2017 FALL INVESTMENT OUTLOOK

As summer turns to autumn in the U.S., the S&P 500 stock index continues its ascent to record highs amidst the most synchronized global growth backdrop since early in the current expansion. Stocks are up more than 13% on a total return basis driven by a decline in core inflation and an acceleration in global GDP growth toward a 3.5% expected rate for 2017, the highest since 2011. Corporate earnings have grown at a double digit rate through the first half of the year led by the energy, financial service, and technology sectors. Emerging market equities have advanced 26% thus far in 2017 on the heels of this momentum as well as higher industrial metals prices, a weak dollar, and an expected moderation in Federal Reserve interest rate hikes. This follows years of underperformance since the 2011 commodity price collapse.

Despite the major indices striking new highs, equity market leadership is narrowing as recent gains have been led by the so-called FANG stocks and the largest capitalization companies. The Value Line Geometric Composite (which measures the median stock price change of approximately 1,700 companies) has gained just 4.9% year-to-date; the Russell 2000 Index (small cap stocks) is up only 7.0%; and Dow Jones Transportation stocks, which usually lead broader market rallies, have risen just 7.4%. Stocks that typically exhibit low volatility and high dividend yield characteristics have also lagged the market over the past year due to the multi-decade high valuations achieved in mid-'16, which coincided with the generational low in long term interest rates.

The Trump administration's failure to achieve a major legislative victory after eight months in office has investors lowering their expectations for the future as depicted in other parts of the capital markets, essentially reversing the fiscal re-flation and stimulus expectation that dominated the fourth quarter of 2016. The U.S. dollar spiked to a 14-year high by the last week of December only to fall 9% thus far in 2017 to a 32-month low. The yield curve has flattened this year despite the pickup in global growth and industrial metals prices; intermediate-to-longer term yields have fallen while shorter maturities have risen as the Federal Reserve pushes its key policy rate higher. The 10-year Treasury note currently yields 2.23% compared to 2.60% in mid-March. Gold has risen 16% since mid-December after falling nearly 14% following the election.

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	Index Price Level	2017 YTD Total Return
Dow 30 Industrials	22,296	+14.9%
S&P 500	2,497	+13.2%
NASDAQ Composite	6,371	+19.3%
MSCI All Country World Index ex-USA	292	+21.5%

Outlook

The current bull market and economic expansion that began some eight plus years ago are among the longest in duration when examining the post-WWII history books. However, bull markets and expansions don't die of old age, as the old Wall Street adage goes; they usually end due to an adverse credit event or a rapid tightening of policy. The financial markets have been disconnected from the real economy in this cycle more so than in any other recent period due to the extraordinary measures taken in response to the financial crisis. The current cycle is certainly displaying its fair share of concerns such as rising corporate leverage, high asset

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valuations, and increasing geopolitical tensions. However, the underlying economy is hardly overheating and leading indicators show no signs of a near term recession. Demand growth is still weak versus historical standards and excess global supply of commodities and manufacturing capacity still exists. Thus, the economic expansion could last longer than many think as the economy plays catch-up to the financial markets.

While the current expansion is among one of the longest on record it has not been a period of steady uninterrupted growth. The economic expansion that commenced in mid-2009 was soon facing China slowdown concerns as early as 2010 along with the related collapse of industrial commodity prices a year later following their April 2011 peak. The U.S. government shutdown and Budget Control Act of 2011 reduced discretionary government spending to levels that are still currently 10% lower on an inflation adjusted basis compared to fiscal 2011 and started the debate around the tradeoff between fiscal austerity and economic growth. The Eurozone debt crisis was well underway by late 2011, pushing the continent into a recession that lasted from 2012 to early 2013. Finally, crude oil prices peaked in June 2014 and eventually entered a bear market that lasted until February 2016 due in part to the U.S. shale revolution as well as OPEC's initial decision to not cut output. During each one of these crises private demand slowed, putting the recovery in a more precarious position.

However, since February 2016 global growth has been uninterrupted and seems to have found its most stable footing of the cycle as all major economies are experiencing progress in unison. Eurozone GDP has grown at a 2.3% annualized rate over the past year, its best four quarter growth rate since early 2011. The deflation-prone Japanese economy has now grown for six straight quarters. While annualized growth was a more modest 1.6% over the past year its economy grew 2.5% in the latest quarter, the best performance since the first quarter of 2015. China's 6.9% year-over-year growth for the first half of 2017 was higher than the 6.5% full year target set by Beijing for 2017.

