Quarterly Economic Update 3Q 2017

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The Quarter in Brief. Strong corporate profits and a renewed focus on tax reform helped push the market to record highs in Q3.

Economic News. The final estimate of Q2 GDP came in at 3.1 percent, better than the 2.6 percent initial estimate, and far better than the Q1 rate of 1.4 percent. Business investment was particularly strong, having grown nearly 7 percent (annualized) in the first six months of the year; a nice rebound from previously lackluster periods.

Total nonfarm payrolls were down 33,000 in September, in part due to a sharp decline in service industries (largely food service). The rest of the quarter was strong, with July up 138,000 and August up 169,000, leaving most to believe that the poor September payroll number was likely due to the impact of Hurricanes Irma and Harvey. The unemployment rate dropped to 4.2 percent in September, and tight labor markets helped push average hourly earnings up 2.9 percent from this time last year.

Business conditions continued to be strong. The ISM Manufacturing Index hit a 13-year high (60.8) while the Non-Manufacturing Index was 59.8, each comfortably in growth territory (readings above 50 are considered expansionary). The NFIB Index of Small Business Optimism remained near historic levels, with a growing number of small business owners planning to increase capital expenditures over the next six months.

While the Federal Reserve left rates unchanged in Q3, it did announce that it will begin to unwind its quantitative easing (QE) program by allowing securities on its balance sheet ($4.5 trillion strong) to mature each month. The Fed will initially allow $10 billion (treasuries and mortgage-backed securities) to mature each month with the intention of increasing this amount over time. At the same time, the Fed's more hawkish tone suggested that another rate hike is in the cards for December.

After failing on the "repeal and replace" of Obamacare, Republicans turned their efforts to tax reform. Rumors of tax reform negotiations started in late August, culminating in the release of the GOP's tax plan on September 27. For businesses, the plan calls for lowering the corporate tax rate to 20 percent (25 percent for pass-through entities), elimination of certain business deductions, and a one-time repatriation tax (at a reduced rate). For individuals, the proposal creates fewer brackets, lower rates, larger standard deductions, repeals the alternative minimum tax, eliminates the state and local tax deduction, and proposes to eliminate the estate tax. While much of the details were left for another day, the tax plan as outlined was met with great enthusiasm from both the business sector and investors alike.

The Markets. Stocks began the quarter strong, helped by continued momentum in corporate earnings. According to FactSet, profits for the S&P 500 increased 12 percent in Q2, better than analysts expected, and the number of companies raising Q3 earnings guidance was the highest in seven years. As tensions with North Korea escalated, stocks erased most of their quarter-to-date gain by mid-August, but quickly rebounded as tax reform talks began to dominate the news cycle. The S&P 500 Index finished the quarter up 4.5 percent, nearly all of which came in the second half of the quarter.

Index Performance	Q3 2017	Q2 2017	YTD
Domestic Equity			
S&P 500	4.48%	3.09%	14.24%
Russell Mid Cap	3.47%	2.70%	11.74%
Russell 2000	5.67%	2.46%	10.94%
International Equity			
MSCI EAFE	5.47%	6.12%	20.47%
MSCI Emerging Markets	8.04%	6.38%	28.14%
Fixed Income			
Barclays Aggregate	0.85%	1.45%	3.14%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Low market volatility masked significant rotation across asset classes in Q3. With tax reform at the forefront, leadership shifted back to those companies that would benefit from Trump policies: cyclicals, commodities, and U.S. oriented stocks. Small cap U.S. stocks, a major beneficiary of tax reform (predominately U.S. based businesses), were the big winner, up 5.67 percent in Q3, with all the gains coming in September (6.24 percent) after the tax reform bill was unveiled.

International stocks, on the other hand, earned most of their return in the first half of the quarter. Eurozone and Asian markets were helped by a better economy, strong corporate earnings, and an increase in oil prices. This combined with U.S. dollar weakness, helped the MSCI EAFE overcome the rotation away from international stocks near the end of the quarter to still post a respectable 5.47 percent in Q3. The 20.47 percent year-to-date return recorded by MSCI EAFE

Index remained one of the better for the year and was 6.23 percent better than its U.S. counterpart, the S&P500.

