SilverOak

WEALTH MANAGEMENT LLC

# Third Quarter 2017 Market Summary

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# Third Quarter 2017 Market Summary

Steady as she goes. Strong market returns continue as many U.S. and international equities markets set new highs or are near prior peaks. Risk assets continue to perform well despite an uptick in macro headlines with political noise, geopolitical threats, and natural disasters. Investors have focused on fundamentals such as corporate earnings, which are on course to grow above trend for both 2017 and 2018. In addition, sales growth is starting to show signs of a resurgence to respectable levels, after being tepid over the past five years. Recent economic data has also been strong and above consensus expectations.

Many investors have been expecting more choppiness in the equity market; however, it has remained calm. Volatility, measured by the CBOE Volatility Index, during the year has been muted and reached all-time lows during the quarter. Year-to-date, we have not had a day in which the S&P 500 had a +/- 2% return, which is the first time in twelve years. The maximum drawdown of the S&P 500 during the year has only been 3%, which is the shallowest in thirty years. The abatement is not just in U.S. large cap stocks as volatility is low across all asset classes.

U.S. large company stocks, represented by the S&P 500 Index, were up 4.5% during the third quarter of 2017. U.S. small company stocks, represented by the Russell 2000 Index, had positive returns of 5.7%. Year-to-date, there has been a bifurcation within equities. Growth stocks have significantly outperformed value stocks by 10% to 14% and large capitalization stocks have outperformed small capitalization stocks. However, over the past month, this trend has reversed with small-caps and value stocks leading the way. This is due to economic data picking up, expected interest rate hikes, and the rising possibility of some tax reform.

Overall, international stock markets had strong performance for the quarter with the MSCI ACWI ex US Index up 6.2%. Emerging markets performed even better with a return of 7.9%. The depreciation of the U.S. dollar, year-to-date, has added to international returns. The U.S. dollar appreciated from 2011 through 2016 which was a headwind for international equities and helped U.S. equities outperform. U.S. investors who invest in international equities benefit when the U.S. dollar is depreciating. With the U.S. dollar down over 10% since the beginning of the year, the dollar may be in for an extended period of weakness, as currency cycles tend to last 5-8 years. Currency trends could provide a tailwind for international equities going forward. International economies are seeing increasing consumer demand, strong manufacturing data and a continued labor market recovery. On the corporate side, earnings are growing and valuations remain more favorable relative to U.S. companies.

For the quarter, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was up 0.9%. The Federal Reserve did not raise the Fed Funds rate in the third quarter; however, investors are expecting a rate increase in December. Treasury interest rates across the yield curve were roughly unchanged during the quarter. An uptick in inflation and an expanding economy should allow the Fed to maintain course in normalizing interest rates. The Federal Reserve recently announced they will begin reducing their balance sheet in October. The announcement did not affect the markets as the news has been telegraphed. However, investors will continue to monitor the Fed and other global central banks as they unwind the experiment that is quantitative easing. Central bank policy can have ripple effects across the economy and markets which could be a source of volatility and negatively impact economic expansion if the tightening is too aggressive.


The outlook for the remainder of the year appears positive with global economies stable and healthy corporate earnings. Any advancement on tax reform or a reduction in regulations will only add to support for equities. If current fundamentals endure, volatility may remain low for some while. When, not if, volatility returns, it may be sudden and significant. At that time, bonds should provide the ballast for a diversified portfolio. In the meantime, bond returns will likely be limited due to lower current yields and rising interest rates.

## HIGHLIGHTS

### MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of third quarter 2017 real GDP, an annual rate increase of 3.0% from the preceding quarter. The estimate was higher than the 2.5% growth rate analysts were expecting.
- The University of Michigan Consumer Sentiment Index final reading for September was 95.1, which was an increase from the second quarter. Consumer sentiment is very strong and has risen to levels last seen in 2004.
- The ISM Manufacturing Index increased during the quarter from 57.8 in June to 60.8 in September, well above expectations. The ISM Index has risen steadily since the beginning of 2016 and has reached the highest level since 2004. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In September, the Conference Board Leading Economic Index decline 0.2% month-over-month to 128.6. Despite the recent down month, the Index has increased gradually over the past year showing steady growth in the economy.
- The price of WTI Crude Oil was $51.67 at the end of September, which is 12% higher than $46.02 at the end of June. The price of Brent Crude Oil increased 21% in the quarter to $57.02. The price of oil is starting to find an equilibrium around $50.
- In September, headline CPI increased 2.2% year-over-year, up from an increase of 1.6% in June. Core CPI, which does not include food and energy, had a 1.7% increase. Inflation is expected to remain low but could increase modestly due to wage growth and commodity price stabilization.

