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Executive Summary

- The start of the Trump presidency has been marked by good economic data and high confidence, while media coverage has reflected lingering uncertainty
- Rock solid fundamentals — the strongest quarterly earnings outlook in five years — has provided a sustainable foundation
- Despite stumbles, the administration's pro-business posture, exemplified by a focus on deregulation and tax reform, has been reassuring to markets
- Foreign markets have been robust, as broad global diversification hit its stride

The First Quarter: Fundamentals and Confidence Join Forces

Fortunately, fundamentals drive markets, not the press or daily political banter. The markets opened the year with a worldwide firehose of positive economic statistics bolstered by enthusiasm for the promise of President Trump's pro-business economic message. Fundamentals, such as corporate earnings, are transparent, measurable and directly relevant to market prices — whereas the political process, with its total lack of transparency, defies accurate reflection in securities pricing.

In the face of this reality, investors let Washington rattle them, and many turned pessimistic. For those who expected a quick repeal and replacement of Obamacare, what were you thinking? Is it good or bad that the Republican healthcare bill failed? Who knows... just fix it.

The legislative agenda will now move to tax cuts, a big potential positive for business and economic growth. Should the corporate tax rate be 15%? Should a border adjustability tax (BAT) be part of the package? Who knows, just cut taxes, because we know it works.

How can the economy grow if small businesses — employers of more than half the U.S. workforce — are overwhelmed with red tape? Not sure, just fix it.

Much attention has been paid to whether the apparent failure of the healthcare bill could make tax reform impossible. To the contrary, the possibility of a bipartisan approach may produce better, more pragmatic tax legislation.

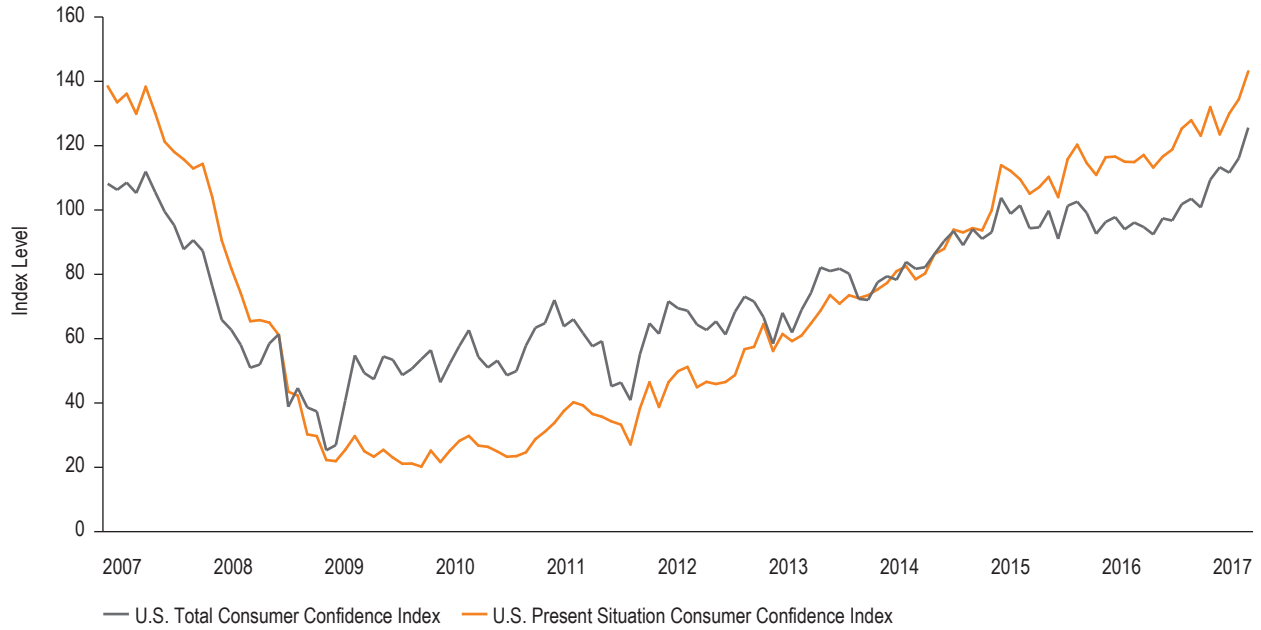
Groucho Marx once said, "Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies." It's always hard to pass good laws, but let's just do it.

