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THIRD QUARTER 2017 MARKET RECAP

U.S. Stocks Hit New Highs; Foreign Stocks Outperform.

Will This Continue?

"Sure Every Thing is Ending, But Not Yet!"

The last three months have included some unusual events. We witnessed the totality of a solar eclipse in the United States followed by Hurricanes Harvey, Irma and Maria and then raging wild fires here in the West. Risks of potential manmade disasters rose as North Korea continues their testing of intercontinental ballistic missiles and hydrogen bombs. Not only has the Trump Administration failed to push any of its fiscal policy initiatives through Congress, but the political rhetoric from the White House is becoming increasing confrontational and combative. Yet despite all of these experiences, stock and bond prices continued to move higher. So like "The Thinker" above, we remain thoughtful how best to position client investment portfolios and what adjustments, if any, will be appropriate going forward.

Keep on Truckin'! The U.S. Stock Market Has Continued to Deliver Good Results.

The Standard & Poor's 500 Index ("S&P 500") was up 4.48% in the third quarter and +14.24% year-to-date. Better-than-expected corporate earnings, which benefited from a weakening U.S. dollar, helped maintain positive investor sentiment despite the absence of any pro-growth fiscal policy changes. A pullback in inflation readings also provided positive support by reducing the prospect for multiple Federal Reserve ("Fed") interest rate hikes this year. A "lower for longer" interest rate mindset tends to benefit stocks as they generally provide higher returns relative to bonds when interest rates are low.

Within the S&P 500 Index, technology (+8.65%) and energy (+6.84%) led third quarter gainers, while consumer staples (-0.86%) was the only sector posting a loss for the quarter. For this year through September, technology (+27.36%) and healthcare (+20.31%) are the largest gainers, while just two sectors, energy (-6.63%) and telecom (-4.69%), remain in negative territory. Growth stocks (+5.90%) outperformed value (dividend paying) stocks (+3.11%) during the quarter extending their year-to-date gains to +20.72% versus +7.92% for value stocks. Even though the second quarter Gross Domestic Product ("GDP") growth rate was revised upwards to +3.1% from +3.0%, the fastest annualized rate for the economy since 1Q 2015, the current expansion's average annual growth rate of 2.2% remains anemic relative to previous economic cycles. This has benefited growth stocks and growth-oriented sectors of the market (e.g. technology) as investors are willing to pay a premium for the shares of companies that can outpace general economic growth.

Foreign Stocks Maintain Their Leadership. Should You Wander Over Yonder?

Continuing an ongoing trend this year, foreign equity markets have generally outpaced U.S. stocks. The MSCI EAFE Index ("Europe, Australia-Asia, and Far East" or everywhere other than the U.S.), which measures developed international market stock returns outside the U.S. and Canada, rose 5.40% during the quarter and is up 19.96% year-to-date. Improving economic trends and continued Central Bank monetary support provided a favorable backdrop for developed market equities. Valuations remain cheap relative to U.S. stocks, and abating populist trends have resulted in lower perceived event risk associated with owning developed market equities.

Emerging market stocks, as measured by the MSCI Emerging Markets Index, extended their rally this year increasing 7.89% during the third quarter and are up 27.78% year-to-date. This sector represents less than 30 of the more than 130 emerging economies with less than a $25,000 per capita income. Increased export activity and stabilizing demand for commodities due to strengthening global economic growth has improved the fundamental outlook for emerging markets. Sentiment has also benefited from fading concerns over declining economic growth in China given more optimistic expectations regarding the country’s ability to control imbalances within its economy. The upside potential for emerging market stocks remains promising due to their attractive valuations relative to developed market equities and considering investor ownership of these assets is relatively light compared to historical levels.

What Should We Expect From Stocks Going Forward?

Over the past twelve months, we have reduced exposure to U.S. equities in favor of owning foreign stocks, both developed markets and emerging markets. Foreign markets not only have more compelling valuations (they are cheaper than U.S. stocks), but the majority of key economies are earlier in their business cycles compared to the U.S., thus providing the potential to compound returns for a longer period of time. With the exception of the Bank of England, monetary policy also remains highly accommodative and is supportive to developed market stocks going forward. Emerging markets remain a compelling long-term investment opportunity given favorable demographic trends and an expanding middle class.

