Economic and Market Overview

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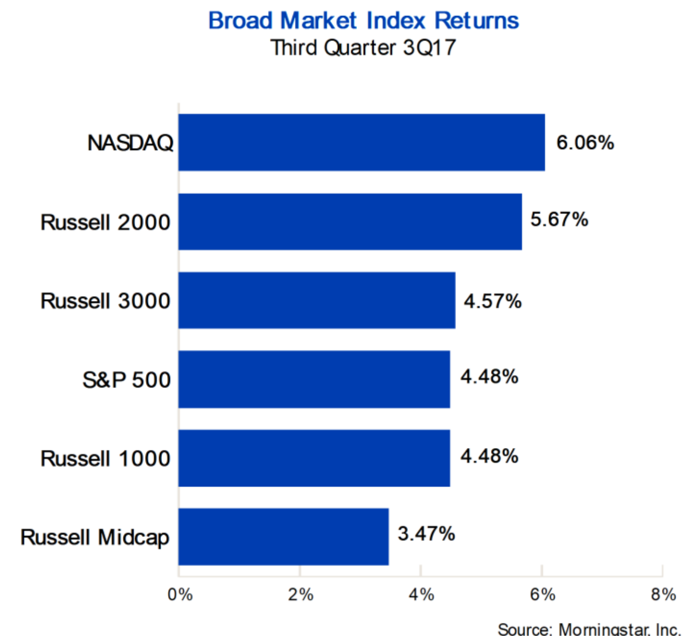
The Economy

The US economy continues on a solid growth trajectory, despite the negative short-term impacts of Hurricanes Harvey and Irma, the continued uncertainty over various policy initiatives in Congress, and the nuclear brinksmanship with North Korea. The Bureau of Economic Analysis reported its third estimate of second quarter 2017 gross domestic product (GDP) of +3.1%, up slightly from the prior estimate, and also higher than the first quarter's +1.2% reading. The employment situation improved over the prior quarter, with an average of approximately 185,000 jobs added each month. At the same time, the unemployment rate ticked up to 4.4%. The Federal Open Market Committee (FOMC) kept its interest rate policy unchanged, with a fed funds rate target range of 1.00% - 1.25%. However, the FOMC announced that it would begin the process of normalizing its balance sheet in October by not replacing maturing securities.



The global economic environment is picking up steam, as many regions of the world are experiencing accelerating growth. The Eurozone economy grew at a 2.2% annual rate in the second quarter, which follows a strong showing in the first quarter. A surge in exports was the primary driver of the region's growth. Asian economies have experienced mixed results, with China producing adequate growth, but emerging economies in the region not faring as well. Economists are forecasting that China should generate 6.7% GDP growth for 2017. Latin American economies such as Brazil and Peru are beginning to accelerate, and inflation remains under control.

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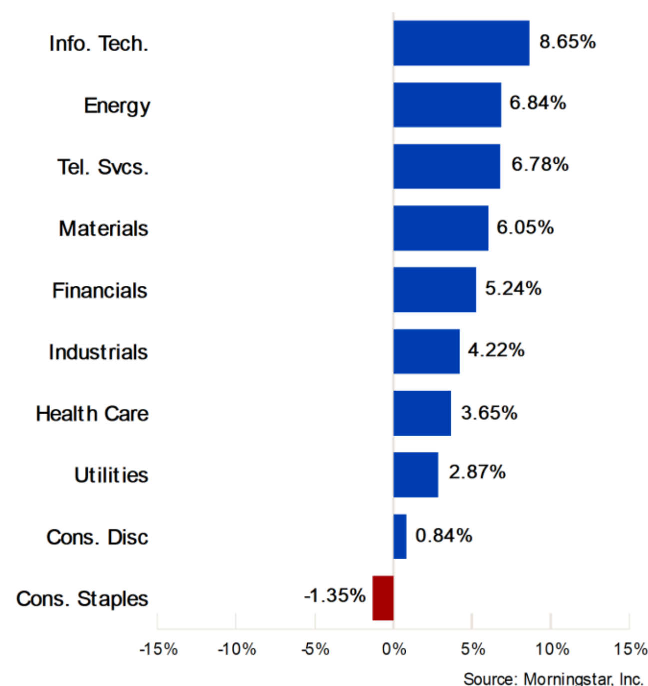
Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the second-quarter 2017 real GDP, a seasonally adjusted annualized rate of +3.1%, up from the first quarter's +1.2% annualized growth, and also up slightly from the +3.0% prior estimate. Economists were buoyed by the results, which demonstrate the economy continues to post steady, albeit unremarkable, growth. Consumer spending was a key driver of growth during the quarter, and fixed investment and trade also contributed positively. Inflation remained in check in the quarter, with the personal consumption expenditures (PCE) index of prices rising +0.3%, following a +2.2% advance in the prior quarter. Corporate profits rose +0.7% (not annualized) during the quarter. Economists generally believe the current growth trend for the remainder of this year and next, despite a possible short-term hurricane-related setback.