Global Move Toward the Growth and Reflation Trade

The United States has been on a tear with solid economic reports across the board. Even more surprising, Europe had higher economic growth than the U.S. last year; China's growth, though unsteady, shows signs it may surprise on the upside in 2017. Let's review some of the more indicative signs of accelerating fundamentals:

- Corporate earnings are accelerating: the growth rate of S&P 500 earnings is expected to reach its highest level in five years for 1Q17; this would mark the third consecutive quarter of accelerating growth
- Manufacturing is broadening: The U.S. Production Manager Index (PMI) surged to a 30-month high echoed by Japan's Tankan survey of large manufacturers, which reached its highest level in three years; euro zone PMIs were the strongest in 71 months
- Confidence abounds, with the Consumer Confidence index soaring to a 16-year high; the Small Business Confidence index has hit a 30-year high; and The CEO Economic Outlook Survey for Q1 2017 has surged to its highest reading in the last three years

Figure 1. Consumer Confidence Has Hit a 30-Year High



Source: The Conference Board, FactSet. 1985 = 100.

First Quarter 2017 Performance

January kicked off the best first quarter since 2015 with strong economic data reports, positive corporate earnings growth and optimism about new fiscal policy to support economic growth. As 2016 ended, small caps had been the equity trailblazers, but they took a breather in the first quarter — a turnaround that reverberated across large-cap sector performance as well.

Overall, the S&P 500 was up 6.1% for the quarter and 11.4% since the election. But many of the high flying sectors in 2016 stepped aside to let others catch up. The post-election rise of the financial sector fell behind, while the technology sector’s fitful fourth-quarter performance gave way to a dramatic 12.2% surge during the first quarter.

Figure 2. S&P Earnings Continue to Accelerate

Sector	Earnings Growth		
	Percent	Positive	Negative
Utilities	15.6	19	8
Real Estate	14.6	22	7
Financials	11.1	46	15
Information Technology	10.0	54	13
Health Care	5.6	46	12
Consumer Staples	5.1	28	9
Energy	4.3	6	14
Materials	3.9	10	13
Consumer Discretionary	3.7	51	33
Industrials	-5.7	38	29
Telecommunication Services	-28.7	1	4
S&P 500	5.0	321	157

Source: Bloomberg and FactSet.

Note: Earnings growth is the percentage change in the cumulative share-weighted earnings per share compared to a year ago. Earnings surprise percent is the share-weighted average of the ratio of actual company earnings vs. consensus estimates.

Out of favor, growth-oriented stocks generally gained ground on their value counterparts during the quarter. Although the market rally hit a slight speed bump in March — as the animal spirits got indigestion over fears that the pro-growth agenda might not still be on the menu — it subsequently rebounded, trading near all-time highs on undeniably strong fundamentals.

One notable exception to this reversion to the mean behavior has been emerging market stocks. Emerging markets — up double digits in 2016 — showed no signs of abating, climbing 11.5% in the first quarter alone. Emerging markets are benefiting from higher commodity prices, an uptick in global growth and a U.S. dollar that got a little ahead of itself and then moderated back to pre-election levels. The euro zone was also a standout in the first quarter in both economic and market performance. The EAFE index climbed three months in a row, posting a 7.4% gain for the quarter. Once again, broad global diversification hit the cover off the ball for investors.

