OAK ASSOCIATES

Market Commentary

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The Calm After the Storms

We have stated many times over the past decade how well the stock market does overlooking the prominent headlines of the day and remaining focused on the underlying economy and its outlook. The third quarter of 2017 was no exception. Despite three devastating hurricanes that wreaked physical and economic havoc on Texas, Florida, Puerto Rico and the majority of the Caribbean, political divisiveness in Washington, and nuclear saber rattling from North Korea, the US stock market rose an impressive 4.5%. If anything, despite repeated setbacks to repeal and replace the Affordable Care Act, optimism is building towards possible tax reform and the prospect that Congress will now successfully address the issue.

The absence of an interest rate increase from the Federal Reserve also helped equities this quarter. Chairman Yellen's desire to lift short-term rates and rearm the Fed's monetary arsenal are well known. The unknown has always been the speed and severity of the rate normalization. After raising interest rates in both Q1 and Q2 of 2017, the Federal Reserve left the Fed Funds rate at 1.25%. Stocks, in general, like a low interest rate, low-inflation environment. Minor inflationary pressures have been appearing, but the backdrop for stocks remains friendly.

The three devastating hurricanes this season will have a lasting effect on the economic numbers going forward. Natural disasters skew economic activity and destroy capital investment. Consumers in Houston and Florida will certainly replace damaged items, particularly vehicles and home furnishings. While initially stimulative, in reality, consumer spending shifts as purchasing is brought forward and future consumption is often suppressed as a result. The destruction of existing capital and investment assets will slow long-term economic growth as these assets, such as factories, inventories, or strategic initiatives, are not easily replaced, financed, or feasible anymore. Competition for rebuilding-related trades and materials will also rise, both regionally and nationally, as assets are redeployed to satisfy demand. However, given the strength of the domestic economy and the sound financial environment, the economic effects of hurricanes Harvey, Irma and Maria are manageable. Monetary policy is still very relaxed, and while the Fed may be eager for higher short-term rates, it has shown a deference to keeping conditions accommodative should extenuating circumstances warrant.

In addition to the meteorological issues in the quarter, aggressive rhetoric with North Korea did increase volatility in mid-August temporarily. The VIX Index, a measure of uncertainty using option prices inputs, spiked twice in the third quarter, reflecting the insecurity over geopolitical issues under President Trump. These spikes were short-lived however, and the VIX Index returned to a historically low level below 10 in September. Undoubtedly a rising stock market helped alleviate investors' uncertainty. By the end of the quarter, the VIX was sitting near a year-to-date low.

Optimism over tax reform under a Republican President and Congress has developed despite the Party's inability to revamp President Obama's Affordable Care Act. Any simplification of the tax code, lowering of tax rates, discussion of repatriation of capital, or fiscal stimulus tends to buoy investor sentiment. It is beyond anyone's ability to foretell the end result, but many believe that the prospect of some tax reform or repatriated capital are higher today than they have been for some time. Should profits held overseas be granted favorable tax treatment, investors are likely to see further dividend growth and stock buybacks.

At this stage of the economic cycle, growth stocks have been outperforming value stocks. Large-caps have also been besting their smaller brethren. Information Technology was the top performing sector for the quarter, and only Consumer Staples produced a negative return. As a whole, companies continue to seem willing to fund buybacks and dividends. Profit margins, while historically high, remain resilient in a low inflation environment. Productivity growth could be better, but absent inflation and labor market issues, it's a minor disappointment.

The national US unemployment rate of 4.4% is a 16-year low. Second quarter GDP was recently revised to 3.1% growth, a very healthy rate. The S&P 500 reached another all-time high in the quarter and is up 14.2% year-to-date. Emerging Markets, as seen by the MSCI Emerging Market's ETF, are also up 28.6% year-to-date. In all, the economy gives us little to complain about.

For now, our companies' fundamentals remain healthy and the stock market has enjoyed the "not-too-hot, not-too-cold" environment. We continue to monitor factors likely to signal a shift in the investment landscape, and track the progress of the economy's expansion. The 2008 financial crisis is far in the rear-view mirror now, yet financial companies still demonstrate a discipline that suggests the recession that often thwarts bull markets is not yet on the horizon. As always, we remain diligent.

Thank you for your time and support of Oak Associates.

Best regards,

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