FINANCIAL MARKET COMMENTARY – Looking Both Ways

Third & Fourth Quarters, 2017

Outlook

We believe (but not without constant due diligence and review) that the factors leading to the constructive stance that we have espoused for some time in structuring and managing investment portfolios, remain solidly in place. Those factors which include an increasingly visible synchronized global expansion, combined with subdued inflation, stimulative monetary policies, increasing U.S. deregulation, possible domestic tax cuts/reform, infrastructure rebuilding (hurricanes & long-term needs), and a weak U.S. dollar (U.S. goods more price competitive) will remain in place, lead to higher U.S. corporate earnings and "justify" continued equity gains. We are sure though that won't happen without some challenges and market volatility along the way.

Following a review of the events and returns achieved during the recently concluded calendar quarter we will share some examples of economic evidence that we review and analyze in order to reach our conclusion.

The 3rd Quarter – The Trend (*synchronized global expansion*) Continued!

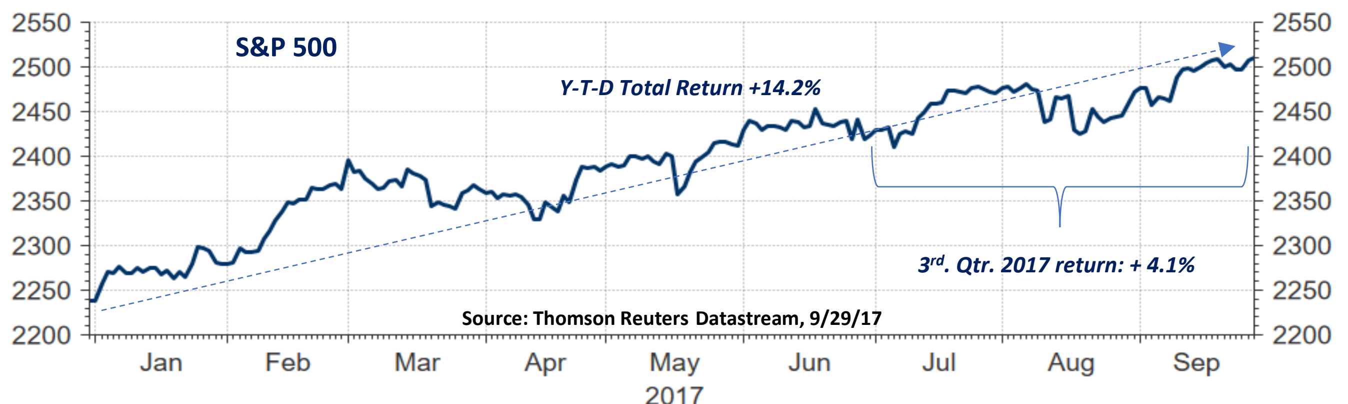
Despite some domestic and global challenges e.g. U.S. hurricanes, North Korean bluster/threats, terrorism in Spain, White House disorder (Press Secretary & Chief of Staff resign), a Venezuelan economic crisis, and even a total solar eclipse, the strength and importance of the improving global economy reflected itself in rising financial valuations.

As a result, virtually every major equity index in the Americas, Europe and Asia, has provided investors with meaningfully positive returns through the first nine months of 2017. In the U.S., each of the major equity indexes achieved positive returns during the 3rd calendar quarter and have now provided investors double digit total returns for the year-to-date. Total returns achieved by each of those indexes through the end of the 3rd quarter are: NASDAQ +12.5%; Dow Jones Industrial Average +15.3% and Standard & Poor's 500 + 14.2%.*

*Source: The Wall Street Journal

In a continuation of the trend begun in January, bonds too provided positive (bonds increase in value as interest rates decline) returns during the third quarter as well as for the year-to-date. During the first nine months of 2017 the 10-year U. S. Treasury bond (a proxy for fixed-income investments) provided investors with a return of +2.3%.

U.S Capital Markets - Stocks



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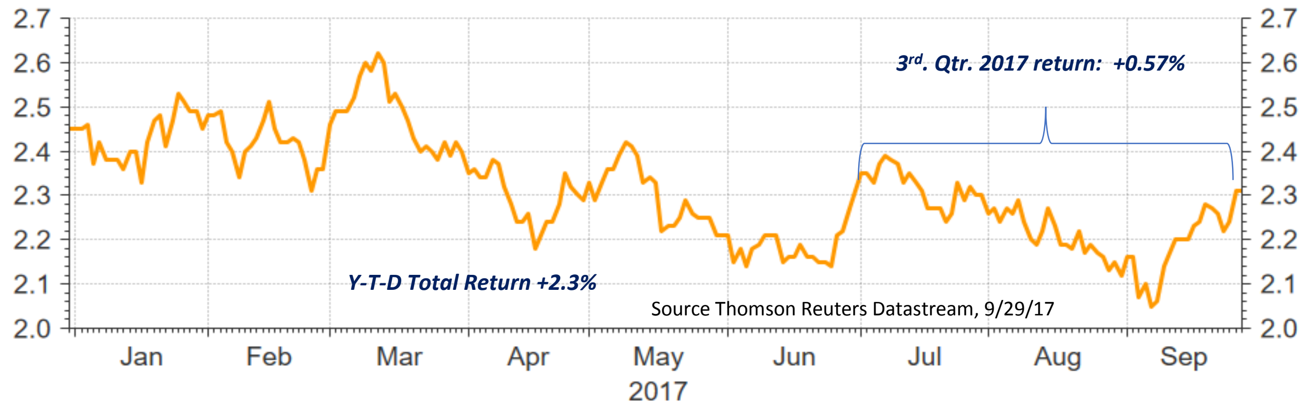
U.S. Capital Markets – 10 Yr. U.S. Treasury Note Yield



