STOKES CAPITAL ADVISORS, LLC

Market Commentary
March 31, 2017

Quarterly Market Review

Markets continued their rally in the first quarter with new record highs put in for several of the broader U.S. equity indices. The renewed emphasis on tax reform as an economic stimulus helped push U.S. stocks to set records for five consecutive sessions—the first time all three major indexes (Dow, S&P 500, and NASDAQ) had done that since January 1992. The Dow hit record highs for 12 consecutive days, something that hadn't happened since 1987, took a pause, and then powered through the 21k mark following the President's address before Congress.

Also during the quarter, as anticipated, the Federal Reserve raised short term interest rates by .25%, the second increase in the last three meetings. The Fed noted continued strength in the labor market and that economic activity continued to expand at a moderate pace. In addition, inflation has increased in recent quarters and is moving closer to the Committee's 2% longer-run objective. While the increase was widely telegraphed by Fed members and market reaction was muted, the delicate process of policy normalization is under way.

In addition, foreign markets participated in the rally as well with mid to upper single digit gains witnessed across much of the globe. Japan was the only exception recording a decline of -1.1% for the quarter. The quarterly results are in stark contrast to the declines witnessed twelve months ago when concerns over growth reigned in investor optimism for risk assets.

Turning to bonds, yields pulled back from the Q4 highs giving a boost to bond prices during the quarter. The Barclays Aggregate Bond Index recorded a total return of 0.82% while riskier credits outperformed as investors continue to chase yield. Over the last 12 months, the Barclays Aggregate Bond Index has lagged the S&P 500 Index by 17%, a performance differential not witnessed since Q3 2015.

Lastly, one element missing from our observations this quarter was volatility. The S&P 500 Index recorded only 2 days with a 1% move or more compared to Q1 2016 which recorded 26 days. The CBOE volatility Index or VIX, which measures market expectation of near term volatility conveyed by stock index options, remains at very low levels declining from the pre-election reading of 22.5 to quarter end reading of 12.4 for the VIX.

Global Economic Outlook

United States: American households remain the linchpin of economic growth, underpinned by buoyant consumer sentiment readings and an exceptionally strong labor market. Although upbeat confidence has not been reflected in recent hard data—retail sales barely grew in February—accelerating wage growth and rising equity and housing prices are likely to boost consumer spending in upcoming months. Economic activity is firming elsewhere, with the ISM manufacturing index rising to an over-three-year high in February. However, little progress, if any, has been made on the fiscal front in recent weeks. Growing disagreements on the repeal-and-replace bill for the Affordable Care Act (ACA) have dominated news headlines. With Republicans focusing their efforts on ACA, a comprehensive tax reform plan is unlikely to be greenlighted anytime soon.

Growth is set to accelerate this year, buttressed by resilient household consumption and a surge in capital outlays on the back of upbeat business sentiment. However, a strong U.S. dollar and the robustness of the domestic market will likely see net trade drag on growth. Both upside and downside risks to the outlook will depend on potential policy shifts in Washington. FocusEconomics panel sees GDP expanding 2.3%, above 2016's 1.6%. For 2018, the panel sees growth picking up slightly to 2.4%.

Eurozone: Momentum is clearly firming in the Eurozone's economy. Robust domestic demand kicked the recovery up a notch in H2 2016, defying earlier expectations of a slowdown due to geopolitical uncertainties. An improving labor market, high confidence levels and ultra-loose monetary policy are acting as tailwinds for the domestic economy. Incoming data for Q1 suggest that growth has kicked into an even higher gear: economic sentiment rose to an almost six-year high in February and the manufacturing PMI surged further into expansionary territory in March. While the picture painted by recent data is sunny, political clouds are gathering. Although the far right failed to come out on top in the Netherlands' March election, a highly fragmented parliament means that forming a solid and effective government will be tough. France will head to the polls on 23 April in an unpredictable race, with fall elections in all-important Germany to come. Against the backdrop of changing leaders, Brexit negotiations are slated to begin after the UK triggers Article 50 at the end of March.

A stronger global economy and firmer labor market will support a healthy expansion this year. However, rising inflation could take a bite out of consumer spending. The FocusEconomics panel sees 1.6% growth this year, which is unchanged from last month's forecast. For 2018, growth is seen steady at 1.6%.

Japan: Although Japan continues to benefit from stronger global demand and a weak currency, risks are looming in the form of rising protectionist tendencies worldwide, a deterioration in China's economy and weak private spending. Moreover, quicker monetary policy tightening in the United States could fuel financial volatility in emerging markets, prompting capital to flee to Japan strengthening the JPY. Analysts see the economy growing 1.1% this year, which is up 0.1 percentage points from last month's projection. For 2018, they see growth at 0.9%.

China: China will continue its transition to a "new normal" growth trajectory, which implies weaker but more sustainable economic growth. However, downside risks in the form of a trade war with the United States and a sharp correction in the property market loom on the horizon. FocusEconomics panelists forecast that the economy will grow 6.5% in 2017, which is up 0.1 percentage points from last month's estimate. In 2018, the panel expects GDP growth to slow to 6.1%.

Investment Strategy

The rapid ascent for equities over the last four months may be due for a pullback or pause. Since the election of Donald Trump, the S&P 500 Index has climbed more than 10% and stretched valuations. Future expansion for equities will likely depend on the current administration delivering on the pro-growth policies outlined since taking office. While we remain optimistic that U.S. businesses will get some much-needed tax and regulatory reform, we concede that we may be borrowing gains from the future. Given recent events in Washington, the political process may prove to be more challenging and delays/failures on reform may induce periods of volatility in the near term. However, we remain optimistic over the longer run and maintain tactical equity allocations at the mid to upper end of client prescribed investment policy ranges and targets.

In our view, while some late cycle pressures are evident, the U.S. economy remains in a mid-cycle expansion. The Federal Reserve's estimate for economic growth is a far cry from than the projections out of Washington. The difference in these outlooks are rooted in the confidence or lack thereof in successfully implementing structural reform.

Quarterly earnings results for the companies we follow (ex-energy) continued to show signs of improvement for the fourth consecutive quarter recoding year over year EPS growth of 9.2%. In addition, managements continued to reward shareholders with dividend increases of 13.2% on a year over year basis.

Energy related names continue to recover from the sell-off in oil last year which witnessed Brent crude trading at $26 per barrel. Oil has double since then and traded in a narrow range since June. OPEC production cuts and a reduction in global rig counts have reduced the global supply glut while demand remains steady. Geopolitical risks appear to have been overlooked for the moment and we would expect to see a pickup in volatility and a risk premium applied to spot price for crude oil going forward.

Performance Scorecard

Benchmark Description	Q1	1 Year
Barclays Aggregate Bond Index TR	0.8%	0.4%
S&P 500 Total Return Index	6.1%	17.2%
NASDAQ Dividend Achievers Select Index TR	6.2%	13.2%
Russell 2000 Index	2.5%	26.2%
Alerian MLP Total Return Index	3.9%	28.3%
MSCI ACWI Ex USA Index (USD)	7.9%	13.6%
U.K. FTSE 100 Index (Price Only)	2.5%	18.6%
China SCI 300 Index (Price Only)	3.8%	6.8%
Japan Nikkei 225 Index (Price Only)	-1.1%	12.8%