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Market Perspectives October 2017

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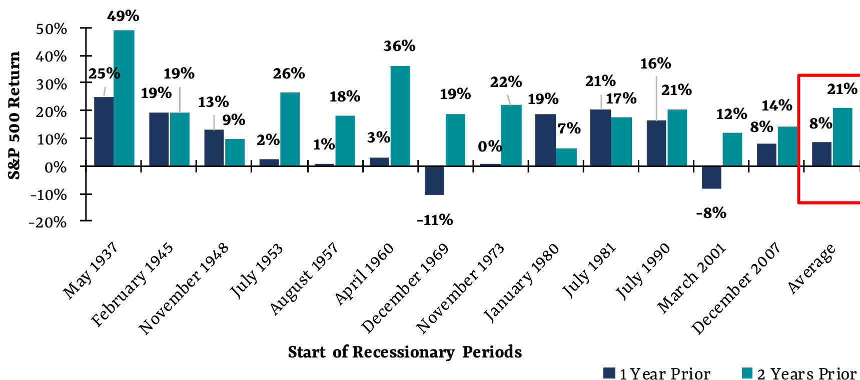
Executive Summary

- September was another positive month for domestic equities, particularly small caps, with all U.S. benchmarks gaining ground and adding to their year-to-date returns.
- On the international front, stocks in developed markets made gains, while emerging markets slipped fractionally. Overseas equities are still outperforming their domestic counterparts by a significant margin in 2017.
- Fixed income returns were mixed: most bond indices edged lower as the yield curve steepened, although high-yield bonds made headway in the more risk-on environment.
- The second quarter GDP estimate was revised slightly upward, to 3.1%, confirming the previous assessment that the economy grew at a faster pace following a lackluster start to the year.
- As expected, the Fed announced that starting in October, the central bank will begin the process of gradually unwinding its balance sheet. Investors largely shrugged off the news, which was in line with expectations.

DE-RISKING BEFORE RECESSION CAN BE COSTLY



Source: PMFA, Bloomberg

Chart above shows the 12 month S&P 500 Index total return 1-year and 2-years prior to the start of a recession.

Monthly Insights

This month we are taking a closer look at how stocks have performed in the years prior to U.S. economic recessions. Using the S&P 500 as a reference, the teal bars in the chart on the left represent annual stock market returns two years before every recession since 1937, and the dark blue bars represent returns one year prior. As the graph demonstrates, the market achieved positive returns in the vast majority of those years, and the average returns for one and two-years prior to a recession are 8% and 21% respectively.

There is a correlation between recessionary periods and bear markets, but as the historical data demonstrates, no such correlation exists for the period before a recession. In fact, attempting to de-risk ahead of a recession can have significant downside. In short, "being early" can look a lot like "being wrong."

Questions and Answers

September was another positive month for stocks, with all U.S. benchmarks gaining ground and adding to their returns year to date. Bonds slipped last month, but here too, the markets made advances in the third quarter, and the major indices are holding onto gains for 2017.

Despite markets continuing to perform well, however, queries are starting to emerge from concerned investors, some media sources and others about what's next for the economy and the stock market. Some of the questions we're hearing include:

- This bull market has lasted a long time; aren't we due for a correction?
- How long can the economic expansion continue?
- Are we heading for a recession?
- Will one or more of the various current geopolitical risks trigger an economic crisis?

