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# THIRD QUARTER 2017 ECONOMIC AND FINANCIAL MARKETS REVIEW

After steady stock market appreciation during the first half of this year, volatility increased during the third quarter as investors became increasingly concerned about political, monetary, and foreign policy issues. Promises from the Trump administration of health care reform, income tax cuts, and infrastructure spending, have not yet materialized. There is also growing concern that the Federal Reserve Board will continue raising interest rates and discontinue their bond-buying program that has been very favorable for stocks since the financial crisis. Finally, heightened hostilities with North Korea have created anxiety for investors. Despite this recent increase in volatility, the S&P 500 Index still ended the third quarter up 12.5% year-to-date, while the Dow Jones Industrial Average gained 13.4%. As expected, bonds have not performed as well as stocks so far this year; the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index was up 2.34% year-to-date as of September 30, 2017. *

One of the main reasons that the dysfunction in Washington, a less accommodative Federal Reserve, and geopolitical tensions have not yet resulted in a broad stock market decline is that corporate profits remain strong. Regardless of short-term news events or interest rate movements, stock prices typically appreciate when corporate earnings are growing faster than expected. Corporate earnings have been growing this year because the U.S. economy has been strengthening. For example, the U.S. economy expanded at a 3.1% annual rate in the second quarter this year, which is the highest rate in the past two years. Although this growth rate is not extraordinary, the job market remains relatively strong, consumer confidence remains high, and measures of manufacturing and service sector strength remain positive. Although recent catastrophic weather conditions are negatively impacting the economy in the short-term, rebuilding from the recent hurricanes could create increased economic activity in future months.

In addition to consistent U.S. economic growth, economic conditions overseas appear to be improving as well. Economic growth rates in emerging markets have stabilized, and the European and Japanese economies are growing faster than at this time last year. This global economic recovery particularly benefits U.S. corporations that generate a significant portion of their revenue in foreign countries.

Another reason U.S. corporate profits have remained resilient is because the U.S. dollar has been weakening this year. When the dollar weakens, U.S. exports typically grow because U.S. goods appear less expensive to foreign buyers. Also, when U.S. corporations translate their overseas revenues derived in stronger foreign currencies back to weaker U.S. dollars, they obtain more dollars, thereby benefiting from foreign currency exchange rates.

Despite price gains for many stocks so far this year, stocks in several industries have not participated in this year's market gains. For example, many energy stocks have been harmed by low energy prices, most retail stocks have been under pressure, and financial and telecommunication stocks have generally underperformed. In order to feel confident that the current bull market in stocks will continue, we would like to see prices of stocks in industries that have lagged lately begin to strengthen.

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As long as the Fed remains patient and does not raise short-term interest rates too aggressively, bond prices should remain stable. However, if inflation becomes problematic or the U.S. loses its creditworthiness, long-term interest rates could rise swiftly, which would result in declining bond prices. Over the last twenty years, "bubbles" have formed in the stock market, real estate market, and the commodities market and these bubbles have all burst, leading to significantly lower prices. The only major asset class that has not yet seen a major decline after a very long period of rising prices has been bonds. We will continue to monitor the bond markets closely going forward because a significant decline in bond prices could lead to instability in the economy and other financial markets. We continue to favor short-term bonds because they tend to be more stable than long-term bonds during a general bond-market decline.

As always, we will continue to monitor economic, interest-rate, and financial market conditions. In the meantime, please contact us if you have any questions or concerns regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays Indices on September 30, 2017.*

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