LongView
ASSET MANAGEMENT

2017 Third Quarter Review and Outlook

Markets around the world delivered strong returns in the third quarter. By September 30th, US stocks were up nearly 14% for the year to date, with international markets gaining substantially more. The roughly 8% decline in the US dollar this year further amplified overseas gains for US investors. Emerging markets, for example, had a local currency gain of almost 24% and returned 28% in US dollar terms. The weaker dollar also helped to boost US exports and fuel a rally in oil and other commodity prices. Domestic corporate earnings are at record levels, helped by the recovery in the energy sector.

After falling through the first half of the year, bond yields recently moved slightly higher. While weak inflation raised doubts about ongoing rate increases, the Federal Reserve signaled one more interest rate hike this year and as many as three in 2018. Domestic unemployment continued its slide towards historically low levels, while wage increases gained traction. US GDP growth has maintained its slow but steady pace, with the second quarter revised growth rate clocking in at +3.2%. Capital goods orders are picking up, indicating a revival of corporate investment on machinery and equipment and an expansion in global manufacturing.

During the third quarter, short bouts of market volatility were sparked by geopolitical events, particularly North Korea's missile tests, and by political uncertainty at home, including the on-again-off-again healthcare votes in Congress and a steady stream of White House resignations. Major hurricanes hit Texas, Florida and Puerto Rico, and Mexico experienced another massive earthquake.

We believe that the markets' sanguine response to these events primarily reflects confidence in current economic and financial conditions. The global economy is robust and, combined with still-very-low interest rates and modest inflation, has provided ample support for rising stock market valuations. Devastating as they have been, even the hurricanes are unlikely to cause more than a hiccup in economic growth.

For the year-to-date through September 30th, the S&P 500 Index gained +14.24% and the MSCI All Country World Index +17.25 %. The Bloomberg Barclays Aggregate Bond Index returned + 3.14% through the end of the quarter

Portfolio Notes

Our clients' portfolios have reflected the markets' strength in 2017. Though US small cap stocks have lagged, creating a drag on domestic holdings, this was largely offset by gains in international funds. Our fixed income and alternative strategy funds, meanwhile, have benefited from an overweight in corporate securities earlier in the year, by gold, and by opportunities for arbitrage.

As investors continue to seek out yield, bond prices have risen and corporate credit spreads compared to Treasuries (the premium investors are paid for taking on the extra credit risk of lower quality bonds) have narrowed to levels only seen a few times in recent decades. In each of the previous instances (1986, 1995 and 2006), these lows were followed by prolonged periods of rising default rates and falling prices for higher-yielding debt. In response, we took the meaningful step in early August of de-risking our bond holdings by selling high-yield and floating-rate bond funds. These market sectors have been important contributors to LongView's bond returns over the past eighteen months, but we feel that, at current levels, the risks outweigh the potential rewards.

Outlook

As equity markets have continued to soar and stock valuations have climbed to above-average levels, a growing number of pundits are predicting a sell-off. Against an increasingly worrisome geopolitical backdrop, many investors also feel understandably anxious. While there are undoubted risk factors ranging from debt ceiling negotiations to relations with North Korea and Iran, we would remind our clients that market movements are virtually impossible to predict. In fact, the Wall Street consensus has been notoriously inaccurate in its prognostications.

The essential insight of American economist Richard Thaler, who was awarded the Nobel Prize in Economics on October 9th, is that people are not perfectly rational and disciplined. While that is no surprise to most of us, Thaler's pioneering work in the field of behavioral finance showed that humans are prone to making economic decisions that are often not in their best interests. And it is in uncertain times such as these when investors are most likely to make self-defeating market calls.

One of LongView's most important roles is to help our clients stick to their investment plan through periods of uncertainty and volatility. Based on currently high valuations, historical precedent indicates that returns could be below average over the next few years. There will also no doubt be a market sell-off at some point. However, precedent also shows that, almost regardless of the circumstances, investors who try to time the markets' moves have predictably lower returns than if they stayed the course. Our view is that current economic fundamentals justify a robust stock market, while low interest rates have made elevated valuations logical. Rather than attempting to predict future developments, we would suggest that this is a good time to review your portfolio's asset allocation targets to ensure that its balance of growth and capital preservation is appropriate for your *long-term* goals and needs.

Please don't hesitate to schedule a meeting to discuss these questions. As always, we welcome your inquiries.

In the meantime, we wish you a beautiful fall and holiday season.

With warm regards,

David Cantor | Mariah Sacoman | Harlan Flint