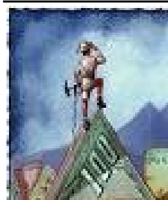
Benchmarks

	30 Sep 2017	30 Jun 2017	30 Sep 2016
S&P 500	2,519	2,423	2,168
DJIA	22,405	21,350	18,308
NASDAQ	6,496	6,140	5,312
6-mo US Treasury Yield	1.19%	1.14%	0.48%
30-yr US Treasury Yield	2.87%	2.87%	2.41%
Prime Rate	4.25%	4.25%	3.50%
Federal Funds Target Rate	1.25%	1.25%	0.50%
30yr Mortgage	3.90%	4.00%	3.46%
Gold – per oz	$1,285	$1,241	$1,313
Oil - WTI / bbl	$52	$46	$48

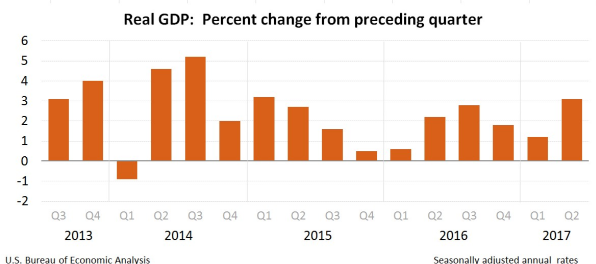
Source: WSJ, Bloomberg, FactSet, Zacks



Uncommon Strength

Other than two hurricanes that wreaked havoc on Texas and Florida, the third quarter was remarkably quiet with the equity markets extending their chain of positive quarterly returns as the "Trump brand" gained steam on potential tax reform following failure on healthcare reform. On top of underlying fundamental strength in corporate earnings, the Republicans' tax over-haul proposal tantalized investors with the prospect of additional economic strength and improved earnings. The corporate tax reform being discussed could, in fact, have a significant impact on corporate "bottom lines," and the market seems to smell it. Conversely, recent market strength is at least partly due to anticipated success in tax reform. Therefore, if the current Administration doesn't deliver on this pre-election promise, we would anticipate a correction in the market.

Politics aside, the economy continues its head of steam. As shown below, the second quarter's revised GDP growth rate



was a surprisingly strong 3.1% - furthering our thesis of an accelerating economy after years of stagnated growth. The U.S. dollar, which usually rises in anticipation of higher interest rates and a stronger economy, staged a comeback in the third quarter after a bruising first half driven by economic and political uncertainty. However, in spite of the dollar's 0.7% climb in Q3, it is still down 7.1% for the year. We see the dollar having changed its course against other major currencies and should continue to strengthen due to a steady pace of interest rate increases and tax reform.

With the backdrop of solid economic fundamentals, corporate profits continue to climb. Following double-digit growth rates in the first two quarters of the year, as shown below, we anticipate a more subdued growth rate of about 3% in the third

quarter before re-accelerating in subsequent quarters. For the full year 2017, we remain comfortable with our earlier forecast of earnings growth in the range of 7% - 10% (compared to a 7% long-term average) with revenue growth of 4% - 5%. As 2018 comes into view, we see earnings growing at a similar rate as in the current year. Sectors such as Technology, Consumer Discretionary and Energy are fueling the growth.

Stocks:

Bucking the trend of volatile third quarters in former years, the S&P 500 and Dow Jones Industrial Average delivered solid returns of 4.0% and 4.9%, respectively, last quarter. This represents– the 8th consecutive quarterly advance and the longest winning streak since 1997. At a current P/E ratio of 17.7, the stock market's valuation seems a bit extended; and we expect a "normal" correction following eight consecutive quarters of positive returns. However, a recession is not in our view and, as such, we expect any correction to be relatively short-lived. Money follows earnings, and as long as corporate earnings are solid, we see near-term volatility giving way to intermediate-term upside. Regarding the potential effect of tax reform on valuations, some have estimated that every percentage point drop in the corporate tax rate could boost the per-share earnings of the S&P 500 by a dollar. If so, an assumed 10-point tax rate reduction from 35% to 25% would potentially represent a 7% one-time profit boost on corporate income statements. Such a change would make the current stock market look less expensive than it now does – adjusting the forward 12-month Price/Earnings ratio from 17.7 currently to 16.5, which would be closer to the 10-year average of 14.1.