The weaker than expected U.S. dollar in 2017 has bought the Chinese authorities some much needed time to implement financial stabilization measures. The yuan has appreciated 6% versus the dollar since late December, which has helped to temporarily halt the capital outflows experienced by China the previous two years. However, the impact on the Chinese financial system from a future resurgence in the U.S. dollar is uncertain and could interrupt what appears to be a softer than expected landing at the moment. The country's credit expansion has been slowing throughout the year which could lead to moderating growth for the balance of 2017.

Headline growth for the U.S. economy was 2.2% over the past year while the underlying private sector advanced 2.9% when excluding the headwinds from net exports, inventory liquidation, and flat discretionary government spending. Government data released in early September shows median household income to be $59,039 (adjusted for inflation) and finally trending higher past the previous peak set in 1999. Recent gains since bottoming in 2012 have helped support consumption in the economy. The personal savings rate declined to 3.5% in July but was as high as 6.0% in the fourth quarter of 2015, thus consumers have been spending the recent income gains. The currently low level of savings, however, gives consumers less of a buffer in case of an unexpected shock. The savings rate has historically been negatively correlated with wealth. Thus, an eventual correction in stock prices or other assets could potentially have an adverse impact on consumer spending.

Core retail sales were sluggish over the summer months, growing only 0.6% annualized since April, the worst four-month stretch since 2013. Auto sales have also fallen to a 3 ½ year low to 16.1 million vehicles. Single family housing starts continue to grow near the 11% trend rate that has persisted since the bottom while multifamily starts have now stalled for a couple of years. Despite the steady progress, current single family starts near 850k units are still some 30% below levels that would be considered normal given reasonable expectations for population growth and household formation. The rebuilding efforts following the devastating hurricanes are likely to be an incremental tailwind to the housing market and related consumption in the near term.

Bank loan growth has slowed recently for both real estate and business categories albeit lending standards have loosened somewhat along with the recovery in crude oil prices. Business loans in particular are just 2.1% higher than year ago levels, a substantial downshift from the double digit rates seen in recent years. While loan growth has historically been a lagging indicator, such a sharp slowdown is typically seen at the end of credit cycles.

Corporate leverage as measured by the debt-to-cash flow ratio is at previous cycle peaks and bears watching. As explained by Adam Richmond, Morgan Stanley's chief credit strategist, "Companies with the weakest fundamentals often show problems first late in the cycle. Investors initially treat those issues as idiosyncratic, and then the problems spread when credit conditions begin to tighten. That is how the late cycle can transition to end of the credit cycle." It is notable that credit spreads in the corporate bond market are very tight while dispersion is on the rise. For example, some 40 junk-rated bonds across multiple industries are currently trading at distressed levels (i.e., below 80 cents on the dollar) compared to just 23 in early March.

The Federal Reserve will begin reducing the size of its balance sheet in October at a rate of $10 billion per month by reducing its purchases of Treasuries and mortgage securities. The Fed is signaling an additional 25 basis point rate hike for December to a range of 1.25%-1.50% and the latest projections from FOMC members indicate the potential for three additional 25 basis point hikes in 2018. However, the fed funds futures market is less sanguine, indicating just a 44% probability of the first rate hike for 2018 occurring by August. There is little historical precedent if any for the Fed to raise interest rates when core inflation is falling, when loan growth is substantially slowing, and the economy is not running hot. The Fed could choose to raise interest rates but its hand is currently not being forced. On the other hand, financial conditions are practically the easiest of the cycle when considering the impact of stock prices, credit spreads, the dollar, and other broad measures on potential economic decision-making and risk-taking.

The risk to financial markets during a monetary tightening cycle is that inflation accelerates and forces the central bank to hike rates at a faster pace than expected. The source of such inflation would emanate from either a rapid and sharp depreciation of the dollar, a tightening labor market, or an imbalance in goods supply/demand. However, none of those scenarios seem to be on the horizon and the lack of inflation has most global central bankers perplexed. Chair Yellen in her latest press conference even stated, "This year the shortfall of inflation…is more of a mystery. I will not say that the committee clearly understands what the causes of that are." There are some secular forces at play holding back inflation that may not be entirely appreciated by central bankers. These headwinds would include demographic factors, the substitution of technology/capital for labor, and limited capacity for households to expand debt levels.

The current headline unemployment rate of 4.4% has historically been associated with strong hourly wage growth of 4%+ compared to the current modest growth of just 2.3%. However, today's unemployment rate may overstate the tightness of the labor market given the severity of the Great Recession. Broader measures of unemployment that capture part-time workers and marginally attached individuals (i.e., those who aren't counted as unemployed because they haven't searched for a job in four weeks) are lagging the progress of the headline rate relative to previous cycles by approximately a year or so, implying there is still some supply of labor to be absorbed before wages begin to accelerate. Higher wage job openings in segments such as professional and business services have stopped expanding the past two years and there are anecdotal stories of higher wage, older workers being replaced with lower wage, younger folks. Nonetheless, business employment surveys measuring the number of hard-to-fill positions and number of unqualified applicants depict a rising trend that could eventually lead to a tighter labor market and higher wage growth.

