First Trust — Quarterly Market Overview

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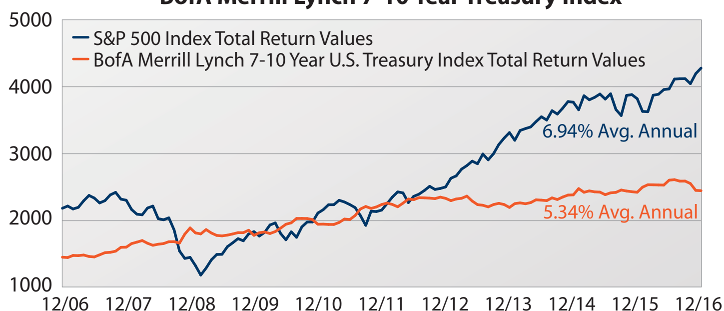
We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

A look at the past decade

Total Return Values for the S&P 500 Index and the BofA Merrill Lynch 7-10 Year Treasury Index



Source: Bloomberg, 12/31/06-12/31/16. Past performance is no guarantee of future results.

Total Assets in Domestic Equity & Bond Mutual Funds & Exchange-Traded Funds (ETFs)

Year	Domestic Equity Funds	Domestic Equity ETFs	Bond Funds	Bond ETFs
2007	$4.69 T	$365.05 B	$1.68 T	$34.65 B
2008	$2.74 T	$324.54 B	$1.57 T	$57.21 B
2009	$3.56 T	$386.10 B	$2.21 T	$107.02 B
2010	$4.05 T	$476.18 B	$2.59 T	$137.78 B
2011	$3.86 T	$509.24 B	$2.84 T	$184.22 B
2012	$4.32 T	$644.72 B	$3.39 T	$243.20 B
2013	$5.73 T	$964.41 B	$3.29 T	$245.86 B
2014	$6.23 T	$1.20 T	$3.46 T	$296.38 B
2015	$6.05 T	$1.23 T	$3.41 T	$340.27 B
2016*	$6.36 T	$1.53 T	$3.64 T	$421.18 B

*Source: Investment Company Institute. *2016 data thru November. B = billions. T = trillions.*

As we turn the page on 2016, we would like to take a glance back at what transpired in the markets over the past decade, and see if it has any relevance or application with respect to expectations moving forward. As you may recall, 2007 was a fairly pivotal year in the markets as investors likely got their initial introduction to the subprime mortgage crisis in July, when Bear Stearns liquidated two hedge funds that invested in risky securities backed by subprime mortgage loans due to dismal returns. This crisis later blossomed into a full-blown global financial crisis that spanned from Q4'07 through most of 2009, with some of the fallout still lingering to this day. The financial crisis was not only responsible for driving the U.S. economy into recession, it brought about an end to a bull market in stocks (10/9/02-10/9/07), in our opinion. A severe bear market in stocks (> 20% decline) soon followed (10/9/07-3/9/09). In that bear market, the S&P 500 Index lost more than half its value (-55.25%), on a total return basis, according to Bloomberg. Some of the fallout we noted was psychological in nature, in our view. There were numerous stories in the financial media about how some investors had lost trust in Wall Street after the "government bailout". We believe that the experience likely influenced, or even altered, many investors' appetite for risk. This is the point that we would like to drill down on.

As indicated in the chart above, from 12/29/06 through 12/30/16, the S&P 500 Index posted an average annual total return of nearly 7.00% (6.94%), and that includes the aforementioned bear market (10/9/07-3/9/09) that accompanied the financial crisis. That equates to 95.72% on a cumulative total return basis, or nearly a double. For those investors more risk-averse, the BofA Merrill Lynch 7-10 U.S. Treasury Index posted an average annual total return of 5.34% over the same period, or a cumulative total return of 68.22%. The yield on the BofA Merrill Lynch 7-10 U.S. Treasury Index stood at 4.90% at the end of 2006, so the index's average annual total return of 5.34% actually outpaced its yield from the start of the period. For comparative purposes, the 4.90% index yield, as of the end of 2006, was nearly in line with the 5.11% average yield on the 10-year T-note for the 30-year period ended 12/30/16, according to Bloomberg. The higher average annual return on the index was a result of a relatively sharp decline in interest rates. From 12/29/06 through 12/30/16, the yield on the benchmark 10-year Treasury note (T-note) declined by 225 basis points, from 4.70% to 2.45%, according to Bloomberg. The drop in interest rates pushed bond prices higher. One of the goals of any investor holding bonds is to at least "earn your coupon." From our perspective, despite the tumultuous times in the markets over the past decade, stocks and bonds posted some solid returns. As indicated in the table above highlighting total Domestic Equity and Bond mutual fund and ETF assets, all four categories reflected relatively strong growth over the period.