A "Deeper Dive" Into Common Stock Returns

As the third quarter ended, the S&P 500 completed its eighth consecutive quarter of positive returns for only the 5th time during the 90 years that the index has been in existence. In addition to a very positive period of returns, this past year has been one of the calmest periods as well. The S&P 500 has experienced movements of only +/- 0.31% during the past 200 trading days.

While investors should be pleased with overall domestic equity market returns during the quarter, returns varied widely by economic sector, as may be seen below. In general, the companies representing sectors that benefit (*operating* leverage) from an improving economy, preformed strongest.

Strongest Performing Sectors*		**Weakest Performing Sectors***	
Technology	+8.6%	Health Care	+3.6%
Materials	+6.1%	Utilities	+2.9%
Energy	+6.8%	Cons. Discretion	+0.9%
Telecom	+6.8%	Real Estate	+0.9%
Financials	+5.2%	Con. Staples	-1.3%
Industrials	+4.2%		

*Source LPL Financial; S&P 500 Index Economic Sector returns for the period 6/30/2017 to 9/29/2017

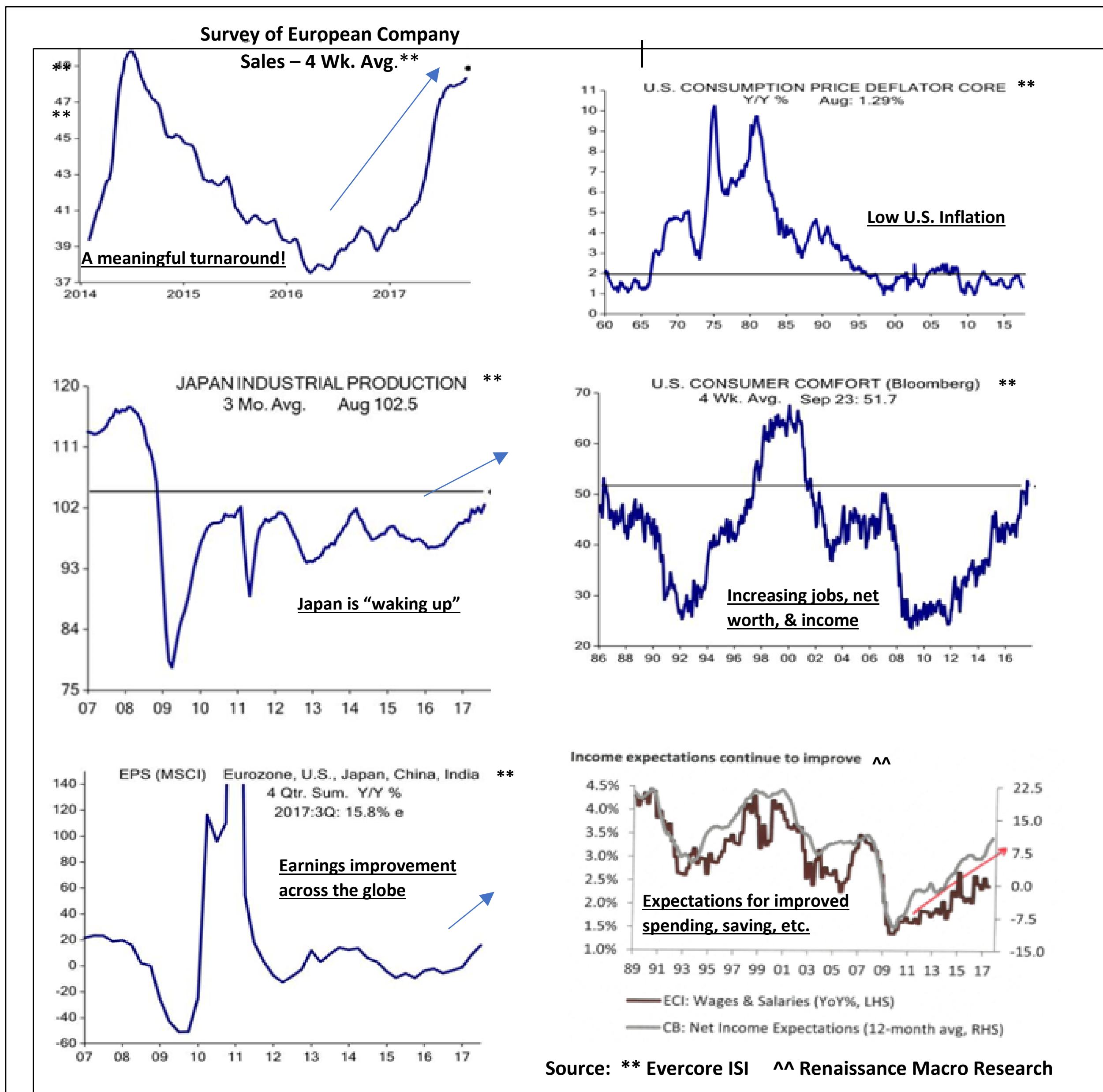
Additionally, investment in areas that provide important strategic (portfolio) asset allocation e.g., non-U.S. investments and mid and smaller market capitalization investments have also provided positive returns in 2017. Proxy ETF's for Emerging Market (EEM) and non-U.S. investments (EFA) have achieved returns of +28.6% and 20.6% respectively thus far in 2017 while Mid (IJH) and Small Cap (IJR) ETFs have returned +9.3% and +8.9% respectively during the same periods.

