MILES Capital

Third Quarter 2017

Economic Commentary

The economy continues to grow at a steady pace with indicators across the board showing strength. The market continues to create jobs at a rate that is sufficient to drive down the unemployment rate while first time unemployment claims are at historical lows, and a surprisingly high share of those jobs have come from the manufacturing sector. In addition, various measures of the manufacturing sector continue to show increased optimism about the current environment as well as future expectations.

The Federal Reserve met twice during the third quarter and elected not to raise rates at either meeting but rather began the implementation of the balance sheet normalization process. Beginning in October, the Fed will begin to taper the reinvestment of its $4.5 trillion balance sheet by reducing its reinvestment of principal and interest payments generated by the portfolio. Initially, the Fed will taper at a rate of $10 billion per month and anticipates increasing that figure by $10 billion per quarter until a pace of $50 billion is reached. At the September meeting, a current dot plot was also released which continues to project one additional rate increase in 2017 and three additional rate increases in 2018. Market expectations are for a more modest trajectory, primarily due to inflation readings that have been consistently lower than the Fed's 2 percent target. The Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) have shown diverging trends with CPI climbing throughout the summer and reaching 1.9 percent while PCE has remained stagnant at 1.4 percent.

As we exit the summer selling season, supply within the housing sectors continued to lead to home price gains as the Case-Schiller national home price index reached a new record high in July, the last month for which data is available. While existing home sales have felt the supply constraint, building permits continue to improve and grew each month during the third quarter. A combination of tighter lending standards, high land costs and elevated levels of student loan debt are making it particularly difficult for first time homebuyers to enter the market, leading to additional pent up longer-term demand.

The final estimate of U.S. GDP growth for the second quarter was revised up to 3.1. Nonresidential fixed investment, exports, federal government spending, and private inventory investments were positive contributors but were partially offset by detractions in residential fixed investment and state/local government spending. Imports also increased during the month which reduce GDP. We anticipate some noise will be created in the coming quarter due to the impacts of Hurricanes Harvey and Irma; natural disasters tend to adversely affect GDP in the quarter immediately following the disaster but then rebounds in subsequent quarters as recovery efforts get underway. Corporate revenues and earnings both extended their growth trajectory, increasing by 5.3 and 9.7 percent, respectively.

Fixed Income Commentary

Investors were presented with a number of unique events during the third quarter which lead to some market volatility. Hurricanes in Texas, Florida, and the Caribbean Islands, on and off policy and politics from Washington DC, and geopolitical risk (e.g. North Korea) all could have sent the markets lower. However, after the dust settled, equities were setting new highs and most sectors within the fixed income markets ended the quarter at recent highs.

Interest rates, as measured by the 10-year U.S. Treasury rate, set year-to-date lows intra-quarter only to rebound in September to finish at 2.33 percent, close to where they started the third quarter. Short term interest rates, as measured by the 2-year Treasury yield, have been moving higher as the U.S. Federal Reserve increased rates three time in the past year and looks poised to raise a fourth time in December.

Sideways interest rates and tighter spreads (lower risk premiums) lead to another solid quarter for the fixed income markets. The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. fixed income markets, returned 0.85 percent for the quarter and is up 3.14 percent for the year. Spread sectors, including corporate bonds, mortgage backed securities, and municipal bonds all outperformed U.S. Treasury securities for the quarter as investors shrugged off external events and focused on positive signs from U.S. and global economies. Corporate bonds performed exceptionally well with strong investor demand on the tail of solid corporate earnings.

Within the corporate sector, financials and industrials outperformed while consumer/retail and communication sectors lagged. Especially strong were energy and commodity companies and banks given the rebound in commodity prices and interest rates respectively. Lower quality outperformed higher quality and longer maturities outperformed shorter bonds. Municipals also performed well for the quarter even with the uncertainty created from the multiple hurricanes that hit the U.S. While the human and local business toll was extensive, the long term impact to most of the municipalities has been fairly muted as was the municipal market reaction. The Texas and Florida hurricanes should not end up being a major credit event for most municipalities operating in those areas.

While valuations appear a bit stretched in many fixed income sectors we can make a case for them to get even tighter as the U.S. and global economics become more in sync and growing together. We expect interest rates to gradually move higher as the Federal Reserve raises rates and the economy stays on solid footing in the coming quarters which should put downward pressure on absolute returns in the fixed income market.

Equity Commentary

For the third quarter of 2017, the S&P 500 returned 4.5 percent. We have now had eight quarters in a row of positive returns. Stronger and more consistent economic data and positive earnings growth during the quarter drove equity market returns.

The earnings rebound continued during the second quarter, with the S&P 500 now having four consecutive quarters of earnings growth. Energy was the only sector to report negative earnings. Year over year, expectations are that earnings growth will be better than 10 percent, although projections for third quarter growth are just over 4 percent.

Expectations are for the Federal Reserve to raise rates one more time in 2017. U.S. equities historically have been resilient to rising interest rates, so we continue to favor high quality stocks – stocks of companies with strong earnings, cash flow, and balance sheets. We prefer multiple potential sources of total return, including dividends, long term appreciation, or both.

Similar to the U.S., in Europe, economic fundamentals have grown in importance relative to the political stories. The MSCI EAFE outperformed the S&P 500 during the quarter (5.4 vs. 4.5 percent). Eurozone consumer confidence remains high. Valuations and dividend yields remain favorable vs. U.S. stocks.

For the third quarter, the MSCI Emerging Markets index returned about 7.9 percent. Similar to both the U.S. and developed markets, emerging markets are benefiting from improving fundamentals as well as from the "reflation trade" in developed markets. The weaker U.S. dollar provided a tailwind for non-U.S. equities.

Volatility in the third quarter, as measured by VIX, experienced some higher spikes but finished the quarter lower overall. Although North Korea tensions, hurricanes, and central banks led the headlines, positive economic news abounded. VIX has stayed significantly below the post-crisis average of 18. We continue to remain cautiously optimistic for equity returns due to firming equity fundamentals, and we are also aware of elevated valuations and remain vigilant in our stock selection.