2017 Third Quarter Review of the Markets

Index	3rd Qtr Return	YTD Return
S&P 500	4.48%	14.24%
MSCI ACWI Ex USA	6.16%	21.13%
Barclay's Bond Index	0.85%	3.14%
Consumer Price Index	1.06%	1.46%

Investment Commentary

The third quarter of 2017 continued to be positive for financial markets with the S&P 500 returning 4.5% for the quarter. Small cap stocks outperformed larger companies for the first time this year, but only after a loss of over 6% from the highs. The impressive recovery was stoked by optimism over corporate tax reform in the United States.

Non-U.S. stocks outpaced domestic stocks once again. The broad international equity index returned 6.3% as emerging market stocks again led the charge.

The interest rate on the 10 Year U.S. Treasury note was essentially flat for the quarter. The yields of corporate bonds relative to U.S. Treasury bonds continued to decline. This, along with fairly stable interest rates, led the Barclays Aggregate Bond index to continue its gains for the year, increasing 0.9%.

It bears mentioning that volatility across markets has been running extraordinarily low relative to historical levels (the Volatility Index, or VIX, set a historical low early in the 3rd quarter). Low volatility regimes can last for prolonged periods, but it is important for investors to avoid being lulled into a false sense of security. We do not know when volatility will return, but one would hardly be bold in predicting that eventually it will.

Economic Outlook

The two largest impacts on markets for the third quarter were the potential for tax reform (on the up side) and the prospect of North Korean saber rattling materializing into a more serious conflict (on the down side). If you've kept up with our previous commentary, you may suspect that both of these fall into the camp of "unable to forecast". Any level of violence out of Pyongyang would of course be negative from both a humanitarian and market perspective. From our perspective, it would be irresponsible for us to guess which of the myriad of potential outcomes is most likely.

Tax reform may seem easier to model, but we've yet to see the new administration push any meaningful legislation through Congress. Even if they are able to get a bill passed, the final piece of legislation may end up looking very different than what has been proposed at this point. Regardless of the viability of tax reform, we are comfortable with the fundamental footing of stocks. Corporate earnings have continued to increase (as have valuations), and the first two quarters showed only small misses from what are often overzealous analyst forecasts. Unless there is a dramatic reversal in the fourth quarter, it appears that corporate earnings will easily grow at double-digit rates in 2017.

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Unemployment remains very low, which creates a broad base of consumer spending. This could put upward pressure on wages, which could squeeze corporate profitability. On the flip side, increased wages for most Americans would go directly to consumption, creating a positive feedback loop across the economy. In any case, meaningful increases in wages have not materialized after two years of unemployment at or below 5%. As touched on last quarter, low unemployment levels make small increases in unemployment much more impactful as they can produce the opposite effect of the positive feedback loop associated with increased wages mentioned above. At this point, it's possible for unemployment to have negative economic effects and still be below 5%. Hurricanes Harvey and Irma did have a significant negative impact on the net number of jobs added in the economy as reported after the close of the quarter; however, the unemployment rate continued to fall.

The employment picture has another important impact on markets. The Fed's dual mandate revolves around "price stability" and "maximizing employment". With unemployment so low, the Fed has met that aspect of their mandate, and thus has some justification for raising rates. However, they have not met their price stability mandate (generally interpreted as an inflation rate of about 2%). This, in theory, suggests the Fed should *not* raise rates. The opposing directions of these two core functions of the Fed highlight that there is a reasonable chance of a policy misstep by the central bank, which could be negative for markets.

Investment Strategy

We stand by our opinion that valuations at the beginning of 2017 were not low enough to compensate our clients for taking an above normal level of risk in their portfolios. Remarkably, valuation increases since the beginning of the year have been slight, meaning that most of this year's return has come from earnings growth rather than from multiple expansion (the price that an investor pays for future earnings). We believe that current valuation levels are still supportive of our strategy of maintaining a neutral weight to risky assets across risk profiles.

We continue to look towards intermediate term, highly rated bonds as the core of our fixed income allocation. It is our expectation that these bonds will continue to produce positive returns in a flat to positive equity market environment and provide outperformance relative to equity markets in the event of a stock market drawdown.

Finally, for the first time since 2007, all 46 countries monitored by the Organization for Economic Cooperation and Development (OECD) are expected to grow. Against this backdrop, the U.S. Federal Reserve is beginning to shrink its balance sheet and continuing to increase the federal funds rate after years of massive asset purchases and near zero interest rates. This supports our thesis for our relatively high weighting to non-U.S. stocks as a percentage of total equity exposure. The path forward for the Japanese and European central banks is less clear, but allowing for quantitative easing while the U.S. central bank is tightening could provide these markets further support. In any case, similar to the U.S. markets, developed foreign market valuations have not moved much since the beginning of the year when we thought they offered attractive relative value.

A decade on from the peak of the housing market in 2007, we have clients who are jubilant that there have not been many negatives to discuss, and we have clients who are fearful that each passing day brings us closer to disaster. We encourage you to bring your questions and concerns to us in order to have a fruitful discussion about your personal risk tolerance and its impact on your financial independence.

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