Asset Strategy Consultants

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We are pleased to present Market Review, featuring a discussion of the Capital Markets during the Third Quarter 2017 and a summary of historical performance for the major asset style passive indices for the period ending September 30, 2017. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Asset Strategy Consultants

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing over $8.2 billion under advisement. Headquartered in Baltimore, ASC has offices throughout the East Coast.

Third Quarter 2017

Market Review

MACROECONOMIC ENVIRONMENT

Last quarter, we wrote about the Goldilocks environment ("Not too hot, not too cold, but just right") and investor complacency keeping volatility at multi-decade lows and propelling stock markets to new highs. The third quarter followed suit in spite of escalating tensions with North Korea, several severe natural disasters and uncertainty around the prospects for tax reform and other domestic agenda items.

In spite of these challenges and questionable valuations, the S&P 500, Russell 2000 and Nasdaq all hit record highs on the final trading day of the quarter. It was the Nasdaq's 50th record close this year. Non-U.S. stocks also posted solid single-digit returns, bolstered by improving economies as well as a weakening U.S. dollar. The risk-on environment continued, and emerging markets equity and debt posted the strongest returns within their respective asset classes. Commodity indices also rose as crude oil prices surged nearly 20% after falling during the first half of the year. All major asset classes delivered positive results in the third quarter, and even cash is up from its dismal 0% days and posted a 0.3% quarterly result.

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In the U.S., second quarter real GDP growth was revised up to 3.1% (annualized), the fastest pace since the first quarter of 2015. While hurricanes Harvey and Irma may provide a temporary setback to U.S. growth, rebuilding efforts are likely to provide a boost to GDP in the fourth quarter and into 2018. And in a relatively new development, the Institute for Supply Management (ISM) manufacturing index is showing signs of strength. In August, the Index hit 58.8 (anything above 50 signals expansion). The September reading, released in early October, rose to 60.8 with both its employment and new orders components signaling broad-based strength. This marked the highest level in thirteen years. Unemployment ticked up slightly in August to 4.4%, but labor conditions remain tight. Inflation continues to fall short of the Fed's 2% target, puzzling many. Headline CPI was 1.9% as of August (year-over-year) while Core was 1.7%. Both were unchanged from levels three months ago. The Fed's favored measure, the PCE price deflator, gained 1.4% year-over-year (also unchanged). The Fed left rates unchanged at its September meeting, but 12 of the 16 FOMC members expect one more hike this year and markets put that probability at about 70%. The Fed also announced that its previously communicated plan to reduce the size of its balance sheet would begin in October of this year. It will reduce reinvestment of its holdings by $10 billion per month, increasing this amount gradually each quarter to $50 billion per month at the end of 2018. In other Fed news, Vice Chairman Stanley Fischer resigned for ''personal reasons," leaving a fourth vacancy on the Fed's governing board. Further, Janet Yellin's term as chair expires in February, 2018 with no clear replacement as of yet.

Also noteworthy was Catalonia's overwhelming vote for independence from Spain as the quarter ended. The outcome remains uncertain but is a reminder that the cohesion of the European Union continues to face challenges.

Non-U.S. developed economies continued to gain traction. Second quarter GDP growth in the euro zone was 2.3% (year-over-year) with consumer confidence and demand both showing strength. The European Central Bank's Governing Council left monetary policy unchanged, but Bank President Mario Draghi indicated that decisions around the timing of a tapering program would be made in October. The euro gained ground versus the U.S. dollar and the pound continued to strengthen on hawkish comments from the Bank of England. German Chancellor Angela Merkel's party won an impressive fourth term but was her victory was tarnished by the showing of the right-wing nationalist party. The "AfD" attracted 13% of voters, marking the first entry of a far-right party into Parliament in more than 60 years. Also noteworthy was Catalonia's overwhelming vote for independence from Spain as the quarter ended. The outcome remains uncertain but is a reminder that the cohesion of the European Union continues to face challenges. Outside of Europe, Japan's economy continued to slowly recover; second quarter GDP growth was 2.5% (annualized). While this was lower than expected, the economy has now expanded for six consecutive quarters. In China, economic news has generally been positive but the country was downgraded to A+ by S&P, which cited growing concerns over credit growth. ■

