"Baseball is 90% mental and the other half is physical" – Yogi Berra

The U.S. equity markets got off to a strong start in 2017 with the Russell 1000 large-cap index rising 6.03% and the Russell 2000 small-cap index rising 2.47%. On the economic front, jobless claims dropped in late February to the lowest number since 1973, with the headline unemployment rate falling to 4.5%. In response to improve economic conditions, the Federal Reserve raised interest rates in March for the third time in the current tightening cycle that began in late 2015. The Fed's preferred measure of inflation has accelerated from 1.2% in September of 2016 to 1.9% in January of 2017, while still running slightly below the Fed's inflation target of 2%.

It's common for politicians to take credit for the financial markets when things are going well (and deny responsibility when things aren't), but the reality is that the stock market over the medium to long term has always been driven by corporate earnings. On that front, the transition of power in Washington has overshadowed a very significant development to U.S. equity investors. According to FactSet the S&P 500 is likely to experience double digit year-over-year earnings per share growth in the first quarter of 2017, which would be the strongest quarter since the third quarter of 2011. Of companies that have already reported first quarter results, 74% have beaten earnings estimates. Year-over-year revenue growth for the S&P 500 is expected to come in around 7% for the quarter, which would also be the strongest growth since 2011.

While corporate earnings drive the stock market over the long term, the news headlines can certainly impact short-term market movements. As we write this letter, geopolitical tensions in Syria and North Korea are escalating and will likely continue to be in the headlines for some time. However, trying to time the market based on these types of events is usually not successful, as there are many more "false alarms" than there are full blown bear markets. While we can't predict the outcome of any of these situations, history has shown that the best course of action for investors is to develop a long-term investment strategy and stay invested.

Confidence On The Rise

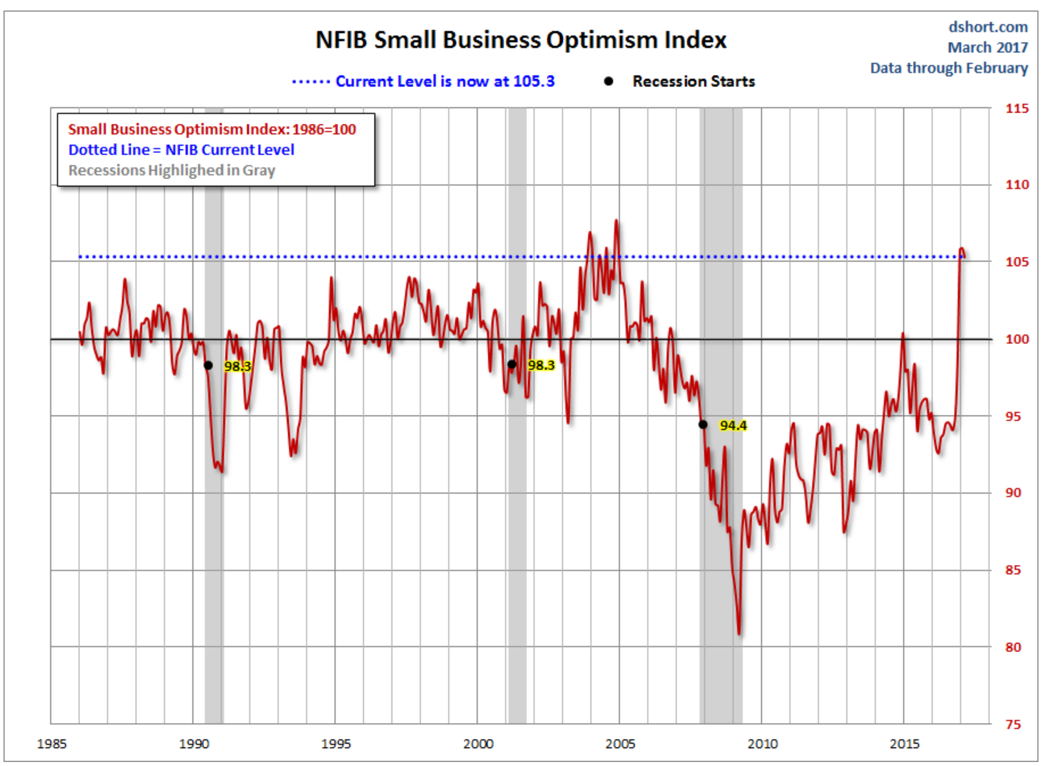
The quote at the beginning of the letter is a comical reference to how important confidence is when standing in the batter's box against a 95 mph fastball, which is quite appropriate given that we began writing this letter on Opening Day here in Cincinnati. However, it could also apply to how important confidence is in the U.S. economy. We have been hearing for years how corporate America has been sitting on record levels of cash, while U.S. consumers have never been in better shape and unemployment is at generational lows. Yet somehow economic growth, while positive, has been below its long-term trend for many years. The missing ingredient may be confidence.