### HOUSING

- The housing sector has been very strong the past few years with increasing sales and home prices. Though, hurricane effects have weighed on housing activity data.
- Preliminary existing home sales decreased in the quarter with a monthly average annualized rate of 5.39 million units from 5.56 million units in the second quarter. The September annualized rate is 1.5% lower than the 5.47 million units in September 2016. Unsold home supply remains at very low levels.
- Median existing home sale prices increased during the quarter. The preliminary prices for September were 4.2% higher than the levels of one year ago and have been trending up since the beginning of 2012. Price are now higher than the previous peak in 2007.
- New home sales have been strong during the year and have been increasing since 2011. However, new home sales remain slightly below average due to the below average housing starts since 2009.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 5.0% year-over-year during the year.

### EMPLOYMENT

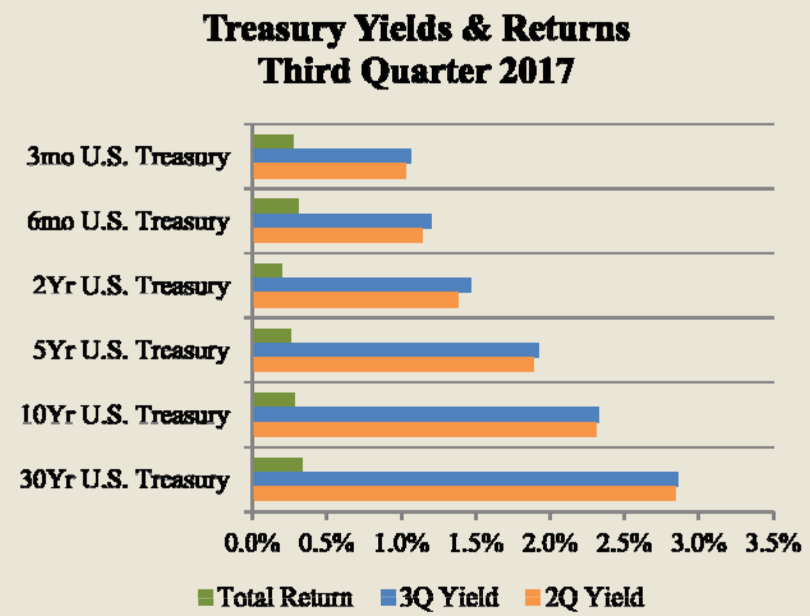
- The labor market data has generally been healthy. The job growth rate has slowed slightly as the labor market is closer to full employment. Wages have been slowly rising over the past few years.
- During the quarter, nonfarm payrolls averaged 91,000 jobs added per month, which is much lower than past quarters due to effects from recent natural disasters.
- The unemployment rate declined to 4.2% from 4.4% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1973, reflecting a tight labor market.

### DOMESTIC CORPORATIONS

- Corporate operating earnings in the second quarter 2017 were higher than the previous year. Estimates for the remainder of 2017 show an acceleration of earnings growth and should surpass peak levels set in 2014.
- Operating margins are currently at all-time highs and well above historical averages. Margins could contract from record levels if interest rates rise and wages increase.
- Forward and trailing P/E multiples are above historical averages.
- The U.S. dollar has depreciated vs. major currencies since the beginning of the year.

