July 2017

The Rally Continues

by George C. McFarland, Jr.

Q2 Recap

The strong stock market rally in January and February resumed during the second quarter, with the S&P 500 advancing by 3.1% on a total return basis. As in the first quarter, large capitalization stocks outperformed mid-and small-cap stocks, while growth stocks outperformed value stocks. On a sector basis, health care turned in the best performance (up over 7%) while energy and telecommunications had the worst performance (down 6.4% and 7% respectively).

International stocks again enjoyed a very strong quarter. Both stocks in developed countries, represented by the MSCI EAFE Index, and emerging market stocks, represented by the MSCI EM index, rose over 6%.

While lagging equity returns, within the U.S., bonds too generated positive quarterly returns, as the Barclays Aggregate Bond Index gained 1.4%. High yield bonds did even better, up 3.2% in the second quarter.

Market Returns at Mid-Year

A healthy economy and improving corporate earnings powered the S&P 500 to its best first half total return since 2013, up 9.3%. By style, during H1, the best performance was in large-cap growth, while the worst performer was small-cap value. Four sectors (technology, health care, consumer discretionary and industrials) outperformed the overall S&P 500, while seven sectors lagged, with energy turning in the worst performance, down over 12%.

As we noted in our April commentary, an underappreciated fact is that we are in the midst of a synchronized global economic expansion. This, combined with low (yet generally rising) inflation, helped produce torrid international returns. During the first six months of 2017, emerging markets gained over 18% while stocks in developed countries rose over 14%.

With yields falling during the first half of the year, bonds in the U.S. performed unexpectedly well. The Barclays Aggregate Bond Index advanced by over 2%, while corporates and high yield returned 3.8% and 4.9% respectively. Municipal bonds also did well, up over 3%.

What's Next

With such a strong first half of the year, a natural question is whether the rally can continue from here, or whether we are in for increased volatility and perhaps a rough patch ahead? The likely answer is both … depending on the time frame.

> *"…a natural question is whether the rally can continue from here…"*

The third quarter is recognized as being a seasonally weak period. Indeed, the months of July through September, on average, have produced the worst (though still positive) quarterly returns for the S&P 500 since 1928. With volatility near all-time lows, and with various legitimate concerns potentially weighing on the markets (stretched valuations in the U.S., the risk that global central banks adopt less accommodative monetary policies, the risk that Congress fails to enact corporate tax reform and other stimulative fiscal policies, and the seemingly ever-present geopolitical risk and risk of terrorism), it is probable that we will see volatility return during Q3. This volatility may well, in turn, produce at least one rough patch.

That said, we still have a positive view on the equity markets over the next six months. The fundamental underpinnings of the rally in the U.S., namely a solid economy and strong corporate earnings growth, likely will continue. During the first half of 2017, the unemployment rate fell to 4.3% — a 16-year low. Apart from a strong labor market, the manufacturing and services

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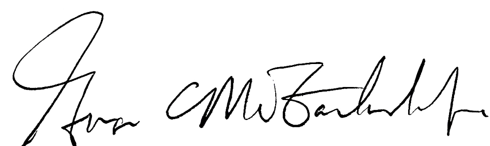
sectors of the economy are expanding, and housing prices are rising.

The domestic inflation rate has been described as at a "goldilocks" level, not too hot and not too cold. With crude oil down dramatically this year on fears of excess supply, and with wage inflation tame at 2.4%, it is likely that inflation will remain within levels that are supportive of equities. After reaching a 14 year high last year, the U.S. dollar has weakened in 2017 versus most major currencies, and this too should help propel earnings growth in the S&P 500 companies. Importantly, we see no recession on the immediate horizon. The strength in transportation stocks confirms this outlook.

To sum up, fasten your seat belts. The ride ahead may get bumpy but the ride still should be worth it.

As always, we encourage you to reach out to us with any questions, concerns, or perspectives you may have.

Contact us at 610.975.4300 or info@penntrust.com.



George C. McFarland, Jr.
President and Chief Investment Officer