Quarterly Update & Economic Commentary—September 30, 2017

Quarter in Review

The third quarter continued what has been a profitable year for most major asset classes. U.S. based equities, developed markets and emerging markets all posted strong returns during the quarter. Equity returns in the U.S. were led by small-cap stocks; the Russell 2000 index of small-cap stocks returned 5.67 percent for the quarter compared with 4.48 percent for the S&P 500. From a sector standpoint, IT, Energy and Telecommunications led returns in the U.S. with returns of 8.65, 7.89 and 6.84 percent, respectively. Consumer Staples, having lost 1.35 percent during the quarter, was the only negative sector. As impressive as returns were in the U.S., international markets still managed to outperform. Stocks in developed countries, as represented by the MSCI EAFE index, returned 5.40 percent. Meanwhile, the MSCI EM index of emerging market stocks returned 7.89 percent in the third quarter and is up 27.78 percent year to date.

Fixed income asset classes managed positive returns despite a somewhat steep increase in interest rates during the last three weeks of the quarter. The yield on the 10 Year Treasury Bill finished the quarter at 2.33 percent. The Bloomberg Barclays US Aggregate Bond index finished the quarter up 0.85 percent while the comparable index of riskier bonds, the Bloomberg Barclays US Corporate High Yield index, finished the quarter up by 1.98 percent.

Consistent with the leadership of the equity market sectors, energy prices saw a jump during the quarter. Both Brent Crude and West Texas oil rallied over ten percent during the quarter. The extreme hurricane season put pressure on supply thus pushing prices higher. Geopolitical uncertainty continues to benefit gold prices. Gold rose over three percent for the quarter and is positive by over 11 percent year-to-date. Copper prices have been on an incredible run this year, finishing the quarter positive by almost nine percent and being up by 16.87 year-to-date. This could be a bullish sign for markets as copper demand is often tied to global economic growth.

The third quarter of 2017 was arguably one of the least volatile on record for equities. The VIX, a measure of volatility that spikes when fear is high, closed below 10 on 16 different days during the quarter. For reference, prior to 2017, the VIX had only closed below 10 a total of 16 days since 1990. Another way to gauge volatility is to consider daily movements in the S&P 500. During the third quarter, the index stayed range bound between -0.50 percent and 0.50 percent on 52 out of 63 trading days, or 83 percent of the time. Such small movements have occurred only 53 percent of the time in the S&P 500 going back to 1950. This level of tranquility in the markets can be attributed to a number of positive news factors as well as a lack of crises on the horizon.

The Federal Reserve, which not long ago was a regular source of volatility in the markets, has become more or less predictable in its outlook and its actions. As of this writing, it is generally believed that the Fed will raise the targeted Federal Funds Rate by another 25 basis points during its December meeting. Chairwoman Yellen has continued to stress that the decision around rate hikes is dependent on both employment and inflation data, the latter of which has been below the Fed's two percent target. While low inflation is a concern for the Fed and is likely hindering the pace and degree of future rate hikes, Yellen recently expressed the opinion that holding off on raising the rate until inflation hits two percent poses the risk of overheating the economy. Equity markets will likely take the Fed's December action in stride whether or not there is a rate hike.

In other noteworthy news, the Fed announced during the third quarter that it would begin offloading some of the $4.5 trillion in assets that sit on the central bank's balance sheet. The Fed's balance sheet ballooned to this size after buying up bonds following the Great Recession. This asset-purchase program, nicknamed "Quantitative Easing," was combined with a reduction in interest rates as a means to stimulate the economy. Now that the economy is on better footing, the Fed has deemed it an appropriate time to reduce its balance sheet to normal levels (prior to the recession, the balance sheet was below $900 billion). However, actively selling its balance sheet assets could stress liquidity in capital markets. Instead, the Fed will let bonds roll off the balance sheet by refraining from reinvesting the proceeds of bonds that mature. The Fed will begin this process in October, and it will presumably run its course until the Fed decides to speed it up or slow it down.

