"When an economist says the evidence is 'mixed,' he or she means that theory says one thing and data says the opposite."

"In order to do good economics, you have to keep in mind that people are human."

— Richard Thaler, 2017 recipient of the Nobel Memorial Prize in Economic Sciences

DATA NOISE

Equity markets expressed persistent optimism in the third quarter, climbing steadily in the face of geopolitical tension and policy uncertainty. Even amid two of the most destructive hurricanes in U.S. history, many market participants seemed to focus only on the stimulatory potential of rebuilding activity. While recognizing the economic opportunities posed by recent events, we believe that a close scrutiny of current and historical data trends justifies a more moderate outlook.

U.S. GDP growth in the second quarter captured some of the delayed activity that caused weak first quarter growth, jumping from 1.2% to 3.1%. While growth in the third quarter, and the overall trend, is likely to come in between these two numbers, other economic data has been harder to interpret. A record-breaking hurricane season, by both interrupting businesses and prompting rebuilding and restocking activity, has been amplifying the noise in unemployment, inventory, shipping, and other data. For example, the ISM Manufacturing Index jumped 2.0 percentage points in September, exciting some market participants. However, 75% of this increase is attributable to the supplier delivery component of the index, which captures shipment activity that accumulated due to the interruption of business activity by hurricanes Harvey and Irma. Tellingly, the last time this component increased this aggressively was immediately following hurricane Katrina in 2005. Historically, these events are unlikely to affect economic trends to the same degree that they affect certain short-term data points. Economic surprise indices published by Bloomberg and Citi each remained negative for the duration of the quarter, indicating that new data has consistently lagged expectations. Despite this, small business confidence and other measures of "soft" data remain persistently high. This broad optimism originated in the wake of last November's elections, and remains linked to the prospects of tax reform and fiscal stimulus with which Congress is currently wrestling.

TAX POLICY: CONGRESS' RUBE GOLDBERG MACHINE

The logical path from fiscal ambitions to accelerated economic activity involves many steps, each of which leave room for error. Republicans intend to first use the budget reconciliation process to set a proposed net change in the federal budget deficit, before filling in the details of how taxes and expenditures will be allocated. As a first step, getting to the 51 Senate votes required to pass the budget resolution will be a challenge given the fervor of many Republicans for lowering the deficit, and the stated goal of lowering tax rates outlined in the tax reform framework already released. Once a resolution is passed, the budget becomes a zero-sum game, within which any further tax cuts must be offset with tax increases to another party.

However, if Republicans are united enough to be successful in creating tax reform legislation consistent with the budget resolution, how it will affect the economy remains an open question. While corporate tax cuts would directly increase after-tax profits, the connection to increased investment spending is uncertain: some of these gains could be distributed to shareholders rather than invested in domestic projects as politicians hope. While any domestic investments made by corporations are likely to increase the productivity of labor, they may also contribute to increasing automation at the cost of job growth. Meanwhile, the global competitiveness of U.S. corporations remains dependent on a broad set of variables including the strength of the U.S. dollar and the performance of foreign economies. It will take significant time for a new budget to be implemented, for its effects to play out, and for expectations and markets to adjust. All we can say at this point is that the degree to which corporate tax reform will boost U.S. economic growth is both uncertain and dependent upon factors beyond the control of Congress.

LATE-CYCLE INTEREST RATE MOVEMENTS: READING TEA LEAVES AT THE BOTTOM OF THE YIELD CURVE

Ongoing economic headwinds compound the challenges of actually achieving effective tax reform. The unemployment rate hit a 16-year low of 4.2% in September, reflecting a tightening labor market. In fact, average hourly earnings have been in a gradual uptrend for the past five years, and just reached 2.9% on a year over year basis, for the first time since mid-2009. Continued hikes in the federal funds rate, which began in December 2015, are also likely to discourage economic growth at the margin. We anticipate the delayed effects of this tightening monetary environment to continue to develop over the next couple of years.