If we were to apply the same type of basic analysis to these two indices heading into 2017, we would get a bit of a different take, at least with respect to the expectations for the BofA Merrill Lynch 7-10 U.S. Treasury Index. A decade ago, the yield on the index stood at 4.90%, more than double its 2.36% yield as of 12/30/16, according to Bloomberg. Remember, one of the goals when investing in bonds is to at least earn your coupon. We believe a yield of 2.36% suggests that investors are potentially looking at an average annual return over the next decade that could fall short of the 3.0% historical rate of inflation in the U.S. since 1926, as measured by the Consumer Price Index, according to Bloomberg. Investors should also factor in the possibility of rising interest rates in 2017, and perhaps beyond. Brian Wesbury, Chief Economist at First Trust Advisors L.P., sees the yield on the 10-year T-note rising to 3.25% by the end of 2017. The Federal Reserve has stated that it is considering initiating three quarter point rate hikes in 2017, according to CNBC.

While the current bull market in stocks is on pace to reach the eight-year mark in March 2017, the S&P 500 Index, as of 12/30/16, compared favorably in some key metrics relative to 2006, according to data from Bloomberg. The index's price-to-book ratio was only slightly higher at 2.90 on 12/30/16, compared to 2.83 on 12/29/06. Its dividend yield was higher than in 2006 (2.09% vs. 1.77%). While its trailing 12-month price-to-earnings ratio was higher (20.90 vs. 16.60), its 2017 earnings estimate looks encouraging, in our view. In dollar terms, the index posted $85.35 in earnings in 2006, compared to an estimated $106.77 in 2016. As of 12/30/16, Bloomberg's consensus earnings estimate for 2017 was $133.20.

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Industrials vs. Materials

For the 20-year period ended December 30, 2016, the average annual total return on the S&P 500 Industrials Index was 8.18%, compared to 6.71% for the S&P 500 Materials Index, according to Bloomberg. The annual total returns are referenced in the table to the right. For comparative purposes, the average annual total return for the broader S&P 500 Index was 7.68%, just above the 7.45% average between the S&P 500 Industrials and S&P 500 Materials Indices. Keep in mind that all of these average return figures are well-below the S&P 500 Index's 91-year (1926-2016) average annual total return of 10.04%, according to Ibbotson Associates/Morningstar. The fact that they came in well-below the historical average could portend the potential for more upside for the current bull market in stocks. Perhaps a catalyst of some sort would help. An acceleration in U.S. economic activity would be a good start, in our opinion, particularly for industrials and materials companies.

On that front, we see some reasons to be optimistic. President-Elect Donald J. Trump is a builder who campaigned in part on increasing U.S. infrastructure and military spending. He also has been outspoken on cutting U.S. corporate tax rates and reducing burdensome government regulations on businesses. His policies and agenda appear to be pro-growth and pro-U.S. He talks often about not only creating more jobs, but bringing some of the jobs back that companies have shipped out of the U.S. We believe the Trump Administration is poised to benefit from the Republican majorities in both houses of Congress. Unrelated to the election results, due to the rebound in the price of crude oil and easier access to capital, Raymond James believes that U.S. shale drillers will boost spending on exploration and production in 2017, according to Reuters. The price of crude oil increased from a multi-year low of $26.21 per barrel on 2/11/16 to $53.72 on 12/30/16, according to Bloomberg. Banks are extending credit lines for the first time in two years. Raymond James estimates that North America-focused oil and gas producers will increase capital investments by 30% in 2017.

A bump in the U.S. GDP growth rate could potentially influence the returns on Industrials and Materials, as evidenced by splitting the 20-year period featured in the table to the right into two halves. From 1997 through 2006, the average annual total return on the S&P 500 Industrials Index was 8.57%, compared to 7.37% for the S&P 500 Materials Index. U.S. GDP growth averaged 3.2% over that same period, according to data from the Bureau of Economic Analysis. From 2007 through 2016, the average annual total return on the S&P 500 Industrials Index was 7.78%, compared to 6.05% for the S&P 500 Materials Index. U.S. GDP growth averaged 1.4% (thru last release in Q3'16) over that same period.

