American Heritage Financial

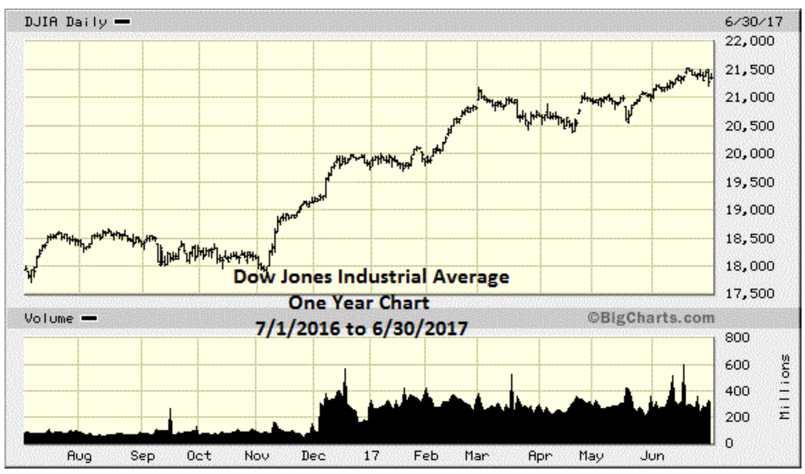
July Update **July 7, 2017**

The First Half of 2017

... Can we have an encore?

The first half of 2017 is in the books and it wouldn't have been a bad ***year!*** In the first six months of 2017, the Dow rose 8.0% while the S&P 500 gained 8.2%; very respectable numbers for a full year!

The year began with even more anxiety than normal. Our country was about to inaugurate its 45th President and concepts of moderate, tolerant or compromising politics were about to take a body blow. While many fervently believed the new President would mark the beginning of the most chaotic and embarrassing political era ever, just as many believed the country had finally taken a first step to reign in overzealous elite. That political play is still in its early scenes and many acts will follow before the plot is resolved. We'll leave the political debate to others but on the economic and market stage, the audience was enthusiastically applauding as the New Year rang in and, while enthusiasm has waned, they remain engaged in the resilient, rewarding and still promising markets and economic conditions.



Yes, despite lots of media whining, **it is hard to find fault with recent financial or economic data**. It would be great if we could "annualize" the first six months of 2017. But in fact, if we look back over the past *twelve months*, from June 30, 2016, we see numbers which, roughly, annualize the first half returns: the Dow is ahead by 18.9% and the S&P is up 15.2% over the last twelve months. The entire market felt the love in the first half of '17 as almost every broad U.S. stock index finished with solid gains, most in the upper single digits. Of course there were weak spots but the only stand-out negative was energy shares, which fell 12.4% in the first half; a decline shrugged off as digestion of huge energy gains in 2016. On the other extreme, a handful of big, dominate growth stocks were over-achievers: The Dow Internet Index advanced 18.9% and the largest 100 NASDAQ stocks gained 16.1%. A small number of hugely successful companies drove those outsized gains and the entire market felt the effect of the innovative companies.

There has also been a refreshing new addition to positive market returns: **foreign markets**. Overall, foreign markets and economies had been in a long funk since the 2008 financial crisis and the 2010 European sovereign debt crisis. It finally appears that the long process of stimulus, restructuring and asset rebalancing is producing a more favorable economic climate for much of the non-U.S. world. As those economies are gaining traction, their respective stock markets are also beginning to perform. The best benchmark representing developed European and Asian markets is something called *iShare MSCI EAFE Index* and that fund is up 11.8% for the first six months of 2017. A measure of stock returns in less developed countries, the *iShare MSCI Emerging Market Index*, is up 17.2% year-to-date. More, most foreign markets trade at much lower valuations and thus, potentially, offer better returns for less risk.

Of course the solid **market returns are ultimately dependent on profits and the overall economy**. Here, signals are mostly favorable but, as typical, include a few important caveats. Corporate profits are the most encouraging facet of 2017 economic data. After a five quarter slide, profit growth turned positive again in late 2016 and the first quarter of 2017 celebrated with a 13.6% increase over the prior year, the fastest growth in nearly six years, according to *FactSet*. Analysts estimate companies in the S&P 500 index will post earnings growth of 6.8% for the second quarter and 11% for the full year, based on a *FastSet* poll.

Profit growth depends on continued economic health. Here, the mostly positive data is peppered with reasons for concern. The overall U.S. economy continues to look healthy and is beginning to get an added boost from the above-mentioned pick-up in European and Asian economies. Employment is red hot with the unemployment rate at 4.3% and consistently solid monthly job growth. Importantly, indicators for consumer sentiment and business optimism are extremely positive—indicating people expect the good times to continue. The concerns relate to the strange fact that the positive employment and general optimism are not translating to a meaningful pick-up in consumer buying or business activity. Recent data on light vehicle sales, housing starts, net exports, retail sales and inventory growth have been coming in below expectations and/or prior readings; all indicating weakness on the demand side of the economy. Many analysts believe the mystery will ultimately be resolved with a pick-up in purchasing and manufacturing but it is impossible to explain why it has not happened already. The lack of demand is having the effect of lowering growth expectations for the rest of the year.

In addition, there is policy risk. The most immediate is the Federal Reserve and reversal of its long and aggressive stimulus programs. The Fed has now raised interest rates three times since mid-December 2016 and has announced plans to begin reducing the trillions of bonds purchased as part of stimulus programs in response to the financial crisis. It is critical that the Fed move back to "more normal" (or less simulative) fiscal policy but there is huge risk of negative consequences. Considering the out-sized benefit that financial assets reaped from Fed stimulus since the financial crisis, those same assets are at significant risk should the Fed tighten too fast. Randall Forsyth of *Barron's* points out that of eleven periods that qualified as financial crises since 1970, each came after the Fed had engineered an increase in interest rates. Add to those scary thoughts the fact that many other central banks around the world are also tightening monetary policy in response to the improving global economy and it is easy to worry that monetary policy may take back all that it gave.

The second source of policy risk is the circus in Washington. As mentioned above, the markets, business and even consumers turned enthusiastically optimistic in response to the pro-business promises of the new administration. The difficulty of actually implementing that agenda is now beginning to look like a reality TV show gone bad. If the quagmire becomes permanent, the economy will suffer from reversal of the optimistic expectations. On the other hand, if even portions of the pro-business agenda become reality, it could help propel our strong economy to much higher levels.

So while we can bask in the gains of the first half, the remainder of the year offers a perplexing mix of opportunity as well as risk. We hope you will bask in the sun of summer and enjoy the rest of the year. We will be working to determine the best ways to meet the challenges ahead. Please don't hesitate to contact your advisor if you would like to discuss these or other issues further.

Best regards,

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Questions or comments?
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