Even though we have been generally reducing exposure to U.S. stocks over the past twelve months, we maintain a positive view of this asset class. Valuations are not cheap, but rather a bit more expensive relative to long-term averages, which is reflective of an aging business cycle that is in its ninth year of expansion. While the Trump administration has yet to deliver on its fiscal stimulus promises, there does appear to be bipartisan support for corporate and personal tax cuts. However, at this point in the cycle, the benefits from lower tax rates or any other stimulus bill, such as increased infrastructure spending, should only provide a modest, transitory boost to the prevailing “slow-but-steady” rate of economic growth. The disruptive and costly effects of Hurricanes Harvey, Irma and Maria over the near-term and the normalization of Fed monetary policy (i.e. higher interest rates suppress demand for loans thus slowing economic activity) present additional headwinds to any fiscal stimulus that may be enacted.

The silver lining associated with slow economic growth in the U.S is an extended business cycle, which provides the potential to prolong the U.S. stock market rally. The market strategists and portfolio managers we speak with do not foresee the U.S. economy falling into a recession over the next twelve to eighteen months, and the consensus estimate for S&P 500 earnings growth is +11.0% for 2018. Barring any unforeseen, systemic risk event, such as a conflict with North Korea or a full-fledged trade war with China, it is not unreasonable to expect a similar return for U.S. stocks next year. It is important to note, however, that the U.S. stock market has seen an extended period of subdued volatility. Since 1980, the S&P 500 has experienced an average intra-year (i.e. within a year) peak-to-trough decline of 14.1% versus only an 8.2% average intra-year peak-to-trough decline since 2012. This year has been especially calm through September with the largest peak-to-trough decline of only -3.0%. Considering stock valuations are essentially in line with historical high levels, there is little embedded "discount" to mitigate the effect of volatility-inducing events. Thus while U.S. stocks have the potential to generate a high single-digit-to-low double digit return going forward, the trajectory of returns could very well become more erratic and vulnerable to geopolitical events, social rhetoric, domestic legislative actions, and the 2018 US elections. Again, these tend to be near-term reactions to a broader long-term positive outlook.

We generally recommend maintaining tactical exposures to technology, healthcare, and financial stocks as we expect these sectors to outperform global equities. Technology and healthcare stocks will disproportionately benefit from a potential onetime repatriation of foreign-domiciled corporate earnings while financial stocks will see a meaningful benefit from any reduction in the corporate tax rate. Financial sector companies will not only benefit from a rising interest rate environment, they appear to also benefit from the Trump administration's deregulation efforts. Certain real estate sector assets remain a viable proxy to owning fixed income as a means to generate lower-volatility returns without meaningfully increasing exposure to key fixed income risk factors, including duration and credit spreads.

We continue to own alternative assets and strategies as a means to lower overall portfolio volatility (i.e. reduce the breadth and frequency of fluctuations in portfolio returns). Since these assets tend to have lower correlated volatility and return patterns compared to traditional stocks and bonds, these assets help stabilize portfolio returns when global stock and bond markets are weak. We remain encouraged regarding the long-term prospects for mid-stream energy multi-limited partnerships ("MLPs") given the continued buildout of the U.S. energy pipeline infrastructure to meet the transportation and storage needs of oil and gas producers, who have seen a substantial increase in extracted oil and gas supplies due innovations in drilling (e.g. hydraulic fracturing and horizontal drilling). The increase in U.S. oil and gas exports will also benefit MLPs given the infrastructure needed to set up new export terminals and the means by which to move oil and gas to these terminals. Structurally, MLPs have very little exposure to commodity (namely oil and gas) prices due to the long-term nature of their contracts with producers. These contracts typically stipulate a mandatory fixed payment (i.e. toll) for the use of their infrastructure regardless of the level of oil and gas prices or how much oil and gas actually flows through the pipelines. Unfortunately, the market's misunderstanding of these contractual terms has not prevented MLPs from trading in sympathy with oil prices over the short-term. This sector has been a drag on returns. We expect positive results going forward.

Fixed Income – Boring Bonds are Beneficial.