HOUSING

The housing segment, while slowing somewhat, continues to produce gains strong enough to cause analysts to maintain a cautiously optimistic outlook. Existing home sales for August (the latest monthly data available) grew at an annualized rate of 5.4 million units, a decrease of about -1.7% from the 5.44 million-unit-rate reached in July, and down -4.8% from May 2017. The inventory of existing homes was slightly more than four months of supply, down modestly from year-ago levels. Existing home prices in August were down -8.8% from July, and have dropped -5.6% from August 2016. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 64, below the level of both the prior month and the level in May. Economists point out that the slowdown is in part due to Hurricanes Harvey and Irma, and the housing segment should accelerate once rebuilding begins in earnest.

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EMPLOYMENT

The employment situation eased somewhat in August from the prior two months' solid growth. Employers added 156,000 jobs during the month, below the consensus expectations of 185,000 new jobs, and also falling short of the prior month's gain of 189,000. Despite the drop in August, the three-month moving average rose slightly, coming in at 185,000. The unemployment rate in August was 4.4%, a slight increase from the prior month. Average hourly earnings increased by a modest +0.1% in August, and have risen +2.5% in the past 12 months. Economists expect a continuation of steady job growth increases, perhaps with an interruption resulting from the effects of the hurricanes.

FEDERAL RESERVE POLICY

The FOMC ended its recent September meeting by announcing, in a widely expected move, that it would be moving from a posture of quantitative easing to one of quantitative tightening. The process of reducing its balance sheet will begin in October, with a cap on maturing Treasurys rolling off the balance sheet initially set at $6 billion per month, and the cap on mortgage securities set at $4 billion per month. The Committee kept interest rate policy unchanged, with the federal funds rate target range remaining at 1.00% - 1.25%. In its statement, the Committee indicated that the hurricanes would cause some short-term slowing of activity, but should have little or no impact over the intermediate term. Inflation is expected to hover around the FOMC's equilibrium target of 2%.

INTEREST RATES

Fixed income securities' prices continued to be affected by several important factors, including the FOMC's widely anticipated decision to begin reducing its balance sheet; a steadily improving economy; rising stock prices; the threat on the Korean peninsula; and an environment of partisan bickering in Washington. Although the FOMC left its interest rate policy unchanged this quarter, it did announce that it would begin the process of unwinding its balance sheet in October. Because the move has been widely anticipated, the formal announcement ultimately had little impact on bond prices. Even though there was some volatility in prices within the quarter, prices and yields ended September at approximately the same levels as in June.

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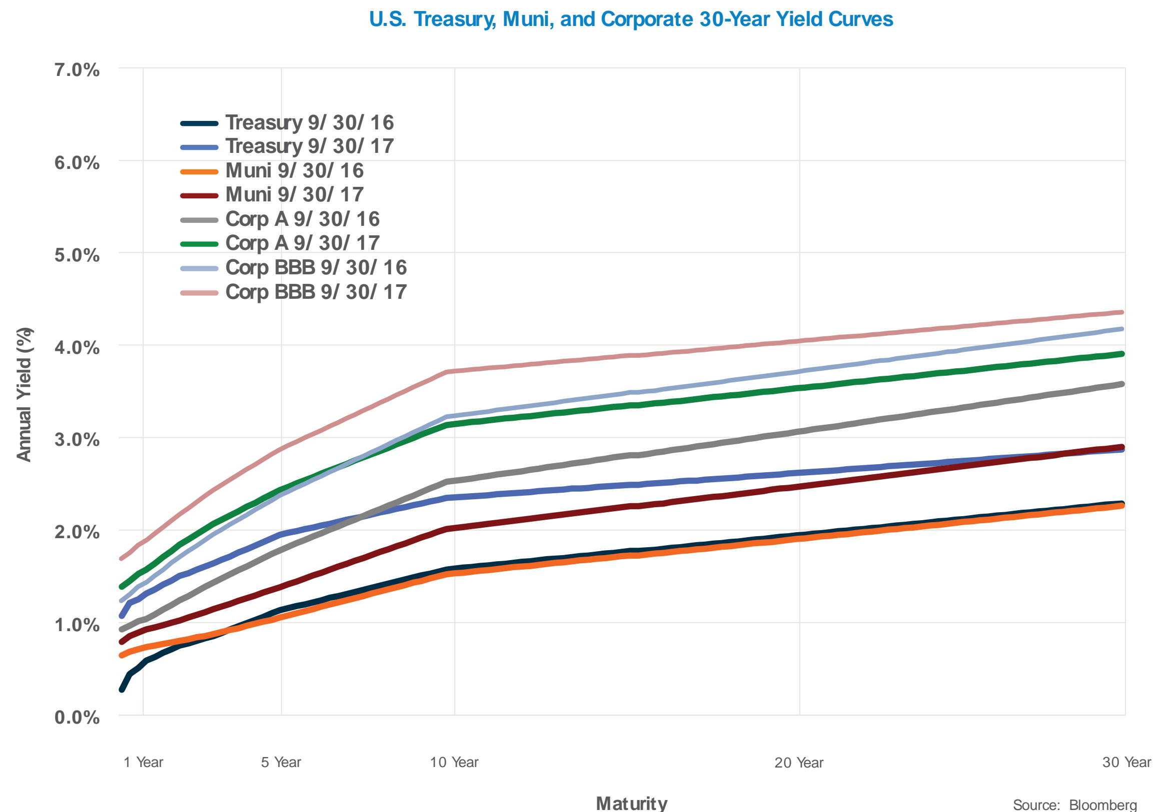

