CONGRESS ASSET MANAGEMENT COMPANY

Economic and Market Outlook

Second Quarter 2017

For almost six months investors, not to mention the general public and politicians, have been trying to discern what President Trump's election means for the markets and both US domestic and foreign policies. Rarely have we seen such an ambitious agenda without a clear path forward. The transition to the new administration has not been smooth. Transitions though are temporary and as the days pass, investors and others will adjust.

While our economy is driven by a combination of consumer, corporate, and government activities, our financial markets are more fickle and susceptible to headlines and emotions. With that in mind, the stock market continued its post Trump Election Day rally into 2017. The S&P 500 Index proved remarkably resilient throughout the quarter gaining more than 6%. At one point, the market experienced over 100 consecutive days without moving more than 1%, a feat last witnessed in the mid 1980's.

Bonds, normally more staid than stocks, have demonstrated more volatility since the election. Ten year bond yields rose from 1.8% to 2.6%, only to later fall to 2.4% after the failed health care reform vote. Some observers believe that the ten year bond yield changes telegraph President Trump's approval ratings.

All new administrations come with their own agendas. The Trump administration has proffered ambitious plans for fiscal stimulus, trade policy, tax reform, and healthcare. To the extent that the stock market rally represents only a Trump policy premium, the stock market could be ahead of itself. Fortunately, there is more that drives the market than just the expected passage of complex policy legislation.

Our economy is stronger than the winds that blow through Washington. The steady, albeit unspectacular growth since the nadir of the 2008 financial crisis continues apace. Strengthening growth prospects will determine the intermediate and longer term performance of both the stock and bond markets.

We are optimistic that the economy's momentum is picking up. Vagaries of monthly economic data fog a clear view, yet key underpinnings are strengthening. Job growth reaccelerated in February with over 235,000 jobs created. Importantly, participation in the key 25-54 year age group is close to 82% and is in a multi-year uptrend. College graduates are also finding jobs. Years of consistent job growth have lowered the unemployment rate below 5% while wages have steadily risen since 2014.

There are hints now that capital spending and manufacturing may finally be strengthening. The US oil and gas rig count has doubled over the past year. This has the dual effect of supporting capital spending while dampening oil prices even as demand for energy ticks higher. In addition, industrial production and durable good shipments are also improving. Could the long awaited awakening of our industrial base finally be taking root?

Housing remains a stalwart. In spite of higher mortgage rates since November, housing affordability remains at constructive levels. Household debt service as a percent of disposable income is down 25% from its peak just before the financial crisis. Years of underinvesting in new housing construction has contributed to pent up demand. While notoriously volatile, house prices were up 7% in February. That is unlikely to turn around abruptly.

The Federal Reserve seems to have recognized the budding momentum with two interest rate increases in the past few months. Inflation is closing in on the Fed's target inflation rate of 2%. Yet market interest rates have not risen as some anticipated. Europe and Japan are still mired in low to negative rate policies, creating demand for US fixed income in spite of increases in short term rates.

Federal Reserve monetary policy requires further mention. The Fed has now raised short term rates three times in slightly over a year. In all likelihood, this is the start of a longer "normalization" process in which the Fed begins to shrink its own balance sheet by not reinvesting its maturing bonds. The end of so called quantitative easing will be gradual and likely well telegraphed. The Fed's aggressiveness throughout the financial crisis provided liquidity for the bond market, and in that vein can probably be viewed as a success. It also likely contributed to distorted valuations for both bonds and stocks earlier in the expansion. We view the Fed pull back, when it happens, as distinctly positive for both stocks and bonds.

There is always noise surrounding the markets. In the past few years investors have experienced numerous events that would not have been on their radar a decade prior: a government sequester, quantitative easing, and the Affordable Care Act to name a few. Companies adapted to these challenges. And while not all have flourished, the resiliency of our system has shown through. Cash flows and balance sheets remain strong. The stock market has persevered with remarkably low volatility while interest rates remain conducive for investment.

The noise surrounding the markets now is more political than economic. President Trump's sweeping agenda, which includes taxes, trade, fiscal policy, and regulatory easing, is far more ambitious than most new administrations. Investors have factored in some level of pro-growth legislation. Policy overhauls however are complex and usually result in some unanticipated consequences. In addition, consumers and businesses need clarity in order to evaluate capital and spending decisions. So far, investors have been patient reflecting expectations of some success in establishing pro-growth policies.

We are confident that the economy's foundation is strong enough to withstand the uncertainty derived from political changes. Over the intermediate and longer term, stocks will respond to earnings growth in conjunction with interest rates and inflation levels. We expect the momentum experienced over the last eight years will accelerate as this year progresses and that under-utilized capacity will keep inflation in check. Stocks remain the preferred asset class although ten year Treasury bond yields in the 2.5% range are also attractive.

Investment Policy Committee
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