Quarterly Outlook

OCTOBER 2017

Third Quarter 2017

2017 has thus far been characterized by historically low levels of volatility and an almost uncanny level of market resiliency. Despite increased geopolitical and domestic political anxiety, rising interest rates, and other factors, the S&P 500 advanced 4.48% in the third quarter to bring its year-to-date total return to 14.24%. As has been the case throughout the year, Q3 market performance was supported by US dollar depreciation, solid earnings reports, and low unemployment. Information Technology once again topped the list of the best performing sectors in the quarter, posting a total return of 8.65% (27.36% year to date). Only the Consumer Staples sector failed to post positive returns, sliding -1.35% in Q3. This comes as little surprise, since Consumer Staples stocks tend to perform better in times of higher volatility.

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The strength of the ongoing economic recovery in the US was evidenced by a number of positive data points released throughout the quarter. Open jobs hit a record 6.2 million, while manufacturing and service sector activity reached 13 and 12-year highs, respectively. Second-quarter GDP growth was upwardly revised to 3.1% (the highest figure in over two years), while the Atlanta Fed initially forecast third-quarter GDP growth of 4%. This estimate will undoubtedly undergo future revisions, but it is safe to say that the sluggishness seen in the first quarter did not continue. As a result, consumer confidence continues to hover around peak levels.

As expected, the Fed did not increase rates any further at the September FOMC meeting. It did, however, announce its plan to begin slowly winding down its almost $4.5 trillion balance sheet of treasury securities and agency and mortgage-backed securities. Markets reacted to these comments with a brief intra-day dip before regaining ground and ultimately rallying before the close. Most members of the FOMC appear to favor at least one more interest rate increase in 2017, with the implied probability of a December rate hike recently climbing to over 90% in response to increases in wage growth.

Fixed income markets have performed respectably year to date despite two short-term interest rate increases by the Fed. Bonds posted positive returns across major categories, with the highest returns coming from riskier classes such as high-yield and emerging-market bonds. This performance is tied to low inflation, since bonds are generally more sensitive to changes in growth and inflation than interest rates.

International stocks also continued to advance in the quarter. The Morgan Stanley Emerging Markets Index grew 24.36%, while the Developed Markets Index added 16.59% as of 9/29/2017 (price return). International stocks have outperformed domestic equities throughout 2017, as the correlation between the world's stock markets returned to the levels which characterized the 1970s, 80s, and 90s. This is great news for investors holding properly diversified portfolios.

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Going Forward: Tandem's Outlook

The last quarter of the year tends to be the most active, and Q4 2017 should be no different. Further, December and November have historically been the second and third best-performing months for US stocks, respectively. In the short term, positive economic data and solid corporate earnings should be enough to keep the bull market alive. However, an increase in volatility is never off the table.

Looking a bit further out, the Fed will continue to slowly raise interest rates while slowly winding down its balance sheet in anticipation of higher inflation due to wage pressures. These actions must be implemented judiciously, as an overly aggressive approach could spell trouble for stocks in 2018.

An additional driver for market performance is the potential for tax reform. According to recent proposals, the GOP may seek to decrease the corporate tax rate from 35% to 20%; however, the likelihood of this actually coming to fruition is unclear given the lack of traction on most of the current administration's pro-growth policy proposals as well as ongoing political rifts and divisions.

Looking abroad, we see growth potential in some European countries, however, given the European Central Bank's continued quantitative easing program, future growth is not self-evident. The Asia-Pacific region is another area of interest, but a potential conflict with North Korea could disrupt commodity markets and trade throughout the region. The nearly 4% year-to-date decline in the Bloomberg Commodity Index suggests that such a conflict may already be priced into the markets.

Tandem continues to apply an informed, disciplined approach to managing portfolios while encouraging clients to focus on their long-term goals and objectives with regard to investing.

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