Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 3Q 2017 Review | **October 6, 2017**

Third Quarter Summary

Despite three severe hurricanes and a missile being launched over Japan by North Korea, the stock market hit an all-time high as the quarter came to a close. The market was cheered by the likelihood of the Trump Administration and Congress passing some sort of tax reform. Although the devil is in the details, which must be hashed out in Congress, it appears that both Corporate America and many Americans are in for a tax cut. Both would be bullish for stocks, and the market reacted accordingly.

The S&P 500 gained 4.5% in the third quarter, bringing its year to date gain to a healthy 14.2%. Technology and Healthcare stocks have led the market gains thus far. Bonds, as represented by the Barclays Aggregate Index, continued to inch up, rising 0.85% in the third quarter, essentially clipping their coupons for the quarter. The Federal Reserve began to implement its plan to shrink its enormous $4.5 trillion balance sheet, which was discussed at its September Federal Open Market Committee (FOMC) Meeting. They plan to start very gradually, trimming the balance sheet by $10 billion a month, eventually picking up the reduction pace to $50 billion a month. The Fed also gave strong signals of one additional quarter point rate hike by the end of the calendar year. In short, market participants are currently viewing the Fed's behavior as accommodative. Hence, the rally continues.

Market Outlook

Our market outlook remains modestly optimistic for equities for the balance of 2017. Depending on the magnitude of tax reform, we estimate anywhere from a 2% to 8% gain for Q4. If no tax reform is implemented, we see minimal upside for the market in Q4 and would not be surprised to see a pullback of 5% or more. The last quarter is usually a positive for the market, despite October historically being one its more volatile months. Indeed, we are approaching the 30th anniversary of the infamous Crash of 1987, where most stock market indexes around the world plunged more than 20% in a single day on October 19th of that year. Our enthusiasm for equities is tempered by the heighted valuation levels of stocks, evident across a range of financial metrics. However, we believe the low level of interest rates and likelihood of economic growth can support above average valuations. Low levels of unemployment (4.4%), rising housing prices, and rising stock prices are a trifecta of economic factors that have put consumers in a good mood. Since consumers account for roughly 70% of U.S. Gross Domestic Product (GDP), it may be unwarranted to take an unduly cautious approach to client portfolios, despite the current bull market being the second longest *and* largest on record. The only stronger bull market occurred during the Internet Bubble.

We continue to believe that bonds are likely to be range bound for the remainder of 2017, despite the Fed's recent actions and outlook. In our view, the benchmark 10-Year Treasury Note, currently at 2.35%, is likely to stay within a band of 2.0% - 2.75%. GDP is likely to be buttressed in Q4 with the rebuilding of parts of Texas, Florida, and Puerto Rico in the aftermath of the devastating effects of Hurricanes Harvey, Irma, and Maria, respectively. Hurricanes typically result in a short-term dip in economic activity, but ultimately recover the bulk of their losses, and then some, as flooded cars are replaced, new structures are built, and so forth. Of course, the personal devastation experienced by many families cannot be quantified in economic terms. Our hearts go out to those affected by these devastating acts of nature. Our municipal bond portfolios are conservatively selected, with an emphasis on high quality issues. Accordingly, we estimate minimal net impact on client portfolios with some exposure to bonds in the regions affected by the hurricanes.

As always, there are macroeconomic risks that loom on the horizon. North Korea stepped up its testing while launching a missile over Japan. Furthermore, it has threatened to test a massively powerful hydrogen bomb in the Pacific Ocean. Such a test, if conducted, will certainly further roil international relations and increases the risk of an uncontrolled disaster. China is trying to assume a peacemaker role in the North Korean nuclear crisis. However, it has had little success thus far in slowing North Korea's nuclear program, and grapples with its own issues of rapidly increasing debt ahead of its one-every-five-years leadership conference of the Chinese Communist Party in mid-October. A meaningful risk closer to home is the unfolding slow motion train wreck of the retail sector which may ultimately tip the economy into recession. We think it's a while away, but it is a story we are watching closely. Thousands of retail stores, such as those operated by RadioShack, Payless, Gymboree, Sears, Kmart, Macy's, JC Penney, Abercrombie & Fitch, Staples, and many others, have closed in 2017 alone – in some cases these firms have disappeared permanently. Are we watching the Darwinian equivalent of survival of the fittest playing out in the retail industry, or a structural shift in behavior, where changes in millennial spending patterns and Amazon's lean, automated, low-cost, business model have permanently altered the retail landscape? Time will tell, but the current impact on conventional retailers is not good and may ultimately prove fatal for many.

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