MARCH MADNESS

Spring 2017

The annual NCAA college basketball tournament has thrilled sports fans for years with dramatic last second victories, unexpected upsets, the emergence of unknown players as stars and the folly of expert predictions. While both the Men's and Women's basketball tournaments this year have provided many of these moments, the madness of March exhibited in Washington may have trumped (so to speak) them all.

March saw the defeat, by Republicans, of the Republican attempt to repeal and replace the Affordable Care Act. This failure casts doubt on the success of meaningful tax reform and the infrastructure investment efforts. In addition, the ongoing investigation into Russian interference in the Presidential election and any Russian connection to members of President Trump's team remains on center stage with secret briefings and the usual Congressional posturing. The Senate is contemplating the "nuclear" option to confirm a new justice to the Supreme Court and tweets and leaks continue to flow from the White House. Any olive branch the President may have extended to both his Republican and Democratic foes seems to be wielded more as a punishing switch than an offer of peace. If this is the new, more businesslike Washington, it is no wonder that investors are a little concerned.

As is often the case, however, amidst the turmoil in Washington, and in spite of the concerns of investors, the stock market managed to finish the first quarter up 5.5% as measured by the S&P 500. The advance in the first quarter of 2017 was better than the average gain of 2.7% in first quarters since 1980 according to Argus Research. In the mad month of March, the S&P 500 was down fractionally after reaching a record high on March 1st. The Dow Jones Industrial Average (DJIA) rose 4.6% for the quarter and the NASDAQ advanced 9.8% boosted by the heavy weighting in Technology stocks. Energy stocks were down for the quarter as crude oil declined by 9.3% and the stocks considered winners in the "Trump" trade, Financials and Industrials, underperformed the Index after retreating from post-election highs. Foreign markets performed well as measured by the MSCI Emerging and Developed Market Indices, rising 11.1% and 7.4 % respectively.

The uncertainty over the potential success of President Trump's initiatives such as corporate tax reform and infrastructure spending and the failure of health care reform looms over the stock market but it is important to understand the positive economic factors underpinning the market as well. Admittedly, factors such as business and consumer confidence, while strong, do depend somewhat on the successful passage of tax, spending and regulatory reform. However even if these efforts are unsuccessful, global growth seems to be getting better and many domestic economic measures remain positive.

Valuations in the stock market seem reasonable. If the S&P 500 earnings per share reach $135 or so in 2017 (consensus estimate according to FactSet), at current levels the forward Price/Earnings (P/E) ratio on the S&P 500 is about 17.5X. With the 10-year Treasury Note at 2.39% and inflation hovering around 2.0% a P/E of 17.5 is not unreasonable.

The yield on the 10-year U.S. Treasury Note will most likely increase as the Federal Reserve is expected to raise interest rates at least two or three more times this year after the recent increase in March. However, with foreign yields remaining very low, the 10 year German Bund yields 0.30%, U.S. Treasury Notes seem quite generous so any increase in bond yields should be gradual. A moderate rise in bond yields could certainly co-exist with increasing stock prices.

Dividend growth is an important component of stock returns and a kind of hedge against rising interest rates and inflation for investors. Dividends on the S&P 500 grew last year by 5.33%. According to Argus Research this was slightly below the average annual growth rate since 1973 of 6.1%. Dividend cuts by energy and commodity materials companies held back the growth of total dividends for the S&P 500 Index. This positive dividend growth in spite of the problems for industries led us to look at the growth of dividends through the years for the S&P 500, during both good and bad times. For example, the years since 2000 have certainly had their share of dramatic events with market crashes, terrorist attacks, wars and the near collapse of the financial system. How would an investor, as measured by dividends, have fared during this period of upheaval and crisis?

An investor with poor timing or luck, theoretically investing in the entire S&P 500 on January 1, 2000, would have seen their hypothetical $100 of S&P 500 dividends shrink to $94.30 by the end of 2001. These years included the market crash as technology stocks collapsed, the events of September 11th and dividend cuts by old standbys such as AT&T and IBM among many others. However, by December 31, 2003 the $94.30 would have increased to $104.16 and would climb to $171.09 before the Great Recession of 2008-2009. As the financial stocks collapsed, dividends on the S&P 500 declined by over 21% in 2009, which brought the hypothetical total down to $134.25. Out of this period of despair dividends resumed their growth and after the modest increase in 2016, the $100 starting figure has grown to $273.85. It is important to note that in the years when dividends declined for the S&P 500 as a whole, the dividend cuts and omissions were often concentrated in one industry or sector. Many companies in the S&P 500 were able to continue increasing their dividends during these periods. While somewhat simplistic and theoretical, this review illustrates not only the resilience of stocks and companies but the importance of maintaining a sound strategy through the most tumultuous times.

We expect volatility and uncertainty in the markets, be they caused by Washington or some other external factor, and we believe it is important to try to see past the current crises and stay focused on long term goals. March Madness in college basketball comes but once a year while the tumult and drama in Washington and throughout the world seem to be with us year round.

We appreciate your support of Knox & Downing Advisors and we encourage you to contact us with any questions about any investment matter.

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