Corporate earnings in the United States were impressive during the third quarter. According to FactSet, the second quarter S&P 500 earnings growth rate was 10.3 percent, which marked the first time since 2011 that the index recorded two consecutive quarters of double-digit earnings growth. The energy sector reported the highest earnings growth at 329 percent and revenue growth of 15.5 percent. Of all the companies in the S&P 500, 70 percent of companies reported actual sales higher than analyst expectations.

Strong economic indicators were another factor contributing to recent equity returns. Housing starts have been climbing over the past eight years and are approaching historical averages. The employment landscape continues to tighten and wages are slowly moving higher. Inflation readings have been somewhat subdued, but certain indicators moved higher as energy prices increased. The last reading of the quarter for Headline Consumer Price Index (CPI) was 1.9 percent and Core CPI 1.7 percent (Core CPI excludes the more volatile food and energy categories). According to the third estimate of the U.S.'s Gross Domestic Product (GDP) released by the Bureau of Economic Analysis, the economy grew at a pace of 3.1 percent, up from 1.2 percent in the first quarter.

Politicians in Washington, D.C. did little to help or hurt economic growth other than keeping the federal government open and raising the debt ceiling. Senate Republicans tried and failed—twice—during the third quarter to pass some version of an Affordable Care Act repeal. While the successive failures and the political realities of passing such legislation in the current Senate suggest that the "Repeal and Replace" effort is done, members of the GOP have shown a surprising willingness to revisit the issue. Moving on from health care, in the final weeks of the quarter the Trump administration released its plan for overhauling the current tax system for both businesses and individuals. Trump's plan contains ambitious tax relief for businesses, including cutting the corporate tax rate to 20 percent and a 25 percent pass-through rate for small business owners. The details for individual taxes are less clear because the income brackets have not yet been decided, but what has been proposed is a reduction in the top income tax rate from 39.6 percent to 35 percent and an increase in the standard deduction to

$12,000. But in exchange for the lower rates and higher deduction, many itemized deductions are being proposed to be cut. In its current form the Trump plan would likely boost economic growth in the short-term; however, the final bill will likely look different, if it even passes at all, due to various factions and interests within the Republican Party.

The third quarter was one of the worst stretches in years for natural disasters in the United States. Three different hurricanes caused devastation of much of the coastal areas around the Gulf of Mexico, including several days of flooding in Houston and its satellite towns, significant wind damage up the western coast of Florida and unexpected flooding in Jacksonville. The third hurricane, Maria, caused so much damage to Puerto Rico that the U.S. territory was still suffering from major power losses and supply shortages as the quarter ended with no end in sight. Despite the massive losses caused by these storms, the country-wide economic impact is expected to be marginal and short-term. In fact, rebuilding necessary in affected areas will create a tailwind for the economy over the longer-term.

Economic news abroad has been promising as well. Growth in Europe has picked up and equity returns have benefitted as a result. The European Central Bank is still in the midst of its own version of quantitative easing, which is providing markets with confidence and liquidity.

A Look At The Numbers

Name	3rd Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	5.58	15.45
S&P 500 TR USD	4.48	14.24
S&P MidCap 400 TR	3.22	9.40
S&P SmallCap 600 TR USD	5.96	8.92
NASDAQ Composite TR USD	6.06	21.67
MSCI EAFE NR USD	5.40	19.96
BBgBarc US Agg Bond TR USD	0.85	3.14
Wilshire US REIT TR USD	0.61	2.44
IA SBBI US 30 Day TBill TR USD	0.25	0.54

Forecast In Brief

The markets have been on quite a hot streak. Both the S&P 500 and the S&P SmallCap 600 have had eight consecutive quarters of positive returns and the S&P 500 has been positive for 11 consecutive months. To provide some optimism for any doubters, the S&P 500 has not had a negative fourth quarter since 2012 when it fell by 0.38 percent.

