Economic & Market Commentary

The third quarter of 2017 marked the eighth consecutive quarterly rise in U.S. stock prices, the longest winning streak since 2013, and the fifth time a streak of that length has occurred since S&P data began being tracked in 1928. The S&P 500 added another 4.5% to its six month gain, to register a total return of 14.2% for the nine months. Bonds produced a small gain, to add to their positive return at six months, but have well underperformed equities year to date. Growth and large cap stocks continued their earlier outperformance, although by dint of a strong September, small cap pulled ahead of large for the full quarter. Volatility remained surprisingly low, with the Chicago Board of Options Exchange Volatility Index (VIX) reaching 9.19, and broaching the prior low of 9.31 recorded in 1993. Five of the S&P's eleven sectors outperformed the index for the quarter, led by information technology (also the leader for the year to date), energy (a reversal, as it was the worst performer year to date) materials, telecom, and financials. For the nine months, only information technology and healthcare outperformed. Global markets generally outdid the U.S. in dollar terms, due to the depreciated dollar, for both the quarter and the nine months. Emerging market equities were the leaders, generating returns close to twice the S&P.

The complacency that we wrote about last time has continued unabated, with risks seemingly ignored. Most of us who have been through the financial crisis of 2007-2009 are aware of "tail risk" and "black swans", those unpredictable, extreme events that can cause large negative reactions. Recently a pundit wrote about this and cautioned that "black swans' are not the only risks that should be thought about. Equally important, he cautioned, are those risks that are well known, but may be ignored. He dubbed these "gray rhinos". From our vantage point, there are several "gray rhinos" lurking. In the political and geopolitical realm, the mercurial nature of the administration in Washington is unsettling. We have written about this in previous outlooks, so there is no need to repeat the whole litany. Suffice it to say that it continues and gets more troubling with each passing day. The fear is that it will lead to actions which could cause meaningful damage to our economy and standing in the world. Among North Korea, China, Iran and even our so called allies, there is ample opportunity to create havoc. Today's investors have seemingly become inured to these global risks, assuming they would be of short duration and have little economic impact. But with the world more integrated and interdependent that is a bold assumption. Take Korea for example: South Korea produces 40% of the world's liquid crystal displays and 17% of its semiconductors. Any conflict on the Korean peninsula, therefore, would create a significant supply chain issue.

On the domestic front, there are "gray rhinos" as well. As we have said before, the original message delivered by the Trump administration, and the fiscal measures proposed, were positive. The messenger, however, is suspect. Nothing has changed this viewpoint, in fact it has been heightened to the point where there are looming questions about whether any of the message will be enacted. A tax bill and reform could be a significant aid to economic growth. With a single party controlling the executive branch, and both houses of Congress, it is disappointing how little has been accomplished, and how the process has devolved into a series of "gotcha" moments filled with vitriol. Clearly, confidence in a positive legislative outcome has decreased. Investors are counting on favorable action on taxes, and failure to act will not be taken lightly.

The final “gray rhino” we should mention is the action taken by the Federal Reserve Board with regard to the pace of interest rate normalization and balance sheet unwind. The Fed has telegraphed their intent to increase (normalize) short term interest rates, and indicated a pace that should not be problematic. Likewise, they have indicated their plan to reduce the $4.5 trillion bloat to their balance sheet, by letting maturing securities run off at a pace of about $10 billion per month. About 10% of the balance sheet assets are of one year or less in maturity, with another 10% in the one to five year range. If this is accomplished as planned, without the sale of securities (they have said they would not sell securities), there should be little dislocation. Global central banks have injected close to $12 trillion into the global economy over the past several years, and that liquidity has had a big hand in inflating financial assets. The fear is that reversing this process could have a deflationary impact on those same financial assets. If the Fed (and other central banks that may follow) sticks to its stated plan (and does not sell securities), we think the stock market can withstand the reduction in monetary stimulus

In spite of these potential “gray rhinos”, our equity markets continue an upward march, reaching new highs almost daily. Valuations, by all measures, except relative to interest rates, are high and stretched. Price/Earnings ratios, both current and long term (based on the ten year average of earnings adjusted for inflation), are extended. The value of all U.S. equities relative to GDP has topped the level reached before the financial crisis (2007), and the only time it was higher was during the “dot-com” era (1999-2000). We all know that valuation is not a good tool to use to gauge short term market moves. However, it is a valid tool for longer term judgements about returns. The Russell Investment group calculates that equity returns for the three years following periods at current valuation levels are less than 5%, which should give long-term investors pause.

