Market Commentary

Third Quarter 2017

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The third quarter of 2017 was another positive one for US equities as the rally that began on Election Day 2016 continued. The benchmark S&P 500 Index had a total return of 4.5% during the third quarter, bringing its gain to 14.2% for the first nine months of 2017. From the February 2016 lows, the S&P 500 has climbed over 42% on a total return basis through the end of September. Volatility continues to remain extremely low, with the S&P 500 rising over 20% since the election without suffering a single correction of 3% or greater. We continue to expect consolidation of the gains over the past 19 months, although it is difficult to point to the catalyst for a pullback. The 10-year note yielded 2.33% on September 30, 2017, virtually unchanged from the 2.30% yield at the end of June. Interest rates moved in a narrow band for most of the quarter, declining slowly during the first two months before rising in September as the Fed announced its intentions for future rate hikes along with balance sheet reduction. Returns for most fixed income holdings were modestly positive during the quarter as lower than expected inflation countered the Fed actions.

Economic and Market Outlook

We are now seeing the most synchronized global economic expansion since before the 2007-2009 recession. We obviously would like to see US GDP growth of 3% or greater, but to see the US, Europe, and many developing markets all expanding their economies at the same time gives us confidence the expansion in the US will continue. At its September meeting, The Federal Reserve announced its long-anticipated balance sheet reduction. While the move had been telegraphed for months, the extremely modest amounts ($10 million per month beginning in October, and rising by $10 million per month each quarter until reaching $50 million monthly in late 2018) means a reduction in the balance sheet of just over 10% by early 2019. More importantly - at least to us - is the continued lowering of estimated interest rates in 2018, 2019 and beyond. The Federal Reserve now believes the Fed Funds rate will approximate 2% at the end of 2018 with minimal rate hikes beyond that. As we have long stated, we did not see a reason for Fed Funds to reach 4% or higher as many (including the Fed) had predicted in the current low-inflation environment. Any rate hikes beyond 2% or so in the Fed Funds rate would likely be due to faster than expected growth in the US economy. We believe the Fed's importance to financial markets and the overall US Economy is overstated to a meaningful extent. While Fed moves generate headlines, fiscal policy – tax rates and regulatory changes – are far more meaningful to the economy.

During the quarter, disruptions at refineries following Hurricane Harvey caused volatility in oil prices for several weeks although this largely abated by the end of the quarter. Over the three month period West Texas Intermediate Crude rose approximately 12% from $46.04 on June 30 to $51.77 on September 30. OPEC continues its efforts to boost oil prices, but the significant increases in US production over the past five years have diminished OPEC's market clout. Although volatility in oil prices has increased in recent weeks, we still believe the fair value for oil is about $50 with a range of $40-60 for the intermediate term.

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The third quarter saw numerous potential headwinds to the equity markets, yet none moved the market lower for more than a couple of days. We endured heightened tensions with North Korea, two major hurricanes hitting the US mainland and the failure of healthcare reform in the US Senate, yet equities moved slowly and steadily higher. The continued absence of any meaningful pullbacks in US equity markets has increased our cautiousness during the past few months.

Although Congress and the President agreed on a short-term resolution to the US debt ceiling in September, they merely kicked the can to December, rather than taking the issue off the table for a longer period of time. There are a number of legislative and budget issues that must be resolved over the remainder of 2017. Any of these have the potential to cause short-term disruptions to financial markets. On the geopolitical front, the continued Washington investigations continue to generate headlines, but little real news. North Korea remains the greatest current international risk, but the Middle East, as well as US –Russian relations also bear watching.

On the positive side, tax reform chances got a boost near quarter end with the release of a blueprint for significant changes in the tax code. Although any likely legislation is months off, the desire to reduce the corporate tax rate to 20% could have the most beneficial effect on equities. With the current estimated effective tax rate of 27% for US corporations, a cut to 20% would boost earnings per share for the S&P 500 by anywhere from $7 to $10.

Portfolio Positioning

We made minimal changes to client portfolios during the recent quarter. For several months, client portfolios have been positioned for steady, albeit modest growth across most economies during the next several quarters. While we believe that interest rates may move modestly higher, continued inflation readings below 2% make the likelihood of sharply higher interest rates very remote. The US equity market sees three declines of 5% or more in a typical year. Thus far in 2017, the largest decline has been under 3%. This extremely low volatility has the ability to increase investor complacency.

Conclusion

To summarize, global economic growth is the best it has been in a decade. We remain in a period of steady job growth with continued low inflation in the US. Hopes for tax reform, while diminished from earlier this year, could still propel stocks higher. We continue to expect some form of tax policy changes in the coming months. Any move to reduce corporate tax rates, combined with a tax break for the repatriation of approximately $2 trillion in overseas earnings would be the most market friendly. With the extended market rally having not seen a decline of 3% for nearly a year now, we expect stocks can continue to move modestly higher with the caveat that a pullback at any time should not be unexpected.

Please feel free to reach out to us if you have any comments or questions about your investment portfolio or any financial topics in general. We always enjoy hearing from our clients.

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