Quarter in Review

Despite its reputation as the worst seasonal period for stocks, the U.S. market delivered strong returns in the third quarter, extending its winning streak to eight consecutive quarters and a remarkable 18 out of the last 19 quarters. The S&P 500 Index closed at an all-time high, gaining 4.5%. But foreign markets did even better, led by emerging markets, which surged 8%. European stocks were also very strong performers, gaining 6.2%. More broadly, developed international stocks rose 5.5%. For the third consecutive quarter, the U.S. dollar depreciated against foreign currencies, boosting dollar-based investor returns in these markets.

Market Environment:

Asset Class	*3Q*	*1 Year*	*5 Years*
U.S. Large-Cap	*4.45%*	*18.46%*	*14.06%*
U.S. Large Growth	*5.76%*	*21.68%*	*15.05%*
U.S. Large Value	*3.00%*	*14.90%*	*12.97%*
U.S. Small Blend	*5.87%*	*20.96%*	*13.86%*
Developed Int'l Stocks	*5.49%*	*19.31%*	*8.96%*
Emerging-Markets Stocks	*7.97%*	*18.66%*	*3.75%*
REITs	*0.84%*	*0.27%*	*9.34%*
Investment-Grade Bonds	*0.71%*	*-0.22%*	*1.86%*
Municipal Bonds	*1.06%*	*0.87%*	*2.81%*
High-Yield Bonds	*2.04%*	*9.06%*	*6.38%*
Global Bonds	*1.81%*	*-2.69%*	*-0.43%*

Within the U.S. market, larger-cap growth stocks—technology stocks in particular—continued their year-to-date dominance over smaller-cap and value stocks, a sharp reversal from what we saw last year. Larger-cap growth stocks are up more than 20% this year, while smaller-cap value stocks have gained 5.6%. The S&P 500 is up 14.1% for the year, while the Russell 2000 has gained 11% (helped by a 6.3% surge in September). Looking at industry sectors, energy stocks had a big rebound in September (up 10%) as oil prices rose above $50. But for the year, the sector is still down 6.6%, while technology and health care have soared 27% and 20%, respectively.

After spiking briefly in August on geopolitical concerns (mainly North Korea), the VIX volatility index dropped back below 10 by quarter-end, near its all-time low. Another indicator of how calm the stock market has been this year is that its largest drawdown has been a loss of 2.8% (from March 1 to April 13). Going back to 1929, there has been only *one* calendar year in which the largest drawdown was smaller than that (in 1995, with a 2.5% intra-year decline), according to Ned Davis Research.

Moving to the fixed-income markets, core investment-grade bonds inched up 0.7% for the quarter. Core bond prices peaked in early September, with the benchmark 10-year Treasury yield (which moves inversely to bond prices) bottoming at 2.06% on a confluence of flight-to-safety fears amidst tensions with North Korea, catastrophic hurricanes in Texas and Florida, and a potential U.S. debt ceiling crisis/government shutdown. But the yield shot up into month-end, closing the quarter at 2.3%—right about where it stood three months earlier. Credit-sensitive (higher-risk) sectors of the fixed-income market outperformed core bonds for the quarter, with the high-yield bond index gaining 2% and floating-rate loans up 1%.

Investment Outlook:

As we look ahead to the remainder of the year, there are reasons to be optimistic. The synchronized global economic growth recovery we wrote about earlier in the year continues apace, providing a solid foundation for corporate earnings and financial assets in general.

Real (net-of-inflation) policy rates remain in negative territory across all the major developed economies, and the European Central Bank and Bank of Japan continue purchasing assets via quantitative easing. Meanwhile, easing inflationary pressures in emerging markets have allowed numerous emerging-market central banks to lower interest rates this year (including Brazil, Russia, India, and South Africa). Lower inflation and lower central bank policy rates are typically positive for local stock markets, and they can also help offset the impact of policy tightening by the Fed on these markets.

Domestically, while real GDP growth remains subpar by historical standards, it continues to grind along at around a 2% annual rate. Financial conditions have eased over the past year—despite the three Federal Reserve rate hikes—due to factors such as the declining dollar, higher stock prices, narrower corporate bond spreads, and lower Treasury bond yields. This could bode well for economic growth over the short term at least.

Offsetting this attractive shorter-term macroeconomic backdrop are, as always, the known and unknown risk factors. Among the known risks are the historically high domestic equity valuations, policy changes that have yet to be passed (e.g., tax reform, Obamacare repeal), and future tightening by the Fed. North Korea also remains a risk we cannot handicap, although if the virtually nonexistent market volatility of the past year is any indicator, any headline news is likely to have a short-term market impact rather than a longer-term one.

Looking Ahead:

Despite the U.S. economy's rather healthy economic indicators, it's worth noting that a typical 5% to 10%-plus stock market correction can happen at any time, triggered by any number of unpredictable and/or unexpected events. Historically, the U.S. market has dropped at least 5% roughly *three times a year* and declined 10% or more about once a year. We are at 330 days and counting since the last 5% drop; this is the longest such streak in *26 years*. Given that historical reference, a sound argument could be made that the U.S. market seems overdue for a correction.

In contrast to a correction, a true bear market in U.S. stocks (a sustained 20%-plus decline) is almost always associated with an economic recession. Absent a recession, a bear market is unlikely. Recessions, in turn, are typically caused by excessive Fed tightening (reflected in an inverted yield curve), usually in response to inflationary pressures, an overheating economy, or financial market excesses, none of which seem imminent in the U.S. or global economy. So although this is now the third-longest economic expansion and second-longest bull market in U.S. history, neither appears ready to die of old age just yet.

Putting It All Together

By building a diversified portfolio that is durable enough to withstand a wide range of potential market outcomes, and knowing exactly what projected cash flow needs look like over the years, clients will be in great shape to handle the periodic nastiness that the market can inflict. As long as we have the fortitude to ride out rough patches and maintain disciplined measures such as rebalancing, we have confidence that things will work out well in the end.

Each portfolio is built to focus on *longer-term returns*, across a wide range of scenarios, while adhering to the portfolio's risk objective. To earn the more attractive medium- to longer-term returns from riskier assets (such as stocks), investors in our more risk-tolerant portfolios must be prepared—psychologically and financially—for market dips and drops along the way. They are inevitable and may be unsettling, but they are also *temporary*.

Nevertheless, the "shorter term" can *feel* "longer term" amid a deep market decline. That is why it is so important for investors to have a defined process and be invested in a portfolio allocation that is truly aligned with their individual risk tolerance, investment temperament, and cash flow situation. Otherwise, chances are they will make a poorly timed, emotionally charged decision to change their portfolio. This can potentially damage their long-term financial well-being, even if it might feel better in the heat of the moment. It is critical to maintain one's investment discipline during such periods, to remain focused on your long-term financial objectives, and remember why you are invested as you are in the first place.

We therefore remain cognizant of, and prepared for, the periods of higher volatility that are certain to come within our long-term investing horizon. This includes regularly revisiting our analysis and keeping our focus on managing downside risks as we seek to capture positive long-term returns for our portfolios.

As always, we appreciate your confidence and welcome questions about your individual portfolio or financial situation.

-We thank you for your continued support!