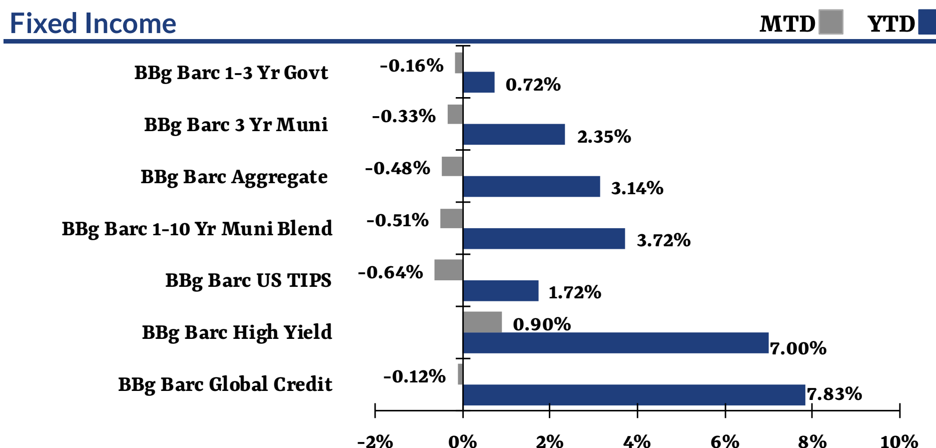
These questions stem from understandable concerns about the potential for increased risk in the market – perhaps fueled by a few alarmist voices – and a desire to determine how to best address any such risk.

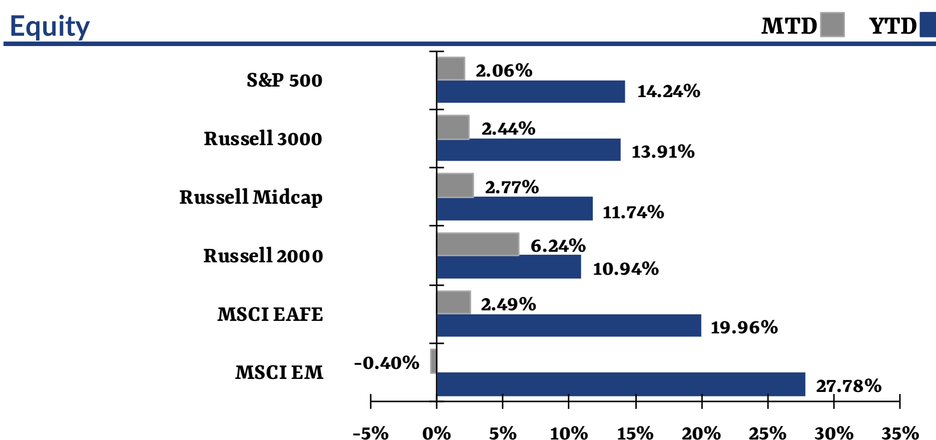
Let's consider the known facts regarding the current market and economic landscape and what they mean in practical terms.

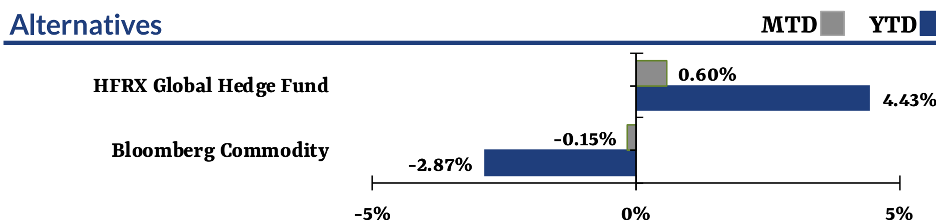
At 8.5 years and counting, the current bull market is indeed one of the longest in recent history – though not yet the longest – and its cumulative returns are significant. Yet, bull markets do not die of old age, so the mere length of this run does not establish or dictate the timing of a market downturn. Bull markets end – and bear markets emerge – when there is a reversal in investor optimism, most often brought on by an economic recession.

Which brings us to the next issue, namely, are we heading for a recession? The short answer is that there is no indication that the economy is headed for a contraction in the near term. The recovery and economic expansion since the 2008 financial crisis is – like the bull market – long in the tooth, and it has also been slower and less robust than many would have liked, but most fundamental economic indicators continue to portray a healthy, growing economy.