All is not totally bleak, however. The U.S. economy has performed reasonably well this year. First quarter real Gross Domestic Product (GDP) of +1.9%, was followed by a second quarter of +3.1%. GDP will suffer a hiccup caused by the recent hurricanes and fires, but it should be short term in nature. Globally, we are in a truly synchronized recovery for the first time in many years, and the International Monetary Fund continues to raise their estimate of global real growth (+3.6%). U.S. corporate earnings have been stronger than most expected (a double digit gain for the first half), and we are just now entering another earnings reporting season. The expectation for the third period is a slowdown in rate of earnings growth (+2.8% per Factset), but this is due to one-time issues (primarily the impact of the catastrophes on insurance companies). Without those non-recurring factors, we would have another double digit gain. Also, importantly, the U.S. economy shows none of the usual signs of a negative inflection. As was true three months ago, we see no imminent signs of recession on the visible horizon, and inflation looks to be well controlled. The Fed has ample room to increase interest rates before they bite economic growth. The ten year U.S. Treasury Note could reach 3.5 – 4.0% (from 2.3% currently) before becoming a headwind for stocks. As mentioned earlier, the successful balance sheet unwind, as enunciated, should have little impact on economic liquidity, so is expected to have little depressing effect on financial assets.

A clearer definition of fiscal policy would also be a significant tailwind. For example, the successful implementation of a tax plan could be a big help. *Barron's* estimates that a corporate tax cut from 27% (the effective tax rate for the S&P 500) to 20% would add $10-$11 per share to S&P earnings. The current consensus S&P earnings for 2018 could go from $146 to $156, which would take valuation back to a more acceptable level.

Putting all this together, we see enough positives on the horizon to stay the course for the near term. We are very conscious of the "gray rhinos" mentioned, and are aware that any of them could gore us along the way, so we will be watching all of them closely as we proceed. We like our current holdings, as we think they are well positioned for the world we envision, and have ample unrealized value, so we see little reason to make significant changes.

FIXED INCOME

As mentioned earlier, bonds produced a modest return for the quarter, which added to their positive position in June. Using the ten year U.S. Treasury Note as a proxy, rates started the year at about 2.45%, ended the six months at about 2.30%, and closed September at 2.33%.

Treasury bond yields rose slightly across the full yield curve during the 3rd quarter, increasing between 3-10 basis points. Examining the movement in yields this quarter a bit further, intermediate and longer-term yields fell throughout much of the quarter from their 2017 highs, as investors grew impatient with the delays in enacting any of the proposed economic legislation championed by the new administration, including increased infrastructure spending, lower taxes and less regulation for businesses. At the same time, short-term interest rates were rising. This scenario of rising short-term rates and falling rates along the rest of the yield curve continued from the end of June through August, causing the yield curve to flatten.

However, this pattern began to reverse itself in September, as intermediate and longer-term yields began rapidly rising, due to renewed belief in the "Trump trade." The administration emphasized that they were committed to enacting comprehensive tax reform and appeared confident that legislation would be passed by the end of the year, which would help spur spending by both businesses and consumers. These changes in sentiment were reflected in the yield of the ten-year Treasury note, which peaked early in the quarter at 2.39% on July 7th and then fell steadily for the next two months, before bottoming at 2.04% on September 7th, only to rise to 2.33% by the end of September, which nearly matched the rate at which it started the quarter.

Although certain economic indicators, including inflation and wage growth, remain well below the Federal Reserve's desired levels, we believe it will remain on course in normalizing interest rates. We still expect that the Fed will raise its targeted Federal Funds Rate in December by 25 basis points. As mentioned earlier, after its September meeting, the Federal Reserve announced that they will begin the process of reducing its balance sheet in October, by not reinvesting principal from $10 Billion of maturing Treasury and mortgage-backed securities each month, with a scheduled increase to this amount over time. The Fed is attempting to telegraph as much as possible about its balance sheet operations to avoid jolting the markets and will adjust course, if necessary, in order to prevent its balance sheet reduction program from disrupting the progress that the U.S. economy has made in terms of employment and economic growth.

Market expectations for a third rate hike this year have rebounded dramatically this quarter, with the probability for the Fed to reach its targeted three interest rate hikes for 2017 climbing from 44% to 70%, based on futures market expectations. Several Fed members including Chair Janet Yellen have spoken out that they believe the lower inflation figures are temporary and not signs of a deflationary environment. That said, the Fed's favored inflation indicator, the Personal Consumption Expenditures (PCE) Index has been falling and remained below the 2% Fed target since this past March, with the current level at just 1.4%. At the same time, jobs growth has continued to be strong with a 189,000 increase in non-farm jobs for the month of July, followed by a 156,000 jobs increase in August, while the unemployment rate slightly decreased over the quarter to 4.2%. September actually saw a 33,000 decrease in jobs for the month, but this was largely due to employment disruptions caused by Hurricanes Harvey and Irma hitting Florida and Texas. Another encouraging data point was that GDP growth also came in stronger than expected registering 3.1% growth for the 2nd quarter and 2.1% in the first half of the year.

Given our view that interest rates will continue rising, client portfolios are structured to limit the impact of significant increases in interest rates, while having the flexibility to invest cash from maturing securities as interest rate levels adjust to changes in fiscal and monetary policy, as well as the economy.