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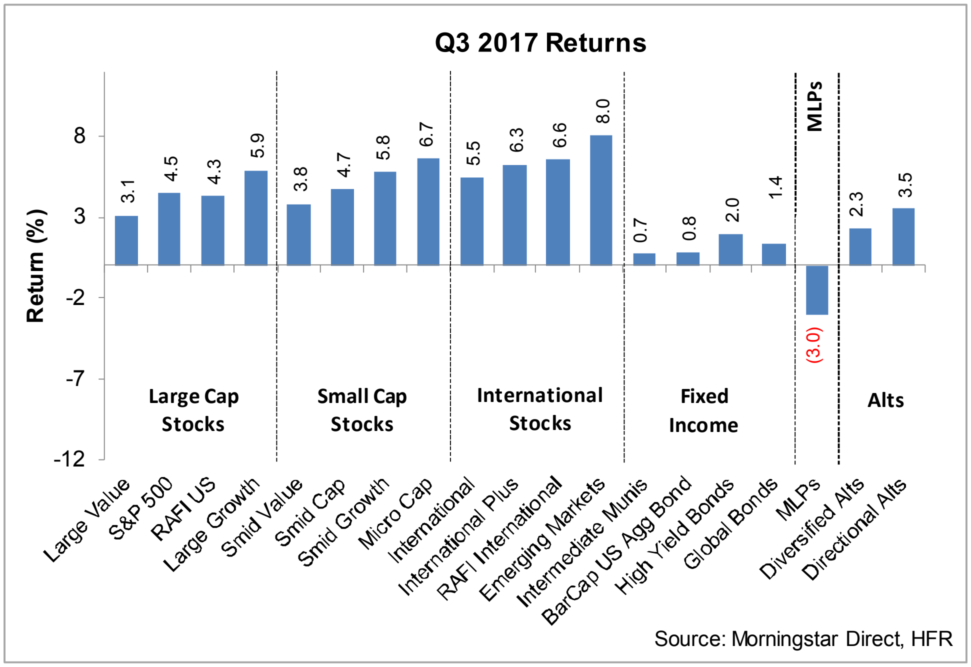
Third Quarter 2017 Investment Review & Outlook



EXECUTIVE SUMMARY

Q3 Recap:

- U.S. stocks extended their streak of positive monthly gains to 12, while non-U.S. stocks surged to their best start in eight years, partially due to currency effects
- The so-called "Trump Trade" re-emerged in the second half of the quarter on news of tax reform, leading to large gains in small caps and reversing 2017's slide in interest rates
- U.S. GDP picked up to its highest rate in more than two years and appears to be exhibiting solid momentum; the recent hurricane catatrophes is expected to have some near-term impact but should be temporary

NEXT Outlook:

- Valuations are elevated but not extreme (about 10% higher than historical), and have surprisingly been held in check in 2017 by strong earnings growth (17.7x forward P/E versus 16.9x at the start of the year)
- Given the unusual persistence of market gains, we believe a modest correction in the next 6-12 months is entirely possible, but we do not advocate a dramatic reduction in risk at this time
- We continue to believe non-U.S. markets offer a multi-year opportunity based on attractive valuations and growth, despite recent currency gains

