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Strength or Complacency?

Dear Clients and Friends,

So far, 2017 has been a good year for investors, with economic and profit growth driving broader markets up 12.4% through September 30. With volatility at historic lows, devastation from Hurricanes Irma and Maria, rising interest rates, and geopolitical threats from North Korea and the Middle East threatening to reverse the market's momentum, we wonder—*Have investors become too complacent*?

As we head into the final stretch of 2017 and begin to map out 2018, we are cautiously optimistic that economic fundamentals and steady profit growth will continue to support investment in equities, as long as the current macroeconomic narrative remains intact.

What happened in Q3?

Looking back at the third quarter, improving economic fundamentals drove positive investor sentiment. Expectations for strong economic growth increased as the government made upward revisions to its third and final GDP growth estimate of 3.1%. As a further boost to investor sentiment, companies beat quarterly profit estimates by 4.5% during the July / August reporting season. Finally, throughout the year, steady improvement and strength in the Purchasing Managers Index (PMI), a leading indicator for expansion, fostered expectations that businesses continue to be bullish. Generally speaking, these upside surprises more than offset investor fears of a geopolitical conflict, hurricane damage, and even the threat of a potential default of federal debt. We got a taste of investor concerns in mid- August, as the VIX or volatility index—also known as the "fear index"—spiked amid rising tensions in North Korea, but then flattened in early September after White House and Congressional leaders delayed a pending debt ceiling debate.

During the third quarter, we focused on quality and valuation for our equity portfolio, proactively trimming our Apple position in September ahead of a new iPhone product cycle, because we felt that investors had priced a flawless product launch into the stock price. Within technology, we also added to a mid-cap semiconductor company called Microchip after the stock declined in July on fears of a cyclical downturn in the industry. In August, Microchip reported quarterly results ahead of investor expectations.

What's next?

Investor sentiment may become a key factor looking forward to 2018. Investors have shrugged off several risk factors so far this year, but we wonder if the trend will continue—especially as stock valuations remain elevated and looming Federal Reserve actions could slow the economy. As of this writing, implied volatility has declined to levels below the historic lows seen earlier this year.

Within the broader fundamental picture, we believe that near-term economic growth will overcome geopolitical concerns and hurricane recovery efforts to meet investor expectations over the coming year. However, we are increasingly cautious on monetary policy actions. Current stock valuations seem to anticipate few surprises from the Fed, despite three open seats on the Federal Reserve board and questions regarding just how hawkish a yet-to-be-named Chairperson might be. Adding to the uncertainty, the Fed will begin reducing its bond holdings this month and is expected to raise rates in December. One of the key factors in the Fed's decision to raise rates will be wage inflation. To date, wages and inflation have remained below the Fed's targets, though a tight job market could lead workers to demand higher wages, boosting inflation and possibly triggering an accelerated schedule of interest rate hikes.

At the market level, we have modest concerns that rising stock valuations this year may limit stock performance next year. The forward price to earnings (PE) ratio for the S&P500 currently stands at 19X, well above the most recent five-year average of 17X, which suggests that further PE expansion is less likely. However, the silver lining for next year may be continued profit growth (currently estimated at 11%), which could drive stocks higher, even if PE ratios remain unchanged.

How are we positioning?

Ultimately, we view favorable economic and profit growth as the most important drivers of security valuation. As such, we recommend that clients stick with long-term stock and bond targets in their portfolios. While it may be easy to become complacent as stocks keep moving up, we continue to weigh upside potential against downside risk. This has led us to move more aggressively this year toward rebalancing client portfolios from an overweight equity posture back toward their long-term allocation targets.

In the recent past, our portfolios have favored domestic securities, because we believe the U.S. has a more stable growth market relative to other countries. Still, we are now considering higher exposure to global markets, in the event that growth in the U.S. slows. European stocks, in particular, could offer upside as the region continues a steady recovery from the 2008-09 recession.

Looking at our equity portfolio, we are currently overweight defensive sectors such as consumer staples and utilities, while underweight cyclical industries such as technology and financials. We may consider changes heading into 2018, especially if rate hikes seem more likely to help financial stocks, or if we find attractive valuations for higher growth sectors, such as technology. Overall, we continue to favor high quality companies that can grow profits, exceed expectations, and return capital to shareholders.

As many take time to enjoy the fall colors, we will continue to reflect on where we are heading, while looking for opportunities to harvest gains where appropriate and make any final distributions necessary prior to year-end. As always, we will keep an eye out for potential down-side threats and signs of strength and make portfolio adjustments accordingly.

With Best Wishes for Autumn,

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