INVESTMENT OUTLOOK

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THIRD QUARTER 2017: NATURAL DISASTERS AND MAN-MADE CRISES

In Hartford, Hereford, and Hampshire, hurricanes hardly happen
-Alan Jay Lerner

Alan J. Lerner may well have been correct when he penned these lyrics for *My Fair Lady*, but that is of little comfort to beleaguered residents of Houston, the Florida Keys, Puerto Rico, and a host of Caribbean islands. Rather, the non-alliterative storm siblings Harvey, Irma and Maria wreaked havoc in their wake.

The scale of these exemplars of Mother Nature's wrath is perhaps best expressed in statistics. Harvey dumped over 50 inches of rain in parts of Texas, summing to 21 trillion gallons of water. In the Florida Keys, virtually every structure experienced damage. On the island of Puerto Rico, 3.4 million residents were without power for days on end.

But hurricanes weren't the only natural disasters we've weathered recently. Mexico experienced two severe earthquakes, measuring 8.1 and 7.1 on the Richter scale, resulting in damage to or destruction of over 150,000 buildings and structures. And in Yosemite, stones the size of apartment buildings broke loose from the venerable El Capitan granite rock face.

Amid these deadly natural phenomena, financial markets continued to exhibit remarkable equanimity. The numbers don't lie, and the numbers are impressive.

Asset Class	Index	3rd Q Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	4.5%	14.2%
US Small Cap Stocks	Russell 2000	5.7%	10.9%
International Developed Stocks	MSCI EAFE	5.4%	20.0%
Emerging Markets Stocks	MSCI EM	7.9%	27.8%
Real Estate	MSCI US Real Estate	0.9%	3.6%
Commodities	Bloomberg Commodity	2.3%	-3.5%
Bonds	Bloomberg Barclays US Aggregate	0.9%	3.1%
Cash	Citigroup 3 month UST Bill	0.2%	0.5%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, BLOOMBERG

Equities large and small, domestic and foreign, turned in solid mid-single digit returns in the third quarter, and all asset classes appreciated. Three quarters of the way through the year, financial assets have generated lofty returns for investors, with stocks recording high double digit returns.

Returns for real estate have been more modest, in the face of potentially higher interest rates. Negative returns in commodities reflect a world well supplied with oil and industrial metals.

ECONOMIC TRANQUILITY IN A STORMY SEASON

Don't bring negative to my door.
-Maya Angelou

The quarter featured some man-made disasters, too. Here, too, statistics tell the stories best. Credit reporting agency Equifax disclosed that hackers had gained access to 143 million individuals' records. The Republican Senate failed in its third effort to repeal and replace the Affordable Care Act. In the geopolitical realm, North Korea launched intercontinental ballistic missiles capable of reaching the US. And we won't even go near the firestorm that erupted between the President and NFL players, which led to a dramatic increase in knee-taking.

These and other unnecessary and self-created kerfuffles and threats proved equally as unable as the natural disasters to weigh down financial markets.

Underlying robust markets have been strengthening domestic and global economies. US GDP growth in the second quarter, at 3.1%, was the best showing in two and a half years. Economies in Europe, in Japan, and in large swaths of emerging markets also showed accelerating growth—this synchronized global growth goes a substantial way toward explaining both market health and lack of volatility.

The domestic economic picture is essentially unchanged. Unemployment continues to fall, to 4.4%, and new unemployment claims have been below 300,000 for 134 weeks, according to Reuters. Still, wages have been slow to rise, housing continues to be sluggish, and automobile sales are down from peak levels. Capital spending has begun to pick up but is not robust. Exports have shown growth, aided by a weaker US dollar. Consumer spending is neither ramping up nor falling off a cliff, even as consumer sentiment remains fairly elevated.

At the same time, inflation remains quiescent, with core PCE (Personal Consumption Expenditures, the Fed's preferred inflation gauge) up 1.3% over the past year—well under the Fed's 2% target.

In the aggregate, it adds up to sufficient strength for the Federal Open Market Committee to begin to unwind the central bank's outsized holding of US Treasury and mortgage securities, and to affirm its bias to continue to raise interest rates, albeit both at very modest paces. Economic data may be ragged in coming weeks, as effects from the hurricanes trickle in, but rebuilding should lead to some modest economic acceleration in the fourth quarter and into the new year.

MARKETS MARCH ONWARD AND UPWARD

When I inevitably met Mr. Right I had no idea
that his first name was "Always."
-Rita Rudner

Financial markets continue to exhibit buoyancy, with multiple new record highs. At the same time, measures of investor enthusiasm do not suggest excess optimism, and funds flows have been stronger to bonds than to stocks. Still, are investors being lulled into believing markets always go up, that equities are always right? How to explain the markets' levitation?

