Third Quarter 2017 Market Newsletter Summary

Stocks, bonds and commodities rallied in the third quarter of 2017

The economies of the world are all growing in a synchronized manner for the first time since 2010. This augurs well for continued growth.

Central banks around the world are removing or considering removing monetary stimulus and increasing interest rates. High interest rates are usually bad for stocks and this bears watching. Currently interest rates around the world are still low.

Corporate earnings are growing in all major regions of the developed and developing world. The underlying economic conditions suggest they should continue to grow.

Stock valuations are at or higher than their 25-year averages, but they are still not stretched or in bubble territory and should help stocks sustain their rally.

In the short term, a correction (Stock prices down by about 10%) can happen at any time and there is enough fodder to fuel one. Geopolitical tensions, policy hiccups by central banks or Governments or potential protectionist measures could all be a catalyst for a correction.

We wrote an article on what you can do to protect yourself in the wake of the Equifax hack. You can read it here.

At Sarsi, we take the task of protecting our client's information and cybersecurity very seriously. We have adopted the best practices laid out by our custodian Charles Schwab. You can read about the best practices here.

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Third Quarter 2017 Market Commentary

Table 1: Market indices (As of September 30, 2017)

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	4.48%	14.24%	18.61%	10.81%	14.22%
S&P Mid Cap 400	3.32%	9.40%	17.52%	11.18%	14.43%
S&P Small Cap 600	5.96%	8.92%	21.05%	14.07%	15.60%
MSCI Emerging Markets	8.04%	28.14%	22.91%	5.28%	4.36%
MSCI EAFE	5.47%	20.47%	19.65%	5.53%	8.87%
Investment Grade Credit (C0A0)	1.36%	5.29%	2.26%	3.99%	3.52%
Non-Investment Grade Credit (H0A0)	2.02%	7.03%	9.04%	5.86%	6.39%
Bloomberg Commodity Index Total Return	2.52%	-2.87%	-0.29%	-10.42%	-10.47%
Dollar Index (DXY)	-2.67%	-8.94%	-2.50%	2.70%	3.09%
Vanguard Total Bond Market Index (VBMFX)	0.70%	3.05%	-0.24%	2.51%	1.85%
10 Yr Rate	2.33% 09/30/2017	2.45% 12/31/2016	1.61% 09/30/2016	2.51% 09/30/2014	1.64% 09/30/2012

Source: Standard and Poor's, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

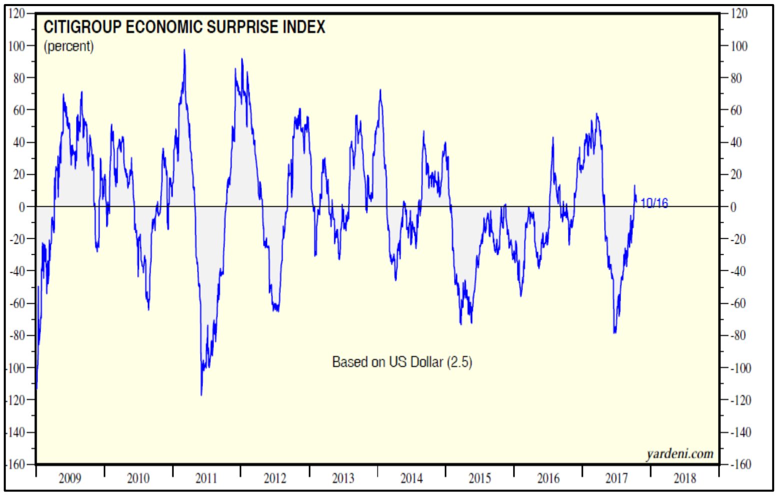
As of Oct 9, 2017			
	Latest Release	Recent Trend	Notes
Non Farm Employment	-33,000	Positive	The surprise drop in jobs was possibly because of the hurricanes in September. The effect will be clearer in the following period. (See claims below) The two positives in the report were a drop in the unemployment rate to a low of 4.2% and a spike up in hourly earnings to a growth rate of 2.9% year over year.
Weekly Claims for Unemployment Insurance	260,000	Positive	Weekly jobless claims fell 12,000 from the previous month (And down 38,000 from early September) as the effect of the hurricanes seem to be fading.
ISM Manufacturing Index (Number over 50 points to growth)	60.8	Positive	This is a 13 year high for the index and reflects a very strong manufacturing sector. The hurricanes actually helped this index by longer delivery times, in addition all other underlying components were strong.
ISM Non Manufacturing Index (Over 50 points to growth)	59.8	Positive	The non manufacturing sector continues to be strong with the ISM index hitting a 3 year high.

