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Monthly Market Commentary

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US Economy

After the equity-market close on September 28, Standard &Poor's (S&P) restructured its 11-sector Global Industry Classification Standard (GICS) lineup as announced late last year. A new sector called Communication Services has replaced the current Telecommunication Services sector. In addition to the existing Telecom companies (e.g. Verizon, AT&T, etc.), the Communication Services sector includes a number of select industry groups that resided in the Consumer Discretionary (Netflix, Walt Disney, CBS) and Information Technology (Facebook, Alphabet (parent-company of Google), and Twitter) sectors. The GICS reconfiguration was motivated by an evolution in how people communicate and connect through the internet, media, and wireless communication, and will better reflect the modern economy.

Now that the GICS changes have gone into effect, the new Communications Services sector represents approximately 10% of the total market capitalization of the S&P 500 Index. The current weighting of the Information Technology sector is now 20%, down from 26%. The Consumer Discretionary weighting dropped from 13.2% to 10.1%. The last change to the S&P GICS occurred on August 31, 2016, when listed Equity Real Estate Investment Trusts (REITs) and other listed real estate companies were removed from the Financial Sector to form a new Real Estate sector.

US Markets

US equity markets trended higher in September as news surrounding a preliminary trade deal with Mexico was announced, consumer and small-business confidence continued to increase, and the effects of the tax reform bill have begun to be felt in the economy. Looking forward, we are closing in on the election season, which is historically a choppy period for the markets, due to rising uncertainty. Nonetheless, after the elections are over, we anticipate the markets could trend higher into year-end. As such, we recommend investors remain patient during this election-cycle, as market-volatility could rise in the near-term.

Fixed Income

As expected, the Federal Open Market Committee (FOMC) decided to increase the range for the federal funds target by 0.25% during their September meeting, with a new range of 2.00% - 2.25%. The FOMC reiterated that it expects economic conditions to evolve in a manner that will warrant gradual increases in the federal funds rate. The Federal Reserve (Fed) will increase its balance sheet reduction by $10 billion in October. The new monthly balance sheet reduction going forward will be $50 billion.

The Fed continued to describe the path of future rate hikes as "gradual." The Fed's newly released projections indicate that one additional rate hike this year is likely and that three additional rate hikes are likely next year. One item of note, in their statement, the phrase “monetary policy remains accommodative” has been removed, suggesting that the Fed views monetary policy as neither accommodative nor restrictive at current levels.

International Markets

Concerns over dollar strength and the magnitude of potential future Fed rate hikes, combined with fears of a global (non-US) slowdown, have contributed to a 20% sell-off in the MSCI Emerging Markets Index since late-January. Dollar strength usually creates headwinds for emerging market (EM) equities as investors worry about commodities (priced largely in dollars) and EM debt denominated in dollars (a stronger dollar means that it would take more EM currency units to pay back debt). Yet, our base case calls for a modestly weaker dollar, good global growth, and a Fed that is not overly aggressive over the next 12 months.

As such, we have become more constructive on EM equities and EM debt. EM equities look oversold when compared to our forward fundamental outlook for the asset class. Consensus earnings-growth estimates suggest stronger performance for EM equities versus US large caps over the next 3 – 5 years. In short, valuations appear attractive on an absolute basis and relative to S&P 500 Index valuations.

Commodities

The US is producing and exporting historic amounts of crude oil. Yet US crude-oil imports also have increased over the past few years. If the US is producing (and exporting) record amounts of oil, why is the US importing more crude oil? The answer boils down to history, economics, and crude oil heterogeneity.

Crude oil is graded on how sweet or sour it is (a measure of sulfur content) – and also how light or heavy it is (a measure of density). Oil from different countries and even from different areas within the same country can have vastly different properties. Light/sweet crude oil tends to trade at a premium to heavy/sour crude oil, because it is easier to refine to produce high-value components such as gasoline and diesel. But as the US was building its refining industry, the vast majority of available crude oil supply leaned toward the heavy/sour spectrum (oil from the Middle East, Canada, Mexico, Venezuela, etc.). So, in order to satisfy the US’ oil appetite, refiners invested billions to be able to refine the most widely available crude oil, which was heavy/sour crude.

This creates an interesting dynamic. Despite the US producing record amounts of mostly light/sweet oil, US refiners still demand heavy/sour crude oil because it is cheaper, and they have equipment to process it. Foreign refiners demand light/sweet oil because it is simpler and cheaper to refine. This means that US refiners will continue to import heavy/sour oil on the cheap at the same time that US producers export their light/sweet oil for a premium.

What Does This Mean To Me?

Now that the election season is almost upon us, we anticipate that market volatility could increase. Nonetheless, the US economy appears to be on solid footing – consumer and small business confidence continues to increase, unemployment remains low, inflation remains in-check, and the US economy continues to expand. Looking globally, many (though not all) developed and emerging economies continue to expand, which we find encouraging. While we do have our concerns (e.g. trade conflicts with China, fiscal uncertainties surrounding Italy), we continue to believe that the global economy could continue to expand in the near-term. As such, we continue to advise investors remain patient during the election-cycle and maintain a long-term outlook.

If you have any questions or concerns, please do not hesitate to reach out to us at any time.

Sincerely,

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