PINNACLE
Wealth Management Group, Inc.

849 Penniman, Suite 201
Plymouth, MI 48170
Phone: (734) 667-5581

FINANCIAL FORUM

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Market Commentary

Meat Loaf's 1977 song, "Two Out of Three Ain't Bad" was a love song but its title just as easily could have been describing 2017's first quarter stock market performance. With Q1 in the books, stocks posted their sixth straight quarterly gain. However, those gains came in the first two months of the quarter. In March, stocks stalled on a failed healthcare bill, concerns over Fed rate hikes and their balance sheet, and signs that economic growth is slowing. Investors had faith that the Republican-controlled government would enact pro-growth legislation, reducing both taxes and regulation, while also spending on a large infrastructure program. The first dent in this armor occurred when the Republicans failed to pass healthcare legislation, which they said had to occur prior to tax reform. Now, with healthcare shelved, Congress and the President will turn to tax reform, which is really what the markets believe is necessary to justify current valuations. In order for tax cuts to keep this rally going, most economists believe that a drop in the corporate tax rate to 20% (which the President promised) is necessary. The reason being is that the tax savings would go straight to the bottom line of corporations and probably add around $10 per share to S&P 500 profits. However, if the market believes that the fractured Republican party won't pass tax cuts or that they will be less than promised, then the melt-up since the election could be reversed.

The Fed announced last week that it is also looking to decrease its $4.5 trillion balance sheet. After the housing and credit markets crashed in the mid-2000s, the Federal Reserve started injecting billions per month into the economy mostly by purchasing, with money they "printed," U.S. Treasuries and mortgage-backed securities. Even back then, former Chairman of the Fed, Ben Bernanke talked about an "exit strategy" because he knew that eventually the newly printed money would have to be withdrawn from the economy before rapid inflation occurred. Up until now, the market has been pretty complacent regarding the Fed, but higher rates and a shrinking Fed balance sheet could produce headwinds on stocks moving forward.

So far in 2017 there has been a disconnect between "soft" and "hard" economic data. Soft data comes from certain economic "surveys," such as consumer and investor confidence or manufacturing and non-manufacturing PMIs. But where the rubber meets the road is with the hard data, such as retail sales (including autos), housing, and jobs. On this front, soft data strength hasn't translated to the hard numbers. The consumer, which drives about 70% of our economy, seems tired. Credit creation is slowing and retail sales, as of late, have disappointed. Additionally, the job market remains basically at full employment and, while wages are rising, they aren't rising fast enough to power incremental acceleration of consumer spending. According to the Atlanta Fed's GDP Now, which is updated throughout the quarter as new economic reports become available, 2017's first quarter GDP estimate is a scrawny 1.2%, hardly the 3%-4% growth promised by policymakers and politicians and less than last year's 1.6% GDP.

Is the auto loan market sending us a signal? According to analysts, about a third of new auto loans are to subprime borrowers, this coming at a time when defaults on both credit cards and home equity lines of credit hit three-year highs. And much like the mid-2000s, these loans are being packaged and sold in the asset-backed securities market. In addition to the diminishing credit quality of some car buyers, used car values are dropping while the inventory of unsold new cars is rising. General Motors, for instance, just reported for the month of March that they hold 98 days' worth of inventory, substantially more than the optimal 60-70 days' worth of product they would like to have on hand. The ripple effect of these rising inventories will have to be watched, as manufacturers will have to pare production, payrolls, and hours, resulting in lower spending by their employees, higher unemployment, and less tax revenues for federal, state, and local governments.

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Around the World – In other news…

It's official. After months of talking, the United Kingdom filed for divorce from the European Union. Prime Minister Theresa May triggered negotiations for Brexit, ending the 44 year marriage. All of this came at a time when the E.U.'s economic numbers look promising. Inflation has started to perk up after years of deflation in the region, while unemployment has finally slipped into single digits. Those figures, along with rising consumer confidence and retail sales, could be enough for the European Central Bank to start tapering its quantitative easing program scheduled to run through December of this year.

Remember Mexico? It was one of President Trump's favorite punching bags during the campaign season and its stocks initially fell hard after our election. Since mid-January, however, its stock market has rebounded over 20%, as investors believe that the Trump administration's "bark is worse than its bite." The rally in Mexico's stock market is another sign, in a growing list, that investors are losing faith in the Republican-controlled government. Cyclical stocks in the U.S., which initially led the market higher after the election, have lagged so far in 2017. Anecdotally, this is a worrisome sign.

Terrorism in Russia and Sweden and the U.S. attacks Syria…Russian authorities detained eight people in relation to an April 3rd St. Petersburg metro bombing that killed 14, including the main suspect. In Stockholm, four were killed on April 7th when a truck plowed into a department store. And closer to home, the U.S. responded to a lethal Syrian government chemical attack on civilians by firing 59 Tomahawk missiles at an air base tied to the chemical attack. The day before, North Korea launched a missile that may have malfunctioned and fell into the Sea of Japan, ratcheting up regional tensions. So far this "Teflon Market" has ignored outside geopolitical and terror risks, but rest assured, if any of these events escalate, Mr. Market could change his mind in a hurry. Of course, we hope this doesn't happen.

A Financial Thought – Excess Spending

Conspicuous consumption often leads to an inconspicuous lack of wealth. Something to think about before you whip out that credit card…

As always, have a great week.

All the best,

Dan

Daniel A. Cesta, CPA, CFP®, MST
President
Pinnacle Wealth Management Group, Inc.
www.pwmgi.com

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you know of anyone who would like to be added to this list or who might benefit from our services, please pass along our name. We are always looking for opportunities to meet and help great people like you.