

JRM Investment Counsel

An Independent Registered Investment Advisor Firm

Market Commentary Third Quarter, 2017

There was no shortage of events and issues to distract investors during the third quarter. North Korea continued to launch missiles (15 year to date) in defiance of the international community, and three major hurricanes caused hundreds of billions of damage in the U.S. and Caribbean. In addition, the FBI investigation into Russian influence in the election heated up, there were numerous high level resignations/firings in the Trump administration, and the Republican controlled Congress failed to repeal and replace the Affordable Care Act legislation, twice.

Meanwhile, market volatility remained low and with the exception of MLPs, valuations continued to grind higher. Investment returns by asset category benchmark this year were:

<u>Asset Category (Benchmark Index)</u>	<u>Third Quarter</u> <u>2017</u>	<u>Year to Date</u> <u>2017</u>
Domestic Equity (S&P 500)	4.5%	14.2%
Developed International Equity (MSCI EAFE)	5.4%	20.0%
Emerging Markets Equity (MSCI Emerging Markets)	7.9%	27.8%
Alternatives (Alerian MLP)	-3.0%	-5.6%
Fixed Income (Barclays US Aggregate Bond)	0.9%	3.0%
Preferred Stock (S&P Preferred Stock)	0.8%	9.0%

The best performing asset category was emerging markets equity, aided by weakness in the dollar. The emerging markets equity asset category is more volatile than domestic or developed international equity markets. Since 1996, emerging markets have declined *intra-year* by 10% or more *each year*, including years when the returns were positive. Although we expect a pull back some time, it is not possible to predict when it will occur, if it will be shallow or deep, short or long duration.

So why do we recommend including emerging markets equities in our portfolios? Emerging markets equities add important diversification to a multiple asset class portfolio. From 1997-2016 cumulative returns from the S&P 500 and emerging markets equities were similar, with the S&P 500 up 188% and emerging markets up 218%. However, over shorter time periods the returns were quite different as noted on the following page.

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<u>Five Years Ending</u> <u>December 31</u>	<u>Emerging Markets</u> <u>Cumulative Return</u>	<u>S&P 500 Cumulative</u> <u>Return</u>
2001	-3.5%	62.0%
2006	143.4%	38.2%
2011	66.6%	12.9%
<u>2016</u>	<u>11.5%</u>	<u>75.4%</u>
Total	218.0%	188.4%

Although both asset categories can be volatile, the volatility often occurs at different times. This is because the drivers of economic activity and returns in the U.S. and abroad are often independent of each other. Including both in a globally diversified portfolio can have a smoothing effect on portfolio returns and volatility over long time horizons.

In spite of the outperformance year to date, foreign equity valuations continue to be slightly more attractive than domestic. Most of our multiple asset class portfolios are modestly overweight developed international equity and emerging markets equity. However, the more important point is the equity allocations are diversified globally.

Regarding domestic equity, growth stocks performed better than value during the third quarter, and small-cap stocks performed better than large-cap. Best and worst performing sectors year to date were technology and energy, +27.4% and -6.6%, respectively.

Interest rates were low and continue to compress. At the end of the quarter, the 10 year treasury yield was 2.31%, down 0.14% this year, and the 2 year treasury yield was 1.38%, up 0.18% this year. This “flattening” of the yield curve implies the market expects relatively low inflation and economic growth for the U.S. economy.

During the quarter, the “official” federal debt topped \$20 trillion, an increase of 7% over last year, while the economy grew 2%. With the federal debt growing faster than the economy, interest expense will consume an increasing portion of the federal budget. In addition, estimates of the unrecorded liabilities for federal employee retirement plans, Social Security and Medicare are \$70 trillion and growing. These entitlement programs will add to annual deficits as more people become eligible for benefits.

On September 27th the Trump administration published its latest proposal to reform the federal tax system by eliminating most itemized deductions and reducing corporate and personal tax rates. If you search for “Trump Tax Plan” there are more than 12,000,000 results, so we will not describe all of the details here. If approved as proposed, the plan would be a boon for many investors, especially those with pass through business structures. The Trump administration contends that the plan will be revenue neutral, primarily by offsetting the tax cuts with much

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higher economic growth that would increase total tax revenues despite the lower rates. Count us as skeptical that true “reform” will become legislation or sustainable economic growth would be sufficient to offset the revenue reduction from lower tax rates. In other words, Congress may cut taxes, but if so it will probably increase the deficit. Regardless of the outcome of the proposed tax plan, we expect the high (and growing) levels of debt will suppress economic growth and inflation, and interest rates will likely remain low for a long time.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio please let us know.

Respectfully,



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