EQUITY MARKET RESULTS

The S&P 500 Index gained 4.5% in the third quarter and is up 14.2% for the year. Several U.S. stock market indices hit record highs going into quarter-end as investors shrugged off bad news and pinned their hopes on meaningful tax reform. Small caps outperformed large caps across styles for the quarter, but trail on a year-to-date basis. Growth outperformed value for the quarter and year-to-date, growth has outperformed value by more than 10 percentage points across the cap spectrum. Technology, namely a handful of stocks, continued to fuel the growth indices' returns, especially in the large cap space (see below). The "FAAMG" stocks have an average return of 31% year-to-date and have contributed 7.3% of the 20.7% year-to-date return for the Russell 1000 Growth Index. Technology stocks now comprise 23% of the S&P 500 Index and 38% of the Russell Growth Index. Along with Technology (+8.6%), Energy (+6.8%) and Telecommunications (+6.8%) were strong sectors. Consumer Staples (-1.3%) was the sole sector to deliver a negative result for the third quarter.

Overseas, the MSCI EAFE Index (+5.4%) outperformed U.S. market in the third quarter and its year-to-date return is a lofty 20.0%. Gains were broad-based with several countries (Austria, Portugal, Italy, and Norway) posting double-digit returns. The U.S. dollar continued to weaken, down 3-4% versus the euro, Canadian dollar, and the U.K. pound. Within the MSCI EAFE, Europe ex-U.K. was up 6.9%, the U.K gained 5.2%, and Japan returned +4.0%. From a sector perspective, Energy and Materials posted double-digit gains while Health Care and Consumer Staples were laggards with results of less than 1%. Emerging markets modestly outperformed developed (MSCI EM USD: +7.9%) and the Index is up an impressive 28% year-to-date. Emerging Asia continued to be the key driver (as was the case in the first and second quarters) with China (+14.7%) taking the lead. The only emerging markets country to deliver a negative return was Greece (-12.1%). Elsewhere, Russia and Brazil (+17.6% and +22.9%) both posted sharp gains as their economies improved, reversing second quarter declines. India, where second quarter growth did not meet expectations, posted a more muted return at +3.0%. ■

FIXED INCOME MARKET RESULTS

Interest rates were range-bound during the third quarter. The yield on the 10-year U.S. Treasury closed the quarter at 2.33%, only two basis points higher than at the end of the second quarter. The yield curve continued its flattening trend and the 2-year Treasury yield ended the quarter at 1.47%, its highest level since August 2008. The Bloomberg Barclays Aggregate U.S. Bond Index posted a +0.8% result with corporate bonds outperforming other investment grade sectors. The Bloomberg Barclays U.S. Corporate Index was up 1.3% for the quarter. High yield corporates fared even better, with the Bloomberg Barclays U.S. Corporate High Yield Index up 2.0%. TIPS regained some of their underperformance from the previous quarter. The Bloomberg Barclays U.S. TIPS Index rose 0.9% and the 10-year breakeven spread (the difference between nominal and real yields) rose to 1.84% as of quarter-end from 1.73% at the end of the second quarter.

Rates were also steady overseas, though dollar weakness boosted returns. The U.S. dollar lost nearly 3% versus a broad basket of developed markets currencies. The Bloomberg Barclays Global Aggregate Index returned +1.8% (unhedged) versus +0.8% for the hedged version. Emerging markets debt posted solid returns. The JPM EMBI Global Diversified Index ($ denominated) was up 2.6%. Gains were broad-based with only beleaguered Venezuela (-11%) posting a negative return. The local currency JPM GBI-EM Global Diversified Index returned +3.6%. Returns were mixed for this Index with Brazil (+11%) being the best performer on improving economic and political news and Argentina's first-ever local bonds (-4%) being the worst on worries over the success of reforms. Year-to-date, the two emerging markets debt indices are up 9.0% and 14.3%, respectively.