The modest inflation levels have had a peculiar impact on stock valuations during the current Fed interest rate hiking cycle compared to the previous three tightening regimes. Stock P/E ratios have actually expanded this time with the S&P 500 trading at 17.8x forward earnings compared to 16.4x in December 2015 when the Fed first raised rates. The previous three tightening cycles saw P/E ratios decline 12-24 months after the initial lift-off. Thus an unexpected back up in interest rates to levels that make bonds more competitive with stocks could adversely impact the equity bull market. Policy tightening by other global central banks could also impact stocks at some point. The European Central Bank (ECB) is expected to announce a tapering of its asset purchases in October and there are various Japanese officials that want the Bank of Japan (BOJ) to publicly outline its own exit plan considering it has accumulated approximately 40% of outstanding Japanese government bonds. JPMorgan Chase Chairman and CEO Jamie Dimon is cautious regarding the unwinding of such central bank bond buying programs and thinks it is an unprecedented challenge that may be more disruptive than people think, stating “We never had QE like this before, we’ve never had unwinding like this before. We act like we know exactly how it’s going to happen and we don’t.”

The federal budget deficit at the U.S. Treasury could be close to $700 billion (3.5% of GDP) when the government closes its books on fiscal 2017 at the end of September. This is up significantly from the low of this cycle of $438.5 billion (2.4% of GDP) as recently as fiscal 2015. Entitlement spending is now crowding out general government funds, which could impact the magnitude of the fiscal programs that the administration hopes to pass before the midterm elections next year. Historically, a rise in the federal deficit has led to higher interest rates. However, the magnitude of this relationship as it relates to the current cycle is quite uncertain. Government debt levels continue to make all-time highs and economic growth is still underwhelming, increasing the likelihood that financial repression continues, holding interest rates below the inflation rate. The Federal Reserve will still be monetizing (buying) approximately 40% of the federal deficit even as it begins to reduce the size of its balance sheet at a modest rate. Furthermore, U.S. government bonds still offer much higher yields compared to its sovereign peers and could be a source of future demand. For example, the current yield of the U.S. 10-year Treasury is 2.23% versus 0.41% for the 10-year German Bund and 0.02% for the 10-year Japanese Government Bond.

President Trump, void of any major legislative victories after eight months in office, appears to be making a slight pivot towards working with the Democrats on issues like Dreamer immigration reform. This could lead to some unexpected legislative and political implications over the next year. Even House Minority Leader Nancy Pelosi stated as recently as September 24th on Meet the Press that she trusted the President on their framework for the so-called DREAM Act and suggested their next deal could be on infrastructure.

With the Republicans failing to pass healthcare reform the focus has shifted towards executing on tax reform. We expect some version of legislation to be passed by the first quarter of 2018 with the emphasis on lowering the U.S. corporate tax rate and unleashing a repatriation of corporate funds that are currently trapped across seas due to punitive rates. Individual tax reform is expected to be less impactful for the wealthy given the necessity to help pay for the cuts and in order to pass the legislation per the arcane budget rules of Congress. According to Capital Economics, American corporations are holding $2.5 trillion abroad. If such funds become available post-reform the cash could be used for shareholder remuneration, growth investments, and acquisitions. Private equity is also holding some $600 billion in uninvested money as fundraising has hit a new record and the volume of PE-backed buyouts has declined the past two years. There is a possibility that once there is more certainty in the tax rules that an M&A frenzy could follow considering such magnitude of cash, leading to a further melt-up in stock prices.

Investment Conclusion

While most stocks continue to be priced at full valuations we have uncovered some select opportunities in well-researched equities as part of our ongoing fundamental analysis. We generally are not increasing our allocation to stocks with recent investment activity but simply shifting the mix—trimming some names with large position sizes and/or high valuations and using these funds as our source of new investment. The 2-year Treasury yield is trending favorably and currently yields 1.44%, the highest level since the fourth quarter of 2008. Thus, fixed income returns should continue to improve. Recent bond investment has emphasized BBB-rated investment grade corporates of short maturity, where we are still capturing a satisfactory spread to comparable maturity Treasuries. Municipal bonds have offered less opportunity recently relative to taxable corporates even for clients in the highest marginal tax brackets as valuations continue to richen. A diversified portfolio with excess cash reserves will be best positioned during an eventual correction and provide an important source of funds for investment when stocks become more attractively priced.

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