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STOCKS CONTINUE TO CLIMB

The steady, upward progress in the stock market seen in the first half of 2017 has persisted during the third quarter, together with the low level of volatility that has marked this advance. According to figures provided by ***Ned Davis Research***, this has been the longest period of time that the Standard and Poor's 500 Index has gone without a 5% correction in the past twenty-one years. In fact, there hasn't been even a 3% dip in the index in almost a year. If the market's momentum lasts a few more weeks, this rally will set the all-time longevity record for avoiding a 3% decline. Stocks around the globe are also on the rise; nearly two-thirds of international markets are within 5% of record highs. The disparate performance of Growth stocks and Value stocks that we wrote about in our last Quarterly Notes has continued during the third quarter, but in the final weeks, there were hints of a potential shift in investor preferences.

Given the mixed economic performance of the U.S. during this recovery, the rising tensions between the U.S. and North Korea as well as the recent powerful hurricanes slamming the U.S., many people are surprised to see stock prices performing so well. With all these worries, both here and abroad, why have stocks generally ignored the bad news?

STOCK'S GAINS ARE BACKED BY SOLID EARNINGS GROWTH

Stock market investors tend to be primarily concerned with two things … corporate profits and interest rates. Each of these factors have turned out to be much, much better this year than investors could have hoped back in January. Thanks to fairly easy comparisons, the vast majority of firms in the S&P 500 Index have beaten analysts' estimates for both profits and sales this year. The two groups hardest hit by the 2014/2015 downturn, Energy and Basic Materials, have had the sharpest gains in profits. This rebound has helped push the rate of gain for overall S&P 500 earnings to above-average levels. Not only have overall corporate profits reached near-record highs, but corporate ***profitability***, as measured by the S&P 500's net margin, reached 10.8 cents on every dollar of sales, the highest level in a quarter century. Normally, margins start to narrow as a recovery ages, but the combination of tight cost controls and slow economic growth have enabled managements to sustain higher margins over longer time periods.

While earnings grew, inflation has remained well contained and below the Fed's 2% target, allowing intermediate and longer-term interest rates to remain at very low levels. As we mentioned in our last letter, one of the biggest surprises this year has been the fact that intermediate-term interest rates have remained in a fairly tight trading range, despite the short-term interest rate hikes by the Federal Reserve. With margins high, profits growing rapidly and interest rates near record lows, in retrospect, it shouldn't be a surprise that stock prices have done well.

TOUGHER COMPARISONS MAKE IT HARDER TO SUSTAIN EARNINGS GROWTH

Although revenue growth is expected to post some acceleration in the third quarter due to faster overseas growth, earnings gains are expected to drop from the double-digit pace shown in the first half. Since year-ago earnings were already showing improvements, the comparisons for the third quarter are more difficult than the prior two. This change in tempo should already be fully incorporated into current estimates, however, since nine out of the eleven major economic sectors in the S&P 500 Index already show negative third-quarter analyst revisions. Also, there have been very few negative pre-announcements from corporations in the lead-up to this quarter's earnings season.

While analysts may be on the right track, it is possible that the broader investment community may be too optimistic. We are concerned that stock prices have gone up so rapidly when analysts have been lowering their forecasts. After seeing two strong quarters of positive surprises, some investor disappointment could arise if companies only match analysts' expectations, rather than exceed them. It might be enough to push the overall level of market volatility higher than we have seen this year.

At this point, corporate earnings seem likely to continue their upward rise next year. Recent weakness in the U.S. dollar should help firms with large international sales, especially in the Technology, Healthcare and Industrials segments. Further recovery in oil prices could also help. Another positive could come from additional capital spending, even though it has taken longer for the economy to absorb its unused capacity this cycle. Despite the low utilization rate, there has already been a slow improvement in new investments.

Capital spending increased slightly in 2016 and it has improved further this year. We do not expect a return to the high rates of investment seen in the prior post-war recoveries, but we do believe that the underlying resiliency in the U.S. economy should encourage another uptick in capital spending next year.

EQUITY VALUATIONS ARE HIGH, BUT TAX REFORM COULD BE A POSITIVE

As we have commented in the past, valuation is not a good timing tool over the short run, but it does have predictive value over the long run. The S&P 500 Index is close to twenty times Wall Street Estimates for 2017 earnings, a level traditionally viewed as expensive. If Congress manages to pass the proposed tax reform bill, however, this could boost earnings significantly and help lower the multiple next year to more reasonable levels. It is hard to know for certain, because the broad outlines for the Administration's tax plan have been given, but the details have yet to be hammered out. Some of the proposals, such as altering the interest deduction, actually could hurt next year's earnings growth. These potential negatives should be more than offset, however, by lowering the corporate statutory rate from 35% to 20%.

