Fixed Market Commentary

September 30, 2017

Shrinking the Balance Sheet

The US Federal Reserve took center stage in Q3. In September, the Fed confirmed that they would begin the long-anticipated process of shrinking their massive balance sheet which had ballooned, due to various iterations of quantitative easing, from $870 billion in 2007 to nearly $4.5 TRILLION today. Thus, the Fed will embark on a journey through unchartered waters; never before has the Fed attempted to drain liquidity on such a massive scale. The Fed will start slowly, allowing a $10 billion per month run-off, gradually increasing to $50 billion in October 2018. For financial markets that have become addicted to the high of monetary heroin, we wonder how financial markets will react when Dr. Yellen curtails the dosage?

In addition to the balance sheet considerations, the Fed has raised the federal funds rate three times since December 2016. Financial markets have priced in another rate hike at the December 2017 meeting. However, a disconnect exists between financial markets and the Fed in terms of rate hike expectations for 2018. A survey of FOMC members indicates that the Fed would like to hike rates three times in 2018, while the market is pricing in approximately one hike in 2018. The bottom line is investors don't believe the economy is strong enough to tolerate three hikes in 2018.

The Fed appears determined to continue hiking rates despite the lack of any signs of inflationary pressures. Rising inflation is a telltale sign of above-trend economic growth. It is almost unheard of for the Fed to hike rates at a time when inflation is so low. To justify its hawkish stance, some FOMC members are downplaying the importance of inflation, and are now focusing instead on "financial conditions" as the tool for evaluating monetary policy. One of the biggest factors influencing financial conditions is the level of stock prices. Despite a series of rate hikes, stocks continue to march higher and financial conditions become more accommodative. Thus, the Fed believes that further rate hikes are necessary to prevent the economy from overheating.

This focus on financial conditions is another way of saying that the Fed is concerned that years of accommodative monetary policy has pushed up stock prices to unsustainable levels. The Fed would like to see equity valuations gradually decline to a level more in line with economic fundamentals. One way to deflate the stock market bubble is to tighten monetary policy. However, raising rates in a 2%-growth-rate-economy is a dangerous game. This is one reason why the US Treasury yield curve has remained so flat (long rates have risen much less than short term rates): investors fear a potential "policy mistake." If the Fed hikes too aggressively, the economy could tilt into recession.

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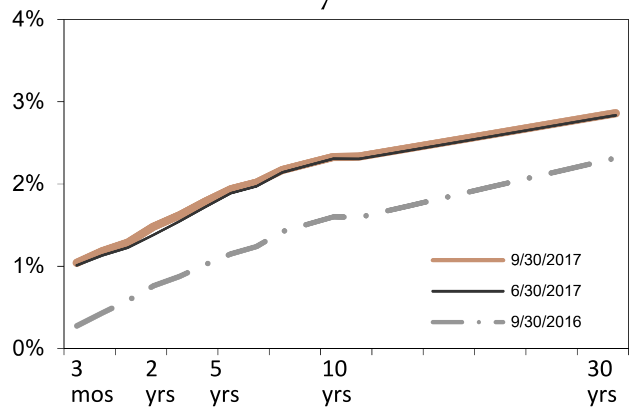

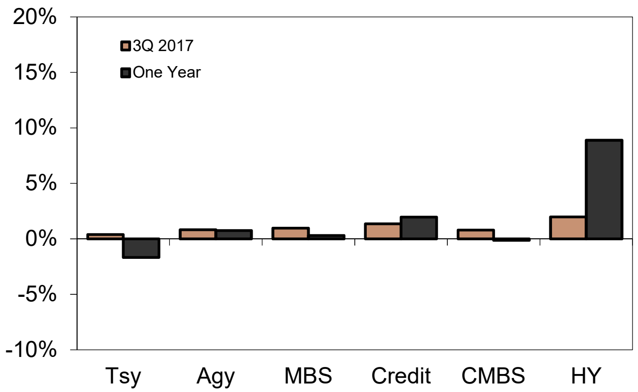

The stock market train is still barreling down the tracks, and three Fed rate hikes have been the equivalent of bugs splattering off the windshield. The S&P 500 was up 4.5% in Q3 and has returned 14.2% year-to-date. The S&P 500 hit another new all-time high of 2555 on October 11, 2017. Through September 2017, the S&P 500 had a positive total return for 11 consecutive months. That's the longest streak since 1958-59!

