does not mean that bonds will provide negative total returns, especially over longer time horizons. A slow and steady rise in interest rates is actually beneficial, particularly for those invested in high-quality, well-diversified bond portfolios. For example, intermediate-term treasury bonds gained 4.1% on an annualized basis during the long rising-rate cycle from 1950-1981. Even during rising-rate cycles, negative-return years are rare. Consider that the worst overall year for bonds was 1994, a year in which the Barclays Aggregate Bond Index returned -2.92%.

Cincinnati
3777 West Fork Road | Cincinnati, OH 45247
P. 513.661.3100 | T. 800.541.0170 | F. 513.661.3160

Columbus
100 E. Broad Street, Suite 2300 | Columbus, OH 43215
P. 614.365.9103 | T. 866.365.4523 | F. 614.365.9943

Dayton
40 North Main Street, Suite 2110 | Dayton, OH 45423
P. 937.461.3790 | T. 800.851.9114 | F. 937.461.2969