	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.4%	Positive	Consumer prices are increasing but at a manageable rate. Year over year CPI is up 1.7%. Core inflation (Excluding the volatile energy and food) is up 1.9% for the year.
Producer Prices (Month over month change)	0.2%	Positive	Like consumer prices, producer prices are increasing at a manageable rate. Year over year they are 2.4%. Core prices are up 1.9% year over year.
Retail Sales	-0.2%	Negative	Retail sales were down possibly affected by the hurricanes. Auto sales were down and gas sales were up suggesting that the hurricanes did have an impact. Nevertheless retail sales have been choppy this year.
Consumer Confidence (Conference Board)	119.8	Positive	Hurricanes or not, consumer confidence continues to be very strong.
Durable Goods (Month over month change)	1.7%	Positive	Durable goods orders, a weakness in the economy for long, has lately begun to show strength. The latest report was a positive surprise compared to consensus. Core capital goods (Which is important for the non defense, non aircraft part of the economy) was up 0.9% for the month and is up a very healthy 3.6% for the year.
Industrial Production	-0.9%	Positive	All three components (Utilities, mining and manufacturing) fell during the month possibly because of the weather.
Capacity Utilization	76.7%	Negative	Capacity utilization fell during the last month.
Housing Starts	1.180MM	Negative	In the latest month, housing starts came in higher than expected but has been soft lately.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.3%	Positive	Home prices have been firm but are slowing down a bit. Year over year, home prices were up 5.8%.
GDP (Real, Annualized)	3.1%	Positive	Consumer spending and non-residential fixed investments helped deliver a strong GDP for the second quarter.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

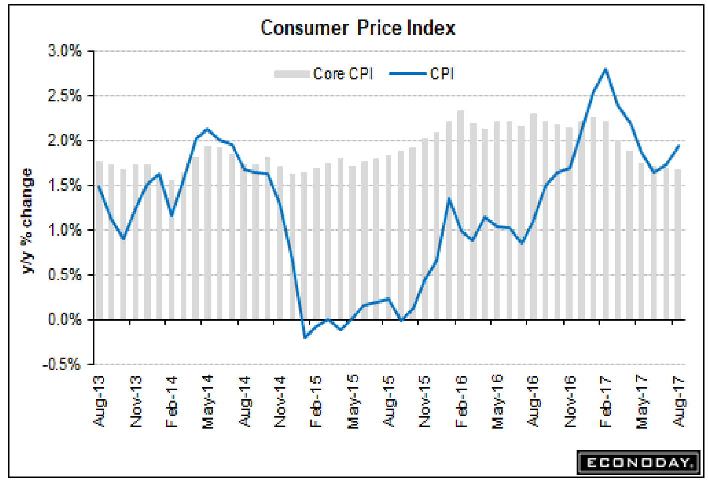
Stocks, bonds and commodities rallied in the third quarter, supported by improving global economies and relatively easy monetary conditions. As seen in the table above, the US economy is in good shape despite the short-term, effects of the Hurricanes that slammed the country. The jobs report was the biggest causality of the hurricanes, as 33,000 jobs were lost last month after several months of job gains. However, the post hurricane improvement has already kicked in as the number of weekly jobless claims fell sharply after spiking in the previous few weeks. Other areas of the economy are very strong, especially manufacturing, and the ISM manufacturing index is at the highest level since 2004. Core capital goods investments, which has been a laggard in this recover thus far, is picking up following strong corporate confidence. The Citi Economic Surprise Index has moved back into positive territory reflecting the improvement in the economy (Figure 1)

Figure 1: Citigroup Economic Surprise Index



Source: Yardeni, Citigroup

Figure 2: Consumer Price Index (Year over Year)

