Financial Advisors, Inc.

3685 Mt. Diablo Blvd., Suite 200
Lafayette, California 94549-3736

FIRST QUARTER 2017
MARKET REVIEW

Although the so called "Trump trade" lost some ground during the first quarter, markets still held on for strong returns. Following the November election, industries that were seen as likely beneficiaries of a Trump presidency rallied. These included financial services from less regulation and higher interest rates, and infrastructure related plays, such as energy, industrials and materials. This unwound somewhat during the quarter as markets became skeptical of the ability of the new administration to implement its agenda and industries that were down following the election, such as health care and technology, enjoyed a nice rebound to lift broad market indexes. Bond markets also recovered some ground as interest rates have fallen a bit following the dramatic post-election spike in rates.

The biggest story of the first quarter was a recovery in foreign equity markets. Following a four-year period of underperformance, the longest in recent history, foreign stocks outperformed U.S. stocks. The dollar strength immediately following the election waned, helping foreign stocks post a strong quarter. Diversified portfolios are benefitting from exposure to international markets, lifting total returns for the first time since 2012. Foreign stocks outperformed U.S. stocks six out of seven years from 2003 to 2009. Given current stock valuations and where we are in the business cycle, we could be headed towards a similar period of outperformance for foreign stocks.

Major Stock & Bond Indexes (Total Return)		*Lipper Mutual Fund Indexes (Total Return)*	
	1Q 2017		1Q 2017
S&P 500 Index	6.1%	Large-Cap Core Funds	5.5%
Dow Jones Industrial	5.2%	Large-Cap Growth Funds	9.3%
Russell Midcap Index	5.2%	Large-Cap Value Funds	3.6%
Russell 2000	2.5%	Mid-Cap Core Funds	5.5%
MSCI EAFE (USD Gross)	7.4%	Small-Cap Core Funds	1.9%
MSCI EM (USD Gross)	11.5%	International Large-Cap Core	7.6%
NAREIT U.S. Real Estate Ind.	2.6%	Emerging Markets	11.3%
Barclays US Agg. Bond (3-5yr)	0.7%	Core Bond	1.0%
Bloomberg Commodity	-2.3%	Intermediate Municipal Debt	1.4%

phone (925) 299-1800 *fax* (925) 299-1812 *email* info@hcfinancial.com *website* www.hcfinancial.com

THE MARKETS:

Stocks continued to post impressive returns, despite some weakness late in the quarter as Congress failed to pass reform to the Affordable Care Act. Trading at roughly 18 times estimated forward earnings, the S&P 500 is certainly near the high-end of its historical valuation range. Although this may temper long-term return expectations for U.S. stocks, valuation is a poor predicter of near-term returns. Expensive markets tend to become increasingly overvalued before they become cheaper. Typically, stocks continue to rise at an accelerated rate as bull markets most often end in euphoria. Eventually, reality fails support investor expectations or the Fed aggressively hikes rates to cool off the economy, leading to a recession and bear market.

The post-election rally, or "Trump bump" as it has been called, has been driven by optimism that the new administration will pursue a course of pro-growth tax cuts, deregulation, and infrastructure spending. Much of the post-election rally has been driven by "soft data", i.e., economic data compiled by surveys. Various date points including consumer confidence, the Institute for Supply Management (ISM) survey, or small business confidence, all measure the optimism of individuals. These soft data points have been boosted by the prospect of lower taxes and reduced regulation. Ultimately, however, we will need to see an acceleration in the "hard data" to sustain an extended rally in U.S. stocks. Hard data points include measures of real economic activity such as Industrial Production, employment reports and Gross Domestic Product.

The failure of Congress to pass healthcare reform stalled the rally somewhat, as it raises questions about the ability of Congress and the new President to work together on the President's agenda. Although healthcare reform is of little concern to investors, a failure to pass corporate tax reform or meaningfully cut regulations are a considerable near-term risk to the market. The pause in U.S. stocks, although slight, is probably a healthy reset of expectations and may prevent markets from getting too far ahead of reality.

