Market **Insights**

Economy | **Capital Markets**

Q3
2017

Economy

The general themes and trends of the past few quarters continued to play out in the economy and capital markets, but with some new twists along the way. The past few months have been characterized by a rise in geopolitical tensions and ongoing political turmoil. Dominating international affairs was North Korea's persistence to conduct a series of missile tests in a threat to the U.S. territory of Guam and a nearby air base. In a rare sign of global solidarity, the UN Security Council unanimously passed a resolution imposing new sanctions on North Korea, targeting the nation's primary exports of coal, iron, lead and seafood. Separately, the U.S. placed fresh sanctions on Russia and Iran, and froze the assets of Venezuelan President Nicolas Maduro amid the country's growing unrest. Domestically, new controversies hampered the Trump administration's policy agenda and the president's approval rating dipped to new lows.

Amidst this international and domestic drama, global growth surprised to the upside and inflation pressures remained relatively subdued. In the second quarter, domestic economic growth expanded at a 3.0 percent annualized pace, the strongest in two years and closer to long-term expectations. The acceleration in growth primarily reflects upturns in private investment, federal government spending and an improvement in consumer spending. Further, business spending on software, structures and equipment jumped, which suggests companies are upbeat about rising orders amid steady demand. Yet, the recent devastating hurricanes in Texas and Florida could potentially shave about 1 percent from third-quarter growth, before the eventual rebuild and reinvestment adds to growth in the quarters ahead.

We also see increasing evidence of economic synchronization across both advanced and emerging markets. Data suggests that the expansion could continue for another couple of years. One way to view the economic outlook is through the lens of the probability of recession over the next two years. Long-term averages suggest a 31 percent recession probability, leaving more than two-thirds chance that the current U.S. expansion becomes the longest on record.

In the capital markets, the continued combination of modest economic growth, healthy corporate earnings and historically low interest rates remained the fuel for a risk-taking mentality among investors. For the quarter, the S&P 500 Index posted a 4.48 percent return, which puts the index at a 14.24 percent return year-to-date. In the riskier and technology heavy Nasdaq Composite Index, returns were better at 6.07 percent for the quarter. Many foreign equity markets have also produced above-average results so far this year, with emerging market stocks posting some of the highest returns. Many of these countries benefit from accommodative monetary policies, improving growth prospects and relatively cheaper valuations as compared to domestic equities.

After an eight-year bull market and one of the longest economic expansions on record, investors are beginning to worry about the market's longevity and the potential timing of the next recession. However, from an economic perspective, many of the traditional "warning" signs still point to fairly robust growth over the next year or two. Further, the combination of low unemployment, healthy manufacturing and strong corporate profits point to a low probability of a recession anytime soon. Yet, from an investment perspective, current market valuations appear elevated relative to historic averages. First, the current price-to-earnings ratio on the S&P 500 Index is more than 30 percent higher than the historical average. Next, dividend yields are near historical lows while earnings levels are near historical highs. Finally, the ratio of corporate equities to Gross Domestic Product (GDP), commonly known as the Buffett Indicator, is now the second highest on record, dating back to the 1950s. Bond valuations aren't much better. The current yield on the 10-year U.S. Treasury bond stands at around 2.25 percent, suggesting meager annual returns over the next decade. The expected returns in riskier bonds, such as investment-grade and high-yield corporates, are also modest with yields near all-time lows. In short, valuations in domestic stocks and bonds are priced to near perfection with little wiggle room if conditions deteriorate.

Looking ahead, we continue to expect the economy to grow at about 2.5 percent for the next year with modest inflation and a healthy job market. Further, with the prospects of reduced federal taxes and lighter regulations, growth could surprise to the upside. Yet, with the Federal Reserve on course to raise interest rates further and reduce their balance sheet holdings over the next few quarters, we are concerned about the potential negative impact on the capital markets and economy. These are unprecedented moves by the Fed, with little historical reference or knowledge of the consequences. Still, they insist their action will be calculated and slow, with the intention of not disturbing the capital markets. Although markets could continue to surprise on the upside, we don't feel compelled to add risk at this point. We continue to take a more cautious stance in portfolios with a discerning eye on downside risk. This does not imply we have raised cash or made any major moves in accounts. However, our asset allocation decisions and manager selection is geared toward managing the risk we see in the markets currently.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

The yield on U.S. Treasury bonds ended the quarter slightly below where it began. Corporate investment-grade and high-yield bonds produced modest returns with absolute yields close to all-time lows. Domestic equity market returns were solid, with larger stocks outpacing mid and smaller stocks. International and emerging market indices continued to produce well above-average returns that trounced most domestic equity markets for the quarter.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%)
As of September 30, 2017

	3rd QTR	YTD	1 Year	Annualized 3 Year
S&P500	4.48	14.24	18.60	10.79
Dow Jones Industrial	5.58	15.45	25.45	12.33
Nasdaq Composite	6.07	21.73	23.79	14.52
Barclays Aggregate Bond	0.85	3.14	0.07	2.71
Citigroup BIG Corporate	1.27	5.15	1.98	4.06
MSCI World	4.96	16.53	18.85	8.33

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.37%	6.15%	**Represents the number of unemployed persons as a percent of the labor force**	**Continues to decline at steady rate**
Consumer Price Index	1.90%	4.10%	**Represents changes in prices of all goods and services purchased for consumption**	**Has moderated recently**
U.S. Capacity Utilization	76.12%	80.32%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	**Has declined recently, but steady**
Gross Domestic Product+	2.20%	2.80%	**Total value of all goods and services produced indicates strength or weakness of the economy**	**Positive, slightly below average**
10 Year Treasury Yield	2.35%	6.45%	**Yield on the current 10 year treasury bond**	**Has increased over the past year**
Annual Housing Starts	1,180,000	1,439,000	**New privately owned housing unit starts annualized rate**	**Steadily rising**

*Average from 1966 to Present ⁺Annualized *Source: Bloomberg*

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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