One of the most noteworthy developments of the last 5 months has been the dramatic rise in confidence by both consumers and businesses. The latest University of Michigan survey of consumer sentiment, which is considered a leading indicator of economic conditions, showed that a record number of respondents believe that the new president is having a positive impact on business conditions. The Conference Board Consumer Confidence Index is now at its highest level in 17 years.

Why is this important? Well for one, every recession since at least 1960 has been preceded by or coincided with a significant deterioration in consumer confidence. This means that it's likely we will see continued economic expansion in 2017. In addition, consumer spending represents 70% of the U.S. economy. As we highlighted in our July 2016 newsletter, U.S. household net worth is at an all-time high and is about 50% higher than pre-financial crisis levels (and about double where it was in 2000). Meanwhile, household debt as a percentage of disposable income is at the lowest level in at least 37 years. This combination of historically low household debt, historically high net worth and high levels of consumer confidence could end up being a very potent combination.

The most recent Business Roundtable's CEO Economic Outlook index, which is a survey of very large U.S. corporations, was also very positive as it increased the most since the last quarter of 2009. The survey's sales outlook for the next 6 months climbed to a 5-year high, while the capital spending portion of the index rose to a 3-year high. Perhaps most importantly, the index of hiring expectations among the CEOs rose to the highest level in 7 years.

The National Federation of Independent Business, which is an organization of small businesses, saw its Optimism Index rise in early 2017 at the fastest pace in the history of the survey. Small businesses are the lifeblood of the U.S. economy and represent about 60% of U.S. employment. It's worth noting that historically this index has been very good at predicting where the economy will be a year or two down the road. Dramatic increases in the index such as those seen in 1991, 1994, 2003 and 2009 have all preceded improvements in the economy over the following years. Meanwhile, the index began to deteriorate at the beginning of 2000 and again in 2005, well in advance of the next recession. Thus, the spike in this index can't be seen as anything other than good news.



There has been a lot of talk in Washington about various policies that could have an impact on economic growth, such as corporate and personal tax cuts. The reality is that the belief amongst business leaders and consumers that these policies will work may be more important than the actual policies themselves. If businesses believe that the economy is due to accelerate, they will hire in anticipation of that and consumers will have more confidence to spend, creating a self-fulfilling prophesy in the process.

Dow 20,000

The Dow Jones Industrial Average (DJIA) crossed 20,000 for the first time ever in January of 2017. While the DJIA only represents 30 of the approximately 4,300 listed companies in the U.S., it is one of the oldest stock market indices and also one of the most familiar to investors. 20,000 is a nice, round number that is psychologically important to investors, which has prompted some questions from clients about whether they should be concerned that the index is at an all-time high. While we are not market timers and fully acknowledge that there will continue to be occasional recessions and bear markets in the U.S., what we can say with confidence is that the stock market hitting all-time highs has historically had no correlation with whether or not we will experience a bear market in stocks.

Over the last century, the DJIA has hit a new all-time high on 1,252 occasions for an average of approximately one per month. Following an all-time high, further gains were experienced over the subsequent 12 months 70.6% of the time, with the average return being 8.9%. Both of these figures are fairly close to the long-term averages.

It's interesting to note how significantly the DJIA constituents have changed over time. Of the 30 constituents in the index in 1975, only 3 are still in it today (P&G, General Electric, and DuPont). Consider some of the 1975 DJIA constituents which are no longer in the index today: Anaconda Mining Company, Bethlehem Steel, Eastman Kodak, International Harvester, International Nickel, International Paper, and F.W. Woolworth. While considered industry leaders at the time, these companies and others in the DJIA in 1975 have experienced rather spectacular declines and been replaced by the likes of Apple, Microsoft, Cisco, Intel, and Pfizer. Forty years from now it's likely that many of the current constituents will have experienced the commoditization of their industries and been replaced by companies we don't even know about yet. This is what makes investing over the long run so difficult. We know that innovation will continue and society will continue to progress, but we have no idea exactly what it will look like.

