We'll take it! Whether attributable to solid improvement in corporate and economic fundamentals or continued optimism around the unfolding of a new administration's potentially pro-business policies, the major U.S. stock markets produced their sixth-straight winning quarter and built on last year's strong finish. The fact that the markets retained almost all their gains despite gradually losing upward momentum suggests real fundamentals played a significant part in driving gains. We wrote in last quarter's commentary that "while policies on tax reform, repatriation of foreign earnings, fiscal stimulus and the reduction of regulations are all expected to be introduced, none of the details about these plans are known, and they won't be until at least March (if ever!)." We have no reason to feel differently today and continue to base our measurement of risks and potential rewards based on what we know rather than hypotheticals. Trying to determine causation is of limited future value anyway, so we prefer to focus on how stocks definitively emerged from a four-quarter earnings "recession" to deliver decent mid-single-digit earnings growth over the second half of 2016. The bar has been set high, but if U.S. corporations can come close to meeting current expectations for 10% growth in 2017, then the backdrop will remain supportive and reduce the likelihood of a significant market pullback.

Value stocks didn't dominate growth stocks this quarter quite like they did during almost all of 2016, but our stock portfolios still captured a good chunk of the market's gains and our fixed income accounts in most cases fared better than their benchmarks. We still believe that the current conditions – a gradually improving economy, expensive valuations and upward-sloping interest rates – are ripe for an extended, multiyear outperformance by value stocks, such as we saw over the seven years following the 2000–2002 bear market (the "Tech Wreck"). This would be a very favorable development for our portfolios. Being classified as a value stock, though, is not a permanent condition – wherever we find opportunity, we can, will and should change!

Late last year, the industries expected to benefit most under President Trump's policies (i.e., Financials, Energy and Industrials) surged, while in the recent quarter they all underperformed the S&P 500. After several years of being one of the market's worst-performing – and, importantly, cheapest – sectors, Financials were reassessed more positively, with expectations for a more profitable interest rate environment and less onerous regulations. Valuations in many cases surpassed ranges traditionally seen in even better climates, so during the first quarter we took profits in U.S. Bancorp in many portfolios. They are among the best-run domestic banks, but the value proposition was much more favorable a year ago when few found it appealing. The Consumer Staples sector and other large multinational companies were largely thrown out after the election as worries grew about a more protectionist trade policy and stronger dollar affecting overseas profits. These names were expensive to begin with after investors had piled in searching for dividend yield, and maybe they were primed for a pullback. Regardless, their selloff marked a good entry point, as over the course of the first quarter we saw strong performance from portfolio holdings like Pepsi and Proctor & Gamble when some of the concerns didn't materialize. The same can be said for Technology stocks, which in many cases earn a large portion of their profits overseas. A number would also be hit particularly hard by immigration curbs, given their reliance on highly skilled foreign labor. After their end-of-year swoon, they reversed upward, led by stalwart Apple, to become the best-performing sector in the first quarter. As current realities clash with hopes and expectations, we should continue to see money sloshing from sector to sector. We hope to continue to take advantage of any opportunities created by these short-term movements and remain flexible in areas where we find value.

For the first time in years, some of the most attractive opportunities may lie outside our borders. Our portfolios have benefitted from being mostly invested in large, U.S.-centric stocks, the best-performing assets in the world since the financial crisis. Consider that the S&P 500 has produced roughly a 100% return over the past decade, while European blue chips have grown a paltry 2% or so. And not only have our markets fared better, they've done so with less risk and volatility. There's supposed to be an inverse relationship between expected returns and safety, but with valuations now stretched here by almost every metric, investors are assuming we can continue to get both indefinitely. We would suggest otherwise. The political election headlines in Europe are obscuring a markedly improved fundamental backdrop, including forecasts for mid-teens earnings growth rates this year and industrial output at six-year highs. European earnings in real terms are merely back to where they were in 2009 – it seems like their profit cycle has a lot of catching up to do versus the U.S. Meanwhile, European price-to-earnings ratios based on the next 12 months of expected earnings are about 25% cheaper than where the S&P 500 trades. Given this landscape, we added Nestlé late last year and ABB, the Swiss industrial power house, to many portfolios to provide a little more leverage to the better value proposition. Both have strong balance sheets with "moat-like" competitive positions, pay strong dividends and are reasonably priced enough to afford healthy share gains if the environment continues to improve. We'll always maintain our core weighting in the most solid and reliable domestic businesses, but we may look for additional international exposure, including in the Emerging Markets, if opportunities become too appealing to ignore.

Most things went right for our portfolios during the first quarter, but one sore spot was our exposure to the Consumer Discretionary sector. Most everyone knows the threat that Amazon and other online retailers pose to the traditional retail format and how challenging the rapidly changing tastes of millennial consumers are to navigate. However, conditions dramatically deteriorated during the holiday selling season, and first-quarter earnings reports were a field of landmines. We had invested in Target a year ago when the stock traded at 15-year valuation lows. If they simply executed competently there seemed plenty of room for the stock price to appreciate. For a while this thesis played out, but during the quarter not only did they preannounce poor results, but they followed up with even lower guidance when earnings were actually released. We want to invest in quality when it's on sale, so with little confidence in the fundamental trajectory and management's ability to make adjustments, we felt we had to move on. We still have relatively light positons in Abercrombie & Fitch and Hanesbrands, but feel expectations are low enough and fundamentals decent enough to stick with them for now. Whenever we hear that a sector is "dead" or clients are telling us to never buy another retail stock, our antennae perk up, as it's such washed-out sentiment that can often help establish a floor. How many times have we heard the same rhetoric over the years with respect to the Financials, Energy, Technology, etc., only to find in retrospect that great buying opportunities were at hand?

Looking forward, based on recent measures of consumer confidence that have jumped beyond near-term reality and waning investor optimism, March's consolidation / correction phase could continue in the second quarter, especially as it's widely believed tax and regulatory relief is essential if corporate fundamentals are to catch up with stock prices. Without this steady improvement or a price adjustment, the markets will look increasingly expensive. Of the myriad influences and news flow in the background, as almost always, outcomes will be determined by earnings and what investors are willing to pay for them. Valuations can help gauge future performance and how much risk is embedded in current prices, and the reality is current valuations levels in the past have delivered poor returns. Meanwhile, the average investor tends to buy after periods of strong performance when valuations are higher and expected returns are lower. We were more comfortable with slightly elevated cash positions in many portfolios to close the quarter and are well-positioned to take advantage of any opportunities that present. Also remember that valuations are a poor timing indicator: Although the last time the market was this expensive was 2004, it didn't peak until the fall of 2007. While we need to be disciplined and on guard for any change in conditions, there are still plenty of reasons to maintain our current weighting in stocks.

As always, we greatly appreciate your trust and confidence and will continue to be careful stewards of your hard-earned assets. We hope you enjoy the rest of your spring!

Best regards,

The Wise Investor Group

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Robert W. Baird & Co. Incorporated. 11951 Freedom Drive, 10th Floor, Reston, VA 20190.
571-203-1600 thewiseinvestorgroup.com