Figure 3. Global Diversification Proves Effective in the First Quarter

Index	March 2017	1Q17
Equity		
S&P 500	0.1	6.1
S&P Midcap	-0.4	3.9
S&P Smallcap	-0.1	1.1
Global REITs	-1.4	2.3
EAFE	2.9	7.4
Emerging Mkts	2.5	11.5
Fixed Income		
Corporate	-0.2	1.2
U.S. Treasury 20+	-0.6	1.4
Global Aggregate	0.2	1.8
High Yield	-0.2	2.7
Senior Loan	0.1	0.9

Source: FactSet, FTSE NAREIT, Voya Investment Management. Asset classes are represented by the S&P 500 index, the S&P 400 Midcap index, the S&P 600 Smallcap index, the MSCI U.S. REIT index and FTSE EPRA REIT index, the MSCI EAFE index, the MSCI BRIC index, the Bloomberg Barclays U.S. Corporate Bond index, the Bloomberg Barclays U.S. Treasury Bond index, the Bloomberg Barclays Global Aggregate Bond index, the Bloomberg Barclays U.S. High Yield Bond index and the S&P LSTA Leveraged Loan index. Returns are annualized for periods longer than one year. **Investors cannot invest directly in an index. Past performance is no guarantee of future results.**

Fixed income investments surprised on the upside, with most major market sectors recording positive returns for the quarter. Investors anticipated a move up in interest rates and although the Federal Reserve hiked short term rates; global growth concerns, aging demographics and continued central bank accommodation have kept long rates in check. As with equities, broad global diversification led the way. High yield bonds continued their run, up 2.7%; but the Barclays Global Aggregate Bond Index was up almost 2% in the first quarter, demonstrating the strength of global economies and balance sheets.

“Where’s the Beef” in Those Pro-Growth Tax Cuts?

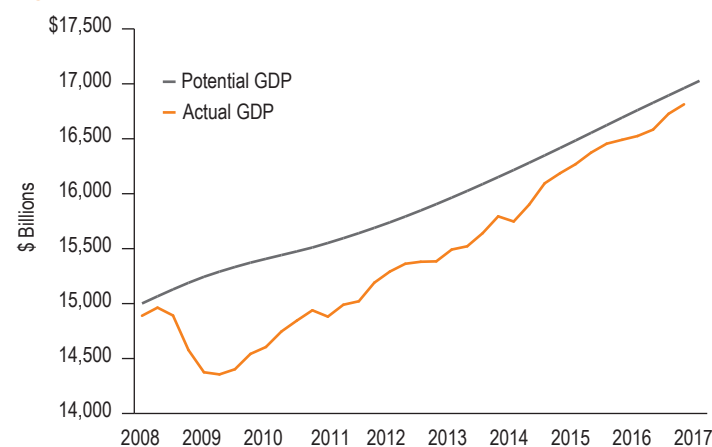
There is a lot of talk of tax cuts as an economic growth driver, so let’s look at them.

Tax rate cuts have been enormously successful ever since the Federal income tax was enacted in 1913. The most significant and notable tax cuts under U.S. presidents occurred in the 1920s under Warren Harding and Calvin Coolidge; in the 1960s under John F. Kennedy and in the 1980s under Ronald Reagan. In every case, government revenues increased for the decade while the rich paid a significantly higher share of taxes even with lower rates — as both markets and the economy prospered.

The reasons behind this apparent conundrum were succinctly clarified by then-Treasury Secretary Andrew Mellon, who in 1924 stated, “The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business.”

History suggests that tax cuts have the best chance to drive growth back to its long-term trend level of 3.2% per annum. Not one year out of the past eight witnessed the U.S. economy reaching this level of growth. The St. Louis Federal Reserve produces a chart comparing the Congressional Budget Office’s estimates of “potential GDP” to “actual GDP,” which shows a gap on average of \$1.8 trillion annually from 2008 through 2016. This diminishes potential corporate earnings, consumer income and spending, jobs and tax receipts, while increasing the large and growing U.S. debt. If prosperity and growth really matters, the U.S. should not just cut taxes; it should slash taxes.

Figure 4. The GDP Output Gap: Potential vs. Actual



Source: Congressional Budget Office

Conclusion

Markets care more about economics than politics, and good news abounds as fundamentals are accelerating in the U.S. and internationally. Yet there is a distinct lack of euphoria in the markets, and we believe the biggest risk for investors is missing the next leg of this rally. The combination of accelerating fundamentals and high confidence could put new spring into the step of this bull market, a scenario which also should benefit from broad global diversification.

Diversification does not guarantee a profit or ensure against loss

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