In addition to pro-growth policies that the market has been focused on, President Trump campaigned on a number of policies that would be detrimental to the economy. Increased protectionism through trade tariffs would likely trigger a swift response from trading partners, resulting in a trade war and significant damage to the global economy. While it is promising that nothing has been done so far to increase tariffs which can be done by executive order, the current tax bill being proposed by Paul Ryan and Kevin Brady would do just that. This tax bill includes what has been called "border adjustments" or "destination adjustments" that taxes imports while excluding exports. Economists believe that a border adjusted tax would be perceived as predatory by our trading partners and elicit retaliatory tariffs, damaging the economy and halting to the current market rally.

GLOBAL ECONOMIC GROWTH:

After seven years of subdued global growth, evidence of an acceleration began mid-2016 and

recent data has shown an improved trajectory over what we have been accustomed to since the financial crisis. A Goldman Sachs report shows that total global GDP growth should reach 3.6% in 2017 from 3.0% in 2016. Developed economies are expected to grow by 1.9% this year, following 1.6% growth in 2016. Most of the global growth should come from emerging markets, which are expected to collectively grow GDP at 5.3% in 2017, up from 4.4% in 2016. All regions of the world are expected to show acceleration, with the exception of the U.K., which is negotiating its exit from the European Union. Recovering commodity prices are expected to lift Brazil and Russia out of recession.

In addition to accelerating economic growth, foreign stock markets should benefit from lower valuations and better potential for earnings recovery. In the U.S., corporate profits are eight years into recovery with growth likely to slow as profit margins have peaked. Europe offers much more potential for earnings growth as profits only began to recover over the last year and valuations are still relatively low on depressed earnings levels. In Europe, business surveys are at their highest levels in six years and consistent with accelerating economic growth. Since Europe has higher corporate operating leverage than the U.S. and U.K., profit growth should accelerate much faster than it has here.

Emerging markets have also posted strong year-to-date performance and have similar dynamics to other international markets, with strong potential profit growth and relatively low valuations. Although the strong dollar has hurt returns over the past several years, this trend could at least be slowing as the more recent trend has been a stable to weakening dollar against other global currencies. There are indications that the European Central Bank could shift to a tighter policy stance which could serve to strengthen the Euro, benefiting U.S. based investors in European stocks.

OUTLOOK:

While rich valuations decrease the expected return rate for U.S. stocks over the next five years, we still expect positive mid-single digit returns. Earnings growth is expected to come in at 10% this year before S&P 500 companies revert back to their historical growth rate 0f 5%. If we assume appreciation of 3% per year from current levels and a 2% dividend yield, the S&P 500 can return to its average valuation in five years returning 5% per year including appreciation and dividends. The path to normal valuation is not likely to be this smooth. If stocks were to rise significantly from here, we would become far more negative on this asset class, just as we would become more positive if we see a meaningful pullback.

Markets are likely to continue to be largely influenced by the political landscape. Although investors have been enthusiastic about potential tax reform and infrastructure spending from the Trump administration, it is becoming clear that a President with a historically low approval rating will have a difficult time driving policy through a very narrow Republican majority in Congress. Investors may need to reign in expectations on help from Washington and realize that

a substantial change to the business environment is easier said than done.

Our most likely scenario for U.S. stocks continues to be a year of 5% to 10% returns driven by an earnings recovery and flat or even a slight compression in P/E multiples. If investors get a renewed sense of optimism over tax cuts and regulatory reform, it may be possible to get P/E multiple expansion and a sharp increase in stock prices. There is likely some downside to markets if tax reform fails to pass through Congress, although expectations have moderated since the failure of health care reform. Significant downside risk from trade restrictions appears less likely than we thought from campaign rhetoric as this appears to be less of a focus for the new Trump administration. Though there is still some talk about a “border adjusted tax” from Representatives Kevin Brady and Paul Ryan, this does not appear likely to make it through Congress. On the other end of the spectrum, risk of a “melt up” where euphoric investors push up the valuation of stocks to untenable levels has decreased substantially over the last several weeks. Longer-term, we expect foreign markets to produce better returns than U.S. stocks.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We want to meet with you at least once a year to review and update any changes in your goals and objectives, cash requirements or asset allocation targets. If we don’t hear from you, we will be calling to schedule a meeting. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

Stephen C. Biggs, CFP®, CFA
April 14, 2017