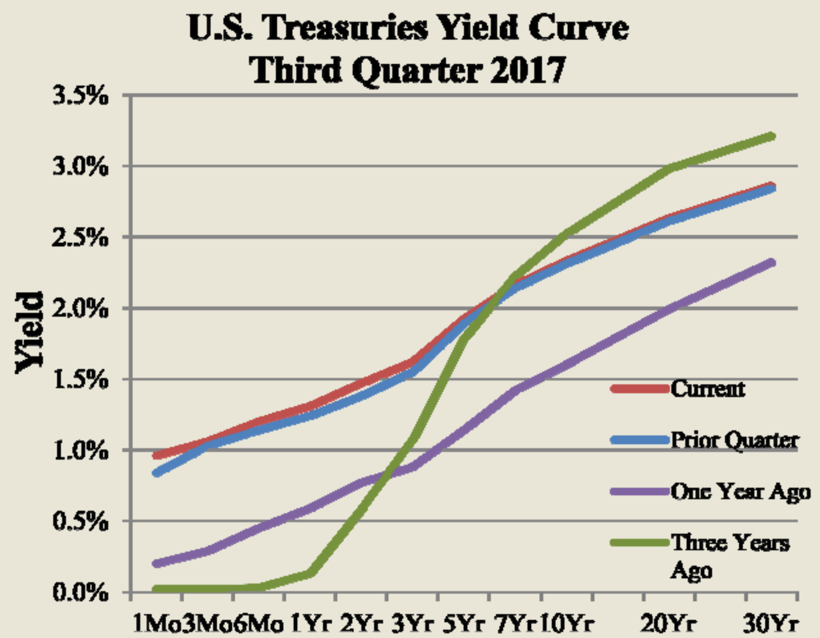
## FED POLICY

- In September, the Federal Open Market Committee (FOMC) decided to leave the federal funds rate unchanged at 1.00% - 1.25%. The Fed's assessment of economic conditions was unchanged. They noted the economy is expanding moderately and the labor market continues to strengthen, despite temporary effects from recent natural disasters.
- The Fed is still forecasting that they expect to raise rates again in 2017 and three times in 2018; however, they will remain data dependent. Market expectations continue to believe the Fed will only raise once or twice by the end of 2018. In the September meeting, the Fed announced a plan to reduce their balance sheet by letting bonds mature rather than reinvesting. The unwinding of the Fed's balance sheet may put upward pressure on interest rates and add volatility to the markets.



