Investment Update

Third Quarter 2017

The S&P large, mid, and small capitalization stock indexes all ended the third quarter at all-time highs. International indexes were slightly below recent highs and still below levels of a decade ago just before the financial crisis started to unfold. The 10-yr Treasury yield traded down to nearly 2% in early September amidst tensions with North Korea, but ended the quarter around 2.3%, just about where it had started.

Equity Markets (Total Return)	3Q17	YTD	1-Yr
Dow Jones Industrials	5.6%	15.5%	25.5%
S&P 500	4.5%	14.2%	18.6%
S&P Mid-Cap	3.2%	9.4%	17.5%
S&P Small-Cap	6.0%	8.9%	21.1%
MSCI All-Country World	5.2%	17.3%	18.7%
MSCI Foreign Developed Markets	5.4%	20.0%	19.1%
MSCI Foreign Emerging Markets	7.9%	27.8%	22.5%
US Bond Markets	**3Q17**	**YTD**	**1-Yr**
Barclays US Govt/Credit Intermediate	0.6%	2.3%	0.2%
Barclays US Govt/Credit Long	1.5%	7.7%	-0.8%
BAML Municipal Intermediate	0.8%	3.5%	1.0%

Stock market gains have been supported domestically by record earnings and expectations for double-digit growth in 2018, as well as the anticipated sustainable demand from a synchronous economic expansion driving up markets around the world. All 45 developed economies tracked by the OECD recently were expanding simultaneously for the first time since 2007, with over two-thirds doing so at an accelerating pace. Growth in the US does continue to be low by historic standards, particularly this late in a post-recession recovery. This has led investors to seek out growth over value stocks, and to aggressively sell the shares of any company that hints at weakness in its growth profile. That many stocks, types of stocks, or certain sectors are materially lagging is easily missed amidst all the headlines about overall record highs.

Investors are still mindful of the Fed's intentions and actions, but seem to be analyzing which sectors the hint of a rate hike or pause will be good and bad for, as opposed to whether it is good or bad for all stocks. Manipulation of short-term interest rates is the Fed's primary time-tested monetary tool and its effect on economic growth is well understood. So far rate hikes have been periodic, with several FOMC meetings between them, and that pace is expected to continue. This is partially due to growth and inflation being within reasonable limits, but also because the Fed is starting to gradually shrink its balance sheet by not reinvesting all of the maturity proceeds of its bond holdings.

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The Fed's balance sheet is around $4 trillion as a result of the quantitative easing programs it engaged in in the years following the financial crisis to push longer-term interest rates down by printing money and buying bonds. It is unclear if and how much this actually helped support the economy, and what exactly will happen as it contracts, but allowing these holdings to mature without reinvesting equates, in theory, to more interest rate hikes. However, most investor attention is on the historically slow but easier to quantify pace of interest rate hikes, which is viewed as supportive of current stock prices.

One dynamic that is unlikely to factor much in the Fed's decision making process is the effect of the devastating hurricanes this year. Much of the damage wrought by these storms occurred on Caribbean islands, and even though several are US territories, only the destruction and clean-up on the mainland is accounted for in US economic data. Storms often end up being something of a zero-sum game economically, with an initial slowdown in demand and increase in unemployment in the region, followed and offset by rebuilding efforts and expenditures. While the human toll is real and tragic, the resulting variations in the data are not viewed as fundamental to the trend in the economy's overall health.

Despite many years of calls from Republicans to repeal the Affordable Care Act, there never really had been any consensus on what to do in its wake as healthcare is not a signature issue for the party as it is for the Democrats. After several healthcare proposals failed to progress through the legislature, the White House released its outline for substantive tax reform late in September. There is far more philosophical unanimity amongst Republicans on the issue of taxes, although those who have campaigned on fiscal austerity may break ranks depending on the size of projected deficits. Even with a potentially more unified front than on healthcare, any discussion of overhauling the tax code will bring lobbyists representing every single special interest group to the table. Legislators on both sides of the aisle will feel the pressure and many will no doubt succumb. The resulting process will likely be messy, and it is anyone's guess what will come of it and when.

There are many positive proposed changes including overall tax code simplification, lowering of corporate rates to make the US more competitive with other developed countries, and allowing foreign profits to be repatriated and taxed at a reasonable rate. However, with the current economic expansion in its later stages it is possible that the resulting stimulative effects of whatever changes actually make it in to law will necessitate the Fed being more aggressive to keep growth under control than it could have been under the status quo.