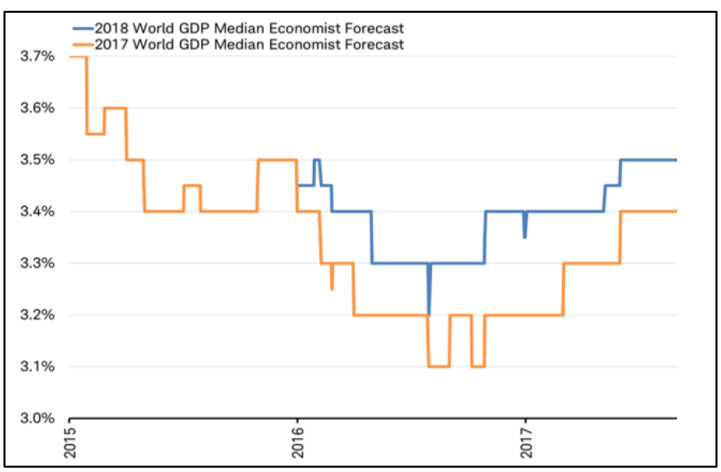


Source: Econoday

The improving fundamentals have not led to an increase in inflation, which is still below the Federal Reserve's (Fed) target of 2% as seen in Figure 2. Based on this, it would seem the Fed will increase rates gradually, which should support equity prices. As of the now, the Fed has indicated that it expects to raise interest rates once this year and thrice next year. This bears watching because recessions usually start when the Fed has raised interest rates several times to fight inflation and markets sell off in response. This time around, there is strong evidence that economic growth and stock prices were stoked by easy monetary policy and there is considerable uncertainty surrounding monetary tightening. However, the economy and the markets have responded well to the removal of monetary stimulus so far. Further, the economic indicators that we follow is showing no signs of a recession in the near future and markets continue to grind higher.

Consumer spending as measured by retail sales has been a bit subdued this year, however consumer confidence is high and real household income is solid. Increase in real household income in 2015-2016 was the highest it has ever been over any two-year period in the last 50 years. This should lead to higher retail sales.

Figure 3: Economists Forecast for Global Growth



Source: Charles Schwab, Bloomberg as of 10/11/2017

Figure 4: IMF World Output (Annual Percentage Change)

		Projections		
	2016	2017	2018	2022
World	3.20	3.60	3.70	3.80
Advanced Economies	1.70	2.20	2.00	1.70
USA	1.50	2.20	2.30	1.70
Euro Area	1.80	2.10	1.90	1.50
Japan	1.00	0.50	0.70	0.60
Other Advanced	2.00	2.40	2.20	2.20
Emerging and Developing Economies	4.30	4.60	4.90	5.00

Source: IMF, October 2017

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Improving economic growth is not just a US story- global economies are growing in a synchronized manner, something that we have not witnessed since the mid 2000's. As seen in Figure 5 below, the manufacturing sector is strong in all major developed and developing nations. Economists, who had been cutting global growth forecasts for the last two years are now increasing their forecasts as seen in Figure 3 and the IMF recently revised up its global growth forecast for 2017 and 2018 to 3.6 and 3.7 respectively (Figure 4).

Fig 5: ISM Manufacturing Index

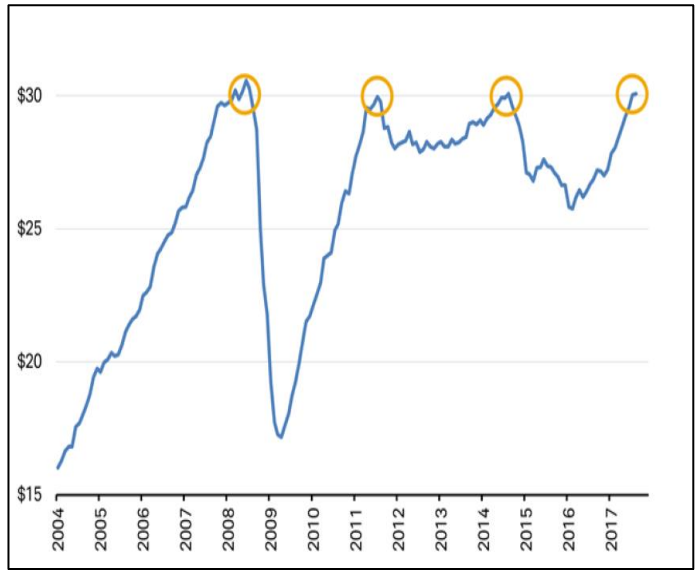
(Shades of green indicates index over 50 and manufacturing is growing)