The shape of the Treasury yield curve flattened modestly in the quarter, but on balance was little changed. Yields on short- to intermediate-term maturities edged slightly higher, while those on long-term issues were substantially unchanged. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury Note was marginally higher, ending the quarter at 2.33%, compared to 2.31% on June 30.

As with the previous quarter, while there was some volatility in yields surrounding the back-and-forth with North Korea, yield changes during the quarter were minimal, as the yield on the 10-year Treasury Note traded within a 33-basis-point range. In addition to the situation surrounding North Korea, other factors contributing to the yield changes were the FOMC’s decision to move ahead with reducing the size of its balance sheet and the expectation for Congress to enact some form of tax reform.

As mentioned above, yields at the shortest end of the yield curve (up to one year) were generally about three to ten basis points higher than in June, whereas those on the longer end were essentially unchanged. The yield on the 3-month Treasury Bill settled at 1.05% at the end of the quarter, up about four basis points from the end of the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 1.94%, compared to 1.89% on June 30, and as mentioned above, the yield on the 10-year Treasury Note inched up to 2.33% from 2.31% over the same period. At the same time, the yield on the 30-year Treasury Bond was a touch higher, ending the period at 2.86%, compared to its beginning level of 2.84%. Inflation expectations inched higher, with the Fed's gauge of five-year forward inflation expectations rising slightly from its 1.75% level of June 30.

Fixed income securities delivered positive total returns in most market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index gained +0.5% for the quarter, and is up +2.4% year-to-date. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index advanced +1.4% during the three months. High yield securities, which often follow the performance of equities, posted a gain of +2.0%; the asset class has gained +7.0% on a year-to-date basis. Municipals were also positive, as the Bloomberg Barclays Municipal Bond Index rose by +1.1% during the quarter. Prices of non-US fixed income securities generated sharp gains in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index advanced +2.5%. Emerging markets bonds continued to benefit from improving global economic conditions, with the JPM EMBI Global Index rising +2.4%.

EQUITIES

Equity markets also continued their march higher in the quarter, tacking on to the strong returns of the past 11 months since the presidential election. Continuing to drive returns during the quarter were steadily improving economic data, accelerating corporate profitability, and anticipation of a tax reform package that would include material tax cuts. These factors contributed to the ongoing low volatility financial market landscape, with the Chicago Board Options Exchange Volatility Index—better known as VIX—remaining at historically low levels. Within this context, the S&P 500 Index finished the quarter with a gain of +4.5%. The index is now up +14.2% year-to-date.

The ten primary economic sectors each generated positive returns, with only one exception. Information Technology, Energy, and Telecommunications Services were the strongest performers, generating gains of +8.7%, +6.8%, and +6.8%, respectively. The Consumer Staples, Consumer Discretionary, and Utilities sectors were the poorest relative performers, posting returns of -1.4%, +0.8%, and +2.9%, respectively.