To Our Clients and Friends,

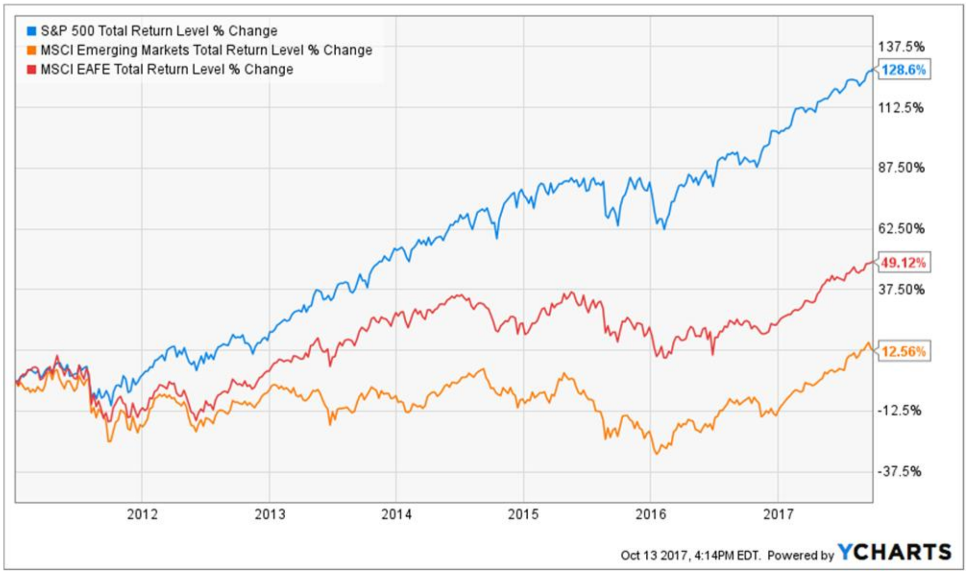
The rally continues! Stocks continued their impressive run in the third quarter, as the S&P 500 rose 4.5% and finished each month in positive fashion. This continued the market's streak without a 5% correction to 318 trading days and the number of consecutive positive months to 12. As we noted in our last letter, that level of consistency has only been observed a handful of times over the past 70 years. For the year, the major U.S. indices are up between 14% and 25% (with the tech-heavy Nasdaq index skewing the top end of that range).

Stocks initially stumbled in early August, amid rising U.S. tensions with North Korea. Those fears were quickly forgotten, however, when news emerged that Republican lawmakers were turning their attention to tax reform. While scant on details and a long way from approval, these headlines were enough to quickly shift market sentiment. This was particularly evident in sectors considered to benefit more from an upswing in cyclical economic growth – the so-called Trump Trade – as small caps and other cyclicals outperformed the broader market.

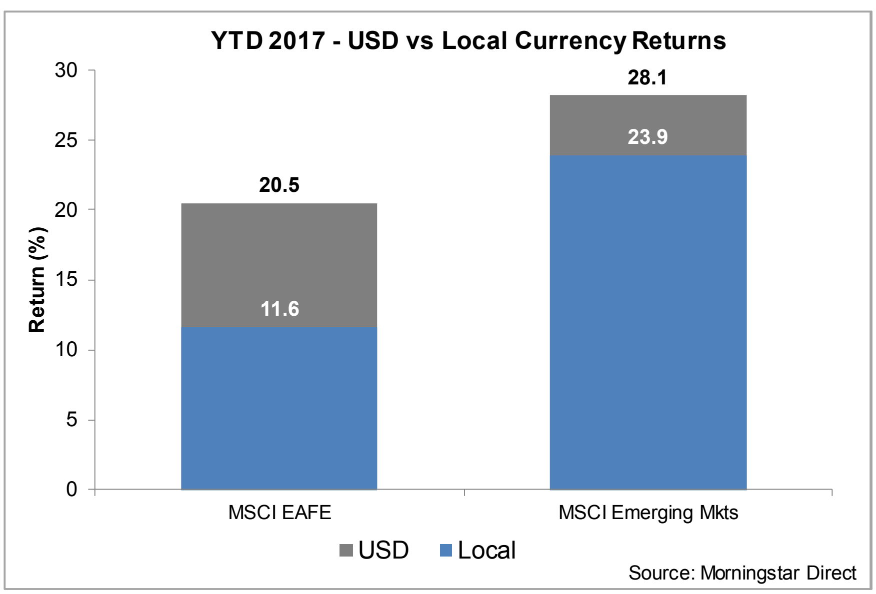
You may recall that we observed a similar phenomenon shortly after the election, when optimism soared that Trump's economic policies would fuel renewed growth and inflation in the U.S. economy. More economically sensitive areas of the market gained as much as 20% in a few short weeks, while interest rates experienced their sharpest increase since the 2013 taper tantrum. Those gains gradually faded away in 2017 as it became evident that Republicans would struggle to come to terms on new legislation.

This time around, market participants seem to feel GOP consensus is more achievable. That certainly remains to be seen, as a sharp divide persists within the party between those who want to cut taxes to stimulate economic growth and those want to prevent further increases in the budget deficit. Ultimately, we expect something to get done – Republicans should probably pass at least one of their agenda items if they want to have some credibility going into 2018 mid-term elections – but the meaningfulness of those changes remains a big question mark.