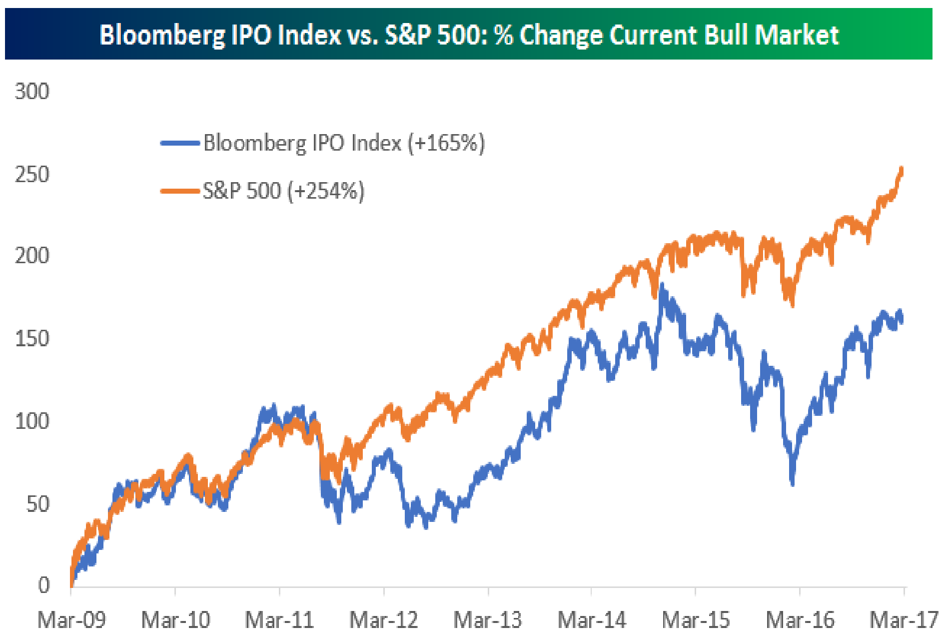
IPOs

In early March Snap Incorporated, owner of the phone messaging app called Snapchat, raised over $3 billion in cash in the largest Initial Public Offering (IPO) of stock since Facebook in 2014. The pricing of the offering valued Snap at over $28 billion, despite the company losing over half a billion dollars in 2016. We periodically receive calls asking about various IPOs that hit the market, in particular if we will be participating in buying shares of the IPO.

We have never participated in IPOs (or bought shares on the open market immediately following an IPO) for several reasons. First is that companies that are raising funds through IPOs are often companies that don't yet have a track record of profitability. Our investment process relies on various measures of growth, valuation, and profitability. IPO stocks generally will not meet the criteria of our process.

A second very important reason is that IPOs are very often a way for the companies' founders to monetize their ownership position, as they are often selling their shares to the public. In the case of Snap Inc., the founders and early investors combined to sell almost $1 billion of their shares to the public during the IPO in early March. The problem with these types of transactions, from an investor's point of view, is that you are at an informational disadvantage compared to the owners of the company. The executives who are selling their shares will obviously try to maximize the value of their shares by attempting to sell at the most advantageous time. So if the people who know the company better than anyone (and have access to all kinds of inside information) have decided it's a good time to sell some of their shares, then the odds of it being a good time to buy are stacked against you.

This does not mean that every single IPO will end up being a bad deal for investors. After all, those who participated in the Google IPO in 2004 have made out very well. But for every Google, there are many other IPOs that underperform the market. Believe it or not, there is actually an index that tracks the performance of stocks in the first year after their IPO called the Bloomberg IPO Index. Performance of the Bloomberg IPO index versus the S&P 500 is shown below.



As can be seen in this chart, the performance of IPO stocks has significantly lagged the S&P 500 over the last 8 years. Specifically, over this time the Bloomberg IPO Index was up 165% compared to a gain in the in the S&P 500 index of 254%. That's a difference of a whopping 89%! While there have been a few that bucked the trend, clearly the odds are stacked against you when it comes to participating in these offerings.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

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The Large Cap Equity Composite includes all discretionary, tax -exempt accounts investing primarily in large cap value equities, with account market values above $50,000. Effective January 1, 2006, closed end funds are no longer utilized in the strategy. Effective January 1, 2012, taxable accounts are no longer included in the composite. The benchmark for the firm's Large Cap Equity strategy is the Russell 1000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Equity Composite includes all discretionary accounts investing primarily in small cap equities. The benchmark for the firm's Small Cap Equity strategy is the Russell 2000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Value Composite includes all discretionary accounts investing primarily in small cap value equities. The benchmark for the firm's Small Cap Value strategy is the Russell 2000 Value Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.