Introduction

In the third quarter, investors in risk assets were rewarded once again as stocks moved higher, shaking off geopolitical risk, major hurricanes in the US, a contentious political environment and rich valuations. At the same time, the Federal Reserve appears on track to increase interest rates one more time in 2017, having had minimal impact on bond returns both in the quarter and year-to-date. Meanwhile, oil prices saw a healthy rebound during the period, although not enough to erase steep losses from earlier in the year.

The S&P 500 Index of large-cap US stocks is up 14.2% for the year, after rising 4.5% during the third quarter with very little volatility. Much of this has been due to the continued strength of technology stocks which have outperformed all other sectors, both for the quarter and the year. Despite energy stocks appreciating by nearly 7% during the period, as the price of oil rebounded above $50, they remain the lagging sector for the year, down 6.6%. Stocks in overseas markets are continuing to outpace those of US companies as they have throughout 2017. This year, developed international markets are up more than 20% and emerging markets are up 28.1%, after both topped the S&P 500 Index in the last quarter. The Bloomberg Barclays US Aggregate Index of bonds added slightly to earlier gains and now is up 3.1% year-to-date, as low inflation offset the Federal Reserve's rate increases.

Heading into the final quarter of the year, stock valuations remain a concern as do investor complacency and the challenging political climate, especially surrounding tax reform proposals. However, solid earnings growth and decent economic data in an environment of subdued inflation and low interest rates may sustain equity markets for the time being. The Fed is signaling a steady pace of rate increases in conjunction with a reduction in its massive balance sheet, but with inflation struggling to sustain a 2% Fed target, policy implementation likely will remain gradual and well-communicated.

3rd Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 9/30/17

	3Q 2017	YTD Return	Price / Value
Dow Jones Industrial Average	5.6%	15.5%	22,405
S&P 500 Index	4.5	14.2	2,519
Russell 2000 Index	5.7	10.9	1,491
MSCI EAFE Index	5.5	20.5	7,801
MSCI EM (Emerging Markets)	8.0	28.1	2,346
Bloomberg Barclay's US Aggregate	0.8	3.1	103
Bloomberg Barclay's Municipal Bond	1.1	4.7	109
Gold – Continuous Contract	3.4	11.6	$1,285
Light Crude Oil – Continuous Contract	12.2	-3.8	$52

Source: Factset

Economy

After a surprisingly strong 3% annual rate of growth in the second quarter, the US economy performed admirably in the third, despite numerous challenges. While the disruptions from Hurricanes Harvey and Irma will cloud the data, it seemed the economy cooled somewhat even prior to the storms. For example, after peaking in June, payroll growth slowed the first two months of the summer, bottoming in August. Further deterioration is likely in September, but the uncertain influence of the storms will minimize its impact on economic forecasts and financial markets. The same holds true for housing activity. Despite low mortgage rates, both new and existing home sales were negative the first two months of the quarter even prior to the weather disruptions. Likewise, with the exception of July, retail sales failed to advance over the past four months, perhaps a byproduct of the tepid wage growth of the past two years. Again, it seems unlikely that September will show meaningful improvement within the consumer sector, although pent-up demand should arise later this year and early next as people in storm-damaged areas finally are in a position to rebuild.

Consistent with the second quarter, manufacturing activity remained robust as evidenced by the Institute of Supply Management's manufacturing survey. The September reading of 60.8 was a 13-year high and well above expectations, reflecting broad gains in both new orders and employment. However, even here the impact of Hurricane Harvey is being felt, as part of the sharp rise in the headline number reflected longer supplier delivery times. Normally, delays reflect companies struggling to keep up with firm demand, but in this case the delays are more reflective of disruption. Regardless, we believe manufacturing will remain additive to overall growth. The Fed's tentative approach to tightening monetary policy should keep the dollar from appreciating meaningfully, which makes domestic manufacturers more competitive abroad. Also, it is estimated that over one million automobiles were destroyed by the storms, which should rejuvenate auto production in coming quarters.

While measures of CEO and consumer sentiment remain high and continue to exhibit resilience, justification for further optimism regarding the economy's prospects resides in the progress of tax reform and other pro-growth initiatives promised by the Trump Administration. The colossal failure of healthcare reform this quarter likely nurtured the downshift in economic activity as doubts arose regarding the ability of the president and Congress to work together on taxes, or anything else for that matter. Surprisingly, a bipartisan dialogue regarding taxes did emerge, and a proposal was offered late in the quarter. While the impact on middle-class individuals is unclear, it does seem that corporate tax rates will be lowered, although passage is no sure thing. While we expect there will be cosmetic changes to the tax code, we remain skeptical that robust reform will materialize. The discord over phasing out popular deductions such as state and local income taxes in order to broaden the tax base to pay for lower marginal rates will be contentious. Representatives from heavily populated, Democratic-leaning, high-tax states such as New York and California, will be pressured by their constituents to reject the reforms, making revenue neutrality an impossibility.

