



Third Quarter 2017 Commentary

Dear Clients,

Please find enclosed your September 30, 2017 Investment Reports.

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 7.9%. European stocks were also very strong performers, gaining 6.2%. More broadly, developed international stocks rose 5.6%. For the third consecutive quarter, the U.S. dollar depreciated against foreign currencies, boosting dollar-based investor returns in those markets.

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 Vanguard 500 is up 14.1% for the year, while the iShares Russell 2000 ETF 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.

Moving to the fixed - income markets, core

Benchmark Returns - As of 9/30/2017

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	4.7%	19.4%	14.2%
US Mid Cap Stocks	3.4%	15.3%	14.5%
US Small Cap Stocks	4.6%	17.3%	14.1%
International Developed Stocks	5.6%	19.7%	8.4%
Emerging Market Stocks	7.9%	20.4%	4.3%
US Bonds	0.8%	0.1%	2.1%
Global Bonds	2.5%	-2.4%	-0.7%
US REITs	0.6%	-0.7%	8.2%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
 US Mid Cap Stocks: CRSP US Mid Cap TR USD
 US Small Cap Stocks: CRSP US Small Cap TR USD
 Emerging Market Stocks: FTSE Emerging TR USD
 International Developed Stocks: FTSE Developed Ex US TR USD
 US Bonds: Barclays US Aggregate Bond TR USD
 Global Bonds: Barclays Global Aggregate Ex USD TR USD
 US REITs: MSCI US REIT NR USD

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 around 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.

In contrast to Europe and Japan, the U.S. Federal Reserve continues to very gradually tighten, reflecting that the United States is further along



in its economic and market cycles. As expected, at its September 19 meeting, the Fed left its policy rate (federal funds rate) unchanged at a range of 1% to 1.25%, but it kept a potential December rate hike on the table and detailed its plan to begin shrinking its \$4.5 trillion (quantitative easing) portfolio of Treasury and mortgage-backed bonds. Starting in October, the Fed will allow \$10 billion worth of bonds to mature and roll off their balance sheet each month, increasing the total roll-off by \$10 billion each quarter until it reaches \$50 billion per month. The financial markets took the Fed announcements largely in stride.



As noted earlier, the near-term macroeconomic (fundamentals) backdrop for U.S. stocks still looks pretty solid. But U.S. stocks have high valuation risk. Across almost every absolute valuation metric, U.S. stocks look expensive to very expensive. 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, the U.S. market seems long overdue for a correction.

However, 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.

Investors in 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 follow an investment process and be invested in a portfolio allocation that is truly aligned with their individual risk tolerance, investment temperament, and financial situation. Otherwise, chances are they will make a poorly timed, emotionally charged decision to change their portfolio. This has real potential to damage their long-term financial well-being, even if it might feel better in the heat of the moment. For example, reducing exposure *after* a sharp selloff, when prices are now cheap and the risk/return attractive; or, chasing a bull market *after* it has run-up to expensive valuations and poor future expected returns. 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.

Thank you for your continued confidence and trust.


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