Outside of the U.S., positive momentum continued for both developed and emerging markets. Developed international stocks rose 5.5% in the period while emerging markets were up an impressive 8.0%. For the year, both indices are up more than 20%. While that might feel too far, too fast for some, it is important to remember that these markets remain well behind the U.S. after sharply underperforming for six-plus years.

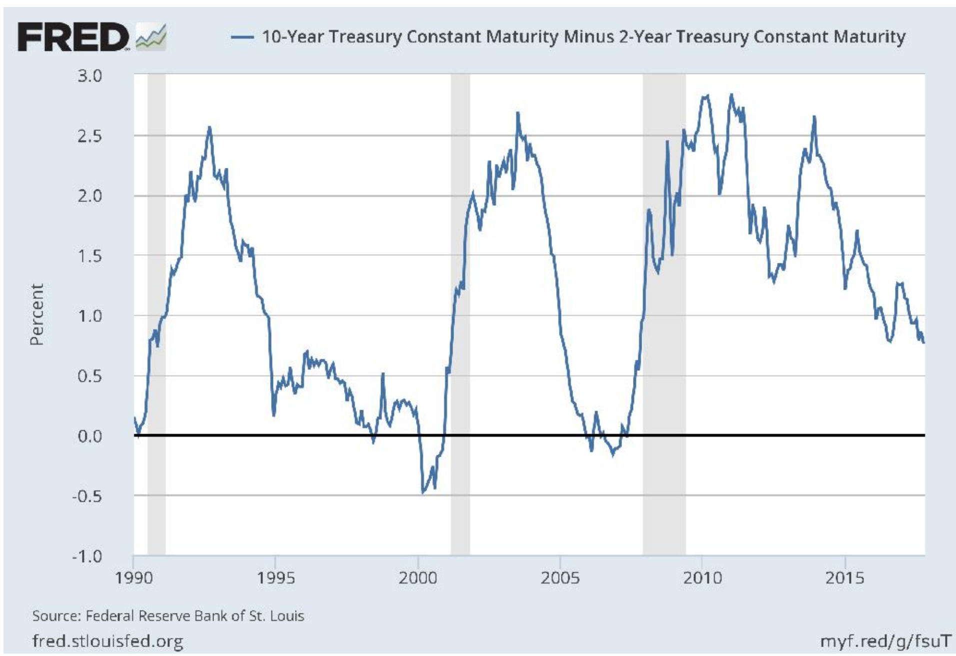


We would also note that much of the currency weakness in these countries between 2011-2016 has reversed course in 2017. This has added to returns for U.S. investors, just as it detracted in those prior years. Currency effects were most evident in developed international stock markets, where a local market return of 11.6% through the first three quarters of the year translated to a 20.5% return in U.S. dollars. In some cases, the reversal has moved a bit more quickly than we would have liked – namely the euro, which has moved from $1.05 to $1.20 in a matter of months – but many foreign currency markets are still recovering from multi-decade lows.