Global Purchasing Managers' Index for manufacturing

		2015			2016												2017								
		Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
	Global	51.0	51.0	50.7	50.9	50.0	50.6	50.2	50.1	50.4	51.0	50.8	51.1	52.0	52.1	52.7	52.8	53.0	53.0	52.7	52.6	52.6	52.7	53.2	53.2
	Developed Markets	52.5	52.3	52.0	52.1	50.8	50.9	50.5	50.4	51.2	51.5	51.2	51.5	52.6	53.0	53.8	54.2	54.1	53.9	54.1	54.1	53.9	54.0	54.2	54.6
	Emerging Markets	49.0	49.2	49.0	49.4	48.9	50.2	49.5	49.5	49.3	50.3	50.1	50.3	51.0	50.8	51.1	50.8	51.3	51.6	50.9	50.6	50.8	50.9	51.7	51.3
Developed	U.S.	54.1	52.8	51.2	52.4	51.3	51.5	50.8	50.7	51.3	52.9	52.0	51.5	53.4	54.1	54.3	55.0	54.2	53.3	52.8	52.7	52.0	53.3	52.8	53.1
	Canada	48.0	48.6	47.5	49.3	49.4	51.5	52.2	52.1	51.8	51.9	51.1	50.3	51.1	51.5	51.8	53.5	54.7	55.5	55.9	55.1	54.7	55.5	54.6	55.0
	Japan	52.4	52.6	52.6	52.3	50.1	49.1	48.2	47.7	48.1	49.3	49.5	50.4	51.4	51.3	52.4	52.7	53.3	52.4	52.7	53.1	52.4	52.1	52.2	52.6
	UK	54.5	52.4	51.2	52.2	50.9	51.3	49.6	50.5	53.1	48.4	53.0	55.6	54.2	53.4	55.8	55.4	54.6	54.3	57.2	56.4	54.2	55.2	56.7	55.9
	Euro Area	52.3	52.8	53.2	52.3	51.2	51.6	51.7	51.5	52.8	52.0	51.7	52.6	53.5	53.7	54.9	55.2	55.4	56.2	56.7	57.0	57.4	56.6	57.4	58.1
	Germany	52.1	52.9	53.2	52.3	50.5	50.7	51.8	52.1	54.5	53.8	53.6	54.3	55.0	54.3	55.6	56.4	56.8	58.3	58.2	59.5	59.6	58.1	59.3	60.6
	France	50.6	50.6	51.4	50.0	50.2	49.6	48.0	48.4	48.3	48.6	48.3	49.7	51.8	51.7	53.5	53.6	52.2	53.3	55.1	53.8	54.8	54.9	55.8	56.0
	Italy	54.1	54.9	55.6	53.2	52.2	53.5	53.9	52.4	53.5	51.2	49.8	51.0	50.9	52.2	53.2	53.0	55.0	55.7	56.2	55.1	55.2	55.1	56.3	56.3
	Spain	51.3	53.1	53.0	55.4	54.1	53.4	53.5	51.8	52.2	51.0	51.0	52.3	53.3	54.5	55.3	55.6	54.8	53.9	54.5	55.4	54.7	54.0	52.4	54.3
	Greece	47.3	48.1	50.2	50.0	48.4	49.0	49.7	48.4	50.4	48.7	50.4	49.2	48.6	48.3	49.3	46.6	47.7	46.7	48.2	49.6	50.5	50.5	52.2	52.8
Emerging	China	48.3	48.6	48.2	48.4	48.0	49.7	49.4	49.2	48.6	50.6	50.0	50.1	51.2	50.9	51.9	51.0	51.7	51.2	50.3	49.6	50.4	51.1	51.6	51.0
	Indonesia	47.8	46.9	47.8	48.9	48.7	50.6	50.9	50.6	51.9	48.4	50.4	50.9	48.7	49.7	49.0	50.4	49.3	50.5	51.2	50.6	49.5	48.6	50.7	50.4
	Korea	49.1	49.1	50.7	49.5	48.7	49.5	50.0	50.1	50.5	50.1	48.6	47.6	48.0	48.0	49.4	49.0	49.2	48.4	49.4	49.2	50.1	49.1	49.9	50.6
	Taiwan	47.8	49.5	51.7	50.6	49.4	51.1	49.7	48.5	50.5	51.0	51.8	52.2	52.7	54.7	56.2	55.6	54.5	56.2	54.4	53.1	53.3	53.6	54.3	54.2
	India	50.7	50.3	49.1	51.1	51.1	52.4	50.5	50.7	51.7	51.8	52.6	52.1	54.4	52.3	49.6	50.4	50.7	52.5	52.5	51.6	50.9	47.9	51.2	51.2
	Brazil	44.1	43.8	45.6	47.4	44.5	46.0	42.6	41.6	43.2	46.0	45.7	46.0	46.3	46.2	45.2	44.0	46.9	49.6	50.1	52.0	50.5	50.0	50.9	50.9
	Mexico	53.0	53.0	52.4	52.2	53.1	53.2	52.4	53.6	51.1	50.6	50.9	51.9	51.8	51.1	50.2	50.8	50.6	51.5	50.7	51.2	52.3	51.2	52.2	52.8
	Russia	50.2	50.1	48.7	49.8	49.3	48.3	48.0	49.6	51.5	49.5	50.8	51.1	52.4	53.6	53.7	54.7	52.5	52.4	50.8	52.4	50.3	52.7	51.6	51.9

