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THIRD QUARTER 2017
MARKET REVIEW

Markets continued their march higher throughout the quarter as volatility has all but disappeared. Year-to-date, intra-day market volatility is the lowest ever recorded in the 32 years the statistic has been recorded. So far, less than 5% of trading days have had a move of 1% or more, and there have been no days with a 2% move. Historically, September has been the worst month for stocks followed by October. However, since September was a good month, this bodes well for October. The lack of volatility has certainly confounded market pundits, who have been calling for increasing volatility due to a number of factors, including high valuations and geopolitical uncertainty.

International stocks, particularly those in emerging or less developed economies, have been the big winners for the year as they have benefitted from a weak U.S. dollar and the early stages of economic recovery in Europe. Domestically, growth stocks have trounced value stocks, meaning investors are optimistic about the future and feel comfortable waiting for earnings to materialize several years out. While a company like Tesla for example, can lose money now, investors are more optimistic about the future when the economy is good and feel comfortable buying the stock on the belief it will one day be profitable. The dot com bubble in the late 1990's was a great example of this sentiment. Back then, investors were so optimistic about the future of the Web, they bid up prices of companies with good business models that ultimately thrived but never reached stock prices set before the bust. Other questionable companies folded as they ran out of money and were not able to issue more stock. Although the overall market is much more rational than it was in 1999, there are pockets of over optimism that warrant caution.

Major Stock & Bond Indexes (Total Return)			*Lipper Mutual Fund Indexes (Total Return)*		
	3Q17	YTD		3Q17	YTD
S&P 500 Index	4.5%	14.2%	Large-Cap Core Funds	4.3%	13.4%
Russell 1000 Growth	5.9%	20.7%	Large-Cap Growth Funds	5.5%	21.6%
Russell 1000 Value	3.1%	7.9%	Large-Cap Value Funds	3.7%	9.5%
Russell Midcap Index	3.5%	11.7%	Mid-Cap Core Funds	3.5%	11.2%
Russell 2000	5.7%	10.9%	Small-Cap Core Funds	4.9%	8.57%
MSCI ACWI Ex USA NR (USD)	6.2%	21.1%	International Large-Cap Core	5.6%	20.7%
MSCI EM (USD Gross)	8.0%	27.8%	Emerging Markets	7.4%	26.5%
S&P U.S. REIT TR	0.8%	2.9%	Core Bond	0.8%	3.2%
Barclays US Agg. Bond (3-5yr)	0.9%	3.1%	Intermediate Municipal Debt	1.0%	4.0%

STOCK MARKETS:

Professor Richard Thaler was awarded the Nobel Prize in Economics last week, which is notable for a number of reasons. After Amos Tversky and Daniel Kahneman, Thaler is only the third Nobel winner involved in researching behavioral economics, or how psychological and emotional factors affect economic decisions and the consequences for markets. Professor Thaler also may be the only Nobel award winning economist to appear in a blockbuster Hollywood movie, *The Big Short*, and is a practitioner in addition to being an academic. Fuller & Thaler Asset Management is half owned by Dr. Thaler, and more importantly, manages the Undiscovered Managers Behavioral Value fund held by HC Financial clients. This fund is a consistent top quartile performer among Small Capitalization Value funds.

Following the award last week, Thaler gave an interview to Bloomberg where he admitted to be worried about the stock market. In the interview, he commented, "We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping". Thaler went on to explain that he was puzzled by not only record highs in the main indexes, but extremely low volatility as well. Of significant concern to Thaler was the likelihood that stocks are still pricing in a massive tax cut, which appears unlikely at this point, given the inability of the Republican-controlled Congress to work together on other legislation.

Whether we are living in the riskiest moment of our lives may depend on your age. Anyone who lived through the Great Depression during the 1930's and World War II later has certainly experienced more risk. The Cold War and Cuban Missile Crisis in the decades that followed were certainly high on the risk spectrum as well. One thing that all these decades have in common is that with the exception of an annualized return of -0.5% on the S&P 500 during the Great Depression decade of 1930's, the other decades all produced positive returns for stocks. The key takeaway here is that a full decade holding period produces sufficient time to overcome downturns caused by current events, and recover nearly all the losses from the worst economic period in our history.