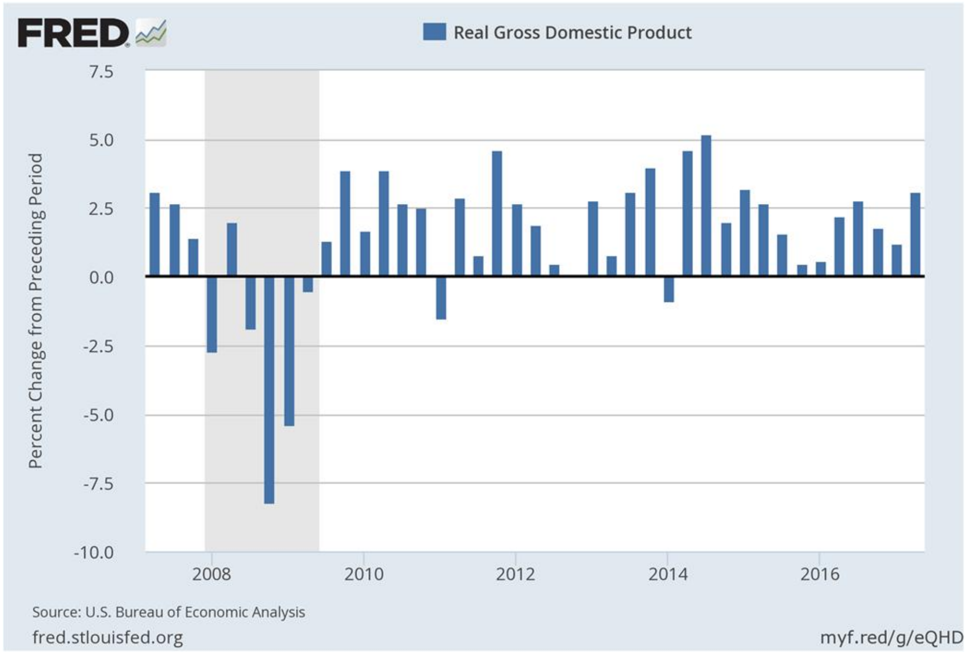
While there have been pockets of concern emanating from Europe such as the Brexit discussions and Catalonian independence, a more powerful trend of economic improvement and political stability seems to be taking root. We continue to believe that foreign markets are setting up for multi-year outperformance relative to the U.S. based on this confluence of factors – weaker currencies, improving growth, and better valuations – but it is unlikely to be a straight line.

Within fixed income, the decline in longer term interest rates that occurred through most of 2017 partially reversed course in Q3. This weighed on bond investments like municipal and investment grade fixed income, but not enough to cause losses for the quarter. High quality debt has generally performed well in 2017 because of the overall move lower in interest rates. With the yield curve starting to flatten more meaningfully, however, we are skeptical that rates can really push much lower from here unless we enter a recessionary environment. To those less familiar with this measure, an inverted yield curve occurs when shorter term interest rates are higher than longer dated rates and typically signifies severe stress in an economy. That seems unlikely to us based on the mosaic of data we see today, and as a result we are less constructive on traditional bond investments.



Credit fixed income, on the other hand, performed well in the quarter as they benefited from positive market sentiment. High yield bonds rose 2% in the period as the yield spread between riskier fixed income and Treasuries narrowed to approximately 375bps. This is not the tightest these spreads have ever been (~250 bps), but it does suggest that positive performance moving forward will be primarily derived from income. Fortunately, credit fundamentals look relatively strong alongside an improving economy, and we are generally expecting an extended "coupon clipping" environment.

The economy was, in fact, quite solid in the third quarter, as second quarter GDP was revised up to 3.1% annualized. This is the highest level of growth in more than two years and represents a sharp increase from the first quarter. Early indicators suggest the third quarter should be slightly weaker, but primarily only because of Hurricanes Harvey and Irma. Those effects are expected to be temporary, however, and may even be a net positive (from a data perspective) after accounting for the rebuilding efforts.



Despite this positive backdrop, we are increasingly hearing that clients are uncomfortable with today's market environment. The persistent gains in the stock market, coupled with elevated valuations and unpredictable leadership in Washington, have created a sense that this market is flirting with calamity.

As we argued three months ago, we may very well be in the final stage of a bull market that could continue for an extended period of time. With central banks around the world remaining extremely accommodative, and economic growth still slowly recovering from the deepest economic contraction in 80 years, it is not difficult to fathom an environment in which the normal economic and market cycle is extended. And while valuations are elevated, they have largely been held in check in 2017 by surprisingly strong earnings growth. Price-to-earnings of 17.7x on the S&P 500 is only marginally higher than the start of the year (16.9x) and just 10% overvalued relative to history.

With that said, we believe the market is probably due for some level of correction in the coming quarters, if for no other reason than history says it should. The nature of financial markets is not to advance forever without at least a temporary decline. If and when that correction comes, however, we expect it to be rather shallow in depth and in magnitude – perhaps something in the range of 5% to 10% – rather than a deeply damaging, extended bear market. As we often note in our letters, diversified portfolios are built to withstand this type of volatility, and the costs of shifting a portfolio around often outweigh any benefit gained from avoiding a temporary decline.

As always, if you feel as though your individual circumstances have changed or your view of portfolio risk has evolved, we encourage you to call or stop by our office at your earliest convenience.

Kindest regards,
Your Investment Team
10/23/2017

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