Investors Trust

Investment and Trust Services

Your Goals. Our Knowledge.

Third Quarter 2017

Bob Fontana, CFA

Our Services:

Individual Retirement
Company Retirement
Investment Services
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FAQ: What makes Investors Trust Company Different? Does Investors Trust Company only manage trust accounts?

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				Total Return	
Index	**9/30/2017**	**6/30/2017**	**12/31/2016**	**2017 YTD**	**Q3 2017**
Dow Jones	22,405.09	21,349.63	19,762.60	13.4%	4.9%
S&P 500	2,519.36	2,423.41	2,238.83	14.2%	4.5%
Nasdaq	6,495.96	6,140.42	5,383.12	21.7%	6.1%
S&P 400 Midcap	1,795.94	1,746.65	1,660.58	9.4%	3.2%
Russell 2000	1,490.86	1,415.36	1,357.13	10.9%	5.7%
Yield on 10-Year Bond	2.31%	2.30%	2.45%		

Source :FactSet

Investment Summary

I am not one to be a Pollyanna. On the contrary, I get paid in part to worry about things that could negatively impact our clients' investment portfolios, and there is never a shortage of concerns. But as I sit looking at the markets today, I am unusually optimistic. Yes, I admit that my spirits are certainly helped by the fact that the markets have been hitting record highs, and doing so in the face of a number of challenges (controversial Trump tweets, failed attempts at healthcare reform, hurricanes, North Korean missile tests, etc.). The market action has simply been impressive. Despite my optimism, we are well overdue for a pullback in equities. Yes, I said that last quarter as well, and yet the markets marched higher without one. Historically, even in very robustly positive years, there is typically a meaningful decline at some point during the year of around 10% or so. We have not had a decline anywhere close to that level this year; in fact, the biggest pullback we have had so far is only about 3.3%. Ironically, that actually makes me nervous. But as we coldly analyze the data that typically suggest the direction of the markets, the outlook appears to be quite good. Admittedly, things can change quickly, but I am quite hopeful in my outlook for the markets. I guess you can call me an Optimistic Worrier.

As for specifics for the third quarter, the equity markets continued to rally, bringing the returns for the year for the major averages up to between 9-22%. The third quarter itself saw strong returns of 3-6% depending on the index. The key drivers for the markets were a notable pick-up in economic activity combined with another strong quarter of double-digit corporate earnings growth. Why have the markets been acting so well? Because earnings growth has been so strong, and the improvement in the economy suggests that earnings growth should continue to be so. Further, if an agreement in Washington can be reached that permits a reduction in corporate tax rates, this strong earnings growth could actually accelerate. With that backdrop, it is easy to be constructive on the markets. As things now stand, I would be a buyer if indeed a pullback occurs. In my opinion, the biggest risk right now to the market is an unexpected external event (i.e. North Korea launches a missile at someone), which we cannot predict but would have to adjust to once it occurred.

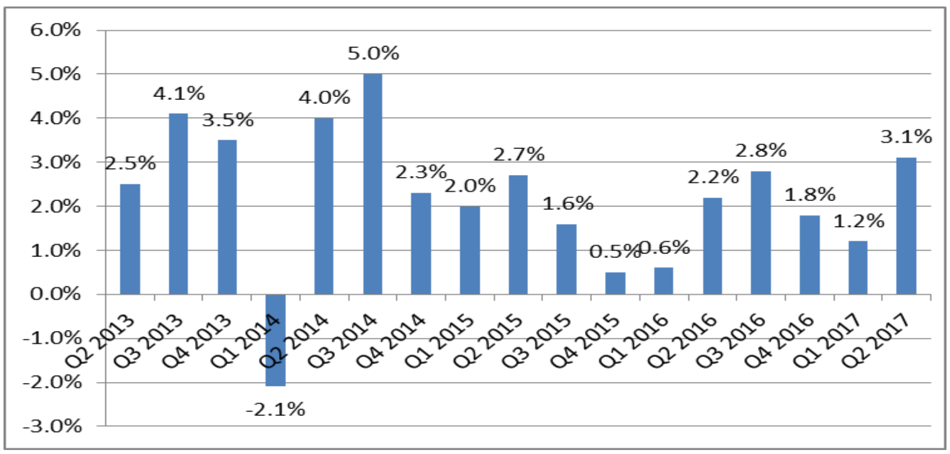
In the bond markets, yields fell to their lowest levels of 2017 in the quarter following concerns about the economic impact of the hurricanes before bouncing back to close the quarter with only a slight increase. The Fed has raised rates twice this year, and with an improving economic backdrop, we expect the Fed to raise rates by another 0.25% before yearend. With inflation appearing to remain in check, we continue to expect the Fed to move gradually with its rate increases. Further, the Fed has indicated that it will begin to unwind its balance sheet, which increased sharply in response to the financial crisis, beginning in the fourth quarter. The Fed has signaled its intentions quite clearly to the Street in this regard, so we do not expect the unwinding of its balance sheet to cause any meaningful volatility in the bond markets.

