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Q3 2017 Market Commentary

As we began a new season, the third quarter was an active one domestically with the hurricanes, a Federal Open Market Committee ("FOMC") meeting and additional clarity around President Donald Trump's tax plan.

Globally, central bankers were looking to moderate accommodative policies, along with continuing fears over the tenuous relationship between the U.S. and North Korea, impacted markets. With all that said, volatility came in like a lamb, turned beastly in August, and then calmed at the end of the quarter as strong second quarter GDP data, rising commodity prices, a weaker U.S. dollar and tax-reform expectations more than offset geopolitical flare-ups and extreme weather.

Trump's agreement with Congress to increase the debt limit and to provide funding for hurricane relief helped avert a crisis surrounding the September 30th debt ceiling deadline. Speaking of Washington, the Trump Administration's original timetable for comprehensive tax reform by August has come and gone, and details are still lacking. Policy uncertainty is driving a wedge between plans for elevated business capital expenditure (capex) and actual capex, which is currently subdued. Our broader assessment of domestic economic trends remains mediocre. Nevertheless, we are cautiously optimistic that Congressional Republicans will want to demonstrate a significant legislative accomplishment (taxes) before the 2018 mid-term elections. But progress has been frustratingly slow, and market expectations have been ratcheted lower. In addition, the worry over trade agreements, i.e. North American Free Trade Agreement (NAFTA), deteriorating U.S. – China relations, and who is the next Fed chairman/woman, will be top of mind as we move into 2018. Strong earnings growth, low unemployment and an exceptionally calm equity market propelled stocks to their 8th consecutive winning quarter.

There have been few places in the global markets where you haven't been able to make money in 2017. Heck even Russia, which has been down virtually all year, swung back into positive territory recently. That leaves just the energy sector as pretty much the only loser this year. Below is a snapshot of the year-to-date performance for domestic equity markets:

Year-to-date Returns

	Price Change (%)		Total Return (%)	
	Cum	Ann (CGR)	Cum	Ann (CGR)
S&P 500	12.53	17.11	14.24	19.50
Nasdaq, Inc.	15.57	21.36	17.31	23.81
DJ Industrial Average	13.37	18.28	15.45	21.20
Russell Midcap	10.32	14.05	11.74	16.01
Russell 2000	9.85	13.40	10.94	14.90

[1]Source: FactSet as of September 30, 2017

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In the third quarter, the Dow added another 5% and the S&P 500 gained 4%. The Nasdaq led the way again with a gain of nearly 9%[1]. The Russell Midcap Index posted a relatively modest advance of 3%. While, small-caps rallied hard in the last month of the quarter to close up nearly 6%. On the year, mid-caps and small-caps are up around 10%, large-caps are up 14% and the Nasdaq has gained more than 17%[1].

After a strong first quarter, S&P 500 companies delivered more robust earnings growth in Q2. It marks the first time that the index has reported double digit growth in back-to-back quarters since 2011. Companies remain generally bullish with their forward guidance as earnings growth in the high single digits is expected over the next few quarters.

Global equity markets turned in another strong quarter led by emerging markets as the global growth backdrop has overwhelmed near-term geopolitical concerns.

Eurozone equities advanced against a backdrop of positive economic data. The possibility that the European Central Bank (ECB) could soon reduce its stimulus measures continued to be a focus for the market. Japanese equities also posted gains amid improving economic data. Politics took the headlines as Prime Minister Abe called an election to be held in October. Emerging markets outperformed with Brazil leading the way.

It seems like déjà vu when it comes to the bond market. Every year since the financial crisis the market pundits make predictions that this will finally be the year for rates to rise back to historic norms. When in fact bond yields have little changed from that period forward, the phrase many like to use, "lower for longer" has played out repeatedly.

Recently, fundamentals have begun to indicant that rates should start to rise. The backdrop of global economic growth, a Federal Reserve ("Fed") that is shrinking its balance sheet, average hourly earnings are accelerating, and energy prices are stabilizing. These pieces could mean higher inflation and point to higher interest rates. We have already witnessed this dynamic taking shape in the short end of the curve with the two-year treasury bond up to its highest level since October 2008.

Municipal yields had somewhat of a roller coaster ride through the latter half of the quarter. They hit year-to-date lows in early September, as market participants sought safe investments after the hurricane news and dovish comments from the FOMC. However, municipal yields increased into quarter-end, with short-dated bonds spiking 0.12% to 0.24%, while 10-year and longer maturities rose 0.08% to 0.13%[2]. Supply in the last week of September was one of the heaviest of the year. For comparison purposes, in September, supply was down 34% versus 2016, at a total of $26.7 billion[2]. Washington could also have a significant impact on municipals going forward. Although, the Republican party's tax plan did not mention the municipal tax exemption, it did discuss a repeal of the alternative minimum tax (AMT), the elimination of the state and local tax deductions, an increase in the standard tax deduction for individuals and a reduction in the corporate tax. The proposed changes may, in some cases, reduce the attraction of the municipal tax deduction if implemented. For example, a reduced corporate tax rate may give businesses or banks less incentive to invest in tax-exempt bonds. All in all, municipal bond returns underperformed for the month of September, after a string of positive returns since December 2016 (excluding June 2017).

Several global central banks made announcements throughout the quarter. The Fed announced that it would begin to unwind its balance sheet in October. The market's expectation for a December rate hike rose from 33% at the start of September to 70% on September 30th[1]. Globally, ECB President Mario Draghi also previewed tapering at that bank's meeting held in September.

Consumer sentiment remains strong for the U.S. macro backdrop and tax reform that results in lower business taxes could provide additional stimulus to the U.S. economy. Yet, an overly aggressive Fed could stifle the economy if they follow through on their forecast of four rate hikes by the end of 2018. This is a dynamic many will be closely watching over the next several months.

1 FactSet financial data and analytics. www.factset.com

2 https://www.breckinridge.com/insights/details/september-market-commentary/

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The stock market continues to climb higher in truly historic fashion. The third quarter represented the 19th positive quarter over the past 20[1]. The last negative quarter was two years ago when the stock market suffered a 6.6% drop during the 3rd quarter of 2015[1]. In fact, the current bull advance without at least a -5% correction is now the 4th longest streak since 1928. The last notable double-digit "correction" was six years ago, way back in 2011, although a few have come close, first quarter 2016.

With all 45 Organization for Economic Co-operation and Development ("OECD") countries showing positive GDP growth in 2017 for the first time in over a decade, there is some evidence to these strong market movements. As they say, economic expansions don't die of old age. As we have stated in previous commentaries, our portfolios remain well diversified. When you look back to the Great Recession a portfolio built of 60% stocks and 40% bonds would have lost 25%, while an all stock portfolio would have lost 50%. In addition, the balanced portfolio would have taken half of the time to recover than the 3+ years of the all stock portfolio. Not everything that we hold as diversifiers will work at any one given time, but we hope that our diversification will pay in times of market turbulence.

To discuss this commentary further, please contact us at 914-825-8630.

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