Market Review

Third Quarter 2017

Stocks posted positive returns during the third quarter, with large-cap stocks (as measured by the S&P 500 Index) up 4.5% and small-cap stocks (as measured by the Russell 2000 Index) up 5.7%. Growth continued to outperform Value, with the Russell 1000 Growth Index climbing 5.9%, versus a 3.1% increase in the Russell 1000 Value Index, widening the year-to-date disparity to nearly 13% (up 20.7% and 7.9%, respectively).

Although domestic politics generated both headwinds and tailwinds, the net effect was positive. Whereas a stalemate on healthcare reform raised questions about the Trump Administration's ability to make good on campaign pledges, markets reacted favorably to the president's proposal for reducing taxes. While it now falls to Congress to hammer out the details, the proposal calls for a reduction in the top rate for individuals from approximately 40% to 35%, as well as a reduction in corporate taxes 35% to 20%. It also calls for a one-time tax on stockpiled foreign profits while allowing for tax-free repatriation of future foreign profits.

Overseas, the North Korean regime conducted multiple missile tests over Japanese airspace, and leader Kim Jong Un traded threats with President Trump. Although resultant upticks in market volatility have dissipated fairly quickly to this point, the situation bears watching. In Europe, Chancellor Angela Merkel scored a muted victory in Germany's recent election, as far-right "Euroskeptic" elements gained enough votes to likely secure a seat at the table in terms of policymaking.

A series of tropical storms impacted southern states and the Caribbean. Gasoline prices rose roughly 5% in the aftermath of Hurricane Harvey, while crude oil initially languished, as several refineries were forced offline. Late in the quarter, oil prices rose, as the International Energy Agency revised its demand outlook upward. In addition, prior skepticism over the ability of the Organization of the Petroleum Exporting Countries to maintain production cuts abated.

Turning to economic data, the Census Bureau reported that median household income rose to $59,039 in 2016, a 3.2% increase from the previous year. Combined with a decline in the poverty rate (now at 12.7%), these figures may have quelled prior objections that the current expansion has only benefitted a limited segment of the population. While the Conference Board Consumer Confidence Index eased slightly in August to 119.8 from 120.4 in August, the aggregate figures were dragged down by large declines among consumers in Texas and Florida, the states most severely impacted by Hurricanes Harvey and Irma. Nevertheless, the Conference Board's release states that consumer expectations suggest that the economy will continue expanding at its current pace.

Even though the Federal Reserve ("Fed") left interest rates unchanged at its September meeting, it did indicate that it plans to follow through on a rate increase before year-end. The Fed also provided further details of its plans to reduce the portfolio of assets it had acquired following the financial crisis. Markets reacted favorably, likely viewing the Fed's actions as a validation of the economy's health.

More than eight and a half years into a bull market, most major market indices are at record highs. However, according to Thomson Reuters, earnings for S&P companies are projected to grow at 10% for full-year 2017 and 7% in 2018—even before considering the potential tailwind should tax cuts be enacted. Not only could the reduction in corporate taxes increase profits, but combining these with lower taxes for individuals could also increase consumption. As we await the legislative outcome, we will continue to take a bottom-up approach, seeking stocks with attractive relative valuations and the potential to exceed expectations.

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