US stock market volatility spiked mid-month after a steady drumbeat of negative headlines coming from Washington prompted many Wall Street investors to question the level of optimism surrounding the Trump administration’s pro-growth agenda, culminating in a plunge of the Dow Jones Industrial Average of greater than 300 points on May 17th, the worst single session performance of the index since September. The turmoil was short lived, however, as improving European economic data and still strong corporate earnings growth combined to push stock prices in the US and globally higher. Amongst equity markets, European stock indexes led monthly gains, as data in Germany and France showed the two largest Eurozone economies are gaining momentum and the second round of French Presidential elections confirmed the most market-friendly candidate had won the seat. Bonds, meanwhile, posted solid monthly returns, in part due to skepticism by investors with respect to the Trump administration’s ability to enact its pro-growth policies, but also due to Federal Reserve minutes that suggest that the pace of future rate hikes could be less aggressive than originally anticipated. In the oil market, crude declined, even after the Organization for Petroleum Exporting Countries (“OPEC”) met and agreed to an extension to the previously agreed to production cuts. The Agreement disappointed market participants which had anticipated a longer more meaningful extension to the cuts, sending oil prices tumbling.

Globally, stocks posted positive returns, led by developed international market indexes, though in the US, the path of those returns was volatile. Several decisions by the Trump administration seemed to elevate investor anxiety, which took its toll on markets, including allegations that classified information was disclosed to the Russian ambassador; the firing of the FBI director Comey; and asking that same FBI director not to pursue his investigation of the former National Security Advisor all culminated in the Dow tumbling by the most since the election. As a result, the Volatility Index (“VIX”) spiked and many investors feared the level of volatility would remain elevated, something that has not been a concern for markets, with a few exceptions, in the last year. US markets brushed aside these concerns, it would turn out, focusing instead on the improving data from abroad and the possibility of a slower pace of Fed rate hikes. Corporate earnings also showed that...
companies grew profits by nearly 15% in the first quarter, the third consecutive quarter of profit growth and an acceleration from the previous quarter.

Turning abroad, stocks performed well, boosted by improvements in survey measures. In Germany, the Ifo Institute’s measure of Business Confidence rose to 114.6 in May, the highest reading since 1991, while first quarter GDP rose by 0.6% the fastest pace in a year, led by exports and capital investments. Meanwhile, the composite Purchasing Manager’s Index (both manufacturing and services) for the broader Eurozone touched a level of 56.8 in May, suggesting the economy was expanding at its quickest pace in six years. Gauges for France and Germany showed similar economic progress. Emerging market stock performance was also solid, driven higher by improving fundamentals in Asia, though a new corruption scandal in Brazil involving the current president, who was installed to root out corruption after the impeachment of the previous president on charges of corruption, added to the geopolitical risk.

Fixed income markets also posted positive monthly returns. The Treasury market remained skeptical that the pro-growth agenda of the Trump administration could be enacted and impact the economy broadly. In addition, inflation remained subdued. As a result, the Treasury yield curve flattened significantly during the month, as the spread between 2- and 10-Year Treasuries narrowed to 91 basis points (“bps”). That narrowing of spread occurred almost entirely at the 10-Year end of the maturity spectrum, with the yield on the 10-Year Treasury falling to about 2.22% from about 2.30%. A flattening yield curve, where the longer dated bond rallies, tends to be a sign of risk aversion. The short end, on the other hand, appeared to be reacting to the high probability of a Fed rate hike at its meeting in June. Interestingly, the minutes from the Fed’s last meeting, which were released during the month, alluded to the possibility of a slowing in the Fed’s rate hike path, a positive for Treasury bonds. High Grade and High Yield bonds, on the other hand, posted better returns than Treasury securities, due to a narrowing of spreads given the improving economic environment. High Yield spreads, for example, narrowed to about 360 bps, closing in on a near-term low in spreads. A narrowing of High Yield spreads suggests investors willingness to accept risk, in stark contrast to the signals being sent by the Treasury market. However, the declines were led not by oil but by weakness in agricultural commodities. Oil, as measured by West Texas Intermediate, did finish the month down triggered by investor disappointment after the news that OPEC’s extension of production cuts would only be nine months. The market had priced in a higher probability of an extension up to 12 months. OPEC’s announcement did leave the door open to further extensions, however, the cartel did state it believed a nine-month extension was sufficient to bring oil inventories to their five-year average. Agricultural commodities, especially Soybeans, fell on concerns that supplies remain elevated. Metal commodities were mostly down, with industrial metals mostly lower on concerns about a slowdown in China, and precious metals also down, a sign that risk aversion was low.

Should you have any questions about this update or your portfolio, please do not hesitate to contact your Portfolio Manager or Trust Officer.
Unless otherwise noted, performance and return data sourced from Bloomberg, LP as of May 31, 2017.

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Interest from certain municipal bonds may be subject to state and/or local taxes and in some circumstances, the alternative minimum tax. Unlike U.S. Treasuries, municipal bonds are subject to credit risk. Quality varies widely depending on the specific issuer. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

This is only an opinion and not a prediction or promise of events to come.

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