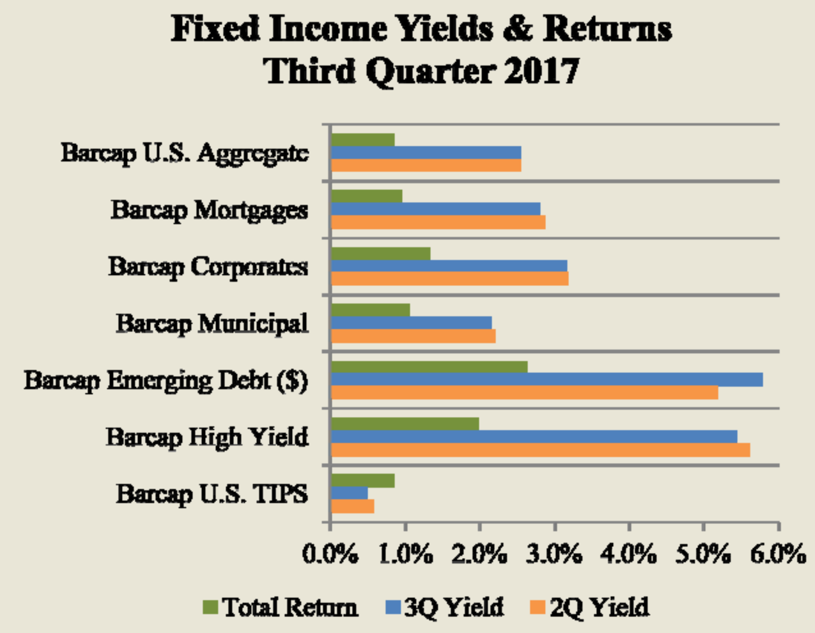

## FIXED INCOME

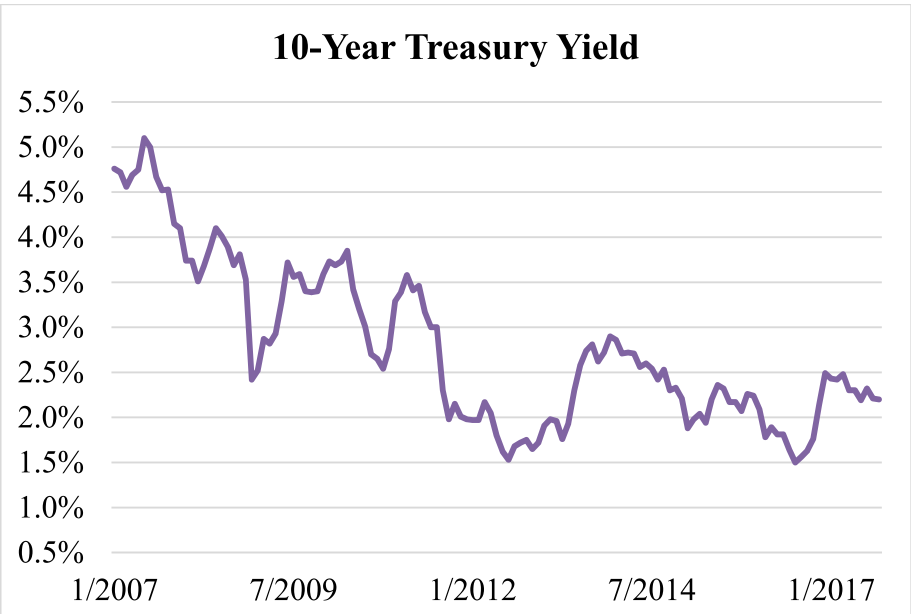
- Intermediate to long term yields were flat quarter-over-quarter; however, the short end of the curve rose causing the yield curve to flatten slightly. Short-term rates rose after the September FOMC meeting as the Fed indicated conditions remain for future rate increases. Short term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth. Historically, the yield curve has flattened as the Fed raises interest rates and the business cycle matures.
- Volatility in the fixed income markets remains at new historical lows. Fixed income managers have become more defensive as the risk/reward opportunities are less attractive with corporate leverage increasing, weakening credit underwriting and low credit spreads.