As a result, we expect the economy to operate close to the 2% trend rate that has prevailed for much of the past two years. We do not foresee a recession in the near term. Normally, manufacturing and industrial production would be retreating in tandem with an increase in the unemployment rate prior to a recession, neither of which is occurring. The Fed noted in its statement following the September meeting that weather disruptions historically have no permanent impact on trend GDP growth. Despite the particularly nasty nature of these two storms, we agree and believe it sets up a spate of activity as Florida and Texas recover. We will be following the tax reform debate closely, since a breakthrough would cause us to upwardly revise our estimate of growth potential for the domestic economy. President Trump and Treasury Secretary Mnuchin state that a durable 3% GDP growth rate is possible only with a robust rewrite of the tax code. At this point we believe 2% trend growth is the more likely outcome given our doubts tax reform will be transformative.

Equities

Equity markets around the world moved higher during the third quarter, driven by healthy corporate profit growth, which encouraged investors despite geopolitical unrest and the Fed's announcement of balance sheet tightening. Market volatility remained subdued with US stocks registering the lowest day-to-day price fluctuation since 1968; the low interest rate environment continued to be a dominant force supporting elevated stock valuations. The S&P 500 has generated positive returns for 11 months in a row, the longest monthly period since 1959, and US large-cap stocks have not weathered even a 5% correction since June of 2016. A similar protracted expansion has not occurred since 1996, also a period of a strong market advance led by technology stocks. At that time, macroeconomic conditions did differ somewhat, with the 10-year Treasury yielding over 6% and GDP growth at 3.8%, heading to well over 4%, as the internet boom took hold of the economy and markets.

During the quarter, the S&P 500 index returned 4.5%, led by strong returns from technology (+8.3%), energy (+6.0%) and materials (+5.6%) stocks. Developed markets outside the US, as measured by EAFE, rose 5.5% as the dollar weakened during the quarter. Latin American stocks led the emerging market group, which returned 8.0%.

Consumer stocks struggled to advance as concerns over rising rates, high valuations and e-commerce disruption drove investors to pursue growth in other sectors. As the quarter ended, the economically sensitive sectors (industrials, financials, energy and materials), benefited from a rotation driven by the global economic recovery and expanding trade activity.

SECTOR	QTD	Q2	Q1	YTD	1YR
Energy	6.03	(7.02)	(7.30)	(8.62)	**(2.62)**
Materials	5.55	2.64	5.31	14.09	18.77
Industrials	3.68	4.16	4.01	12.32	19.71
Consumer Discretionary	0.48	1.97	8.09	10.75	12.82
Consumer Staples	(2.02)	0.90	5.64	4.44	1.62
Health Care	3.20	**6.65**	7.89	18.75	13.50
Financials ex. Real Estate	4.76	3.80	2.08	11.01	**33.75**
Information Technology	**8.28**	3.76	**12.16**	**26.02**	27.00
Telecommunication Services	5.41	(8.14)	(5.06)	(8.07)	(4.81)
Utilities	1.97	1.36	5.43	8.97	8.11
Real Estate	0.10	1.84	2.73	4.72	(0.80)

Source: Factset

We remain hopeful that Congress will pass legislation to make the US corporate tax rate competitive with the rest of the world. If the agreed-upon rate is close to the 20% proposal, this reduction would provide a welcome 10+% lift to earnings in 2018. While this magnitude may be too optimistic, we believe a corporate tax cut combined with a tax incentive to repatriate foreign earnings would provide a stimulus to the economy through increased capital spending. We expect companies to split repatriated cash between returning shareholder capital and increased growth investment. Of the taxable cash held abroad, 92% of the balance is held across technology (69%), healthcare (16%) and industrial (7%) companies.

As we enter the fourth quarter, which historically is the strongest for equity markets, the ability to deliver meaningful earnings and revenue growth will continue to be in strong demand. We believe the technology, healthcare, industrial, and financial sectors offer better-than-average opportunities and we will continue to identify worthy additions to portfolios.

Barring cataclysmic geopolitical events, recession risk in the US and globally is very low by most indicators. We are respectful of the elevated market valuation and acknowledge that prolonged periods of low rates and volatility can result in excessive risk taking, but we continue to believe US and global equities offer better returns than fixed income or cash.

Economic and Market Drivers

Tailwinds	Headwinds
Low interest rates	Fed Policy – rising rates and balance sheet runoff
Fiscal Stimulus Package	High U.S. Equity Valuations
Improving Real Household Income	Tight U.S. labor market – rising labor costs
Low Inflation	Political confusion – debt ceiling
Animal Spirits rising - Business Optimism	Protectionist Trade Policies
Household Formation Increasing	Aging Demographics in Developed Markets
Lack of Investor Euphoria	China Slowdown - Over Investment

Bonds

The meager, but positive, 0.85% quarterly return posted by the Bloomberg Barclays Aggregate Index might imply that the third quarter was uneventful for bonds. However, that would not be accurate. For most of the period, investors were fearful that Congress would not pass a budget or raise the debt ceiling. As such, Treasury bills maturing in October yielded more than bills maturing in November and December. Just prior to the debt deal in early September, the 10-year Treasury yield approached 2% before reversing course and trading through 2.30%. Despite the significant move, the 10-year Treasury yield has been relatively range bound thus far this year, which suggests it may take a lot to move rates materially higher. Aside from the politics, investors also have been focused on Fed policy and whether the recent hurricanes might delay another rate hike this year.