Source: JP Morgan Asset Management

Fig 6: MSCI AC World Index Consensus EPS next 12 months



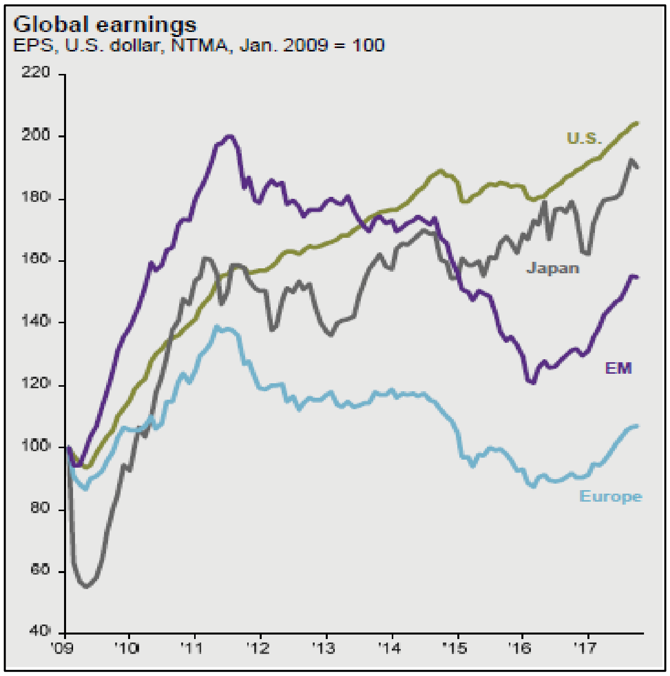
Source: Charles Schwab, Factset as of 08/17/2017

Central banks around the world have begun to or, in some cases (As in Europe), begun to talk about reducing monetary stimulus by reducing their balance sheets and increasing interest rates. However, they have indicated that they plan to do it in a measured manner if inflation continues to be low. As mentioned above, increase in interest rates is usually bad for the stocks and bonds, however, increasing interest rates with an improving economy in the background can support higher stock prices.

Global economic growth is translating into corporate earnings growth, which is what matters for the markets. As seen in Figure 7 below, corporate earnings in all major developed and developing nations are on an upswing. Interestingly, global corporate earnings per share are set to exceed $30 for the fourth time in ten years as seen in figure 6. The last three times, only a few regions contributed to the rise towards $30 and subsequently earnings fell back because of a recession somewhere. The difference this time around is that the economies of all the regions are growing solidly and may support earnings growth past $30.