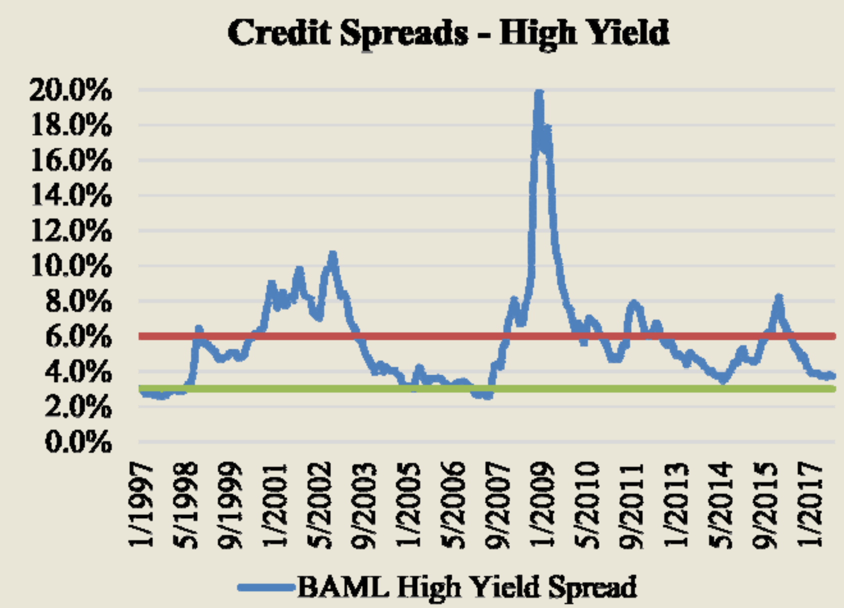


## FIXED INCOME (continued)

- Returns across fixed income sectors were positive, with the Barclays U.S. Aggregate up almost one percent during the quarter. Municipal returns outperformed taxable bonds. High yield and corporates performed well as credit spreads tightened due to strong corporate earnings and investors' appetite for income. Emerging market debt also performed well with rising global growth prospects.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are still at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. Despite the low rates and muted expected returns of fixed income, it remains an important part of a diversified portfolio as it provides stability when equity markets decline.

