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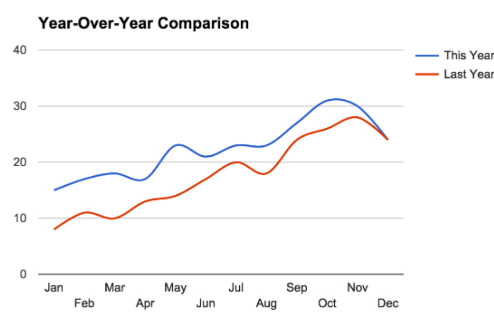
Markets Keep Moving Up with a Backdrop of Taxes, The Fed & Politics
October 2017

Dear Client:

Now that the Federal Reserve ("the Fed") has officially commenced its quantitative tightening (i.e., an attempt to normalize and shrink the size of its massive balance sheet), the Fed's view of the world has become one of investors' most important considerations. Under the leadership of Chair Janet Yellen, and particularly since Vice Chair Stanley Fischer unexpectedly retired in September, the U.S Central Bank and its governors are incrementally preparing the financial markets and the world for impending policy shifts. I fully expect the Fed to raise short-term interest rates one more time this year, likely in December, which would confirm guidance from earlier in the year that there would be three rate hikes in 2017. The Fed is not the only Central Bank that merits scrutiny right now. I am monitoring the European Central Bank ("ECB"), People's Bank of China ("PBOC") and the Bank of Japan ("BOJ") as well. At the margin, I think changes in ECB policy may be as important to the outlook for U.S. interest rates as adjustments in the Fed's anticipated actions are. Even modest policy actions by the ECB could be indicative of continuing economic healing in the EU, the decreased likelihood (for now) of an EU break-up, the improved stability of the Euro, and basic support for the Fed.

Third Quarter Review



Right now, the pace of quantitative tightening is expected to quicken over the course of 2018, from very modest changes in the third quarter 2017. In my view, the Fed is likely to adhere to a slow pace of normalization, consistent with how it has approached raising Fed Funds. It is important to consider that tightening Fed policy will likely affect all domestic securities, not just U.S. equities, as both corporate bonds and U.S. Treasuries will also be impacted. Keep in mind that Fed policy is not the only thing that can affect long-term interest rates. Debt, demographics, and technology-driven disinflation can all work to suppress long-term rates. If other major global Central Banks are still pursuing loose policy while the Fed tightens, I believe that these actions may still provide support for U.S. and global markets.

Currently, the mass psychology of investors, particularly in the U.S., is very positive (bullish) despite the reality that many stock prices and valuation measures are standing at all-time highs. One example, according to Harvard Prof. John Y. Campbell is the C.A.P.E. (cyclically-adjusted price-earnings) ratio, which has been sustained near record highs recently. The C.A.P.E. ratio is calculated as the inflation-corrected stock price divided by the lagging ten-year average of real earnings. The C.A.P.E. ratio is currently above 30, compared with an average of 16.8 since

1881. It has been above 30 in only two other periods: in 1929 when it reached 33, and between 1997 and 2002, when it soared as high as 44.

U.S. Equity Market

The markets have posted gains for a while, with no appearance of declining investor sentiment on the horizon. In the third quarter of 2017, the broad U.S. equity market (as measured by the MSCI USA IMI Index) rose 4.60%, and the large-cap focused S&P 500® Index rose 4.48%. Small-capitalization stocks fared better than larger cap stocks, and growth-oriented stocks outpaced their value-oriented peers across the market capitalization spectrum. Of the 11 economic sectors within the S&P 500 Index (which provides a proxy for the equity market), the Information Technology and Energy sectors posted the greatest gains. In contrast, the Consumer Staples and Consumer Discretionary sectors had the worst returns.

Emerging Markets

Foreign and emerging market stocks also had a strong third quarter. International developed equity markets, as measured by the MSCI EAFE Index (net of taxes), rose 5.40%. Markets in all but two of the world's developed countries posted positive results for the quarter. Norway and Italy were the best performing developed market countries, while Israel and New Zealand were the worst performing. Emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), rose 7.89%. There was a wide disparity in performance across individual emerging markets countries. Brazil and Russia were the best performing emerging markets countries, while Pakistan and Greece were the worst. It is important to note that the recent heated rhetoric between the U.S and North Korea has shown little if any market impact; however, the geopolitical risks are ratcheting upward.

U.S. Bonds

Bond markets continued to perform relatively well in the third quarter, with most major indices and sectors posting gains. The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, rose 0.85% for the quarter. Longer-duration maturities fared better than shorter-duration maturities. Riskier sectors of the fixed income market fared better than less risky sectors, such as U.S. government bonds. The yield on the 10-year U.S. Treasury note ended the quarter at 2.33%, up from 2.31% at the end of the second quarter 2017. I, like many other investment advisors, would also point to the high-yield area of the fixed income market as a further example of the bullishness that remains in the market. Along with the traditional high-yield securities, are also the private debt and middle market lending funds that have flourished in the post-2009 recession period. Typically, the high yield market is a good place to watch as a precursor to declines in the equity market. Once investors become concerned about risky debt, then they are likely to turn their apprehensions to other risky assets, like equities, next.

I believe we are still in a late-cycle expansion with a U.S. Central Bank that is becoming more hawkish (i.e., a Central Bank that is moving away from ultra-accommodative monetary policies). Equity prices and valuations stand at near-record multiples. Serious global political challenges linger. I believe investors' geopolitical concerns have become more acute, although markets remain resilient. Growth has picked up a notch, sentiment remains strong, and labor markets continue to chug along nicely. With major global Central Banks in a "move slow and don't break stuff" mode, markets appear to believe they have a reason for optimism.

A Look Ahead

This outlook brings me back to mass psychology, and here I will simply quote the words of John Maynard Keynes from The General Theory of Employment, Interest and Money (1936). *"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."*

With this as a backdrop, I think it is important for investors to remain patient and focused on clearly defined investment objectives, risk tolerance, and appropriate time horizons. Metaphorically speaking, it is neither the time to feel the need to try and catch the train that has already left the station, nor to jump haphazardly on the next train that comes along without clarity that it is heading to your desired destination. Simply put, it is important to maintain ***your disciplined investment approach*** and to focus on total portfolio risk management. There are still opportunities available today, tomorrow, and even more in the years to come. Thus, while we have enjoyed the ride on the wave of upwardly trending markets over the past several years, we know by experience that it will come to an end, and after it does…a new wave will begin. These insights guide me to continue to build upon the portfolio management themes from my first quarter 2017 letter. So, consider that risk is quietly growing and keep your overall equity exposure in-line with portfolio allocation targets. I would consider the following portfolio actions:

1) let equity holdings tilt away from U.S. to International (buy emerging markets equities!);
2) use gains in U.S. equities for liquidity needs;
3) tilt to value versus growth;
4) favor small caps versus large caps, be they at home or abroad;
5) seek out a selected niche and special illiquid private investments;
6) rotate to short duration and floating rate bonds; and
7) rebalance and hold cash from gains add to your margin of safety

Fall is upon us, although in most places across the U.S. the weather feels more like Spring. Let's continue to ensure that the asset allocation we have in place is still suitable for your current plans and circumstances and that it remains proactive. If you have questions or concerns about your investments or your long-term strategy – or if you would like to discuss the challenges and opportunities that the current market may present for your specific situation – let's review and discuss your portfolio and investment strategy. As always, I look forward to continuing to work with you toward achieving your investment goals.

Appreciatively,

Walid L. Petiri

Market Commentary
Monthly Foresight
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Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board