We have also been intrigued by the proposed changes concerning the repatriation of overseas earnings. If we understand the proposal correctly, accumulated overseas earnings will be treated as repatriated, whether or not any of the money is actually returned to the U.S. This would provide a strong incentive for corporations to bring the overseas cash home, since they will be paying the repatriation tax regardless. (Gary Cohn, the White House Economic Council, indicated that the tax rate would be lower for tangible investments, like factories and inventory, and higher for liquid assets.) With U.S. corporations hoarding over $2.5 trillion overseas, repatriation could provide the anticipated boost in capital spending if managers put some of that money to work here in the U.S.

ARE PREFERENCES SHIFTING TOWARD VALUE FROM GROWTH?

As we have commented all year, there has been a notable difference in performance this year between Growth stocks and Value stocks, as measured by the Russell Indexes, which continued in the third quarter. The Russell Growth Index added another 5.9% of total return in the quarter to bring the year-to-date total return over 20.7%. Value lagged again by only gaining 3.1% during the quarter to bring the total return to 7.9% year-to-date. We had been concerned that a relative handful of Growth stocks had generated so much of the market's return this year. Narrow markets are generally not healthy ones. The last weeks of September, however, saw a reversal that pushed Value ahead of Growth for the month.

A few weeks do not make a trend, but we have been intrigued that leadership in the stock market may be broadening. Improvements in factory orders and the higher monthly Institute for Supply Management (ISM) manufacturing data show better performance in some of the more economically sensitive sectors.

Also, as we noted above, the chance for significant tax reform seemed to improve during September. Interest rates also firmed in September, which helped the Financial sector to outperform for the month as well. The key point is that investors may be getting more confident in the pace of economic growth next year. We will be watching closely to see if September's shift to Value has legs, or if it sputters out before the end of the year.

SUBDUED INFLATION HELPS THE BOND MARKET

In a September 26th speech, Fed Chair Janet Yellen noted that many of the models generated by their PhD economists had been consistently wrong on the path of inflation. Even though the unemployment rate had dropped from 6.7% in 2014 to 4.2% this September, wage inflation has remained stuck at 2.5% and price inflation has yet to move above 2.0%. There is an internal debate among the Federal Reserve Governors whether the shortfall from their models is simply delayed, due to the dramatic break in the energy markets, or if it reflects longer-term, more persistent economic changes. The answer is critical to the performance of the fixed income markets in 2018. If pent-up pressures cause inflation to suddenly accelerate next year, monetary policy makers would find themselves behind the curve and they would have little choice but to raise short-term interest rates aggressively. We doubt investors would greet such news with glee.

Our sense is that inflation has been held back by two major global forces that have overwhelmed the normal economic response to lax monetary policies. The rapid pace of technological innovation has improved consumer's price discovery, making it easier for them to buy at lower prices … sharpening competition for their purchases. Online shopping has gone from virtually nothing fifteen years ago to over 30% of retail sales currently. Improved technology has also improved efficiencies in both the manufacturing and service areas of the economy that have been hard to measure, but are real, nonetheless. Also, the entry of lower-cost foreign labor from underdeveloped countries continues to put wage pressure on workers in the developed world, including the U.S.

OUR WORRIES

Since the global financial crisis, the major central banks have purchased roughly $15 trillion of assets through Quantitative Easing. While economists may disagree on the exact mechanism, they do agree that this huge influx of liquidity has been a factor in raising Price/Earnings ratios among the world's stock markets. Now, the monetary backdrop is in the process of changing. The Federal Reserve Board has announced plans to begin the process of normalizing its balance sheet and there have been hints by European Central Bank (ECB) President Draghi that the ECB could begin to taper its bond purchases over the next year. Since there is no historical precedent for the course of monetary policy since the Financial Crisis, there also is no benchmark as to what the effect may be of unwinding it.

Ultimately, the impact will be decided by the speed the central banks tighten, how quickly the financial system adjusts to the changes in liquidity and how the economy reacts. Janet Yellen has stated that the Fed's policy of quantitative tightening will be like "watching paint dry," but there is still the risk that any shrinking of the Fed's balance sheet may be too much for the markets to bear.

It is also worth noting that the last significant downturn in the stock market was not triggered by events in the U.S., but by worries about a possible economic downturn in China. It was only by the Chinese government resorting to a combination of allowing the issuance of large levels of debt, imposing tight capital controls and reducing overcapacity in some industries that a downturn was avoided. The resulting huge level of debt now outstanding in the Chinese economy has the potential to vastly magnify any policy mistakes that the Central Committee may eventually make and the level of bad debts in the economy is unsettling. The risk of heightened trade tensions between the U.S. and China could exacerbate any weaknesses in the financial system.

WILL HIGHER INTEREST RATES APPEAR IN 2018?

U.S. Treasuries have traded in a remarkably narrow range for the past five months as the yield curve flattened. While inflation has remained low, it is not zero, however, and we believe the level of real (inflation-adjusted) interest rates will limit further flattening of the curve. As the Federal Reserve raises short-term rates, we believe more of the increase will be transmitted throughout the bond market. Accordingly, we have maintained some degree of caution and our target duration and average maturity for the bond portion of our portfolios remain close to our benchmark.

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