

2017 SPRING OUTLOOK

Markets React Positively to Improved Business Sentiment

The Standard & Poor's (S&P) 500 has enjoyed the best performing post-election stock market in modern history. The S&P 500 is up 11% since election day as "animal spirits"¹ have consumed investors. The White House is as pro-business as ever and business leaders are increasingly optimistic. Tax reform and a rollback of regulations top investors' wish lists. With the market trading at 20x trailing earnings, it may appear many of the positives have already been baked in, but pro-growth policies out of Washington and increasing economic activity could continue to buoy stocks. If earnings grow 10% this year, the market is trading at a little less than 18x 2017 earnings.

The U.S. economy is proving to be incredibly robust. Confidence levels are high, employment is strong, and economic surveys such as the Purchasing Managers' Index (PMI) are at very elevated levels. Incidentally, Gross Domestic Product (GDP) is the only measure that seems to be lagging.

¹ "Animal spirits" is a term used by John Maynard Keynes in his 1936 publication, *The General Theory of Employment, Interest and Money*. The term is used to describe human emotion that drives consumer confidence.

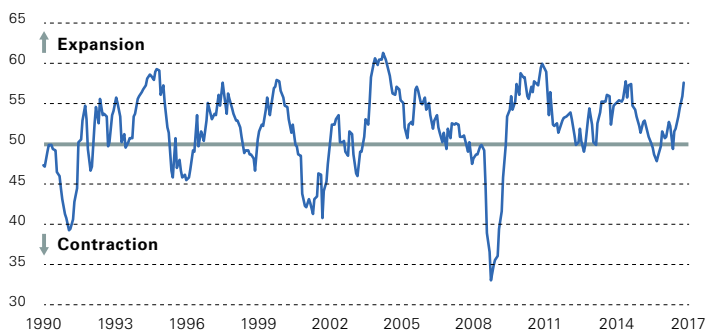
Survey Data Predicts GDP Acceleration

On March 14th, the Federal Open Market Committee (FOMC) raised the Fed Funds target a quarter of one point to 0.75–1.00%. The increase came with minimal media fanfare and as no surprise to the financial markets. Even the most dovish committee members had made it clear conditions were appropriate for a rate hike. Labor markets are strong, inflation is subdued, and conditions globally are improving.

February non-farm payrolls rose 235,000, the unemployment rate fell to 4.7%, average hourly earnings rose, the labor force participation rate climbed, and weekly jobless claims remain at 40-year lows. Historically, a negative inflection point in employment data typically leads a recession by up to two years.

The strong jobs market is one reason consumer confidence surged to a cycle high in March. Also, U.S. household net worth is at a record high of \$92.8 trillion, driven by the eight-year bull market in stocks and the recovery in home prices. Additionally, many CEO confidence surveys saw their largest quarterly jump in seven years.

Institute for Supply Management (ISM) U.S. Manufacturing Purchasing Managers' Index (PMI)



The February 2017 Manufacturing ISM® *Report on Business*® showed that the U.S. manufacturing sector expanded in February and the overall economy grew for the 93rd consecutive month. 17 out of 18 industries measured reported growth. The recent reading is elevated and near the natural ceiling for this index. Historically, the S&P 500 has returned approximately 9% twelve months following a peak in U.S. Purchasing Managers' Index (PMI) data.¹

The surge in manufacturing activity is not exclusive to the United States. Global PMI is rising as well. The latest data from Markit Economics showed that all global sectors recorded growth in output in February. Japan's economy is improving, as is Europe, albeit from a low base. There is increasing confidence that China is successfully engineering a "soft landing" to growth of 6%–6.5%. A year ago investors were gripped with a fear of a global recession—what a difference a year makes!

Ironically, with all of the good economic data, the Federal Reserve Bank of Atlanta estimates that first quarter GDP will show only 1.0% growth. The difference between the "soft" data provided by surveys and the "hard" data coming from official government sources is significant and implies that business and consumer confidence are rising.

The case of the discrepancy between soft and hard data is most likely two-fold. First, we could be in a period where confidence data leads actual data. Second, this first quarter slowdown is an anomaly that has occurred over the past several years due to seasonal adjustment factors. If past patterns are a guide, the second quarter may be much stronger. We believe improved confidence will allow full year GDP to outperform the 2% growth rate that has defined this eight-year expansion. Any pro-growth policies coming out of Washington will not materially affect GDP until 2018.

Congress has bungled the repeal and replace of the Affordable Care Act and in doing so wasted valuable political capital. Meaningful and lasting tax reform has become even more difficult to pass following the failure of the healthcare bill. If tax reform and infrastructure spending are jeopardized it is likely that elevated confidence levels will evaporate. Elections in France (April–May 2017) and Germany (September 2017) may have economic fallout. North Korea is an ongoing wildcard. For now, though, a U.S. recession over the next 12–18 months looks like a remote possibility.