We continue to attribute market appreciation to favorable fundamental conditions. Better economic growth around the globe is providing higher revenues to companies as demand for their products and services increases. And better top line sales momentum is responsible for higher corporate profits. We maintain that this is the soundest reason for higher stock prices. If corporate profits are rising and likely to continue to do so, it follows logically that stock prices—which ultimately are a reflection of cumulative future profits—should follow suit higher.

Would that it were so simple. For one, we are likely to see some deceleration of corporate profits growth in the second half of 2017, given more challenging year-over-year comparisons, and expectations for profit growth reacceleration in 2018 may be premature. But it should also be acknowledged that the long stock market rally was initiated and sustained by unprecedented central bank accommodation, in the form of extraordinarily low interest rates and record bond purchases. The Fed appears to be ringing the death-knell on this era, and equities may in time lose their comparative attractiveness if interest rates rise meaningfully.

Additionally, investors need to incorporate into their forecasts the fact that markets have recognized the improved profit outlook for companies—that is, after all, why stock prices are higher. So the question becomes what will support and drive stock prices higher from here. Perhaps the global economy may continue to accelerate. Perhaps US companies will obtain substantial tax relief. Perhaps technological advances will drive greater efficiencies.

Any or all of these possibilities could continue to propel stock prices. But it's not a world without headwinds, too. Geopolitical mistakes in North Korea and elsewhere could occur. Leadership at the Fed seems increasingly likely to change, leading to policy uncertainty. Nationalist sentiment around the world may lead us in surprising new directions.

In short, a constructive backdrop holds limited predictive value.

PORTFOLIOS: SMOOTH SAILING ON GLASSY SEAS?

It is unwise to be too sure of one's own wisdom.
It is healthy to be reminded that the
strongest might weaken and the wisest might err.
-Mahatma Gandhi

We have positioned portfolios this year for faster international growth, particularly in emerging markets, and for secular growth plays in information technology and health care. That stance has proven beneficial.

As we enter the fourth quarter, there are some early indications of a revival of the "Trump trade," favoring smaller cap companies and cyclical growth sectors. We have responded to these shifts in investor sentiment by making new investments in companies in the industrial and consumer discretionary sectors. This changed investment weather pattern may also inure to the benefit of materials and financial companies.

In the bond space, it's worthwhile to remember that the era of quantitative easing ended in 2014. The Fed first raised interest rates in December 2015, and has now engineered a total of four increases. We think the direction for interest rates continues to be north, but absent a dramatic economic acceleration and/or a sustained boost to actual or prospective inflation it will be a very gentle climb.

What it means for fixed income investments is that longer dated instruments are at some risk of price declines, and shorter term instruments—including money market funds and CDs—should benefit from rising rates. We also note that the proposed tax reforms have raised questions as to whether the advantages of municipal bonds may be diminished.

HOW WE WEATHER INVESTMENT STORMS

The more stable things become and the longer things are stable,
the more unstable they will be when the crisis hits.
-Hyman Minsky

In portfolio management, most disasters are of the man-made variety, arising from complacency, over-confidence, and arrogance. These qualities evidence themselves when investors chase returns or take on risks greater than their true comfort level. They evidence themselves when conservative investors buy junk bonds because they don't like (or accept) the yields available on higher quality bonds. And they evidence themselves when investors bid up prices of stocks with no earnings, eschewing cheaper and higher quality stocks.

There is only limited, scattered evidence of this sort in the markets today. But we are mindful that these unnatural disasters have a quality in common with natural disasters. That common quality is that while we are usually surprised when disasters occur, we shouldn't be. Most earthquakes occur on known fault lines. Dormant volcanoes are dormant until they erupt. Hurricane patterns spinning off of West Africa are well understood. All of which is to say, we should not be surprised when markets stop marching relentlessly higher. As economist Hyman Minsky once noted, "Stability leads to instability."

Because the timing, and often the cause, of market reversals is not readily determinable in advance, we strive mightily to affirm the appropriateness of asset allocation choices. And we endeavor to be continuously aware of knowable risks, whilst acknowledging that invisible risks always exist. By definition, we can't protect against what Donald Rumsfeld characterized as "unknown unknowns." But we can be vigilant in monitoring the financial soundness of issuers of bonds we own, and in monitoring the strength and sustainability of the business models of companies whose stock we own. And we can maintain keen sensitivity to the price of a given security versus its true underlying value. In the end, these safeguards constitute a disaster avoidance policy, which is highly preferable to a disaster recovery plan.

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