U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Government Bond Index, were up 0.38% in 3Q 2017 and +2.25% year-to-date. The yield on benchmark 10-year Treasury Notes ended the third quarter at 2.33%, up just two basis points (100 basis points equals one percent) during the quarter. Investment grade bonds of all types, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, performed incrementally better than safe-haven U.S. government bonds, increasing 0.85% in the third quarter and +3.14% for the year through September. Municipal bonds, which typically provide a higher (non-tax adjusted) rate of return relative to U.S. investment grade bonds for assuming credit risk, were up 1.06% and 4.66% for third quarter and year-to-date, respectively. Global investment grade bonds of all types, as measured by the Bloomberg Barclays Global Aggregate Index, also outperformed U.S. investment grade bonds generating a +1.76% return in 3Q 2017 and +4.41% return during the first three quarters of 2017 due in large part to the index's exposure to higher returning emerging market government bonds.

Bond yields of all types remain near historically low levels, which means there is very little upside to bond prices from current levels (bond prices move inversely to the direction of bond yields). The Fed is also tightening monetary policy by raising its target level for the Federal Funds Rate (the overnight rate at which banks and credit unions lend money to each other) and by reducing the value of its Treasury bond and agency mortgage-backed security holdings, which it has been actively buying as part of its quantitative easing ("QE") program since late 2008. While monetary tightening will induce bond yields to move higher, the pace at which the Fed will execute its tightening measures is expected to remain slow and steady. Normally, the Fed would be much more "hawkish" when tightening monetary policy at this stage of the business cycle, but the prevailing level of inflation and slow pace of economic growth have allowed it to pursue a more methodical approach increasing interest rates. Furthermore, European Central Bank and Bank of Japan monetary policy remain highly accommodative, which has pushed interest rates into negative territory thereby increasing the relative attractiveness of Treasury bonds and other U.S. investment grade bonds. The Fed's slow-and-steady approach to tightening monetary policy and continued demand for U.S. investment grade bonds from foreign investors will allow bond prices to adjust in a more orderly fashion as U.S. interest rates continue to rise. This provides the opportunity for investment grade bonds to continue to deliver positive returns as the yields generated from interest payments more than offset incremental declines in bond prices.

Who Will be The Next Fed Chairperson? Does it Matter?

Fed policy remains the biggest risk to investment grade bonds at this time. The tenure of current Fed Chairperson, Janet Yellen, who has been instrumental in executing the Fed's slow-and-steady approach to monetary policy, is set to expire in February of next year. Media reports infer President Trump will announce his nominee to head the Federal Reserve for the next two years starting in February 2018 by the middle of November. The current frontrunner, Fed Governor Jerome "Jay" Powell, is expected to maintain the status quo whereas other potential candidates, such as Former Fed Governor Keven Warsh, are expected to take a "more aggressive" (i.e. hawkish) approach toward tightening monetary policy. We continue to monitor this situation closely and will consider making portfolio adjustments if Fed policy is anticipated to dramatically deviate from current expectations.

We continue to advocate owning a diversified mix of domestic and global investment grade bonds with no direct investments in non-investment grade segments, such as high yield or bank loans. Given where the U.S. is in its business cycle, we think it is no longer prudent to emphasize non-investment grade, "credit sensitive" bond categories. These assets have a greater correlation to stocks and tend to experience much higher price fluctuations as the credit environment deteriorates (e.g. lending standards begin to tighten). This typically occurs towards the end of a business cycle. We also continue to maintain a modest level of duration (a measure of interest rate sensitivity) such that bond assets have the ability to deliver a higher-than-money market return while interest rates rise. We are further diversifying client investment grade bond holdings, thus lowering volatility, by reducing direct exposure to investment grade corporate bonds in favor of increasing holdings of lower credit-sensitive, structured notes (primarily investment grade mortgages and mortgage-backed securities).

Prudent Asset Allocation May Be The Best Way to Minimize Risk

At this point in the market cycle, where both bond and stock prices are trading near historical highs, it is prudent for our clients' fixed income holdings to serve as a "shock absorber" to potential downdrafts in the financial markets. Another way of saying this is that we prefer to assume higher levels of risk, thus the potential for higher levels of returns, within the equities or stocks portion of your portfolio, rather than with fixed income or bonds. Not only do equities generally deliver higher levels of returns over time, but minimizing the volatility within your fixed income holdings helps moderate overall return fluctuations enabling your portfolio to compound returns more efficiently over time.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.