Making Sense of Finance

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Third Quarter 2017 Review

STOCK MARKET

Stocks in the U.S. continued to rise in the third quarter. All major indexes increased, led by the tech-heavy Nasdaq Composite which posted a gain of 5.8% for the quarter. Other large indexes, (S & P 500 and the Dow Jones Industrial Average) were not far behind with a rise of 4.0% and 4.9% respectively. With the lack of any rate increases by the Federal Reserve in the last quarter, equities continued to move upward with a minimum amount of volatility. Even Kim Jong Un's threats did not win out over some favorable economic data (U.S. manufacturing output at a 13 year high and the U.S. economy rebounding to 3.1% real GDP growth in the second quarter) to deter stock investors. As mentioned in our last newsletter, valuations as measured by the price/earnings (P/E) ratio remain the same as this time last year. A year ago the trailing P/E of the S & P 500 index was 24.6, currently it is 24.7. As long as interest rates do not rise dramatically, these valuations may endure. Earnings have continued to rise for companies in the S&P 500, which is partially due to the fact of where we are in the business cycle, but also part of the reason may not be cyclical at all. Stock buybacks have been fairly large in recent years thereby increasing a company's earnings per share, all things being equal (if there are less shares outstanding earnings per share would increase even if overall net income did not increase). Also the average age of a company in the S&P 500 index has dropped from almost 60 years old in the 1950's to less than 20 years currently. Whether due to mergers or new technologies gaining ground, perhaps these companies have more room to grow earnings outside of a typical business cycle.

Technology stocks were the best performing sector last quarter, as they have been leaders all year, this time aided by semiconductor stock performance in addition to prominent internet and consumer electronic stocks. Other stock sectors which did better than the overall market were energy (driven by an increase in oil price though still lagging year to date) and financial stocks (in particular asset managers). Industrial stocks also performed well led by those in aerospace and defense, benefitting from increased global defense spending. Consumer staple stocks were the only industry group to post a decline in the third quarter.

It is not only the U.S. economy

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

Contributors:

Seaver T. Wang

Christine Terry

1 Baltic Place suite 201D

Croton On Hudson, NY 10016

www.toinvest.com

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that is showing signs of growth this year but most foreign economies are too. No major economy is presently in a recession. This widespread economic growth is reflected in the stock market performance overseas. Most developed markets gained in the third quarter as measured by the MSCI EAFE index. This U.S. dollar based index rose 4.8% in the third quarter and on a year to date basis is up 17.2%, ahead of the S&P 500 index. Stock markets in France, Germany and Japan all participated in this global rally. Emerging market stock indexes had even greater gains (these typically have greater swings in price movements up and down). The MSCI EM index (also measured in U.S. dollars) increased 7% last quarter. A pickup in commodity prices benefitted some markets such as Russia. Brazil was the best performing market in the third quarter as the political environment did not appear to be as bad for business as it seemed earlier this year.

BOND MARKET

Interest rates barely moved during the last quarter; the Barclay Aggregate bond index had a total return of 0.70%, which includes interest payments. There was no Federal Fund rate increase over this time period but there are strong indications for one more rate hike by the end of the year. Due to this prognostication, short term Treasury rates on the very short end had a more noticeable increase, a one month Treasury bill annualized yield rose from 0.84% at the end of June to a recent yield of 1.04%. However it is the longer term maturities where there was barely any movement continuing the flattening of the yield curve. The 10 Year Treasury yield is now at 2.35%, not much different than the end of the second quarter when it was at 2.31%. Continued foreign demand keeps these yields lower than they might have been otherwise. As we have seen for a while, most developed country government bonds have yields lower than the U.S., with the exception of Australia. In fact many yields are still negative as the European Union has not yet started a “tightening” strategy as the Federal Reserve has here.

With our most recent reported inflation rate at 2.2% for the last twelve months, investors are still in search of yield to keep ahead of inflation. Lower quality bonds such as emerging market government bonds and below investment grade corporate bonds have done well this year as credit spreads have narrowed, meaning investors are willing to take on more risk for slightly better returns. Municipal bonds still see a steady amount of demand against a lesser amount of supply compared to last year. This demand for tax-exempt bonds should not change even with the proposed tax reforms.

OUTLOOK

…And the stock market continues to steadily rise. When will it end? The key word is “steady”. Volatility continues to be absent from the stock and even bond markets, which give us hope for longer-term gains. This combined with improving fundamentals means that there probably is no bubble to burst. Additionally, consumer debt does not seem out of hand either. The downside is that volatility at some point is more likely in the future. When, we cannot determine. The Fed is playing a balancing game between increasing rates without restricting capital from corporations, and so far it is working. Bond prices continue to face headwinds but they have been mild. The problem is that the yield curve is flattening which means that the risk reward favors shorter-term bonds, but the shorter-term bonds have miniscule yield and limited capital appreciation potential. Our order of preference for each asset class remains; stocks, followed by real estate and then bonds. Over the past 6 years we’ve generally been bullish, despite naysayers who think that the stock market is on some kind of predetermined schedule for a downturn (i.e. a business cycle averages 5 years, etc.), but our analysis and reality has proven that this can be extended given extraordinary circumstances. So far we have been proven right, but even though we can pat ourselves on the back, most investors miss the point of corrections in the market. Assuming you believe that corporate profits will be higher in the future, then you should be invested. Since we do not know when the next “extraordinary” event will occur, it would be foolish to just sit on the sidelines. You could miss a 100% increase in the markets by trying to avoid a 10% or 20% decline over a 10-year period. To mitigate this stress of the unknown, we diversify so that no matter what happens, investors will be more likely to have healthy returns with a bit less year-to-year downside risk.

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