Economic & Market Quarterly

Fall 2017

This summary is provided by BMT Wealth Management.

Complacency or Optimism?

A combination of positive economic reports, rising corporate profits, and easing tensions between the United States and North Korea, at least for now, created a favorable environment for risk assets during the third quarter of 2017.

Financial markets appear to be discounting, at least to some degree, the likelihood of tax reform, financial deregulation, and fiscal policy measures being enacted. The markets seem confident that this economic expansion, which is already the third longest in the post-World War II era, is showing no visible signs of slowing.

We regularly review our "Recession Check List," which looks at a variety of leading, coincident, and lagging economic indicators. It is set forth below.

Indicator	BMT Assessment
Conference Board Index of Leading Indicators	Positive
Smoothed U.S. Recession Probability Index (NBER)	Positive
Inflation	Positive
Unemployment Rate	Neutral
Wage Growth	Positive
Capacity Utilization	Positive
Housing Prices	Positive
Other Housing Data	Neutral
Consumer Confidence	Positive
Yield Curve (2-10 Spread)	Neutral
Liquidity (M2 Change)	Positive

Indicator	BMT Assessment
Surveys (ISM/PMI)	Positive
Small Cap Equity Performance	Positive
Financial Equity Performance	Positive
Credit Spreads	Positive
Corporate Profits	Positive
Oil Prices	Positive
Base Metals (Copper)	Positive

The various indicators we follow are not flashing warning signs. We recognize that this business cycle has been atypical, given the magnitude of central bank policy accommodation and the persistently low levels of inflation and growth. As a result, indicators that have helped detect inflection points in prior business cycles may be less reliable going forward.

That said, barring a "black swan event," or a central bank policy blunder, we do not think the economy is on the verge of entering a recession.

In fact, we have been wondering whether the markets are getting too complacent, given the absence of sustained market pullbacks thus far in 2017.

One way to gauge investor optimism or pessimism is to analyze the Chicago Board of Exchange Volatility Index (VIX), which measures expectations of future market volatility. The VIX is often referred to as the investor fear gauge, with higher readings accompanying significant declines in stock prices. Lower readings are registered as equity prices steadily march higher.

Of the 250 lowest end-of-day VIX closing prices ever recorded (more than 7,200 between 1/1/1990 and 10/24/2017), 110 have occurred in 2017. This period of low volatility is unprecedented since the creation of the VIX, going back to Jan. 1, 1990.

Does a very low VIX reading have any predictive power?

Based on our observations, very low market volatility is not necessarily a harbinger for poor equity returns. For the two other periods of very low volatility (1993-1995 and 2005-2007), future market returns were very different. Rising volatility and weakening economic fundamentals preceded the two most recent bear markets. Neither of these conditions exist currently, but this does not mean a market correction cannot occur.

Equity Markets Keep Chugging Along

Stocks continued their march upward in the third quarter, as the S&P 500 gained 4.48% on a total return basis, elevating the year-to-date return to 14.24%.

Within the United States, small cap stocks, as represented by the Russell 2000 Index, advanced a strong 5.67% in the quarter. Smaller cap stocks have underperformed their larger cap brethren this year through Sept. 30, as the Russell 2000 advanced 10.37% through the third quarter. The rebound in smaller cap issues in September was due mainly to tax reform taking "front burner" status.

International stocks have outperformed domestic issues through the end of the third quarter. Developed market stocks, as measured by MSCI EAFE, rose 5.40% in the quarter and are ahead 19.96% for the first nine months of the year.

Emerging markets, however, led the way with a 7.89% quarterly move to the upside, resulting in a year-to-date increase of 27.78%.

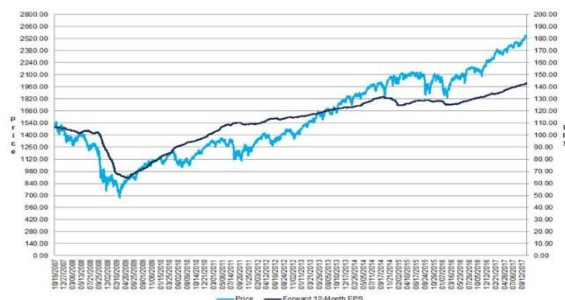
Earnings and Stock Prices

There are certainly non-fundamental catalysts that can affect the behavior of stock prices over shorter time periods, both positively and negatively. However, we maintain that revenues and earnings are the main drivers of stock prices over the long term.

The graph below plots the change in price for the S&P 500 (blue line) versus the forward 12-month earnings-per-share forecast for the Index over the last ten years. The visual correlation between stock prices and expected earnings is quite clear.

Over the last two years, as illustrated below, valuations have also risen, propelling stocks ahead faster than earnings growth. The last several quarters of strong earnings performance have moderated this "gap" somewhat.