After staying out of the news for most of the year, markets will be paying attention to Federal Reserve policy and news. The Fed announced that they would begin reducing the balance sheet in October by letting some maturing bonds "run-off" as opposed to being reinvested. Being that this is unchartered territory, the impact will be monitored closely for any surprising impact. The Fed is also expected to raise interest rates again in December. The Fed is in a balancing act they want rate increases to be gradual, but many question the Fed's continued rate increases when inflation remains below the Fed's 2 percent target. To add additional uncertainty and complexity to the Fed, it appears that President Trump will make good on his campaign promise of replacing Fed Chair Yellen in early 2018. The President has been interviewing possible successors and he has indicated a decision could be announced sometime in October. The President has been clear that he prefers lower rates and a weaker dollar so you could expect Yellen's replacement to have a similar preference. This is yet another reason why the Fed will most likely move to raise rates in December.

Economic readings will be a little difficult to understand over the next couple of months. The recent storms that hit Florida, Texas and Puerto Rico will undoubtedly impact the numbers. As of this writing, the storm impact has already been seen in the weak employment report which actually showed job losses for the month of September. Over the short-term, U.S. GDP will take a hit, but over the long-term, the rebuilding will add to GDP. The government has stepped in to add federal dollars to the rebuilding efforts which will act as additional stimulus. In addition to housing, the auto industry is expected to benefit from the large number of vehicles that were destroyed by the flooding in Houston.

Washington will continue to be closely watched to see if any progress is made on Trump's policies. A top initiative of the administration appears to be the tax reform which was unveiled during the third quarter. The White House provided guidelines on what they felt was acceptable; now it is in Congress's hands to flesh out the details. The proposal in its current form does not appear to be a bill that could be passed. Tax reform is very complicated and it appears that both sides are too far apart to make positive progress. With mid-term elections coming in 2018, if a bill is not passed between now and year-end it is unlikely that a bill will get passed before Americans head to the polls in late 2018.

Corporate earnings releases and conference calls are set to begin during the second week of October. Earnings growth rates are expected to be positive but below the last two quarterly releases which were in the double-digits. FactSet is predicting an earnings growth rate for the third quarter of 2.8 percent and revenue growth rate of 4.9 percent. Companies with global operations are providing the leadership. Companies with more than 50 percent of their sales coming from outside the U.S. are expected to grow earnings at 7.9 percent and companies with more sales coming from the U.S. are expected to suffer a slight decline (-0.1%). With global economic growth exceeding U.S. growth and a weaker dollar, companies with global exposure are performing better in this environment.

In general, U.S. markets have outpaced international markets over the last four years; however, this year both international developed and international emerging markets are outperforming the U.S. markets. There are a few reasons for the recent outperformance and reasonable expectations for future outperformance. The global economy is growing at a faster pace than the U.S., foreign central banks continue accommodating policies while the Federal Reserve has been tightening monetary policy, and valuations are more attractive outside the U.S. Much of the outperformance has been a result of the dollar weakening this year after years of strengthening. There are many reasons to be positive on areas outside of the U.S.; however, the same issues that caused fears in the European Union over the years still exist and will at some point in time be an issue in the future. Greece is broken and will continue to need bailouts and there continues to be political uncertainty– citizens in many countries believe they would be better off out of the Euro Zone, and immigration policies continue to be a political hot button.

It is hard to believe that the fourth quarter is here, with Christmas decorations already showing up in some department stores. Thanksgiving will be here before we know and the hustle and bustle of Christmas will soon follow. The National Retail Federation expects holiday retail sales to grow at a pace of between 3.6 and 4.0 percent. This could potentially be highest growth rate since 2014 when the growth was five percent. Given the better-positioned consumer, the upbeat holiday forecast and the small potential for tax reform, we could be hopeful to see a Santa Claus rally.

If anything has changed with your financial picture that might require changes to your investments, or if you wish to discuss your portfolio, please feel free to give us a call to set up a meeting.

— Robert Moyer, CFA, CFP®, CAIA
Director of Research

1640 Huguenot Place
Midlothian, Virginia 23113
Phone: 804.323.1886
Fax: 804.323.1889
www.acgworldwide.com