Strategy Asset Managers

MARKET ENVIRONMENT

The stock market continued its winning ways in the third quarter of 2017 as company earnings for Q2 produced the second consecutive quarter of double digit year-over-year growth for the first time since the third and fourth quarters of 2011 (according to Factset). Earnings growth combined with the continuation of the supportive "Goldilocks" economic environment has now resulted in eight consecutive quarters of robust total returns for the S&P 500 index. For the quarter, the S&P 500 index returned 4.5% resulting in a 14.2% total return for the first three quarters of 2017. The non-US MSCI-EAFE index returned 5.5% for the quarter and 20.5% for the first 9 months of 2017 as rising international growth expectations and a weaker US dollar aided returns.

From a sector performance perspective, Technology was the leader returning 8.6% as a remarkable 87% of technology companies reported Q2 earnings above expectations (according to Thomson Reuters). Although there was notable strength in semiconductor stocks, the move up in technology stocks has generally been broad-based. Energy and Telecommunications each returned over 6.5% for the quarter, but the move was more of a bounce off the bottom as both sectors remain negative year-to-date.

On the downside, Consumer Staples returned a negative 1.4% hurt by tobacco companies that slumped on an unexpected announcement by the FDA to reduce nicotine levels in cigarettes, which we suspect would take some time to accomplish from a regulatory perspective. In addition, many Consumer Staples stocks are considered "Value" stocks which have generally underperformed this year in what has been a strong "Growth" market. The S&P 500 Value index returned a respectable 3.5% for the third quarter and 8.5% year-to-date versus 5.3% and 19.3%, respectively, for the S&P 500 Growth index. Notably, one has to go back to the Dot-Com bubble to find the last time the S&P 500 Growth index outperformed the S&P Value index by a greater amount in the first nine months of a year (1998).

The US bond market, as measured by the Bloomberg Barclays Intermediate Government/Corporate index, produced a "coupon-like" return of 0.6% for the third quarter and 2.3% for the nine months. Despite two interest rate hikes (totaling one half of one percent) by the Federal Reserve so far this year, "above- coupon" bond market returns for the nine months have benefitted from the outperformance of corporate bonds as investors continue to reach for higher yields.

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OUTLOOK

Our “Goldilocks” outlook remains basically unchanged. Moderate economic growth (2-2.5%), low inflation (still less than 2%), low unemployment (4.2%) and relatively low interest rates should continue to support the stock market and corporate earnings. Overall market valuations remain on the expensive side of “average”, but not significantly so.

Our concerns last quarter about upcoming US budget negotiations turned out to be premature as the Administration and Congress effectively “kicked the can down the road” by tying a contentious temporary increase in the US debt limit to a popular bill for Disaster relief. The next episode for the budget will begin in December. While Geopolitical risks and natural disasters (our thoughts and prayers go out to those affected) abound, the stock market remains focused on earnings and newly heightened hopes of tax cuts (as actual tax reform appears less likely) resulting in dampened volatility.

We discussed last quarter the extremely low level of stock market volatility and the 3rd quarter saw a continuation of that trend. Looking back at the number of daily +/- 1% moves in the S&P 500 index, shows a yearly average of 49 days for the five years ended 2016. For the first nine months of 2017, the total has been 8 – a significant variation from the past. With expectations of earnings growth for the third quarter currently centered in the mid-single digits (down from double digits of the last two quarters), should tax cut mania fade we would expect a pick-up in volatility. Even with a return to normalized volatility, we remain constructive on the markets but with somewhat lowered total return expectations should tax cuts not materialize.

September 30, 2017