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Q1 2017 Commentary: Rising market expectations…

Six months ago, we were talking about the resumption of earnings growth by the S&P 500 companies and in the fourth quarter we were not disappointed. For the first time since the third quarter of 2015, earnings for the S&P 500 were higher than the previous year's level. Earnings growth has continued in the first quarter and this growth and the prospect of continued growth is propelling stocks higher. In the first quarter, the S&P 500 rose 6.1% led by large growth companies and the technology and real estate sectors.

As anticipated, the Federal Reserve raised the federal funds rate by one quarter percent continuing its move to normalize interest rate policy. The Fed was comfortable taking this action because economic trends have consistently indicated the economy is capable of self-sustaining growth. Despite short term rates rising, long term rates have held steady. The 10-year US Treasury yield fell slightly, moving from 2.44% to 2.40%. As we have seen over the course of the current bull market, rising earnings and low rates provide powerful fuel for the stock market. These conditions are expected to continue.

Rising long term interest rates would be a significant obstacle for the stock market to overcome. However, higher rates have yet to materialize and we do not expect them any time soon. The stable 10-year Treasury yield reflects the expectation that inflation will remain low. In the first quarter inflation was moderate and there were no red flags among commodity prices and wages that might alarm the bond market. Furthermore, the announcement that first quarter GDP grew at a sputtering 0.7% annual rate is sure to postpone a rise in rates. First quarter GDP growth was the slowest in three years and reminds us that the economy is still stuck in the moderate growth mode that has persisted since 2009. At this point, there is little risk of an overheating economy spurring rates higher.

The Trump rally continues, but the rally can be attributed more to the growth in earnings in the fourth and first quarters than anything the Trump administration has accomplished. The news on first quarter earnings is good. Of companies reporting so far, 77% have exceeded their consensus estimate. The S&P 500 companies are on track for earnings to grow by more than 12%. Also significant is that the quality of the growth is sound. The past few years, revenue growth has been anemic and often earnings growth has been manufactured from cost containment and share buybacks. However, first quarter revenues are growing at better than 7% which is the highest rate since 2011.

Earnings growth is all well and good, but the S&P 500 is already trading at 17x this year's earnings estimate. To justify current market levels, future growth prospects must be sustained. Investors are fully expecting a major source for this growth to come from the new president's legislative policies. With that in mind, the train wreck effort to reverse Obamacare could be viewed as a blessing for investors. Instead of getting bogged down in a legislative quagmire over healthcare, the Trump administration has turned to introducing the tax reform and other pro-growth policies that investors initially expected. If the administration can push forward with these initiatives, the bull market can continue. New policies boost future earnings expectations which ultimately support stock prices.