S&P 500 Change in Forward 12-Month Earnings per Share vs. Change in Price: 10 Years



Source: FactSet, Inc.

Strong earnings gains, dating back to the fourth quarter of 2016, will also create some headwinds, as earnings comparisons on a year-over-year basis become more challenging.

We maintain that meaningful corporate tax reform is essential to driving GDP growth beyond the torpid 2% level and creating the backdrop to support revenues, earnings, and stock prices at current levels.

Fixed Income: Third Quarter 2017

The U.S. fixed income markets gave up some of their gains in the final month of the third quarter, as inflation expectations inched higher toward the U.S. Federal Reserve's (the Fed's) annual target of 2% and investor optimism for tax reform regained its footing.

The Bloomberg Barclays U.S. Intermediate Government Credit Index returned 0.60% during the period and is up 2.34% for the year.

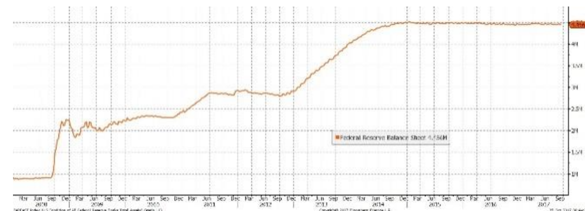
U.S. Treasury yields increased across the yield curve, with the two-year U.S. Treasury yield outpacing the 10-year, leading to a flatter yield curve by roughly 10 basis points (0.10%). The two-year ended the quarter at its highest level in more than eight years, as investors increased the odds of a December rate hike up to 70%, based on the federal funds futures probability table.

The Fed continued to downplay consecutive months of low inflationary data, referring to the causes as mostly transitory. The Fed believes the healthy labor market will eventually lead to higher wages and overall higher inflation. Given the Fed's expectations, we believe increasing the federal funds target rate closer to a more normal level remains an appropriate path.

It is also worth noting that the Fed agreed at its September meeting to begin shrinking its balance sheet from its current size of roughly $4.5 trillion by tapering its monthly reinvestments of both U.S. Treasuries and U.S. mortgage-backed securities.

The scaling back of bond purchases began in October and is expected to operate behind the scenes, as the Fed utilizes the federal funds target rate as its primary tool to conduct monetary policy.

Federal Reserve Balance Sheet
1/2/2008 – 9/30/2017



Source: Bloomberg Finance L.P.

Interestingly, investor attention to monetary policy took a back seat to fiscal policy in the final trading days of the third quarter, after new details regarding tax reform became the primary topic of discussion. Although there remain many unknowns, investors are hopeful that fiscal policy will add another leg to the current economic expansion, and they responded by pushing bond yields higher.

Worth noting during the quarter, decisions regarding the debt ceiling and the U.S. government's budget were pushed off until later this year. Although not resolved, it provided lawmakers a small window to focus their attention on tax reform.

In municipals, tax reform discussions have had little impact on municipal yields. Instead, demand remains robust, while limited supply has contributed to a favorable environment for municipal bond returns. The Bloomberg Barclays Municipal Bond Index returned 1.06% in the third quarter and 4.66% for the year.

Closing Thoughts/ Looking Ahead

Despite a preponderance of negative headlines involving North Korea, the damage caused by hurricanes Harvey, Irma, Jose, and Maria, and concerns about a lack of progress in Washington with regard to fiscal policy/reform, investors have experienced healthy gains across a wide assortment of asset classes.

Within both the equity and fixed income markets, investors have generally been rewarded for taking more risk. Higher beta stocks, such as emerging market equities, have outperformed. On the fixed income side, high-yield corporates have outpaced their investment-grade brethren.

All eyes will be focused on tax reform and the appointment of the next Fed chair. Saying stocks are priced to perfection is probably a little bit of a stretch, but given that equities are trading at above-average historical valuations, a lack of tax reform or a more hawkish Fed chair could pose a material headwind for risk assets.

As we approach the end of 2017, we think that declining equity correlations could create some opportunities for bottom-up fundamental investors. On the fixed income side, yield curve positioning and issuer selection will remain our primary focus.

The views expressed herein are those of Bryn Mawr Trust as of the date above and are subject to change based on market conditions and other factors. Past performance is no guarantee of future results. This publication is for informational purposes only and should not be construed as a recommendation for any specific security or sector. Information has been collected from sources believed to be reliable, but has not been verified for accuracy.

Securities and insurance products: (1) are not bank deposits; (2) are not insured or guaranteed by the FDIC or any other government agency; (3) are not obligations of, or guaranteed by, any financial institution; and (4) involve investment risks, including the potential for fluctuations in investment return and the possible loss of principal.

© 2017 The Bryn Mawr Trust Company

BMT Wealth Management
Ernest E. Cecilia, CFA | Chief Investment Officer
610.254.2030 | ececilia@bmtc.com
bmtc.com/wealth