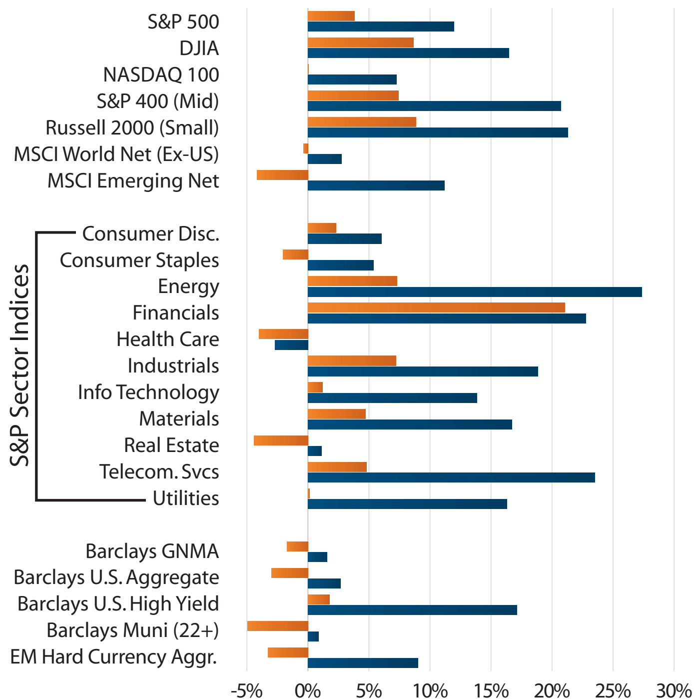
The relative strength of the U.S. dollar can influence the performance of these two sectors over time. A strong U.S. dollar is potentially where the concern lies. When the U.S. dollar is strong relative to other major foreign currencies, U.S. goods can become pricier in the global marketplace, and vice versa. Since most raw materials are priced in U.S. dollars, a strong dollar can impact the amount of materials that can be purchased by foreign buyers, and vice versa. When a buyer exchanges their weaker currency for U.S. dollars, they receive less dollars in return, which means they have less money to spend on materials. From 1997 through 2006, the U.S. Dollar Index declined by 5.07%, but rose by 22.19% from 2007 through 2016, according to Bloomberg. In 2015, for example, while the S&P 500 Index posted a total return of 1.38%, the S&P 500 Industrials and S&P 500 Materials Indices were down 2.53% and 8.38%, respectively, according to Bloomberg. The U.S Dollar Index (DXY), which rose by 9.26% in 2015, may have provided some headwind, in our opinion.

In 2016, investors funneled an estimated net $7.38 billion into U.S. Industrial mutual funds and ETFs, compared to $774 million for U.S. Natural Resources mutual funds and ETFs, according to Morningstar.

Year	S&P 500 Industrials Index	S&P 500 Materials Index
1997	27.04%	8.42%
1998	10.88%	-6.18%
1999	21.50%	25.25%
2000	5.88%	-15.72%
2001	-5.74%	3.48%
2002	-26.34%	-5.45%
2003	32.19%	38.19%
2004	18.03%	13.20%
2005	2.32%	4.42%
2006	13.29%	18.63%
2007	12.03%	22.53%
2008	-39.92%	-45.66%
2009	20.93%	48.59%
2010	26.73%	22.20%
2011	-0.59%	-9.75%
2012	15.35%	14.97%
2013	40.68%	25.60%
2014	9.83%	6.91%
2015	-2.53%	-8.38%
2016	18.86%	16.69%
20-Yr Avg	**8.18%**	**6.71%**

Source: Bloomberg

Total returns for *Q4* and past **12 months** (12/30/16)



Sources: Bloomberg and Barclays. Past performance is no guarantee of future results.

A Look Ahead:

The outlook for earnings (year-over-year comparison in $)...

	Q1'17E	Q1'16A	**Q2'17E**	Q2'16A	**2017E**	2016E
Consumer Discretionary	**7.87**	7.70	**9.05**	8.56	**35.83**	33.14
Consumer Staples	**6.28**	5.71	**6.81**	6.30	**27.50**	25.35
Energy	**3.14**	-2.71	**4.12**	-2.06	**16.38**	-1.77
Financials	**6.59**	5.47	**6.89**	5.46	**27.78**	24.28
Health Care	**13.25**	10.49	**13.82**	10.94	**55.29**	44.68
Industrials	**6.29**	5.88	**7.88**	7.14	**30.08**	27.57
Information Technology	**11.31**	8.03	**11.27**	8.27	**49.45**	38.89
Materials	**4.73**	1.67	**5.31**	4.91	**18.44**	13.67
Real Estate	**1.10**	2.55	**1.23**	1.51	**4.94**	6.70
Telecom. Services	**3.17**	2.80	**3.21**	1.92	**12.55**	10.12
Utilities	**3.63**	3.66	**3.10**	2.68	**14.32**	14.05
S&P 500 Index	**30.09**	23.97	**32.23**	25.70	**130.84**	108.84
S&P 400 Index (Mid-Cap)	**18.56**	13.28	**21.16**	16.38	**84.38**	67.47
S&P 600 Index (Small-Cap)	**8.83**	5.36	**10.13**	6.64	**40.92**	28.34

Source: Standard & Poor's (1/4/17)