Market and economic update

October 2, 2017

Current economic events
Distortions in economic data from Hurricanes Harvey and Irma are starting to appear, including jobless claims and personal spending data. The release of the September employment report later this week is also likely to be distorted, with payroll growth moderating to reflect difficulties in Texas and Florida. However, high-frequency survey data seem to indicate the economy remains on solid footing. Regional Federal Reserve (Fed) surveys on business activity, including Dallas, Richmond, Chicago and Philadelphia, are pointing to stronger activity, despite the weather. Consumer confidence data for September has also remained quite solid, typically a positive sign for future consumer spending. Based on these trends, we anticipate U.S. economic growth will remain near recent trend levels, around 2 percent, unless a significant fiscal stimulus is enacted, such as a tax cut or infrastructure spending plan.

The Fed continues to watch the modest levels of inflation in the economy, despite easy financial conditions. Outside the United States, the inflation picture has been somewhat more robust, with relatively solid consumer price inflation across Europe, the United Kingdom and Japan. Global monetary stimulus has clearly aided the battle against deflation, but weaker currency values have also likely supported rising inflation. Growth in Europe and Japan is likely to remain on its modest, positive trend. Growth in the United Kingdom has been supported by currency weakness and monetary stimulus in the wake of Brexit negotiations, but uncertainty may tighten financial conditions, dragging down economic growth.

Equity markets
Increasing earnings, generally constrained inflation and low interest rates provide the basis for a risk-on bias as we begin the fourth quarter and look toward 2018. Additionally, technical trend lines appear constructive, with the S&P 500 near all-time highs.

- Equity performance has been remarkably resilient throughout the first three quarters of 2017, overcoming rising geopolitical tensions, including economic and political uncertainty.
The S&P 500, Dow Jones Industrial Average, Russell 2000, MSCI EAFE and MSCI EM indices ended the first three quarters of 2017 up between 9.9 percent and 28 percent, with nine of 11 S&P 500 sectors posting positive returns.

Perhaps most noteworthy in September was the strong performance of small-cap companies, evidenced by the 6.1 percent gain in the Russell 2000 versus the S&P 500 staying unchanged. The strong performance of the Russell 2000 is perhaps an indicator that President Trump’s reflation trade is back in favor.

On balance, broad-based returns among indices and sectors are typically indicative of a market that is poised to trend higher.

- Earnings are increasing. Consensus expectations are for earnings growth of roughly 10 percent over year-ago levels have remained consistent throughout 2017, according to FactSet and S&P Global, while third quarter earnings are projected to increase nearly 5 percent year over year. To be determined is the extent to which the recent hurricane activity has impacted third quarter economic activity and company earnings. The release of third quarter results ramp up during the week of October 9 when many money center banks report. At the start of the fourth quarter, the S&P 500 trades at roughly 21.5 times and 19 times trailing 12-month and current-year estimates, respectively, above the historical averages. On balance, higher earnings provide valuation support and the basis for higher stock prices.

- While our outlook for equities remains positive, risks remain. A flattening yield curve, political wrangling and low expectations for fiscal policy, potential Fed policy errors, and elevated geopolitical tensions are among items expected to weigh on sentiment and equity returns into year-end.

**Fixed income markets**

Bond yields rose last week after an outline of a Republican tax bill stoked optimism for economic growth and the potential for an increase in U.S. Treasury bond supply down the road. The Trump administration’s emphasis over the weekend on deregulation pushed bond yields higher, as well. Attention this week will be on a host of Fed speakers, minutes from the last European Central Bank (ECB) meeting and payroll data on Friday. While inflation data remains lackluster, the Fed has implied that for the time being, they are comfortable continuing their gradual rate hiking campaign in light of strong economic data, including signs of a tight labor market.

President Trump stated last week that he has had “four meetings for Fed chairman and I’ll be making a decision over the next two or three weeks.” While investors believe the highest likelihood is for a reappointment of current Fed Chair Janet Yellen, there are meaningful odds of a new chairperson. Kevin Warsh is one candidate who could nudge the Committee to remove policy accommodation at a faster pace than Yellen, leading, in turn, to higher bond yields.

Core Personal Consumption Expenditures (PCE), the Fed’s preferred measure of inflation, posted a meager 1.3 percent year-over-year increase last week, below expectations of 1.4 percent. The average hourly earnings report on Friday this week will provide further evidence as to whether signs of inflationary pressures are building in the labor market. The Fed has leaned heavily on the idea that the low inflation postings in recent months are transitory in nature, and a December increase to their target funds rate is increasingly likely, according to market-based odds. However, if low inflation readings persist, the pace and magnitude of further hikes would be brought into question.
In light of ongoing synchronized global growth, low inflation and accommodative central banks, we continue to be comfortable taking risk in the form of bonds with equity-like characteristics, such as high yield and emerging market debt. However, we caution that while fundamentals are conducive to attractive performance in the near term, re-pricing risk is meaningful considering high valuations and the susceptibility of high yield and emerging markets to changes in equity market valuations and volatility. As a result, sizing and portfolio diversification remains key and we urge the use of active managers in both high yield and emerging market bonds given wide dispersion within the categories.

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