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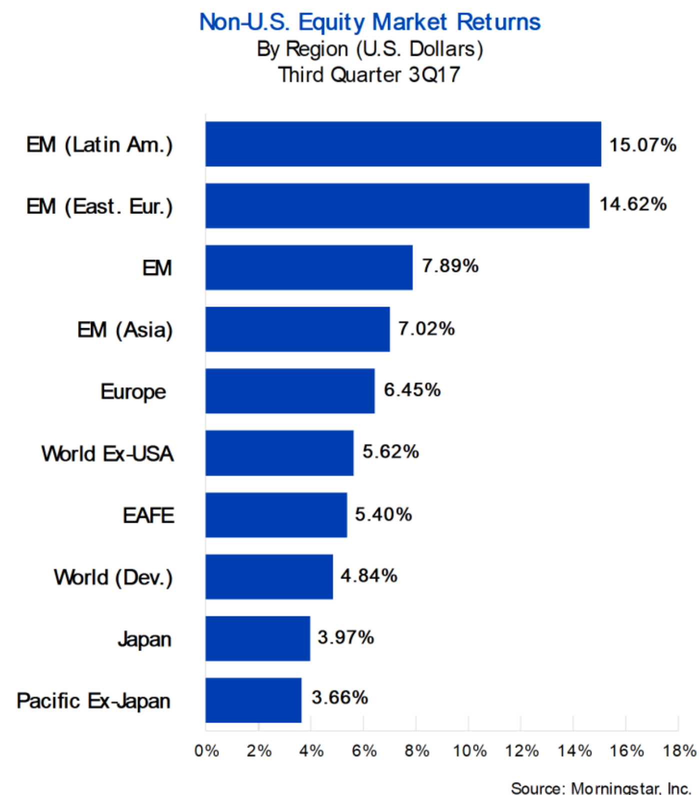
The Russell 1000 Index of large capitalization stocks generated a +4.5% total return, and is up +14.2% on a year-to-date basis. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps, finishing the quarter with a total return of +5.7%. Small cap growth outperformed small cap value, with the outperformance now amounting to more than 1000 basis points year-to-date. The Nasdaq Composite, dominated by information technology stocks, finished the quarter with a gain of +6.1%, and is now up +21.7% in 2017. The Dow Jones Industrial Average of 30 large industrial companies advanced +5.6%.



Real Estate Investment Trusts (REITs) were little changed during the quarter, with the DJ US Select REIT Index gaining +0.4%. Commodities rebounded, with the Bloomberg Commodity Index gaining +2.5%.

International stocks performed in line with US equities, on balance. European economies continued their resurgence, after several years of sub-par results. In addition, China's growth has held steady, even as the country goes through a process of structural reforms. With that as a backdrop, international stock indices were almost universally higher. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the US, gained +6.2%. The MSCI EAFE Index of developed markets stocks advanced +5.4%, and is now up +20.0% in 2017. Regional performance was also strongly positive. Latin America was the strongest performer on a relative basis, with the MSCI EM Latin America Index posting a return of +15.1%. Eastern Europe and China also delivered outsize returns, with gains of +14.6% and +14.7%, respectively. Japan was the poorest performer on a relative basis, but still delivered a +4.0% return. Emerging markets performance continued to be solid, as the MSCI Emerging Markets Index jumped +7.9%, and is now up +27.8% year-to-date.

Outlook

Despite bitter divisions in Washington, flashpoints in North Korea and Iran, and a devastating hurricane season, the US economy continues to churn ahead. It remains the third-longest economic expansion on record, and the consensus among economists is that there is little on the horizon to indicate its steady path will face obstacles in the near term. Expectations for tax reform are high, and rising corporate profitability is providing justification for record stock prices. Interest rates remain low, inflation continues to be benign, and the subdued market reaction to the FOMC's initiation of balance sheet normalization have combined to create a low volatility environment. Unlike the past several years, the global environment is now contributing positively, with the Eurozone picking up steam, and other regions enjoying a positive outlook. In spite of the seeming "Goldilocks" environment, risks do remain. As mentioned last quarter, with the market at all-time highs, volatility at historic lows, and valuations extended (at least in the eyes of some market analysts), stock prices could be susceptible to an unforeseen outcome, either on the policy side or on the earnings front. In addition, if tensions with North Korea go beyond mere rhetoric, volatility is likely to spike, and stock prices may suffer a setback. But on balance, investors have reason to be cautiously optimistic.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization-index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across four Emerging Markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the Index are weighted according to the market size of each bond type. Most US-traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The Index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between five and ten years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes treasury bonds issued by the US with a time to maturity of at least five years, but no more than seven years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1000 largest US companies in the Russell 3000 Index (which comprises the 3,000 largest US companies). The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market, and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members, designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for external debt instruments traded in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **Federal Funds Rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB’s main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards individuals and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor’s and MSCI Barra.