RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

FIRST QUARTER 2017 MARKET COMMENTARY
April 2017

STATE OF THE MARKETS

The "Trump rally" continued throughout much of the First Quarter 2017 before easing somewhat in March. The rally has been built largely on the hope that the new administration can implement pro-business tax and regulatory reforms that will lead to economic growth. However, we believe there are valid concerns that the market is overestimating the ease with which the new administration can effectuate these reforms, as evidenced by the failure of "Trumpcare" at the end of the Quarter. Additionally, the S&P 500 stands at about 18 times forward earnings expectations, which is somewhat high by historical standards. As a result, we have decided to maintain a cash position that is larger than normal for many of our portfolios, cashing in on gains for existing accounts and only slowly investing cash for new accounts.

The RDM large-cap value equity composite also continued its streak of quarterly gains with a 2.5% + return in the First Quarter. Our quarterly performance slightly trailed the S&P 500 due to our relatively large cash position mentioned above and a small pullback in the financial and energy sectors at the end of the quarter after last year's strong performance. However, our firm's large-cap value equity composite continues to outperform the S&P 500 on a trailing 12 month basis with a gain of 18% compared to a 14.5% gain for the S&P 500, which is consistent with our long-term focus.

Looking ahead to the remainder of 2017, we would not be surprised if the equity markets pull back some more from current levels. However, we would view any such declines as a buying opportunity for long-term investors – the main reason we have raised cash. With continued economic growth, lower taxes and regulatory reform, domestic businesses could thrive in the coming years. Therefore, we remain optimistic for positive equity returns over the medium to long term driven by earnings growth, improving U.S. economic fundamentals and a more business-friendly political/regulatory climate.

Impact of Key Developments in the Quarter

Two major developments impacted the capital markets during the First Quarter.

First, interest rates marched higher in response to increasing inflation expectations and economic growth, with the Fed reiterating its desire to return interest rate policy to normalcy within the medium term. The Fed raised the Fed Funds rate by 0.25% to 0.75% at its March meeting and suggested more rate rises are likely this year. This move was widely anticipated as economic fundamentals have improved during the quarter, the equity markets have been strong and inflation has ticked higher. Because the Fed clearly telegraphed the rate increase, the markets responded with relative calm. As we have previously mentioned, a slow, steady increase of the Fed Funds rate to a historically normal rate can be a positive for the equity markets, as long as it parallels the continued improvement of the U.S. economy. At the very least, the Fed's interest rate path continues to provide a floor under the recent gains in the financial sector, as most large banks and other financial institutions benefit from higher interest rates, due to greater net interest spreads and income from fixed obligations.

Second, Democrats in the House of Representatives and the Freedom Caucus members of the Republican Party torpedoed legislation to replace "Obamacare" with "Trumpcare," at least temporarily. While health insurance reform certainly impacts stocks such as health insurers, hospital providers, pharmaceutical manufacturers, etc., the failure of the Trump-backed bill was even more significant because it foreshadowed the difficulty of passing corporate tax reform. Optimism surrounding tax reform has been a key support of the markets since President Trump won the election in November. However, the concept is not without its own controversy. While many Democrats oppose lowering corporate taxes and personal taxes that might benefit wealthier Americans, many Republicans oppose the border adjustment tax that would impose a tax on imported goods, which would hurt some industries, particularly the retail and consumer goods industries. The border adjustment tax is a main component of the Trump administration's corporate tax reform, as it is intended to offset some of the lost government revenue from a lower effective corporate tax rate.

On the personal income side, the Trump administration would like any tax cuts to favor the middle class and be "revenue neutral" so as not to further increase the national debt. This likely will lead to the removal of certain tax deductions, which will cause proponents of each deduction to protest. Thus, the failure of the Trump administration to push healthcare reform through a Republican controlled Congress may portend more political infighting ahead.

Looking Ahead in 2017

For the remainder of 2017, we view returns on equities to be dependent in large part on the success or failure of tax and regulatory reform, as well as continued economic improvement and one to two additional interest rate hikes. While we believe some kind of tax reform is inevitable, the markets in the short term will be focusing on the Trump administration's progress in passing specific legislation this year. It is important to note, however, that the impact of any legislation that is passed in 2017 will not be immediately felt in corporate earnings and household incomes until sometime next year, at the earliest. More generally, the expected political climate may cause a return to some volatility as the dynamics of a Trump administration and the Washington establishment play out.

Regarding the path of interest rates, we will be closely following new economic data releases, both foreign and domestic, as they impact whether the Fed stays on course to raise rates in a methodical fashion or decides to quicken or slow down the interest rate path. We believe the Fed is determined to maintain its previously stated course of interest rates higher barring any major unforeseen economic and geopolitical developments and that two additional interest rate increases this year are most likely.

We also will be keeping an eye on developments in Europe, particularly with respect to the progress of the U.K.'s Brexit implementation and elections across the continent that could lead to victories by populist/nationalist leaders. The impact of Brexit on the European economy and financial markets so far has been relatively limited as economic conditions there have begun to stabilize and show signs of returning to a growth trajectory, but the long-term economic impact of Brexit and the European populist movement in general remains to be seen.

We currently are seeing individual market opportunities within the healthcare sector, particularly in the biotech and pharmaceutical industries. The current political climate has put pressure on drug pricing but more draconian drug pricing restrictions will be difficult to implement politically and legally. We also have identified company-specific events that have presented attractive opportunities in other sectors, focusing on pro-cyclical sectors that could benefit the most from economic growth and inflation, such as industrials, financials, energy and materials. We will continue to maintain healthy cash balances in client accounts in the near term, as we expect the surprising and historic period of low volatility since the presidential election to end soon. While an increase in volatility may be temporarily painful to investors, an occasional 10% correction in the equities markets is a normal and healthy part of any bull market and would be an attractive buying opportunity for long-term investors.

As usual, we value and appreciate any comments you might have.

Very Truly,

RDM Capital Associates, Inc.