## ECONOMIC HIGHLIGHTS

New Single-Family Home Sales for August came in at a 560,000 annualized rate versus 571,000 for July. New Durable Goods Orders were up 1.7% for August, and up 5.1% for the 12 months ended August. Most of the strength over the past year has come from areas outside of transportation, so the growth in orders has had wide breadth. The Chicago Purchasing Managers Index came in very strong for September, at 65.2 versus 58.5 consensus. U.S. Real GDP growth for the second quarter came in at +3.1% on an annualized basis, with the price index up only 1.0%.

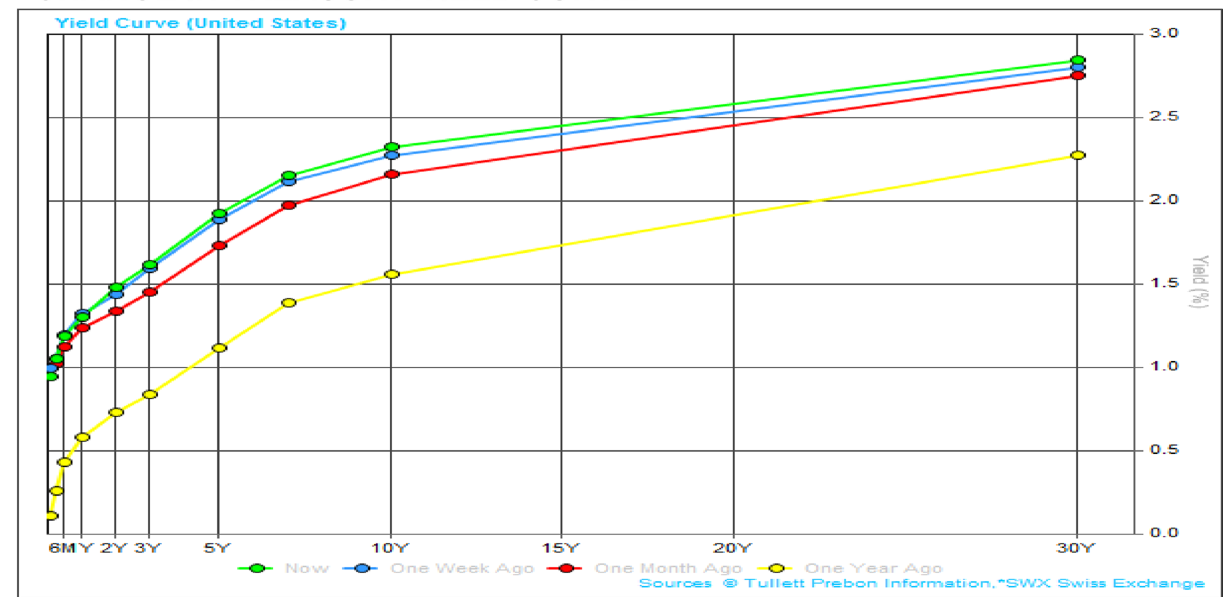
## FIXED INCOME

While market participants were watching the myriad of Federal Reserve speakers last week to gauge the likelihood of a rate hike in December, the more interesting discussion was taking place in Europe on the risks surrounding the unwind of the central bank's $4.5 trillion balance sheet. In a panel titled "Exit From Non-Standard Monetary Policy," held at the Second ECB Annual Research Conference on September 25, former Fed Governor Jeremy Stein focused on the uncertainty on the liability side of the balance sheet. The implementation of post-financial crisis capital rules designed to keep the financial system safe, particularly the liquidity coverage ratio, have incentivized commercial banks to park more excess reserves at the Fed (currently at $2.2 trillion) and slowed demand for safe assets. By massively increasing reserves, the Fed "was creating at least a certain kind of safe asset that was actually really helpful," Stein said. "My point is, now as we start to unwind, one ball you want to keep your eye on is what's happening there and whether we will see some sort of the strains that were papered over finally starting to emerge." Demand for high-quality liquid assets from the eight systemically important banks in the U.S. is about $2.7 trillion, of which roughly $1 trillion is held in the form of reserves, according to Stein. The uncertainty about the reserves depends on how banks decide to replace them. As the Fed starts unwinding its balance sheet this month, banks could opt to hold Treasuries of any maturity or prefer to hold bills, creating further competition for short-term paper already in high demand from money-market funds. Should banks choose the latter; Treasury can decide to alter its supply, issuing less long-term debt in favor of short-term paper. "The idea that Treasury is going to add a trillion to the very short end is probably not likely," according to Stein.

**CURRENT GENERIC BONDS YIELDS**

| TREAURIES | | AGENCIES | | CORPORATES | | MUNICIPALS | |
|---|---|---|---|---|---|---|---|
| 3 mo | 1.04% | 3 mo | 1.06% | 3 mo | 1.34% | 3 mo | 0.79% |
| 6 mo | 1.19% | 6 mo | 1.14% | 6 mo | 1.41% | 6 mo | 0.84% |
| 1 yr | 1.29% | 1 yr | 1.30% | 1 yr | 1.51% | 1 yr | 0.89% |
| 2 yr | 1.48% | 2 yr | 1.52% | 2 yr | 1.75% | 2 yr | 1.03% |
| 5 yr | 1.94% | 5 yr | 1.81% | 5 yr | 2.33% | 5 yr | 1.48% |
| 10 yr | 2.33% | 10 yr | 2.74% | 10 yr | 3.06% | 10 yr | 2.20% |
| 30 yr | 2.86% | 30 yr | | 30 yr | 3.84% | 30 yr | 3.36% |

**CHANGE IN TREASURY YIELD CURVE**




## EQUITY

| INDEX RETURNS | LAST WEEK | YTD |
|---|---|---|
| Dow Jones Industrials | 0.25% | 15.45% |
| S&P 500 (Large Cap) | 0.72% | 14.24% |
| S&P 400 (Mid Cap) | 1.60% | 9.40% |
| Russell 2000 (Small Cap) | 2.83% | 10.93% |
| NASDAQ Composite | 1.09% | 21.73% |
| MSCI EAFE (International) | 0.13% | 20.56% |
| iShares Real Estate | 0.62% | 6.66% |

Stocks bucked the seasonal tendency of weakness for the month of September by finishing the month up nearly 2% for the S&P 500 and over 2% for the Dow Jones Industrial Average. The S&P 500 also closed the quarter with its 8th straight quarterly advance.