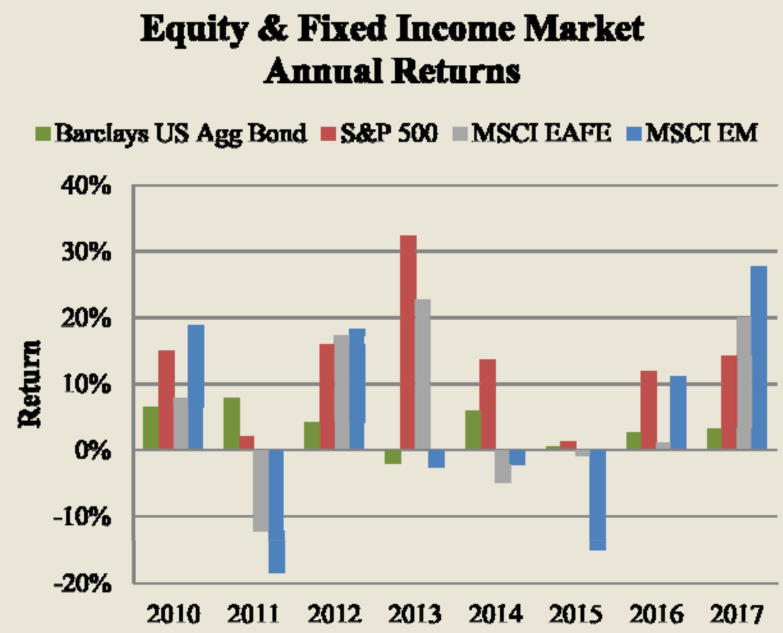


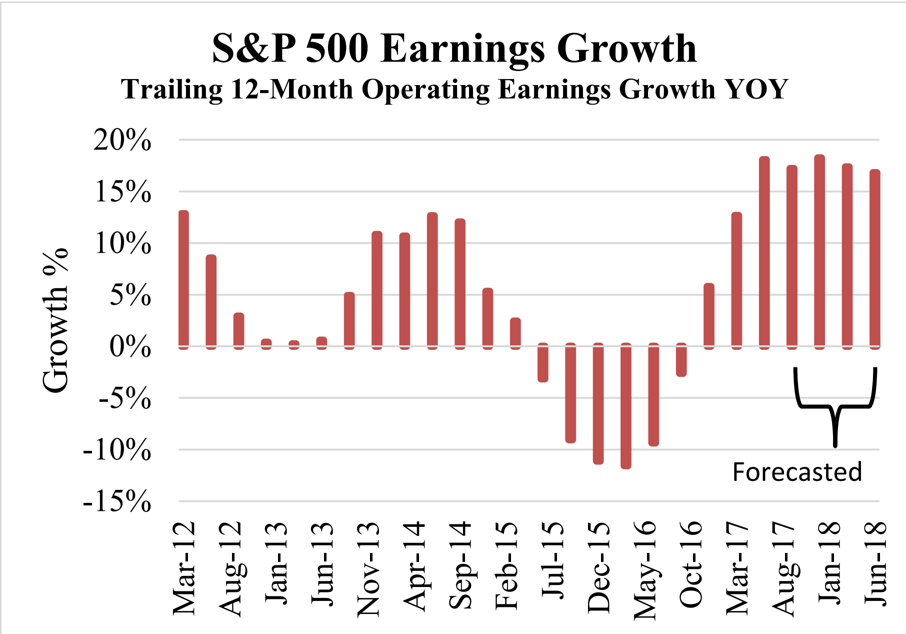



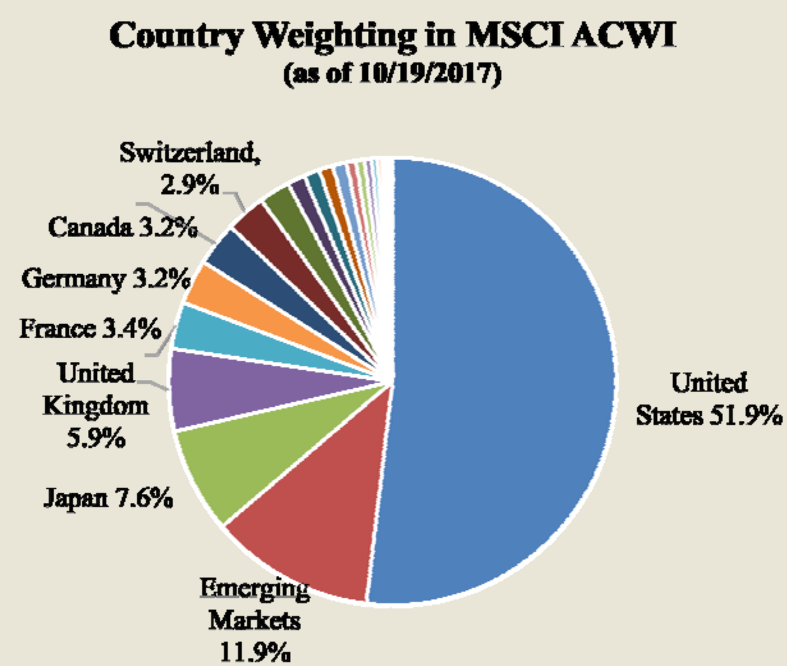



## EQUITIES

- Equities performed strongly during the quarter as volatility continued to be unusually low. The fundamental trends that have elevated global equities the past year remain intact. Corporate earnings are expected to grow double digits in 2017 and 2018. In addition, revenues are growing at respectable rates. Leading economic indicators and the yield curve are positive thus not forecasting a recession anytime soon.
- Despite relatively strong economic data the equity markets have some headwinds. Valuations remain higher than average and geopolitical risks are a concern. However, valuations have little correlation with equity returns over the short-term. Equity returns will likely be driven by revenue and earnings growth rather than valuation expansion. Correlations among equities has moderated which may provide benefits for a diversified equity portfolio.