Fourth Quarter 2017 & Beyond – Our View (Global Markets & Taxes)

Bull markets don't "die" of old age, they deteriorate as fundamentals change from positive to negative. While we are aware that both the equity and fixed-income markets are valued at slight premiums to their historic valuations, we also believe that economic fundamentals, in addition to synchronized global growth and potential changes in fiscal and regulatory policies, support those valuations.

"Synchronized Global Growth"

The diverse charts below are evidence that economic conditions around the globe are positive and will be stimulative to U.S. economic and earnings (the "engine" that drives stock prices) growth.



Global growth? Consensus is U.S. +3.0% +/-; China & India +7.0%; Europe & Japan 2.0%+. Not robust, but the positive direction and "synchronization" is very important.

Tax Reform/Tax Reduction

The current “tax talk” is just that, a plan, not a bill and is probably not likely to pass with all of the current aspects intact. ***<u>However</u>***, the direction of the bill and the positive impact of its proposals, particularly those which relate to corporate taxation, are quite positive and likely to have a substantial impact on S&P 500 earnings and thus stock valuations.

While most are probably aware of the key provisions within the “tax talk”, they are summarized below.

1. Collapse of personal tax brackets from 7 to 3.
2. A doubling of the Standard Deduction
3. Allowing “pass through” of business income to be taxed at a 25% rate instead of the higher personal income tax rates
4. Elimination of the Estate Tax
5. A reduction of the maximum corporate tax rate from 35% to 20%

Prior to the formalization of a tax bill, is the necessity of passing a 2018 federal budget. We believe this will be completed shortly. A budget bill requires only a simple majority.

In Conclusion

There are many factors, trends, and data points that we review/analyze each day in order to reach strategic decisions and relate them to our clients’ portfolios. Currently those factors described in the first paragraph of this paper e.g. “synchronized global growth”, low inflation, rising corporate profits, stimulative monetary policy, the need for infrastructure rebuilding, tax reform, a more positive business environment and a strong consumer footing are those that we believe are important to investors and that create a positive environment for investing.

With the above in mind, one might ask, “What would cause a change in our current positive outlook and portfolio “positioning”? As described in previous **ECONOMIC & FINANCIAL MARKET UPDATES**, primary factors that would cause a change would include a change in direction (decline) of corporate profits and/or consumer sentiment; a cessation to growth in China or the Eurozone; and/or an inversion of the yield curve (interest rates on short-maturity investments exceed those on longer-maturity investments). This last item (inverted yield curve) has “always” been a precursor to an economic slowdown. We do not anticipate a change in any of the above in the near future.

Tax Efficiency

While tax-efficiency is a hallmark of our investment strategy/style, and will continue to be, realizing some capital gains that have been achieved during the market’s rise the past nine and one-half years may be warranted. However, as we approach the end of the calendar year, we are less likely to realize those gains until the beginning of the next year.

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Portfolio Strategy

No change here. Within equity portfolios, we continue to emphasize investment in high quality (consistent revenue/earnings growth; modest debt; high return on equity, etc.) companies and diversification with a modest overweighting in sectors/companies that are operationally leveraged to the economy and that may benefit from the "synchronized global growth" scenario that we anticipate. As we have seen in the past these companies are better able to increase their earnings and to share those earnings, in the form of growing dividends, with their shareholders.

The companies that we emphasize generally may be characterized as Technology, Industrial, Financial, Health Care or Consumer Discretionary companies.

With respect to the other important component of client portfolios, fixed-income (bonds), we continue to recommend ownership of bonds with shorter rather than longer maturities. In an environment where interest rates may be rising due to continued economic growth, we believe a strategy of "staying short" increases flexibility and reduces risk.

Lastly, we again share with you a chart, that in one picture, displays four very important factors that impact the economy and ultimately the financial markets. The descriptions of those factors are shown in gold lettering.

We appreciate the opportunity to serve you. If you have any questions, or if we may be of assistance in any way, please do not hesitate to contact us. We look forward to meeting with you in the near future.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All indices are unmanaged and may not be invested into directly.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

The prices of small and mid-cap stocks are generally more volatile than large cap stocks.

Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Investment advice offered through Stratos Wealth Partners, Ltd., a registered investment advisor.

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