While both the U.S. stock market and surveys of business sentiment appear to be anticipating increased growth, the bond market has been more skeptical of the growth impact of tax reform and the change in administration. We can analyze this through the functional components of current bond yields. After last November's election, and again in September, the yield on ten-year U.S. Treasury bonds increased, and the yield curve steepened. Historically, such an increase in the difference between long term and short term bond yields is associated with an improving economic outlook. However, a component of bond yields tied to inflation expectations increased during the same periods, meaning that the increase of real, inflation-adjusted yields was less significant. Another component of bond yields, the term premium, represents the amount of additional yield investors require to hold a bond with a longer duration. As with inflation expectations, estimates of the term premium increased during both of the periods mentioned above. When we subtract both of these components, the remaining changes in bond yields should solely reflect the market's expectation for economic growth. Again, for both September and in the wake of the election, this measure of growth expectations declined. We find it advisable to continue to scrutinize the reaction of both equity and bond markets to ongoing political developments and their capacity for supporting economic growth.

REVIEW OF THIRD QUARTER PERFORMANCE

Equity markets saw steady and broad-based gains in the third quarter. Defensive themes continued to outperform in July and August, while the renewed focus of Congress on tax reform, along with rebounds in oil prices and the U.S. dollar, gave small-cap and value stocks a boost in September. The S&P 500 returned +4.48% for the quarter, while the S&P 600 small-cap index returned +5.96% after climbing +7.71% in September. The Russell 1000 Growth index returned +5.90% for the quarter, while the Russell 1000 Value index ended up +3.11% after negative performance in the first two months of the quarter. All sectors of the S&P 500 saw positive returns except for Consumer Staples, which ended the quarter down -1.35%. In a reaction to both hurricane-induced interruptions in supply and further OPEC production cuts, oil prices gained over 12% during the quarter, with a barrel of West Texas Intermediate oil ending the quarter at a value of $51.67. As a result, energy stocks were the second-strongest sector during the quarter, returning +6.84% while the Technology sector gained +8.65%.

International stocks were supported by continued weakness in the dollar, and had overall performance similar to U.S. stocks. The MSCI All Country World index excluding the U.S. returned +6.25% for U.S. investors during the quarter. Bond returns were solid in July and August, but prices softened in September in anticipation of another hike in the federal funds rate, and in response to a bounce in cyclical factors in equity markets. Over the quarter, the Barclays Municipal Bond Index gained +1.06%, while the Barclays Government/Credit Intermediate Index returned +0.60%.

VALUATION AND POSITIONING

Given both late-cycle economic headwinds and the policy uncertainty discussed above, we do not anticipate significant improvements in U.S. economic growth above the post-financial crisis average of about 2.25%, and stock valuations thus appear somewhat expensive. The S&P 500 index closed the quarter at 18.2 times expected earnings for the next twelve months, up from 17.5 last quarter and slightly over the 25-year average of 16.0 times earnings. The cyclically adjusted P/E ratio, which uses the average of ten years trailing earnings, is at 30.7 times earnings, 0.7 standard deviations over the 25 year average. Compared to the current S&P 500 earnings yield of 5.4%, the yield on the 10 Year Treasury Inflation Protected Securities is just 0.48%, indicating that stocks should return about 4.9% more than bonds. Despite this potential return, we believe that current valuations and economic conditions also present significant risks. We believe that the current expectations for higher growth embedded in stock market valuations will gradually decline to a level more consistent with the post-financial crisis average. As a result, we continue to maintain a neutral equity exposure for portfolios with discretionary allocations, as well as a risk-neutral positioning in our equity strategies.

Geopolitical risks, while often unpredictable, remain ever capable of shocking financial markets. Though we are not altering our investment strategy in anticipation of any specific crises at this time, we are concerned by the directly conflicting strategies of Secretary Tillerson and President Trump for responding to North Korea's ongoing development of nuclear weapons. Likewise, this hurricane season has provided a taste of the increased risks associated with global climate change, and we continue to actively evaluate the environmental risk management practices of our portfolio companies.