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The municipal bond market also performed well, benefiting from favorable supply/demand dynamics and steady rates. New issue supply was down 17% from 2016 (through the first three quarters of 2017). The Bloomberg Barclays Municipal Bond Index returned 1.1% for the quarter and the shorter duration 1-10 Year Blend Index was up 0.7%. Puerto Rico remained in the headlines in the aftermath of the devastating hurricane with its bonds trading at less than 50 cents on the dollar. ■

REAL ASSETS RESULTS

Brent crude oil prices rose nearly 20% for the quarter on relatively strong demand and signs that OPEC's production cuts may be easing the supply glut. The energy-heavy S&P GSCI Commodity Index gained 7.2% while the more diversified Bloomberg Commodity Index was up 2.5%. The Alerian MLP Index (-3%) was hurt by one of its larger constituents cutting its dividend, and its performance illustrates that MLP prices do not always move in tandem with oil prices. Gold gained 3.4% and REITs were up modestly (S&P Global REIT: +1.4%; MSCI US REIT: +0.9%). U.S. TIPS outperformed nominal Treasuries; the Bloomberg Barclays U.S. TIPS Index returned +0.9%. The DJB Global Infrastructure Index gained 3.3% and is up 15.2% year-to-date. ■

CLOSING THOUGHTS

We entered 2017 with U.S. stock markets at record highs and historically low volatility. We approach year-end with markets at new record highs, continued low volatility, and valuations stretched across most areas of the investment markets. Meanwhile, challenges remain both geopolitically as well as with respect to the domestic legislative agenda. Hopes for tax reform (read "cuts") remain high, but President Trump's framework is only a first step in what is likely to be a long and contentious process. Finally, inflows from overseas buyers have contributed to the appreciation in markets, but it is impossible to predict what will cause these flows to reverse course. We caution investors to temper return expectations. As always, Asset Strategy Consultants encourages investors to maintain a long-term perspective and prudent asset allocation with appropriate levels of diversification. ■

