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Market Commentary
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Introduction

Despite geopolitical events dominating the headlines, stocks around the globe continued on their upward path in the third quarter. The economic environment has been consistently healthy with no major negative data. Unemployment remains low at a 4.4% rate, inflation is not extreme in either direction with CPI up 1.9%, and the real GDP growth rate was revised up to 3.1% in Q2 with the largest contribution from consumer spending. The Federal Reserve chair, Janet Yellen, continues to suggest the central bank will raise the Fed Funds rate despite uncertainty surrounding the forces keeping inflat ion low. With a robust labor market and synchronized global growth at hand, the Fed feels it would be imprudent t o keep monetary policy on hold. Looking ahead, equities have potential to rise further with tax reform from the White House which would be a boon for U.S. corporations but could also create concerns with the potential of rising inter est rates.

Domestic Equities

Domestic stocks had another excellent quarter as the S&P 500 finished Q3 2017 up 4.48% and year-to-date up 14.24%. Performance has been supported by a mostly positive economic backdrop and the earnings and sales growth of U.S. corporations within the S&P 500, which were up +9.67% and +5.25% respectively. This has now been the fourth consecutive quarter of positive earnings growth since the earnings recession. Further, tax reform is at the top of the priority list for the White House, with the current proposal suggesting to drop the corporate tax rate to 20%. This would significantly boost earnings for U.S. companies and temper some of the valuation concerns market participants may have today. These tax cuts would also disproportionately benefit smaller sized stocks here in the U.S. as their effective tax rates tend to be higher than larger multinational firms.

In our view, a bear market does not seem likely in the immediate future. While the bull market should continue, valuations are becoming concerning and will need a catalyst, perhaps tax reform, or earnings growth, to improve.

International Equities

International equities outperformed domestic equities for the quarter as the MSCI EAFE index returned 5.40%, beating the S&P 500 by 0.92%, supported by macro tailwinds, improving earnings, and parting political clouds. On an annualized basis, the Eurozone economy expanded by 2.6% in the second quarter, representing an upward revision from the previous estimate of 2.5%. Eurozone business and consumer confidence reached its highest level since June 2007, which should further boost the economy. Japan's economy grew at a faster-than-expected pace of 4% in the second quarter, representing the sixth straight quarter of growth. While uncertainty remains, we believe the developed international economies are still early on in their economic cycle and have ample room to grow.

Emerging markets (EM) had another good quarter with the MSCI EM index returning 7.89% on the quarter and 27.78% on the year. EM equities benefitted from improving EM fundamentals, global economic rebound, softer U.S. dollar, range bound commodity prices, and cheaper valuation. In the near term, one of the most pertinent downside risks is a stronger dollar from a tightening Fed, but we believe EM countries will benefit from a trading perspective with their currencies being cheaper. In addition, improving fundamentals and cheap valuations will continue to make the space attractive. Critically, it is important to note that not all EM countries are alike. We prefer more consumer-oriented EM economies over commodity-oriented EM economies.

Fixed Income

Geopolitical risk, natural disasters, the June Fed meeting, and the new proposed tax reform all meaningfully impacted the fixed income market this quarter. The 10-year U.S. Treasury yield hit its lowest point of the year at 2.04% on September 7th and spiked up to end the quarter at 2.33%. This was a result of the Fed committing that in October they will begin to winddown the treasuries and agency mortgage backed securities that were purchased as part of previous quantitative easing programs. This caused intermediate term and long term interest rates to move higher and the Bloomberg Barclays Agg Bond Index (Agg) to end the quarter up only 0.85%. With no significant increases in inflation and moderate economic growth, the market believes the Fed will raise rates at a more modest pace. Additionally, the high demand for yields from both the aging domestic population and foreign investors who favor higher yielding U.S. bonds relative to international developed country debt, should keep U.S. intermediate to long term rates range bound. However, if other major central banks, such as the European Central Bank, also become less accommodative in their monetary policies in reaction to better economic fundamentals, there could be a selloff in global bonds, which would drive yields up. In terms of sectors, low credit quality bonds continue to outperform high credit quality bonds, benefitting from global economic recovery. The Bloomberg Barclays US Corporate High Yield Bond Index was up 1.98% on the quarter, more than doubling that of the Agg. We believe it would be prudent to not make large bets on duration as it will be hard to predict movements in global interest rates and instead, seek opportunities in the credit market.

Alternatives

Alternative asset classes lagged during the third quarter. Oil prices rose following Hurricane Harvey, causing a disruption in supply and pushing prices higher, with WTI crude ending the quarter at $51.67 per barrel, rising from $46.04 per barrel at the end of the second quarter. Though the Morningstar Diversified Alternative index returned only 0.98% on the quarter**,** risk-reducing alternatives were able to provide valuable downside protection during a quarter that saw an increasing level of volatility due to geopolitical tensions. Hedge fund-like alternatives will continue to play a key role in downside protection and reducing volatility within a portfolio by maintaining low correlation to equity and fixed income markets as we approach a late stage U.S. economy.

Real Estate

Real estate should remain a positive contributor to the economy in the quarters ahead as wage growth accelerates and low borrowing rates encourage more people to buy homes. Recent data has been negative, with new home sales falling 3.4% in August, and down 1.2% from a year ago, though much of the recent negative data may be skewed due to Hurricane Harvey and Hurricane Irma. The NAHB index, a measure of homebuilder optimism and a leading indicator for the housing market, remained high at 64 in September. Though the negative data may be short term in nature, tight supply, rising home prices, and the rising cost of borrowing remain headwinds for housing moving forward.

Conclusion

At the start of the year we compared the economy to the fairy tale "Goldilocks", stating it is not too hot, growing at a steady pace and not too cold, showing no signs of an impending recession. This thesis has continued to play out and has built a smooth runway for stocks to move higher globally. As we enter the holiday season and wait for Congress to come to an agreement on tax reform, we remain cautiously optimistic in regards to equities, taking risk, while always considering the downside.