Financials and Energy were the clear winners amongst the eleven major sector groups. HealthCare and Utilities were the only two sectors to fall on the week. For the month of September, the post-election reflation trade roared back. Cyclical sectors showed strong performance while more defensive sectors lagged.

Ryan Detrick of LPL Financial pointed out in a research note last week that September saw 8 new highs for the S&P 500 – the 3rd most ever for any September. That mark only trails 1995 which had 10 new highs and 1955 which had 11.

The Regional Bank sector saw a large reversal during the final three weeks of September. The group entered the period down -10% through September 6, then proceeded to rally over 14% to end the month up nearly 3% on a year-to-date total return.

Looking ahead to October, Bespoke wrote in a seasonality note that stocks are now entering the best three-month period – October, November, and December. The Dow Jones Industrials has averaged a positive return for October over the past 100, 50, and 20 years. Over the past 20 years, the Dow has averaged a gain of nearly 2% with positive returns 70% of the time.

Bespoke also noted since 1928, when the S&P 500 has been up between 10% and 20% year-to-date through September, the index has averaged a gain of 4.79% over the final three months. So far this year, the S&P 500 is up 11%.

Moving forward, politics will be the main focus of headlines, specifically the evolution of last week's tax reform Republicans unveiled. Expect sectors and industries to fluctuate based on perceived winners and losers as details continue to emerge throughout this legislative process.

The first iteration of tax reform resulted in a sharp rally for cyclical stocks and those that derive large portions of their revenue from overseas – for example, Technology and Industrial stocks. Two key provisions of the proposal are a lowering of the corporate tax rate from its current level of 35% and a feature that allows for an avenue to repatriate revenue generated and held overseas.

The S&P 500 closed last week at 2519 – we continue to watch the following support levels – 2465, 2400, 2395, and 2325. Keep in mind the new all-time intraday high now stands at 2519.

## ASSET ALLOCATION

| CURRENT SENTIMENT | |
|---|---|
| Cash | Neutral |
| Short Fixed Income | Neutral |
| Intermediate Fixed Income | Neutral |
| Inflation-Adjusted Fixed Income | Unfavorable |
| High Yield Fixed Income | Neutral |
| International Fixed Income | Neutral |
| Equity Income | Favorable |
| Large Cap Equity | Favorable |
| Mid Cap Equity | Favorable |
| Small Cap Equity | Neutral |
| International Equity | Neutral |
| Emerging Markets Equity | Favorable |
| Real Estate | Favorable |
| Commodities | Unfavorable |

Below is a summery of our current stance on most asset classes:

**Cash** - Holding as little as possible given the miniscule yields in money market instruments. Any exposure is for defensive positioning.
**Short Term Bonds** - Relative to Intermediate Bonds, the reduced duration is preferable given the outlook for higher interest rates.
**Intermediate Term Bonds** - The current trading range of intermediate bonds warrants a neutral position with limited upside potential. Some opportunities still remain present in spread products.
**Inflation-Adjusted Bonds** - Low inflation expected in near-term providing zero real return.
**High Yield Bonds** - Spreads have tightened; however, still remain attractive versus Treasuries.
**International Bonds** - Emerging market bonds offer good diversification qualities while providing higher yield opportunities relative to domestic fixed income.
**Equity Income** - High quality and higher-dividend-paying companies remain attractive for long-term investors given their favorable risk-adjusted profile and current yield curves.
**Large Cap Stocks** - A favorable weighting is recommended. Growth has reemerged as a more favorable style and should be overweighed versus Value.
**Mid Cap Stocks** - Mid cap exposure along with a value tilt is preferred. Mid cap stocks continue to provide the "sweet spot" of market capitalization - large enough to provide stability, but small enough to be more nimble.
**Small Cap Stocks** - In broad market corrections, small cap stocks will suffer most with increased volatility. However, a recent divergence of relative strength between small caps and large caps warrants a neutral exposure.
**International Stocks** - Given most foreign investment is in developed markets and European countries, until sovereign debt concerns are alleviated, an underweight to neutral weight is recommended.
**Emerging Market Stocks** - Stronger balance sheets, less debt, and better growth potential make emerging markets more fundamentally attractive than developed countries longer-term. Recent relative performance versus developed markets support the stronger fundamental backdrop and positions have been added.
**Real Estate** - Pricing has stabilized and long-term valuations appear attractive. Real Estate has performed well of late and should continue to be a strong alternative to other asset classes.
**Commodities** - Global demand should support higher prices if the global recovery remains on track. Although, volatility will be higher and commodities will be susceptible to short-term price shocks, if used in conjunction with other asset classes, risk can be reduced substantially to a diversified portfolio. However, used alone is not recommended as the short-term outlook is not favorable.

*Sources of statistical information are Bloomberg and Ned Davis Research.*

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