PERFORMANCE OVERVIEW - AS OF 09/30/17







Source: PMFA

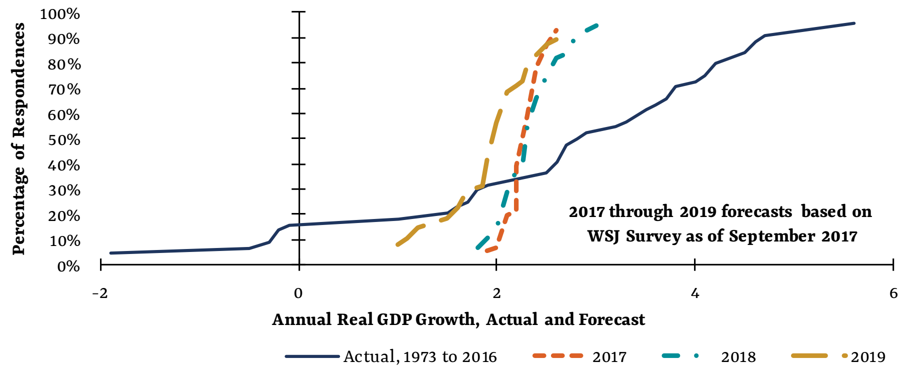
Could increasing tensions on the international front or continued delay of pro-growth domestic policies due to gridlock in Washington cause confidence to falter and volatility to reemerge? The simple answer is "yes" – but that risk always exists. However, recent events have once again demonstrated the difficulty in predicting market movements based on such risks. Neither the escalation of tensions with North Korea, the damage inflicted by two major hurricanes, nor the ongoing drama between Congress and the President in Washington has so far put a meaningful dent in investor or consumer confidence.

Yes, consumer sentiment declined modestly in September, likely in response to hurricanes Harvey and Irma. While sentiment has fallen slightly since reaching cyclical highs earlier this year, the overall consumer mood remains upbeat – and well above its long-term average. As we noted in last month's Market Perspectives, there is a strong correlation between consumer confidence and the stock market's ability to sustain relatively high valuations on a price-to-earnings basis – so strong consumer sentiment should be supportive of stock prices.

For the concerned investor, the net result is this: there is always a degree of risk in the markets, but – as the data from our Monthly insights demonstrates – attempting to time the market by "de-risking" ahead of a downturn can do far more harm than good.

Taking a closer look at recent economic developments, the Commerce Department revised its second quarter GDP estimate slightly upwards last month to 3.1% (from 3.0%), confirming the economy grew at an appreciably faster pace after a lackluster six months lasting from late 2016 to early 2017. That stronger growth is mainly attributed to increases in consumer spending and nonresidential investment.

MOST ECONOMISTS SEE EYE TO EYE ON GDP FORECASTS



Source: PMFA, Wall Street Journal, Bloomberg, Standish Mellon

The report had little impact on the markets. Attention is now firmly focused on how the economy fared in the third quarter, and how it will perform through the end of the year. The destruction caused by Hurricanes Harvey and Irma, and the resulting regional economic disruption, are expected to be a drag on growth, but the drag is expected to be temporary.

Despite that short-term headwind, the economy remains on track and even picked up its pace, while employment conditions continue to be robust. It will take more than one quarter of growth exceeding 3% to conclude that a stronger growth trajectory can be sustained, however, the overall trend remains sound.

For its part, the Federal Reserve is responding to the resilience of the economy by moving forward with the next step in its plans to normalize monetary policy.

As expected, the Federal Open Market Committee took the opportunity at its latest meeting to announce that starting in October, the central bank will begin the process of gradually unwinding its balance sheet. This puts the central bank in uncharted waters, as it's the first time that the Fed has attempted to reverse the effects of Quantitative Easing (QE). As such, it's been cited as a potential risk to the markets and therefore a potential source of market volatility. So far, however, as with many other recent developments, investors have also taken this one in stride.

The Fed also kept its benchmark short-term interest rate steady last month, though Chair Janet Yellen and other committee members held firm in projecting one more increase before the end of 2017. Market expectations appear to have come around to this point of view as well, as Fed Funds Futures now indicate an expected 25-basis point increase this December as a near certainty.

For a more detailed and up to the minute assessment of economic and monetary policy trends, please visit our Market Perspectives Blog.

