The Trudge Forward Continues

The stock market continued its winning ways in the third quarter with the S&P 500 clocking in at 4.5%. Small capitalization (cap) stocks had lagged large caps in the first half of the year but rose by a stellar 5.7%. Small caps are seen as the prime beneficiaries of tax reform and therefore got a boost late in the quarter as the market began to anticipate real progress on this initiative in Congress. For most of the year international stocks have led the way and they had another solid quarter gaining 5.6%.

The conundrum for stock market observers continues to be the **absence of volatility**. According to an analysis by The Wall Street Journal's Market Data Group, the S&P 500 had its least volatile September in 66 years. The change between the indices' closing high and closing low for the month was just 2.1%, the smallest since 1951. U.S. stocks usually undergo a 5% decline about four or five times a year, but there has not been a hint of one since early 2016. In fact, with one quarter to go, the S&P 500 has moved 1% or more in either direction on just eight occasions. These are truly remarkable statistics.

Adding to the mystery is that there are **plenty of reasons for the market to be nervous**. While not outrageous valuations are not low at a time when most central banks around the world are starting to normalize monetary policy after years of extraordinary measures. Interest rates are ticking up and balance sheets are expected to shrink in the coming years. Even multiple terror events and the recent nuclear saber-rattling between Trump and North Korea are met with indifference.

What is clear is that the positives are overwhelming the negatives giving investors historically low volatility and solid returns. **Accelerating global growth, robust corporate earnings, and investor skepticism are the fuel for higher stock prices. Manufacturing, consumer confidence and the job market are booming both here and in Europe. In the U.S., the ISM Manufacturing Index ticked up above 60, for its highest reading since 2004** (the ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries). The European economy has grown at its fastest rate since the eruption of the debt crisis six years ago. Even Japan is looking healthy. The Japanese economy had its sixth consecutive quarter of growth, the longest unbroken streak in more than a decade.

The strong global economy has bolstered corporate earnings but investors are wary. Just 29.3% of individual investors say they are bullish on stocks for the next six months, according to a recent American Association of Individual Investor's sentiment survey. Historically, 38.3% have rated themselves bullish on stocks, according to AAII. The stock market rarely corrects when earnings are strong and investors are cautious.

As we've commented on several times this year for most of the long bull market and for this year Growth stocks has trounced Value stocks**. However, early in September Value stocks started to outperform in a meaningful manner.** We hope this is a start of a definitive trend as we have tilted the portfolios toward Value. The bottom line is the path of least resistance for stocks appears to be higher, and we will wait for either unreasonably high valuations or a pick-up in volatility before we go to a defensive posture in the portfolios.

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OUTSIDE COMMENTARY

Blackstone Market Commentary

Byron Wein

Low Volatility is here to Stay (Excerpt)

October 2017 (Excerpt)

….. but I believe we could continue on a positive course for both the economy and the market for several more years.

The principal reason for this conclusion is that the usual factors that warn of a bear market or recession are not evident. What would really worry me would be an inverted yield curve, but there is now almost an eighty-basis point spread between the two-year Treasury and the ten-year. I would also be concerned if retail investors were euphoric about equites as they were in 1999 or 2007. They are generally optimistic, but not excessively so, although earlier this year sentiment did rise to a worrisome level. Investors large and small are also leaning toward the defensive. Hedge fund net exposure clearly shows a mood of caution: it is just under 50% now; it was mostly 55%–60% in the 2000–2008 period. Individuals are still buying bond funds even at these low yields because of their lack of confidence in the stock market. Institutions, in their desperate search for yield, have bid up the price of lower-quality bonds to the point where their spread with Treasurys is historically low. Warnings of trouble ahead, however, would usually be associated with high spreads. Maybe investors are too complacent, but not this may not be the case if the economy continues to grow.

Strong business activity exists not only in the United States, but throughout the world: Europe should grow at close to 2% this year; so will Japan. The rates for China, and India will be close to 7%. The U.S. will benefit from continued strength in these key areas.