KayneCast

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Episode 53

A Market Review of the Third Quarter of 2017, and an Outlook for the Rest of the Year

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Is the “Trump Trade” back? Stocks continued to march higher in the third quarter driven by low inflation, benign interest rates and improving global earnings. The S&P 500 Index advanced 4.5 percent for the quarter, bringing the year-to-date return to 14.2 percent. Small stocks, as measured by the Russell 2000 Index, did slightly better in the quarter relative to large stocks advancing 5.7 percent, but are still trailing for the year-to-date with a return of 10.9 percent. Despite some improvement in September, value stocks continued to lag growth stocks for the year-to-date with the Russell 1000 Growth Index up 20.7 percent versus the Russell 1000 Value Index advancing only 7.9 percent. International stocks performed even better than the S&P 500 with the MSCI EAFE Index advancing 19.9 percent year-to-date. Emerging market stocks have been the real standout thus far in the year, appreciating 27.8 percent for the year.

Bonds continued to advance modestly in the third quarter, with the Bloomberg Barclays U.S. Agg Index up 0.85 percent, bringing the year-to-date return to 3.1 percent. Cal muni bonds advanced 1.03 percent, bringing the year-to-date return up to 4.7 percent. Credit, as evidenced by the high yield returns of 2.0 percent for the quarter and 7.0 percent for the year-to-date, has continued to perform well. There was virtually no change in the 10-year U.S. Treasury yield during the quarter (2.3 percent as of June 30th versus 2.33 percent as of the end of the third quarter, September 30th).

The global recovery is progressing. The last 12 months has represented the first time since the global financial crisis of 2008 that global earnings growth has been in a synchronized recovery. Europe, Japan and many emerging market countries were not showing a broad-based recovery until last year. Normally with this type of earnings growth, especially late in the business cycle, we would expect to see significant upward pressure on interest rates globally. However, many central banks (including those in the U.S.) are still operating below targeted inflation rates. This has allowed the central banks more time to ponder or even put off future rate increases. Inflation seems well-controlled overall due to low energy production costs (particularly due to shale oil) and intense global competition from disruptive technologies in a variety of industries. In an environment of improving global earnings and tame interest rates, it would be unusual for equities not do well.

The U.S. Federal Reserve has telegraphed its intention to start shrinking its balance sheet gradually and raise short-term interest rates one more time in December this year. The Fed is simply attempting to move back to a more normal monetary policy stance and is not trying to engineer a major slowdown. Many so-called macro investors fear this slowdown in stimulus, but we believe the economy can absorb these events without any major difficulties as we go forward.

Trump Trade 2.0. The so-called "Trump Trade," which has been dead all year, started to come back over the last three weeks of September. Since the Obamacare repeal failed, the Trump administration and Congress have pivoted towards tax reform. This has created some budding optimism that tax reform could occur before year end or early next year. We are not so sure given both Trump and Congress's inability to get anything done so far. However, if meaningful reform is accomplished over the next year, it should have a positive impact on many high tax-paying companies and many large multinationals with billions of dollars currently trapped overseas. Merger and acquisition activity has slowed this year, as many corporate boards have awaited tax reform before undertaking any significant deals. This will surely accelerate if repatriation actually occurs. Early estimates show that the S&P 500 could benefit 5 to 15 percent in overall earnings growth if tax reform passes.

On balance, the outlook for equities continues to be favorable. Any meaningful uptick in inflation caused by either higher energy prices or significant wage growth is the principal risk in the outlook for the stock market. We will continue to monitor inflationary trends closely over the next couple of years. Geopolitical events, such as hurricanes and tensions with North Korea, have taken a back seat to the improving global earnings outlook so far this year. With the stock market at all-time highs, we believe it is more important than ever for clients to focus on their longer-term goals and risk tolerance as market corrections can and do frequently occur, even in a bull markets. With such unpredictability, we recommend that clients try not to time the market, as most often investors fail severely in this endeavor and usually hurt their returns.

We thank you for your trust and confidence in managing your assets.