Economic & Market Overview

as of September 30, 2017

Stock market returns for the third quarter of 2017 were positive thanks to good earnings reports from corporations and the prospect of even higher earnings going forward. Bond prices ended the quarter fairly close to where they began the quarter – in the aggregate – which means interest income made up most of the bond market's third quarter return. Lower quality and longer maturity bonds did best, particularly corporate bonds.

Economic growth here and abroad is firm by the standard of this recovery and may even be set to accelerate. Unlike a few years ago, most countries now seem to be doing better, even laggards like Greece and Brazil. A broader economic recovery has been good for earnings. Ordinarily in this environment, interest rates would be rising to higher levels. However, the European, Swiss, and Japanese central banks to name three have been aggressively buying fixed income securities and have thus held interest rates at unusually low levels. This combination of earnings growth and low interest rates is favorable for asset prices, so stock, bond, residential real estate, and commercial real estate prices are elevated and likely to remain high until there is a material increase in interest rates or a fall in corporate earnings or some combination of the two.

While earnings are growing at a good pace, the quality of earnings is deteriorating. The S&P 500's average tax rate has fallen from 26.4 percent in 2016 to 21.3 percent in the second quarter of 2017, per Yardeni Research. Additionally, the gap between earnings reported according to generally accepted accounting principles and operating earnings, which exclude items considered to be onetime events, has grown to over $10 for the S&P 500. This is unusually wide, particularly at this stage of the economic cycle. Corporate debt has also risen to record levels. Earnings based on tax strategies, accounting techniques, and borrowing are not generally sustainable. We spend time and effort trying to make sure we are investing in real earnings progress.

The consensus outlook for the fourth quarter and 2018 is for continued but slowing earnings growth accompanied by modestly higher interest rates. This causes pundits to estimate the stock market will continue to advance but at a slower pace. While there are a number of things that could go wrong, we believe this modestly positive outlook seems reasonable. The portfolios are diversified, liquid, and flexible enough to allow us to respond to any opportunities we identify.