The S&P 500 has returned 11.3%[1] since last November's election on the premise that a pro-business agenda focused on tax cuts, deregulation, and infrastructure spending would be positive for the economy and the stock market. Five months into the rally and with little in the way of concrete results yet, this upturn will need to be accompanied by policy achievements in Washington and continued improvement in the U.S. economy to support the market's higher valuations. We believe the following are important if U.S. equities are to continue to advance:

• **Lower Corporate Taxes:** From a stock market point of view, the most important government initiative is passing a corporate tax cut. The equity markets care much more about lower taxes than reforming the Affordable Care Act (ACA), and to some unknowable degree stocks are anticipating success on this front. A tax cut would have at least three benefits: it would remind corporate America that the new administration is pro-business, providing further support for labor markets and capital expenditures; it would be immediately accretive to corporate earnings; and it would improve the perception of the new administration's ability to implement policy.

• **Better Economic Data:** Business, consumer, and economic sentiment indices[2] have shown strong advances since the election and are at levels that we have not seen in years. Capital expenditure plans are beginning to show real increases. Now this needs to translate through to hard economic data. U.S. GDP in the fourth quarter of 2016 was +1.9%, and the Atlanta Fed's current estimate for the first quarter of 2017 is +1.0%. These modest levels are inconsistent with the sentiment indicators and we expect them to turn up.

• **Accelerating Corporate Profits:** For two years U.S. quarterly corporate profits exhibited negative year over year growth due mostly to the collapse in energy prices. Earnings growth turned positive in the third quarter of 2016 (+2.5%), improved in the fourth quarter (+8.2%), and is currently estimated to accelerate further in the first quarter this year (+14.4%)[3]. Improving economic growth and lower taxes should translate into better corporate profits.

• **Benign Inflation:** The Federal Reserve raised rates in March and is likely to raise rates later this year as well. However, this is in conjunction with improvements in the economy, and not due to inflation concerns. U.S. inflation is still benign and Yellen's most recent comments suggest that she does not believe the Fed has fallen behind the curve in terms of the speed and magnitude of rate hikes.

The commencement or continuation of these positive factors can support, and even increase, the present level of the U.S. stock market, despite equity valuations that are above long term averages[4]. However, there are developing risks that we are watching closely:

• **Washington Politics:** One might have thought that Washington would be easier to navigate with the same party controlling the White House, Senate and House. However, the new administration has already experienced challenges in passing meaningful legislation for which there are a myriad of views and interests on both sides of the aisle. Some collaboration, compromise, and even bi-partisanship appears to be necessary to get fiscal policy including corporate tax reform implemented, and this has been in short supply in Washington for years.

• **North Korea:** Decades of failed policy to contain the acquisition and testing of nuclear weapons has resulted in an increasingly intractable problem, the resolution of which is not apparent and could be very unsettling.

• **Border Adjustment Tax (BAT):** The BAT's negatives include a stronger U.S. dollar, a headwind for U.S. corporate competitiveness, and an increased likelihood of trade wars, from which there are no winners. Fortunately, the failure of the ACA Bill means that the BAT is less likely to gain traction given its complexity and already apparent bi-partisan opposition in Congress.

• **Questions Regarding Russia:** It is unclear what the investigation into Russia's interference with the election will conclude. At best it is a distraction for the new administration. Possible collusion by members of the new administration would obviously have a negative impact on popular and market sentiment and the ability to create effective legislation.

The challenge with risks like these is that there isn't a model that accurately predicts the outcomes. These and others will be "wait and see" events, which are likely to lead to volatility in markets as news ebbs and flows.

Current Positioning

The confluence of a strong equity market, higher valuations, the challenges of making progress in Washington, and risks enumerated above have led us take some profits in accounts with higher exposure to U.S. long only equity. While the risk/return profiles of clients will differ, as of April 1, portfolio exposure of roughly 70% to long-term growth investments[5] is now our higher end of allocation levels. The majority of portfolio equity exposure continues to be in the U.S. However, we would be inclined to increase the ratio of international equity to U.S. equity, and we are watching near term events and catalysts. A Marine Le Pen win in the French election this May would be a significant negative for the European Union and global equity markets. While currently an unlikely result, the last year has taught us to be skeptical of polling returns until the votes are actually tallied.

As we reduce equity exposure, we are increasing our exposure to diversifying strategies, a combination of cash, fixed income, fixed income alternatives, and investments with differentiated drivers of return. In fixed income we continue to prefer shorter duration bonds and loans. Individual accounts will differ based on client risk profiles, but diversifying strategies represent roughly 20% of portfolios. In short, we remain constructive while increasing the diversification of portfolios and staying vigilant to the changing landscape.

[1] Total return 11/8/16 to 3/31/17. Source Bloomberg.
[2] Examples include: The NFIB Small Business Optimism Index, The University of Michigan Consumer Sentiment Index, and the Conference Board U.S. Leading Economic Indicator Index.
[3] Source Bloomberg.
[4] The S&P 500 trades at 18.3x forward twelve month earnings. Source Bloomberg.
[5] Long-Term Growth Investments include U.S. and International equity, private equity, and distressed credit and equity. Portfolio exposures will differ by account.