¹ Strategas Research Partners

The Bond Market Weighs the Likelihood of Economic Acceleration

During the first quarter, the benchmark 10-year U.S. Treasury note has traded in a relatively stable range between yields of 2.3% and 2.6%. Immediately following the Presidential election, yields rose 65 basis points in less than a month. We expect bond yields to exhibit more volatility as the bond market weighs the probability of stronger economic growth predicted by the survey data previously discussed. We believe the market could create opportunities to increase yield in client accounts as it wavers between “growth is coming!” and a “no, it’s not!”

After years of forecasting higher rates, chances are that the consensus opinion will at last be right in 2017 and 2018. Investors logically question, “should we shorten maturities in advance of rising rates?” Unfortunately, the answer is, “it depends.” A very long-dated portfolio is more at risk to rising rates, but Haverford emphasizes intermediate maturity bonds. The benefits of shortening a portfolio of intermediate-term bonds are negligible and inconclusive. A bond with a four-year maturity will only have three years to maturity a year from

now. It will have essentially de-risked itself all the while paying a larger yield. Avoiding longer bonds is the most valuable decision to protect portfolios from rising interest rates.

As we discussed in our *2017 Outlook*, tax policy uncertainty puts unwarranted pressure on municipal bonds. Fears have since abated to the degree that yields on tax-exempt municipal bonds have fallen while yields on U.S. Treasury issues have risen. In our opinion, the once undervalued municipal bond market is now fairly valued.

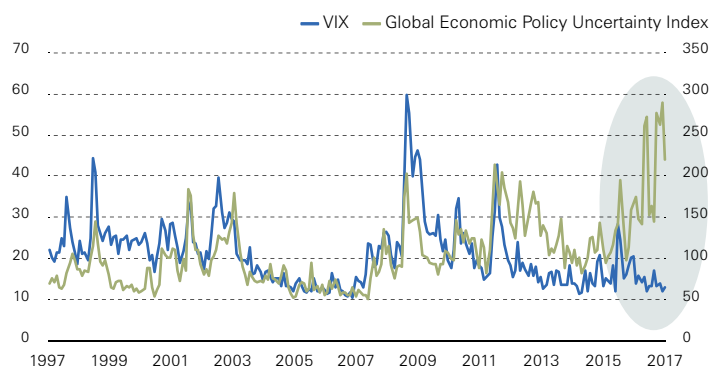
Equities are Seeing Past Political Rhetoric; Focused on Pro-Growth Reforms

Even as the volume in global political rhetoric hits all-time highs, equity markets remain sanguine. The post-election rally has exhibited remarkably little volatility. The S&P 500 has declined 1%-or-more only once in over 100 trading days. The CBOE Volatility Index® (VIX®) remains at very low levels. The dispersion between political uncertainty and market volatility is astonishing. The market is saying, “the volatility is in political rhetoric, not in economic uncertainty.”

The questions investors most want to know is, “Where will the markets be in twelve-months and when will the next pull-back occur?” We wish we knew the answers! Even surprise negative headlines, such as oil’s sharp one-week 9% decline, had little impact on the broad market. A year or two ago, a move in oil of that magnitude would have dragged stocks down.

The expectation of pro-growth policies including tax and regulatory reform are expected to add \$10 to the S&P 500’s 2018 profits according to many Wall Street strategists. If both politicians and the economy deliver, the expected multiple on 2018 is 16.5x, which is certainly a reasonable multiple in an environment of faster GDP growth.

Market Shrugs off Volatility in Political Rhetoric



Source: Economic Policy Uncertainty, CBOE, FactSet

This doesn't mean the equity markets will be immune from volatility or a prolonged decline in prices, but it is important to differentiate typical market downturns from those associated with an economic recession. The preponderance of the economic data means the chances of an economic recession are very low.

History has shown us that the market tends to correct 10% or more every year on average. During the past 25 years, when an economic recession was part of the mix, market declines averaged 25%, but non-recession corrections had average declines of only 14% and lasted less than three months.

Following all but one non-recession-correction, the S&P 500 index rebounded +10% off its lows within three months. On average it was up 16%.

It seems to us that it is virtually impossible to discern what could cause near-term declines in the market. Rather, we will continue focusing on owning solid businesses within a well-diversified portfolio. As always, we will trim positions that we calculate to be expensive, and add to companies that look relatively inexpensive. We will sell those stocks with a broken investment thesis and seek to buy new positions at attractive entry points.

All data as of March 24, 2017, unless otherwise noted.

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QUALITY INVESTING

THE HAVERFORD TRUST COMPANY

Three Radnor Corporate Center, Suite 450 Radnor, Pennsylvania 19087-4580
T 610-995-8700 / 888-995-5995 / F 610-995-8796 / haverfordquality.com
