ECONOMIC COMMENTARY

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"A Tom Petty Market"

- John T. Boland

A lot has happened since we wrote our last commentary. International tensions reached critical levels, the country was hit by two major hurricanes, the Federal Reserve announced the start of policy normalization, and several major legislative losses raised doubts about the probability of tax reform and other hoped for economic initiatives passing through Congress. Despite the negatives, global equity markets continued to surge ahead in the quarter, with virtually all domestic and foreign stock indices hitting new record highs. Investors may be saying "Yer So Bad" to the headlines, but their actions are saying this is "the best thing I ever had" as money continues to flow into markets around the globe.

Domestic stocks, as measured by the S&P 500 Index, were up 4.48% in the third quarter and are up 14.24% since the beginning of the year. Foreign markets have fared even better, with the MSCI EAFE Index up 5.40% in the quarter and 19.96% since the end of December. Even bonds were positive in this environment, with the Bloomberg Barclays U.S. Intermediate Aggregate Index posting a 0.72% gain for the quarter. Year to date, bonds are up 2.34%, despite signs the Fed has begun a sustained move to normalize monetary policy.

As the current bull market rapidly approaches the 1990 – 2000 timeframe as the longest period without a 20% correction, many investors worry how long the current run will last. Those that are invested worry they should pull out before the market crashes. Those that have already reduced stock holdings or stayed largely in cash worry that they will miss out on further gains and want to find the best time to put idle cash to work. Whether fully invested or not, it is important to remember that time is a coincident factor of market turmoil, not a cause. Or, as nearly every guest on CNBC now reminds viewers, bull markets do not die of old age; they die from critical economic problems, such as a recession or an unexpected shock to the system.

With economic data showing little indication of a pending slowdown, investors looking for signs of a looming recession have limited tangible evidence on which to base their fears. A frequently heard worry is whether the policies of the Trump administration will cause a recession, but very few presidents - as we have often noted here in the past – have had a tangible impact on the economy. Indeed, the best markets of the past 25 years (1995 – 1999 and 2013) were characterized by legislative gridlock which prevented any substantive change to the status quo. Another worry is the slowdown in global trade. This is a significant concern, as we have discussed in previous letters. However, very little unilateral action has taken place so far and we have even seen signs of compromise from many of the contra-parties involved. Ironically, even the North Korea situation has become a positive for trade issues since we need China's help in dealing with Pyongyang and it is doubtful the Administration will create more friction until a resolution on the nuclear arms crisis has been achieved.

While any of these issues could trigger a correction at some point, the stock market remains a reliable proxy for economic conditions. The markets appear to be at such lofty levels for rational reasons. We are in the midst of a global economic expansion and it is reflected in equity prices. Corporate earnings continue to increase and many companies have announced expansion plans. New technologies are often the catalyst for the next up-leg in a market cycle and we appear to be on the cusp of a new wave of innovation focused on artificial intelligence, robotics, and the "Internet-of-Things" (IOT). Hurricanes Harvey, Irma, and Nate will even be positives for the economy in the long run, as the damage wreaked by these storms will need to be repaired.

It is said markets climb a wall of worry. There is more than enough headline risk these days to worry even the most seasoned bull. It is understandable that many investors still maintain large cash holdings. However, for those willing to say "I Won't Back Down", there may still be room for further market gains.

Strategy and Market Outlook

Asset valuation remains the biggest concern as we review portfolios. Economic data continues to improve and corporate earnings have been steady. With expanding growth rates and surging consumer confidence numbers, there is little reason to suspect a major correction is imminent. However, stocks do look expensive by several key measures.

This could lead to a sharper pull back than warranted on a negative news event. With stocks seemingly pricing in the best of everything, there are many items that must fall into place to avoid a near term pause in the rally. The failure of Congress to pass meaningful tax reform, for example, would catch many by surprise. This would not send markets Free Fallin', but at today's prices, even a 5% pull back will seem large. We are not suggesting a wholesale move to cash, but taking action on strength is preferable to acting after the markets have corrected.

We expect to use the recent price strength to lock in some profits on securities that have run up in value (basis points in the bank, as we say). We will also look to reposition certain holdings that are either fully valued or have not performed as expected. We plan to use the proceeds to increase international exposure and to increase the position sizes of some stocks that still offer compelling value. We continue to search for new names to add to client portfolios, as well. For now, at least, there is little to suggest a change in direction is imminent. The evidence suggests there are more than enough factors in place to help the market reach new highs in the fourth quarter.

On the bond side, September provided some warning that the status quo may be about to change. For much of the past eight years, there was little fear the Fed would tighten monetary policy, in any form. Standard policy for many firms had been to disregard official comments about monetary policy changes since most folks believed the Fed would not act. The Fed caught markets off guard with the September announcement that they will commence downsizing their balance sheet this month. Interest rates rose following the meeting and the market-derived probability of a December rate hike surged from zero before the September FOMC meeting to 70% at month end.

As if to drive the point home, Fed Chairwoman Janet Yellen spoke to the National Association for

Business Economics (NABE) on September 26th and made some very direct comments. After making the obligatory statement that the Fed would continue to adjust its outlook when warranted by new data, she warned the Fed should be "wary of moving too gradually." Yellen went on to acknowledge the Fed is perplexed by chronically low inflation. She then warned that downward inflation pressures may "unexpectedly" persist, but stated it would be imprudent to stay on hold until inflation is at 2%. She went on to say that inflation overshooting 2% "wouldn't be a tragedy." She concluded her comments by noting the need to keep tightening gradually, regardless of short term weakness in economic data points. One can only conclude from these events that we are at the start of a new phase for monetary policy.

One segment of the bond market that we believe warrants greater attention are municipal bonds. This segment has rallied sharply over the past few years and is now generally back in line with pre-Crisis levels. However, the resurgence of tax cut talks has placed the sector under greater scrutiny. Should tax rates and credits change, municipal bonds will be less appealing to investors. Credit issues continue to improve and some states are raising taxes, but these factors may not be enough to offset the proposed cuts at the Federal level.

With equity markets putting in record highs seemingly daily, credit spreads at or near historically low levels, the continued flattening of the US Treasury yield curve, and the elongation of duration within the MBS sector, we believe shorter duration (5-years and in) and higher quality (U.S. Treasuries) securities offer the best safe havens in the bond market. Given geopolitical risks and the complacency of the financial markets, there is not enough spread to make other products attractive. Our strategy remains cautious. Risk reduction is prudent.

In lieu of our usual practice of using musical lyrics as the themes for our commentary, we have incorporated a few Tom Petty song titles and verses into this issue of our letter in honor of his recent passing. We hope our message was not muddled by this writing style and that you were not put off by this gesture.

As always, please contact us should you have questions.

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