Economy

The backdrop for the US economy has started to improve; indeed, several economic data points that we regularly review to assess the outlook for the US economy began to improve in the first quarter, and many are now sitting at or near decade (if not record) highs. Encouragingly, this suggests that the outlook for the US economy is quite good. In fact, the economic data are generally so strong that it is, ironically, starting to make me worry. Objectively, the relative lack of substantive progress out of Washington, DC, rising geopolitical tensions, and yet another tragic domestic event (Las Vegas) resulting in significant casualties should hurt US economic prospects. Yet the data suggest otherwise.

Let's start with US economic growth, which picked up steam in the second quarter. As Chart 1 below shows, US economic growth in the second quarter improved to 3.1%, which is the best quarterly pace of economic growth since 2014. It is also a nice improvement from the 1.2% that the US saw in the first quarter of 2017. Projections for growth in the third quarter, which will come out preliminarily at the end of October, call for growth of around 2.5%, as the recent hurricanes that hit the US will likely slow growth in the third (and fourth) quarters. Encouragingly, this economic growth has occurred with little legislative help from Washington, DC; if indeed, some progress could be made on such things as corporate tax reform, then economic growth could be poised to accelerate more meaningfully.

Chart 1: US Gross Domestic Product Growth, Q2 2013 – Q2 2017



Source: US Bureau of Economic Analysis

Beyond the economic growth data, we note:

- Measures of US manufacturing activity have been quite robust. The September ISM Manufacturing Report, which provides a broad survey of US manufacturing data related to production, orders, deliveries, among other items, reached its highest level since May 2004. This ISM report was so strong that, if it were annualized, it would imply US economic growth of around 5.5%.
- Measures of US services activity are strong. The September ISM Services Report, which measures orders, employment, prices, and backlog for services businesses, reached its highest level since August 2005.
- Consumer Confidence hit a 17-year high back in March of this year, and currently sits only slightly below those levels despite the understandably negative responses from people in the hurricane-impacted states of Texas and Florida.
- The Unemployment Rate is near a 10-year low.

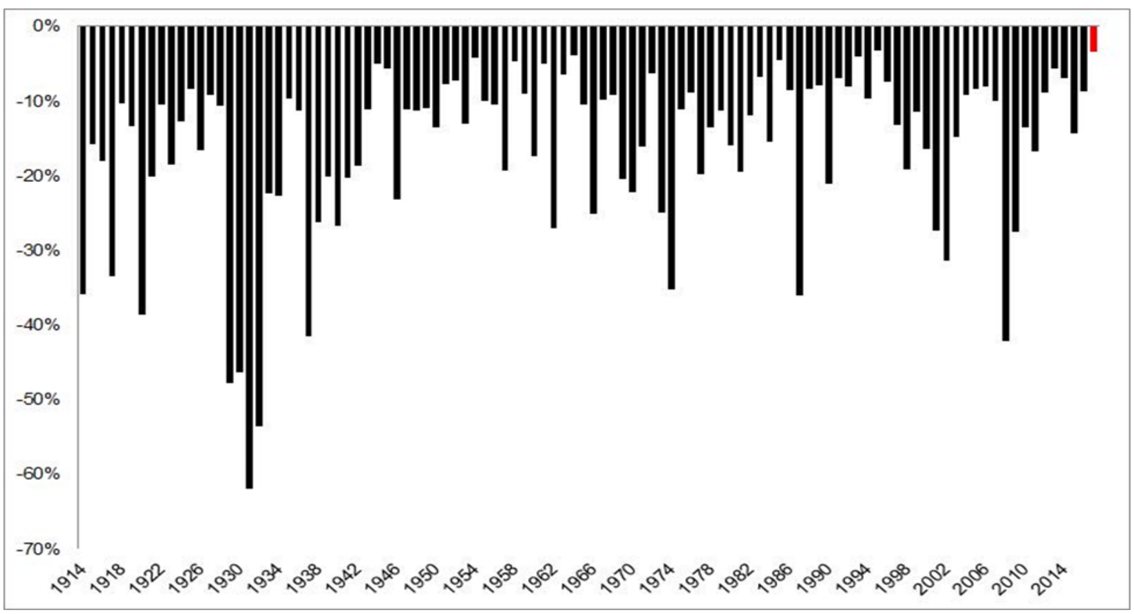
The key takeaway from the broad strength of the economic data is that there are virtually no signs of a forthcoming economic recession in the US occurring anytime soon. Admittedly, the economic backdrop can change fairly quickly, but the prospects for the US economy as things sit today are quite healthy.