Turning to market performance in September, U.S. stocks were nicely positive across all major indices, led by a rally in small caps. The small-cap Russell 2000, which had previously lagged its counterparts, added an impressive 6.2% in September, bringing its year-to-date returns to 10.9% and more in line with the broad market. Russell Midcaps gained 2.8% and the large-cap S&P 500 advanced 2.1% last month, bringing their returns for 2017 to 11.7% and 14.2% respectively.

International stocks had more mixed results in September. The MSCI EAFE, which includes developed market equities, added 2.5%, while the MSCI Emerging Markets index lost 0.4%. Since the start of 2017, however, both are significantly outpacing U.S. equities, with developed market stocks holding on to a 20% gain, and emerging market equities returning nearly 28%.

We continue to recommend a slight overweight to international equities, which offer relatively greater growth potential than their U.S. counterparts. U.S. investors in overseas assets have also benefitted from a softening dollar this year, which has provided an additional tailwind to returns.

Fixed income returns were mixed: most bond indices slipped as the yield curve steepened, while high-yield bonds made headway in the ongoing risk-on environment. The Bloomberg Barclays Aggregate and the 1-10 Year Municipal indices both dipped 0.5% in September, while the Bloomberg Barclays High Yield index added 0.9%.

Although they gave some ground last month, bonds enjoyed a positive quarter, and the benchmarks remain in positive territory for 2017. Municipal bonds continue to outperform taxables on a year-to-date basis.

Returning to the critical issues underlying the questions we explored earlier – namely, what is the risk environment today, and what does that mean for investors – we thought it would be useful to look at expert predictions for the economy over the next 2+ years.

The chart on page three shows the collected forecasts of a wide range of economists for U.S. GDP growth through 2019. Their expectations for the remainder of 2017 and all of 2018 are tightly grouped in the range of 2-3% annual growth, which is similar to the steady expansionary pace the economy has enjoyed over the past several years.

Looking further out, to 2019, the expectations remain positive – if more muted – with the range extending from about 1.0-2.5%.

We would acknowledge that economists have a tendency to gravitate toward the status quo in the absence of compelling evidence to the contrary. As a group, they are also notoriously bad at projecting turning points in the economic cycle until after the fact – and typically well after the market has already at least started to price in the change in direction.

Nonetheless, the economic news today remains broadly positive, and for the first time in several years, there are indications that the global economy is on an upswing, with a more synchronized growth environment taking hold.

As noted above, there are always risks in the market, and it's impossible to predict precisely when a downturn in the economy or a bout of equity market volatility may emerge. The key is not in trying to time the markets to sidestep those periodic bouts of volatility, but in remaining disciplined in your investment approach.

Nevertheless, with the outlook for the economy generally positive, and the frequently substantial downside costs of attempting to market time and de-risk a portfolio ahead of a bear market (as illustrated in our Monthly Insight on page 1), the best course of action for long-term investors today is to stay the course, rebalancing as necessary and as market conditions create both the need and opportunity to do so. Of course, it is appropriate to periodically review your plan to evaluate progress toward your objectives and goals, and reaffirm that the risk that you are taking and your asset allocation are consistent with your goals, objectives, tolerance for risk, required rate of return, and investment time horizon.

Any changes to one's plan should be made on the basis of long-term objectives and requirements. Any attempt to read the tea leaves, predict potential turning points in the cycle or sidestep potential market volatility may sound good on paper, but can be a very costly mistake.

Gratuitously Unnecessary Regulatory Intervention of the Month

Heartless regulators?

The Nashoba Brook Bakery in Massachusetts cares deeply about its products, claiming to add a generous helping of love to every batch of granola it makes. In fact, it even included "love" on the ingredients list. Until recently.

In September, the Food and Drug Administration sent a warning letter to the bakery's owners, telling them to remove "love" from the list, noting that it is not "a common or usual name of an ingredient."

Nashoba's CEO disagrees, stating that the prohibition "just feels silly," though the company has agreed to comply with the FDA's request. Which is a shame, since it really added no calories.

Source: Bloomberg

Blog

For other up-to-date economic briefs, visit PMFA's Market Perspectives Blog at **plantemoran.com/market-perspectives-blog**.

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

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