Until the most recent Fed meeting, the market leaned towards no additional rate increases. While GDP growth surprisingly exceeded 3% in the second quarter, the economic data softened somewhat in the third. Inflation remained stubbornly absent despite a seemingly tight labor market, and wages could not break out of the prevailing, tepid pace of growth. Congress's failure to enact healthcare reform nurtured doubts that President Trump's pro-growth platform, particularly tax reform and infrastructure spending, would come to pass. As a result, the market scaled back its expectation for Fed rate increases. Meanwhile, hostile rhetoric between North Korea and the United States led to global unease, while hurricane season created chaos and destruction in Texas, Florida, Puerto Rico and the US Virgin Islands, among other Caribbean nations. By early September, interest rates outside of the shortest maturities resided at the lowest levels since last November. With every possible economic and geopolitical worry seemingly priced into the bond market, many, including us, concluded the rally was overdone. Despite the recent downshift in growth, the odds of a recession are extremely low, and the Fed communicated its conviction to raise rates again in December, which admittedly was a surprise. In addition, it remains committed to initiating the unwinding of its holdings of Treasury and mortgage-backed securities, which on the margin should pressure interest rates higher over time. While we believe the hurricanes could have given the Fed an excuse to pause, they did not do so, maintaining that there is little lasting impact from weather-related disruptions. Perhaps most importantly, a bipartisan push to rekindle tax reform discussions gathered momentum, culminating in an actual proposal in the final week of the quarter. While many questions remain and passage is no sure thing, bond investors took note, and interest rates rose significantly.

While the Fed controls the short end of the curve, we believe that ongoing foreign demand will keep the long end of the curve in check. We therefore will maintain our purchases in the intermediate part of the curve where we have been long underweight. For the time being, we are content remaining underweight duration until we see inflation start to ramp up or the dollar strengthen to the point it deters foreign investors.

Corporate bonds benefited early in the quarter from ideal conditions such as low volatility, increasing commodity prices, strong corporate earnings and weak inflation. However, the direction eventually reversed as issuers, including AT&T and Amazon, flooded the market with supply and political events reminded investors that risks still loom. In September, fiscal and monetary policy combined to tighten corporate spreads, which kept excess returns positive for the period, despite the rise in Treasury rates. The outlook for investment grade corporates remains favorable with the unrelenting search for yield and persistent demand from overseas. We will maintain the current overweight to corporate bonds but will be more selective regarding credit risk and tenure as the positive correlation between stocks and bonds seems unsustainable and spreads are relatively narrow.

In the municipal market, third-quarter returns were solid despite a sharp sell-off in the final weeks of the period. The Barclays Municipal Bond Index advanced 1.06% during the past three months, although sentiment turned inescapably negative by quarter-end. Specific to tax-free bonds, new issue supply continued to track well below last year's pace through August, while strong demand for muni bonds via mutual funds and direct investment continued in a price-indiscriminate manner. This confluence of factors was supportive overall to tax-free bonds, as evidenced by the 4.7% gain, year-to-date.

As noted in prior communications, we have been reluctant to extend maturities until better opportunities arise. Normally, rising yield environments usually have foreshadowed a reversal out of bond mutual funds, but perhaps due to a demographically-driven quest for yield and risk aversion, this seems no longer to be the case. Nonetheless, we did see a long-awaited rise in new issuance late in the quarter and expect many municipalities will come to the market to fund neglected capital needs, especially with clarity regarding the tax code. As Texas and Florida recover from the hurricane damage, we could see a near-term pick up in bonding. While concentrated issuance may provide an opportunity, pricing on both states' municipal bonds thus far remains firm given the strong credit quality and economic strength in these regions. Regardless, the combination of tax reform and a corresponding unwind of the Fed balance sheet should be sufficient to keep bond yields on a gradual upward climb. Where appropriate, we will likely use any meaningful rise from here to opportunistically add duration and augment income streams since we do not envision a disorderly spike in interest rates in this environment of low inflation.

Conclusion

We continue to forecast that economic growth will remain in the range of 2%, where it has been throughout much of the recovery, modest but positive, with continued subdued inflation. In this environment, equities and bonds both have managed to do well. However, there are plenty of headwinds facing investors: rich valuations and the advanced age of the bull market for stocks, investor complacency, Fed rate increases and balance sheet reduction, geopolitical risk and the contentious political climate. We believe these elevate the potential for increasing volatility in all financial markets, but do not believe we will see a recession. We are looking for decent earnings growth for stocks and only gradual Fed tightening, which leaves us cautious but modestly optimistic for the remainder of 2017 and into early 2018.