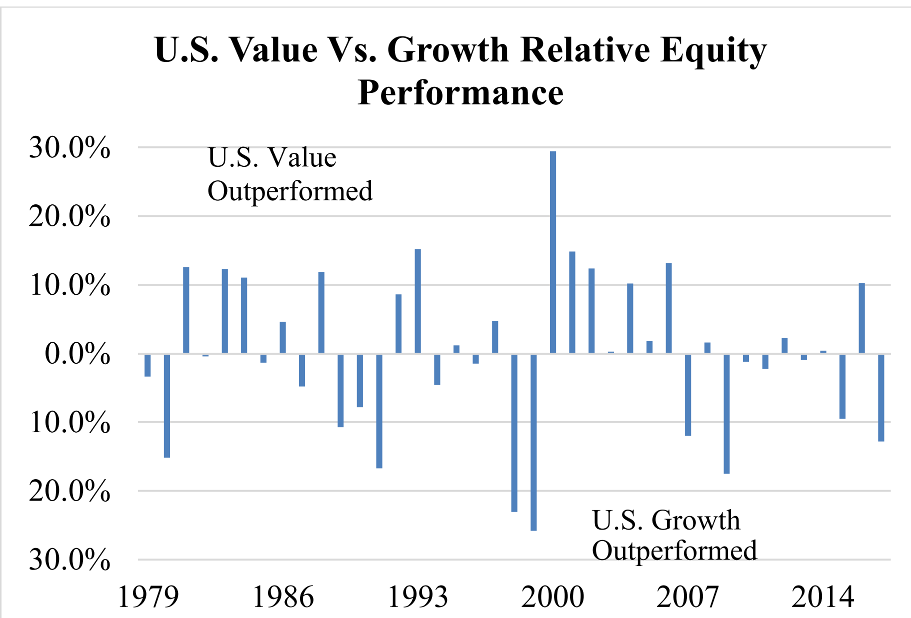



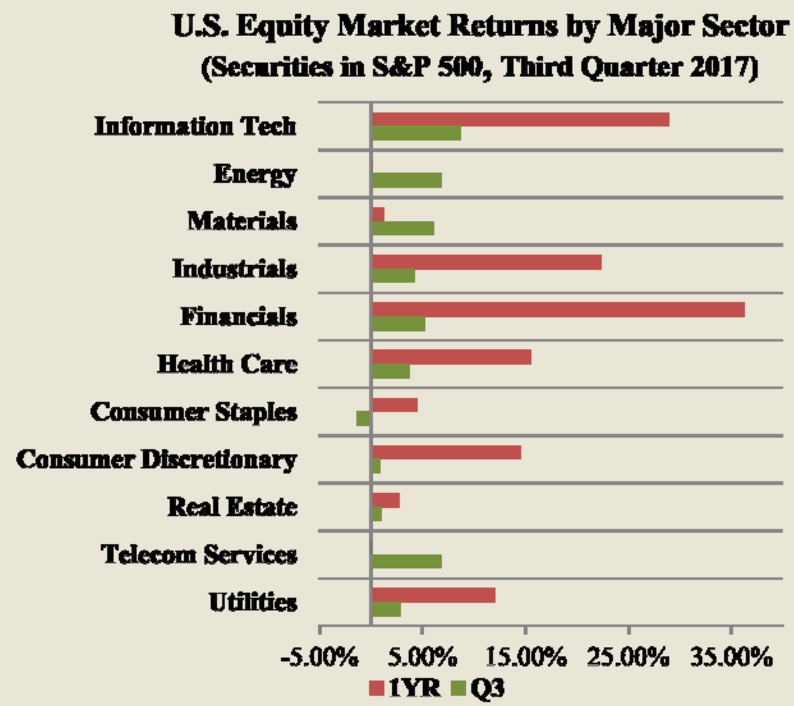
## DOMESTIC EQUITIES (continued)

- The Russell 1000 Index of large capitalization stocks posted a total return of 4.5% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 18.5%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 5.7% during the quarter. On a year-over-year basis, the index has increased 20.7%.
- Market leadership persisted with growth outperforming value across market capitalization and geography. Technology was the best performing sector. Consumer sectors and REITs were roughly flat during the quarter.

**Third Quarter 2017 Returns**

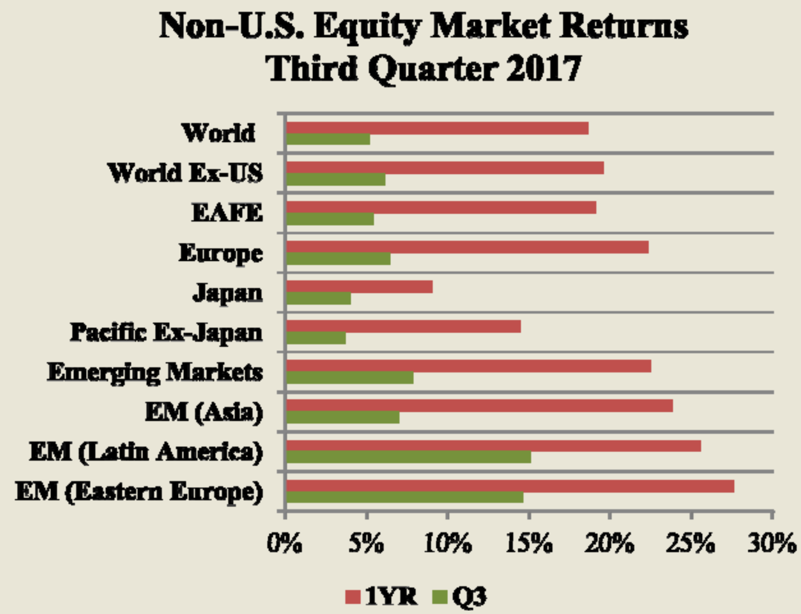
| | Value | Core | Growth |
|---|---|---|---|
| **Mega Cap** | | 4.8% | |
| **Large Cap** | 3.1% | 4.5% | 5.9% |
| **Mid Cap** | 2.1% | 3.5% | 5.3% |
| **Small Cap** | 5.1% | 5.7% | 6.2% |
| **Micro Cap** | 6.4% | 6.7% | 7.0% |