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 3Q17

	Last Mo.	Mo. Ending 8/31/17	Mo. Ending 7/31/17	Last Quarter	Last 2 Quarters	Last 3 Quarters	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
MSCI:ACWI	1.93	0.38	2.79	5.18	9.68	17.25	18.65	7.43	10.20	3.88	9.13
Russell:3000 Index	2.44	0.19	1.89	4.57	7.72	13.91	18.71	10.74	14.23	7.57	10.37
Russell:3000 Growth Index	1.62	1.68	2.52	5.93	10.86	20.43	21.87	12.65	15.18	9.03	10.73
Russell:3000 Value Index	3.26	-1.26	1.28	3.27	4.60	7.72	15.53	8.79	13.20	6.01	9.89
MegaCap											
Russell:Top 50	1.36	1.12	2.20	4.75	7.43	14.50	18.45	10.82	13.00	6.85	8.94
Russell:Top 200	1.88	0.74	2.18	4.88	8.23	15.14	19.84	11.06	14.26	7.35	9.60
Russell:Top 200 Growth	0.82	2.20	2.98	6.10	11.22	21.91	23.39	13.73	15.69	9.48	10.31
Russell:Top 200 Value	3.07	-0.83	1.33	3.58	4.96	8.16	15.95	8.26	12.72	5.15	8.87
Large Cap											
S&P:500	2.06	0.31	2.06	4.48	7.71	14.24	18.61	10.81	14.22	7.44	10.04
Russell:1000 Index	2.13	0.31	1.98	4.48	7.68	14.17	18.54	10.63	14.27	7.55	10.29
Russell:1000 Growth	1.30	1.83	2.66	5.90	10.84	20.72	21.94	12.69	15.26	9.08	10.65
Russell:1000 Value	2.96	-1.16	1.33	3.11	4.50	7.92	15.12	8.53	13.20	5.92	9.82
MidCap											
S&P:400 Mid Cap	3.92	-1.53	0.88	3.22	5.26	9.40	17.52	11.18	14.43	9.00	11.97
Russell:Midcap Index	2.77	-0.78	1.47	3.47	6.27	11.74	15.32	9.54	14.26	8.08	12.20
Russell:Midcap Growth	2.83	0.71	1.67	5.28	9.72	17.29	17.82	9.96	14.18	8.20	12.12
Russell:Midcap Value	2.73	-1.87	1.33	2.14	3.54	7.43	13.37	9.19	14.33	7.85	12.07
Small Cap											
S&P:600 Small Cap	7.71	-2.56	0.97	5.96	7.78	8.92	21.05	14.07	15.60	9.27	12.34
Russell:2000 Index	6.24	-1.27	0.74	5.67	8.27	10.94	20.74	12.18	13.79	7.85	11.37
Russell:2000 Growth	5.45	-0.12	0.85	6.22	10.88	16.81	20.98	12.17	14.28	8.47	11.78
Russell:2000 Value	7.08	-2.46	0.63	5.11	5.81	5.68	20.55	12.12	13.27	7.14	10.86
Russell:Microcap	8.15	-0.83	-0.56	6.65	10.74	11.16	22.33	12.16	13.89	6.65	10.76
Non-US Equity											
MSCI:ACWI ex US	1.86	0.52	3.69	6.16	12.30	21.13	19.61	4.70	6.97	1.28	8.88
MSCI:EAFE	2.49	-0.04	2.88	5.40	11.86	19.96	19.10	5.04	8.38	1.34	8.26
MSCI:EAFE Growth	1.89	0.56	2.42	4.94	12.83	22.45	15.68	6.48	8.89	2.12	8.17
MSCI:EAFE Value	3.08	-0.62	3.34	5.87	10.93	17.63	22.55	3.50	7.80	0.49	8.26
MSCI:EAFE Small Cap	2.85	0.82	3.62	7.46	16.16	25.42	21.84	11.13	12.85	4.63	11.77
MSCI:EM	-0.40	2.23	5.96	7.89	14.66	27.78	22.46	4.90	3.99	1.32	12.49
Fixed Income											
Blmbg:Aggregate	-0.48	0.90	0.43	0.85	2.31	3.14	0.07	2.71	2.06	4.27	4.23
Blmbg:US TIPS	-0.64	1.06	0.45	0.86	0.46	1.72	-0.73	1.62	0.02	3.90	4.38
Blmbg:Long Gov/Credit	-0.96	2.25	0.26	1.53	5.98	7.65	-0.79	5.45	3.94	7.37	6.70
Blmbg:Long Credit A	-0.40	1.62	0.71	1.92	6.82	7.98	1.82	6.25	4.68	7.16	6.59
Blmbg:High Yield Cash Pay	0.90	-0.04	1.11	1.98	4.18	6.99	8.86	5.82	6.36	7.85	9.35
Blmbg:Muni 1-10 Yr	-0.51	0.56	0.68	0.73	2.13	3.72	1.00	2.20	2.12	3.77	3.57
Blmbg:Glob Agg ex USD	-1.26	1.07	2.68	2.48	6.11	8.74	-2.42	0.20	-0.73	2.57	4.56
Blmbg:Glob Agg ex USD H	-0.47	0.93	0.23	0.68	1.27	1.33	-0.55	3.40	3.74	4.29	4.22
JPM:EMBI Plus	-0.11	1.92	0.41	2.23	4.69	8.64	2.86	6.30	4.03	7.10	10.04
Other Assets											
Blmbg:Commodity TR Idx	-0.15	0.40	2.26	2.52	-0.56	-2.87	-0.29	-10.41	-10.47	-6.83	-0.31
GS Commodity Index	3.32	-0.78	4.58	7.22	1.36	-3.76	1.79	-19.56	-14.38	-10.02	-2.89
S&P:Gold Spot Price Ix	-2.83	3.83	2.50	3.42	2.69	11.56	-2.45	1.97	-6.25	5.53	9.59
FTSE:NAREIT Equity Index	-0.03	-0.25	1.22	0.94	2.47	3.67	0.67	9.86	9.69	5.83	10.82
Alerian:MLP Index	0.69	-4.94	1.29	-3.05	-9.21	-5.62	-3.70	-12.93	-0.57	6.49	11.04

DISCLAIMER AND SOURCES

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