10-year Treasury notes rallied most of July and August as yields fell from 2.3% to 2.05% in early September. But the surprisingly hawkish tone of the September FOMC meeting caused yields to completely reverse course, finishing Q3 at 2.3%. The third quarter return on the Barclays Aggregate Index was 0.9%. YTD, the Aggregate is up 3.1%. One of the big drivers of bond returns has been the relentless tightening of corporate credit spreads. High grade corporate bond spreads, as measured by the Bank of America/Merrill Lynch Corporate Index, hit a new post-crisis low of 105 basis points. That's the lowest level in more than ten years. This is another indication of very accommodative financial conditions, which concerns the Fed.

Given the Fed's increasingly hawkish stance, active fixed income management is the key to protecting the invested principal of client portfolios from rising interest rates. We will continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. Our client portfolios are underweight government and mortgage-backed securities, while maintaining an overweight position in the investment grade credit sector.

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Steady As She Goes

The third quarter of 2017 was a positive one for markets Worldwide, as the global economy experienced a steady expansion with low inflation and little risk of a recession. Businesses and consumers remain confident and investors continue to believe in the pro-growth rhetoric coming out of Washington, despite little actually getting done. This all during a quarter that historically has not been kind to investors. However, this year was different here and abroad. International developed and emerging market stocks lead the way as the MSCI International Index gained 5.62%, while the MSCI EAFE Emerging Markets Index rose 7.89%. Domestically the S&P 500 gained a respectable 4.48%, with small-capitalization stocks doing better than their larger brethren and growth stocks besting their value counterparts.

Entering the last quarter of the year, hope for a stimulative tax reform package out of Washington, and/or progress on Obamacare medical reform and/or replace, remains high. The broad market continues its expansion as small and mid-cap stocks surge, which is healthy to see a broadening out of the markets, as highly concentrated bets in just a handful of stocks can be destructive. If this trend continues the bull market that started in 2009 is likely to continue for the foreseeable future. Stay tuned.

Sector Observations

- The *Consumer Discretionary* sector experiences net positive change as the sector rallies from its oversold condition. The improvement is not enough to warrant an upgrade from our *negative* rating. The *Consumer Staples* sector sinks deeper and is almost uniformly *negative*. The surge in broad market themes coupled with interest rates ticking higher in September was not helpful.
- After spending the entire year as the worst performing sector (by far) in the market, the *Energy* sector leads the market higher in September. Time will tell if we've reached "the" bottom but for now, the evidence is early and inconclusive.
- After a shaky summer, the *Financial* sector bounces higher in September as the uptrend is firmly back on track for this *positive* sector.
- *Health Care* stocks consolidate in September, but the pullback does little to influence our *positive* view on this highly constructive sector. Investors should use this as an opportunity to add exposure on the pullback.
- The *Industrials* sector surges in September and is upgraded from neutral to *positive* this month. As the global economy seemingly picks up steam, this economically sensitive sector accelerates.
- The *Information Technology* sector loses some momentum in September but remains solidly in a long-term *uptrend*. As a result, more *buys* emerge this month for those still wanting to add exposure to this leadership sector.

- The *Materials* sector accelerates in September but remains *neutral*. If the global economy continues to improve, it's possible this sector will emerge from its doldrums. Stay tuned.
- The *Telecom* sector remains entrenched in a long-term decline. There is little new to report here and we continue to recommend *avoiding* this sector.
- The positively rated *Utilities* sector barely hangs on as a sudden reversal in interest rates softens the uptrend. Holding some exposure to this defensive sector seems prudent right now.
- The *International* sector continues to surge within its recently established *uptrend*. This sector has not paused since turning positive earlier this year and the appetite to add foreign exposure is increasing.

Reversal Comments

Our trend reversal summary shifts back to slightly positive as nine issues reverse upward and six issues turn downward. There is no notable theme within either the *upward* or the *downward* list this month.