Equities

The equity markets saw strong third quarter returns, as the improving economic landscape combined with double digit corporate earnings growth to drive the rally for US stocks. Earnings growth in the first and second quarters of 2017 approximated 14% and 12% respectively, both the best quarters since 2011. As a result, the S&P 500 has posted a total return of 14.2% through the third quarter 2017, with the more aggressive "growth" stocks continuing to outperform the "safer" dividend-paying stocks. Impressively, the earnings growth has come with no corporate tax reform, though hopes on the Street for some progress in that regard are starting to increase. As we have noted in the past, a reduction in corporate tax rates could be a significant driver of further earnings growth, with estimates ranging from growth of 17% to over 30% depending on where the corporate tax rate ultimately settles.

Given the economic backdrop and strong earnings growth, our outlook for the equity markets remains constructive. Admittedly, we are overdue for a pullback, something that I have been saying for a few months now. Even in markets that have strong positive returns, the markets typically experience a meaningful pullback at some point during the year. Thus far in 2017, the biggest pullback we have had is only about 3.3%. If it stands, this would be the second smallest pullback in the market EVER….that's right, ever! Chart 2 below shows the maximum pullbacks in the market by year going all the way back to 1914. The pullback for 2017 is at the far right, so it is indeed unusual.

Chart 2: Maximum Pullbacks in the S&P 500 Each Year



Source: thereformedbroker.com

Corporate earnings reports for the third quarter are set to begin the latter half of October. Historically, a run-up in stocks heading into earnings season has not been good for stocks, as the stocks had already priced in good earnings reports so did not move meaningfully higher. The optimism around earnings reports this quarter has been muted somewhat due to the potential impact of the hurricanes that hit during the quarter, so we will see how the market reacts to the reports. The Street will likely be more concerned about the outlooks that company managements offer going forward than the third quarter results themselves.

Fixed Income

On the surface, interest rates appeared to move little in the quarter, with the yield on the US 10-year Treasury finishing the third quarter at 2.31% compared to 2.30% at the end of the second quarter. However, the fixed income markets were actually much more volatile than it appears on the surface. Indeed, in spite of the pick-up in US economic growth, concerns over forthcoming hurricane-related impacts on the economy combined with continued geopolitical fears to push interest rates down to their lowest levels of the year at 2.04% during the quarter. Further pressuring rates, tame inflation data suggested that there was no need for urgency for the Fed, which had already raised rates twice heading into the third quarter, to raise rates a third time before the end of the year.

This tone in the fixed income markets changed notably after estimates from hurricane impacts were less than feared, at least from an economic perspective, and Trump negotiated a surprise deal with the Democrats related to increasing the US debt ceiling including a hurricane relief package. The deal was particularly noteworthy on the Street, as it suggested that Trump may be able to negotiate successfully a tax package that would actually have a chance of passing Congress, and thus spur meaningful economic growth. As a result, as Chart 3 below shows, interest rates rallied sharply off their lows to finish the third quarter relatively unchanged.

It does appear that the Fed is on track to raise rates one more time by 0.25% before yearend. At the same time, the Fed has indicated that it will begin to reduce its balance sheet beginning in the fourth quarter, though this will be done gradually and with fairly clear visibility. In the near-term, we believe that this could put some upward pressure on interest rates, though we do not expect rates to rise significantly. Longer-term, we continue to believe that the trend in rates is higher. As a result, we continue to position our client bond portfolios with relatively short durations.

Chart 3: Yields on US 10-Year Treasuries, October 2, 2015 – September 29, 2017

Source: FactSet