Emerging markets stocks notched their third consecutive quarterly gain (+8.04 percent), despite a -.37 percent return in September. Brazil, Russia, and China were standouts in Q3, but rotation back to U.S. equities hurt performance in the back half of the quarter. The MSCI Emerging Markets Index is up 28.14 percent for the year, the best return among the major indices.

The ten-year treasury yield hit a year-to-date low of 2.06 percent on September 8, but rose to 2.32 percent by the end of September as markets digested the realities of a less accommodative Fed. The two-year yield, which is more sensitive to monetary policy, finished Q3 at 1.49 percent, the highest level in almost nine years. The Barclays Aggregate Bond Index (+.85 percent) was helped by relative out performance of corporate bonds in the quarter.

Ten of the eleven primary economic sectors generated positive returns in Q3, with economically sensitive stocks generally providing stronger returns than defensive sectors. Information technology was the top sector, adding 8.64 percent. Energy was up 6.84 percent in Q3, getting all of its return in September (+9.94 percent) when oil prices moved higher due to storm-related supply issues. Expanding economic activity helped both materials stocks (6.05 percent) and industrial stocks (4.22 percent) to have another positive quarter. Financials (5.24 percent) moved higher as the market began to anticipate the unwinding of QE and further rate hikes. Healthcare managed a 3.65 percent return, even as the controversy surrounding Obamacare created significant volatility. Consumer discretionary names lagged (.84 percent) and consumer staples (-1.35 percent), the only negative sector in Q3, struggled as large global companies that aren't as leveraged to U.S. tax reform faced selling pressure.

S&P 500 Sector Performance	Q3 2017	Q2 2017	YTD
Consumer Discretionary	0.84%	2.35%	11.93%
Consumer Staples	-1.35%	1.57%	6.57%
Energy	6.84%	-6.36%	-6.63%
Financials	5.24%	4.25%	12.48%
Healthcare	3.65%	7.10%	20.31%
Industrials	4.22%	4.73%	14.13%
Information Technology	8.64%	4.14%	27.36%
Materials	6.05%	3.17%	15.82%
Real Estate	0.93%	2.76%	7.39%
Telecommunications	6.78%	-7.05%	-4.69%
Utilities	2.87%	2.21%	11.87%

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Outlook. The U.S. economy rebounded from a weak Q1, growth in the eurozone is accelerating, and Japan just reported a Q2 GDP growth rate of 4.0 percent, the strongest in over two years. Of the 43 major economies tracked by the Organization for Economic Cooperation & Development (OECD), only Iceland reported negative Q2 GDP growth.

U.S. economic data may be sloppy in the near term as the impact of hurricanes Harvey and Irma will undoubtedly skew the data. However, any weakness will likely be discounted as subsequent quarters should benefit from the massive rebuilding effort underway.

Broad market volatility remains historically low even as sector rotation within the market has increased. In fact, the S&P 500 has risen every month since the presidential election and has been positive for 18 of the last 19 quarters. Q3 of 2015 (-2.47 percent) was the only quarter that was negative.

Markets will have to contend with the gradual removal of monetary stimulus going forward. The Fed is already beginning to shrink its balance sheet and the odds (based on fed funds futures) of a .25 percent rate increase in December now stands at 90 percent. The good news is this is happening because the economy is good. Nonetheless, market rates will likely rise and market volatility, you would think, would have to move higher.

High P/E multiples (and record stock prices) have long been supported by easy monetary policy and lower interest rates. A transition to a higher rate environment will require stronger earnings growth to support current stock prices. At quarter-end the S&P 500 Index traded at a forward P/E of 18 times next year's earnings, a healthy premium to historical averages. Tax reform would boost future profit growth and would help alleviate concerns over lofty valuations.

As the economic expansion matures and monetary policy gets tighter, the risk of a recession will grow. While this expansion is already the third longest on record, nearly all signs support the idea that this one has further to go.