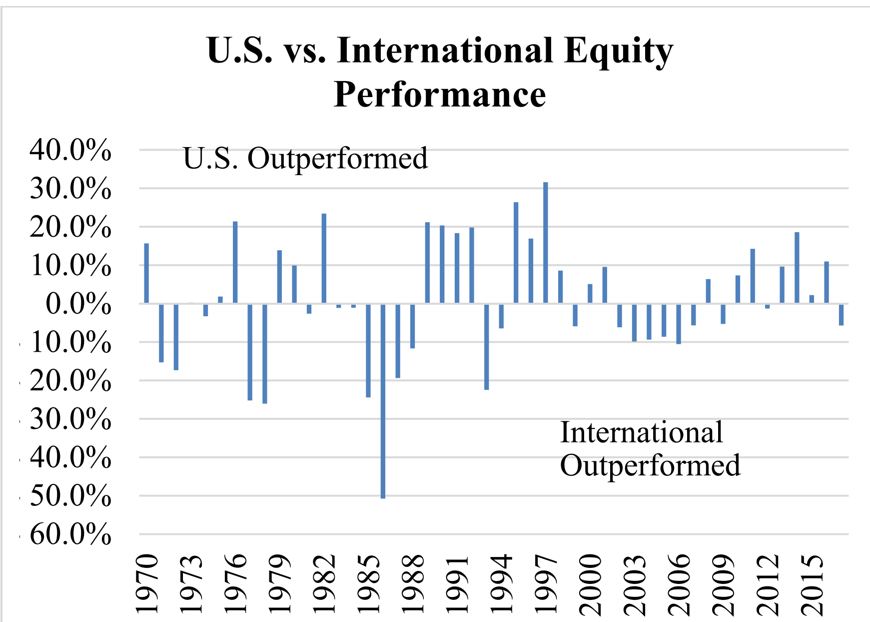


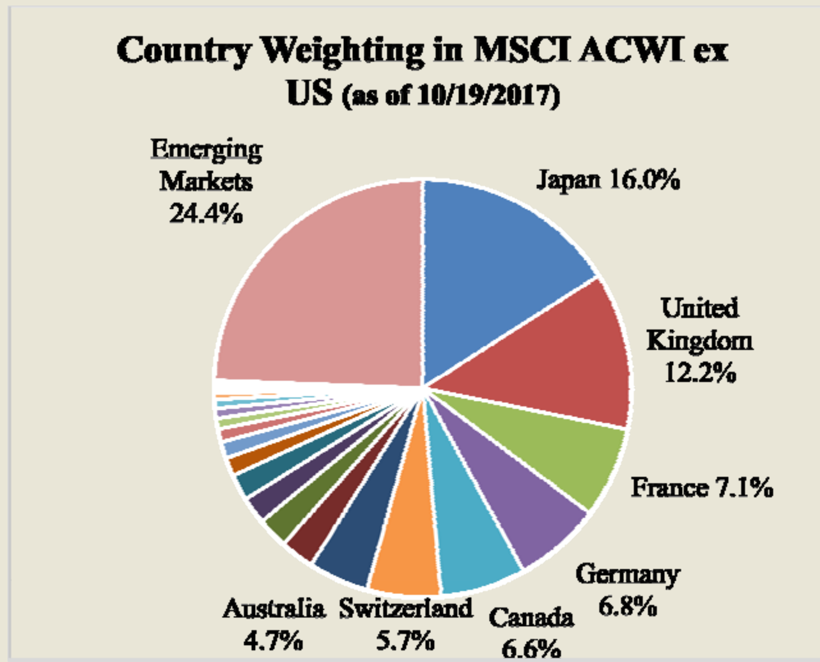



## INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were up 5.4% during the quarter and performed better than U.S. domestic equities. On a year-over-year basis, the EAFE is up 19.1%.
- Emerging market stocks had a strong quarter, outperforming developed markets. The MSCI Emerging Markets Index increased 7.9% in the quarter and has increased 22.5% over the past year.
- Global monetary policy and a depreciating U.S. dollar continue to aid international equity returns. Developed international and emerging market corporate earnings and margins have grown the past year; however, they are still below pre-crisis levels. Despite the many geopolitical risks, global growth is currently the strongest it has been in years.



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