Interest Rates:

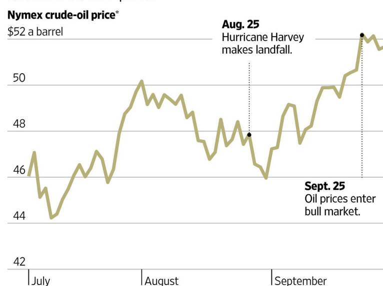
Because of the backdrop of economic strength, pressure is building on the Federal Reserve to continue its pace of interest rate hikes. After years of managing short-term rates near zero to stimulate the economy following the 2008 recession, the Fed has moved the Fed Funds rate to 1.25% through four manufactured rate hikes. We believe they will act again in December with another 25-point move, which will likely be followed by more rate increases of similar magnitude in 2018. In addition to rate increases, the Fed continues its tightening stance by selling bonds and reducing its balance sheet. The Fed is walking a "tight-rope." If it is too aggressive in raising rates, it risks throwing the economy into a recession; but, if it is too timid, it risks fueling excessive credit, which would over-inflate the economy and financial assets and would likely precede a more severe market correction. In spite of continued subdued inflation, other economic indicators would suggest the market is heating up, including wage inflation, now pushing 3.0% - nearly double the rate four years ago.

Inflation:

Recent Consumer Price Index readings of 1.4% (less than the 2.0% Fed target) suggest that inflation is stubbornly low compared to the rising economic activity, full employment (4.2% unemployment rate) and strong job growth. However, we see inflation moderately rising in coming months which will pressure bond values. While any rapid upward change in inflation could jeopardize both the bond and stock markets, we see moderate increases ahead.

Oil:

Nearly three years ago, crude oil prices (WTI) broke from over $100 per barrel and bottomed below $30 per barrel - ushering in the most severe Energy recession in memory. During the third quarter WTI prices rose from $46 to $52 in the face of a declining oil glut and improving demand. We see greater optimism in industry executives who believe the worst is behind us. We also see early signs of a potentially long and sustainable recovery rather than a sharp, near-term reversal.



Risks and Uncertainties:

We see the following as significant risks: 1) whether congress and the Administration will find common ground on a tax reform policy, 2) whether the Fed can engineer a monetary policy that neither creates excessive credit nor drives the economy toward recession, 3) whether inflation can remain subdued in the face of economic expansion, 4) whether corporate profits can maintain a trend of attractive growth, and 5) whether the global geopolitical risks can be calmed. Negative turns in any of these areas could lead to dislocations in the financial markets.

Forecast

Populism, Federal Reserve strategy, tax reform and U.S. corporate earnings are at center stage.

1. ***The "Populism Movement" is slowing but will continue to impact the markets.*** However, central banks' "easy money" policies seem to be ending.
2. ***Business & consumer confidence will continue to improve.*** The prospect of lower regulations and lower taxes will nudge economic growth upward.
3. ***Oil prices signaling recovery.*** Having improved recently, we believe a bottom was set in 2016 and we find intermediate-term value in the Energy sector.
4. ***Federal Reserve to continue tightening.*** Both through rate hikes and by reducing the size of its balance sheet.
5. ***U.S. Economic growth remains on a slow path to better.*** Economic growth and corporate profits should improve – we see no imminent sign of recession.
6. ***Employment improves.*** The labor market will continue to slowly improve as the unemployment rate approaches 4%.
7. ***U.S. Dollar weakness.*** Following a 7.1% drop against other major currencies YTD, we believe the greenback has changed course and will strengthen near term.
8. ***Pressure resumes on the bond market.*** Because we anticipate rising interest rates, we desire to remain "short" with our fixed income strategy. Rising interest rates will put pressure on bond returns.
9. ***Stock market will be bumpy but will generate positive returns for 2017.*** We anticipate a near-term correction that should be relatively short-lived. Successful tax reform and continued strength in corporate profits should offer up intermediate term opportunity.
10. ***Our long-term forecast remains unchanged.*** We believe the stock market, while still subject to periodic corrections, is in an upward trend.

In Summary

We believe the economy is healthy and corporate profits are improving. As we have reiterated each quarter since the bear market of 2008, **our investment strategies change with market conditions but our principles do not.** Just as our principles have not changed, our long-term optimism remains in tact. We recognize that during times of uncertainty, communication is important. **It is a pleasure doing business with you.** We appreciate your confidence in us, especially during uncertain times.

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