Statistician Nate Silver, author of *The Signal and the Noise*, differentiates between risks and uncertainties. Risks are potential hazards that are known and have been dealt with in the past, and are easier to model into expectations. Uncertainties, however, are events that are not recurring, and so we have very little data on them, making their impact hard to predict.

Risks we are monitoring in today's market include interest rate hikes by the Federal Reserve, an economy reaching full capacity, and legislative actions or inactions in Washington. The first two risks are part of a classic business cycle we have seen many times before. As the economy accelerates, the Fed raises short-term interest rates to prevent the economy from overheating, with the intent of prolonging economic expansion and delaying a recession. Although the recession is inevitable, and since the ability of the economy to grow in not unlimited, the cause of the recession is typically aggressive tightening by the Fed. One indication of a coming recession is an inverted yield curve, where the Fed increases short-term rates to the point they are higher than long-term rates. Other indicators of a coming recession are decreasing rates of unemployment and other leading economic indicators, such as consumer confidence. In anticipation of slower economic growth in the future, we can reduce the impact of a recession on investment portfolios by moving into more defensive industries, such as consumer staples and healthcare, and out of economically sensitive industries like banks, industrials and technology. The addition of a variety of alternative investments also helps reduce risk. Although Washington appears more dysfunctional than ever, the risk of not passing tax reform legislation will have an expected impact on corporate profits. Tax reform currently proposed would boost corporate profits by about 10%, meaning stocks should in theory trade 10% higher using today's valuations. However, if we assume that tax reform is already priced into stocks, we can expect about 10% downside should it fail to occur.

Silver considers "uncertainties" things that we know less about because they are not typical, haven't happened and are harder to put into a statistical model. For example, statistical models failed during the housing and ensuing financial crisis because they did not factor in unprecedented events, such as the synchronized decline in nationwide housing prices and 10:1 leverage on subprime mortgage debt through synthetic investment instruments. An uncertainty currently on many people's minds is geopolitical risk. With both North Korea and the U.S engaged in saber rattling, we have no idea what would happen if war ensues and the impact on financial assets. Some clients ask why stocks continue to rise when there is an overhanging threat of nuclear war. The truth is that geopolitical uncertainties are probably not adequately priced into the markets given that many of these uncertainties are viewed as low probability events and the impact on the markets is not well known. The spate of recent natural disasters is another uncertainty. Although we know the typical impact of a hurricane, earthquake or wild fire, we don't know if these events are correlated and we are headed towards a period of increasing natural disasters or the last few months are simply a coincidence and we will return to normal. Although it is possible to protect portfolios against uncertainties such as these, this type of protection severely limits upside gains. For most clients, a balance of market risk investments like stocks that participate in growth and more stable investments like bonds and alternatives provide the right combination of potential growth and downside protection.

OUTLOOK:

The lack of market volatility and fairly optimistic conditions are typically a "contrarian" indicator, meaning that a period of increased volatility is on its way. Although we certainly expect volatility to increase at some point, there is no indication of a bear market in the near-term as there are no signs that a recession is imminent. We also don't currently feel levels of euphoria in stocks that were present during the bull market of 1987 and the late 1990s, as many investors are still very skeptical of our current bull market. Despite impressive year-to-date gains in stock prices, this move coincides with earnings growth. Although P/E valuations are elevated, they have not increased since January as strong earnings have driven returns. Third quarter earnings will be released over the coming weeks, and with the exception of hurricane disruptions on some retailers, they should be strong overall and help to continue to support stock prices.

Despite some uncertainties, we are still optimistic that the U.S. economy has a couple years of expansion remaining before we move into the contraction or recessionary phase of the business cycle. Growth appears to be accelerating as key leading indicators, including the Institute for Supply Management's (ISM) Survey recently showed its highest reading since 2004. Given high current valuations on stocks and many individual stocks being outside of our "buy" range, we would be much more optimistic for future gains if we see a pullback in prices. While we believe many U.S. stocks are fully if not somewhat overpriced, international markets represent a better investment opportunity as their current valuations are more attractive and the economic growth outside the U.S. continues to accelerate.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We want to meet with you at least once a year to review and update any changes in your goals and objectives. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

Stephen C. Biggs, CFP®, CFA

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