Equity Market Update

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Equities finished the 3rd quarter on a strong note. Investors were encouraged by evidence of an improving global economy and hopes for tax cuts from Congress. Sentiment changed in favor of cyclical, value names over growth stocks. The rotation enabled most indexes to post new all-time highs. Volatility measures remain at all-time low levels despite concerns about a possible military conflict with North Korea and further rate hikes from the Federal Reserve.

The S&P 500 gained 2.06% in September. The index has produced a positive total return for ten straight months and eight consecutive quarters—it's longest stretch in 20 years. Year-to-date, the S&P 500 is up 14.24%.

The results are similar for the Dow Jones Industrial Average. It gained 2.16% for the month. Like the S&P 500, the Dow has also been up for eight straight quarters—its best showing since 1997. In 2017, the index has returned a strong 15.45%.

All year long, the NASDAQ has produced the best results. However, last month was the first time in which its monthly return trailed the S&P 500 and Dow as investors searched for value names that had underperformed in 2017. Despite the sentiment shift, inflows remained positive, thus helping the index gain another 1.11% in September. Year-to-date, the NASDAQ has zoomed 21.73% on sharp gains in social media, e-commerce, internet portals, semiconductors, and biotech.

Talks of reducing corporate taxes and an advance in the US Dollar benefitted mid and small-sized companies. In September, the S&P 400 Mid-Cap Index increased 3.92%, while the S&P 600 Small Cap Index gained 7.71%. Thus far in 2017, both indexes still trail their large cap peers. Mid-cap stocks are up 9.40%, while small-cap stocks have gained 8.90%.

Improving economic results in Europe, along with further stimulus from the ECB, helped lift the MSCI EAFE Index. In September, it gained 2.50%. Year-to-date, it is up 20.47%. Gains in the US Dollar hurt emerging market stocks for the month. The MSCI Emerging Market Index declined 0.39%. However, it is still the best performing index in 2017 with gains of 28.08%. International stocks have benefitted this year from the broadening of global growth across different geographic regions, the defeat of populist candidates in European elections, monetary stimulus programs from the ECB and the Bank of Japan, and lower valuations compared to US stocks.

For eight months, we wrote about overcrowding in growth stocks. Investors rushed into technology and healthcare stocks due to uneven economic data and concerns that Congressional gridlock would derail President Trump's economic agenda. By the end of August, these two sectors accounted for 71% of the market's entire return!

Investor mindset changed in September as corporate earnings remained strong. We also got economic data indicating that growth is improving around the world. Charles Schwab produced a graphic that showed none of the 45 largest economies in world are expected be in recession in 2017 and 2018. If this comes to fruition, it would be the first time since 2006-2007 that all the major global economies are in expansion. Next, the Federal Reserve indicated they are considering a rate increase in December and three additional hikes in 2018. Finally, President Trump announced the White House has worked with Congressional Republicans in both the House and the Senate on a tax cut framework. This is extremely beneficial to stocks because every 1% reduction in the tax rate is estimated to boost per-share earnings of the S&P 500 by a dollar. The President hopes to have a bill written and passed by year-end.

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These data points provided investors the opportunity to expand their horizons beyond technology and healthcare. Banks did very well because higher interest rates should improve their earnings. They will also be a big benefactor of lower tax rates since many banks pay the current 35% corporate rate. Finally, investors hope clarity on taxes will enable banks to reverse a decline in business loan growth.

Industrials and energy were also big winners in the recent rotation. Increased global growth, along with the need to rebuild from two massive hurricanes, brightened the economic picture for these cyclical companies. Finally, as we indicated above, small-sized companies zoomed to new all-time highs given their sensitivity to US economic data and the prospect for lower taxes.

The large increase in stock prices has pushed up valuations, despite the improved economic picture. Currently, the S&P 500 trades at 17.88x EPS estimates for the next 12 months. This is above the long-term historical average of 15.93x. The trailing PE is 21.57. These are the highest PEs for non-recessionary conditions in 13 years.

With interest rates still low compared to historical standards, stocks are able to trade at a premium. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here solely on the shoulders of continued earnings growth and legislative victories in Washington.

Finally, the victory in cyclical stocks could soon turn to losses if the inflation picture does not improve. At the recent Fed meeting, Janet Yellen downgraded the long-term estimate of the Fed Funds Rate to 2.75% from 3%. She also admitted the Fed's actions since the financial crisis has produced far less inflation than originally thought. With current inflation measurements still well below the Fed's target of 2%, it is imperative that tax policy be passed and for the economy to continue improving, or else crowding into growth stocks and bond surrogates will once again take hold.

Collectively, we remain positive on the economy and equities; however, we believe the possibility for higher volatility is present given the debate over tax policy and possible military action against North Korea. Our internal economic checklist indicates the economy continues to improve. Recently, more of our indicators are signaling a transition from the mid-cycle to the late cycle. As a result, we have shaved-off some of our cyclical overweight relative to our benchmarks. Among cyclical sectors, we are overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare and telecommunications given their attractive valuation paired with underweights in consumer staples and utilities.

On the global scale, we remain overweight US stocks with an underweight in developed international countries. We have an inline weight to emerging markets. Inside the US, we have maintained our overweight to mid and small-sized companies since they stand to benefit the most from Trump's pro-growth economic agenda.

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