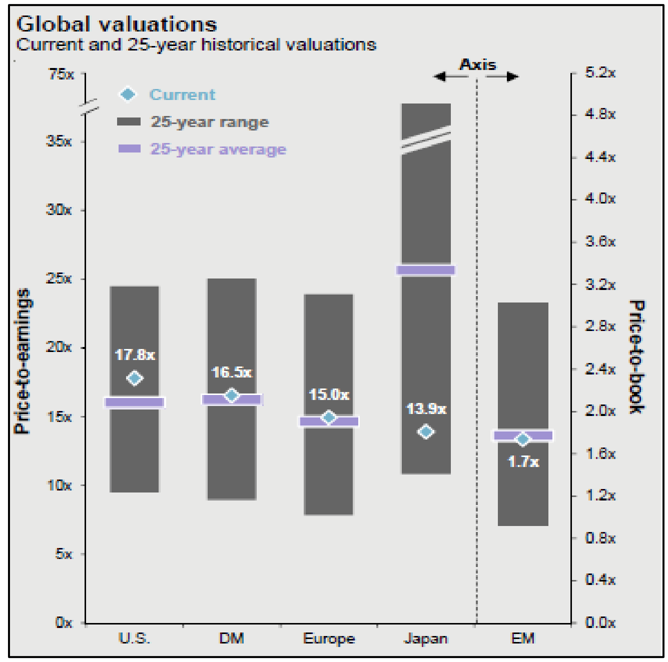
The rally in stock prices is leading to higher stock valuations as seen in Figure 8. While valuations are at or higher than their 25-year averages, they are still not stretched or in bubble territory and should help stocks sustain their rally. In the short term, a correction can happen at any time and there is enough fodder to fuel one. Geopolitical tensions, policy hiccups by central banks or Governments or potential protectionist measures could all be a catalyst for a correction. Recently, no negative domestic or international news has managed to trip the markets and investor optimism is very high. Usually, high investor optimism is a contrarian indicator suggesting stocks should fall, however the optimism is not leading to large fund flows into equities. On the contrary, as per Evercore ISI, fund flows into domestic equity is negative suggesting caution despite the optimism. In other words, we are not witnessing the excessive investor behavior that is seen at market tops. If investor's actions follow their optimism then markets could rally strongly.

Figure 7: Global Earnings



Source: JP Morgan Asset Management

Figure 8: Global Stock Valuations



Source: JP Morgan Asset Management

The Equifax data breach

In September people were shocked to learn that there was a security breach at Equifax, one of the consumer credit reporting agenc in the US. The breach affected 143 million consumers, more than half the adult US population, potentially compromising their sensitive information. The important thing to note is that even people who never explicitly used Equifax services could be affected as the firm collects consumer information routinely. This was a wake up call to a number of consumers on the need to be pro-active in protecting their information. We wrote an article on what you can do to protect yourself. You can read it here.

At Sarsi, we take the task of protecting our client information and cybersecurity very seriously. We have adopted the best practices laid out by our custodian Charles Schwab. You can read about the best practices here.

The opportunity cost of waiting for a crash to invest is high: Follow up

As expected, we received several e-mails in response to our analysis on the above subject in our second quarter newsletter. We are aware that the analsis appeared to be self serving but would like to clarify that the analysis was not in support of simply buying and holding stocks, but rather the futility of timing market crashes. As we said in our conclusion to the analysis, ' … on average waiting for the market to crash is not a good investment strategy. Investors are better off creating a sound investment strategy in line with their objectives and sticking to it. Robust portfolio construction, selecting suitable investment vehicles, tactical allocation and macro aware investing can add additional value.' We would also like to point out that the standard deviation (Volatility) of returns of a buy and hold strategy is the highest as compared to all other timing strategies that we considered in the analysis. This supports the view that if, as we believe, it is impossible to time the market then portfolios should be constructed in line with investor's risk profiles because the ability to tolerate volatility differs from person to person. On the margins, additional value can be added by investment selection, tactical allocation and macro aware investing.

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