THIRD QUARTER 2017 MARKET COMMENTARY
October 2017

STATE OF THE MARKETS

Equity markets rose again in the third quarter, bolstered largely by solid corporate earnings growth, low inflation, low unemployment, and the potential for corporate tax reform. The Dow Jones Industrial Average has set over 40 new record closing highs in 2017 while equities have experienced historically low volatility. Although growth stocks continue to out-perform the S&P 500 this year, value stocks benefitted from a late quarter bounce, due largely to expectations of corporate tax reform that may benefit financials and a recovery in the energy sector. Rising 3.5% in the Third Quarter, the RDM Capital Large Cap Value Equity composite is now up over 6% for the year and almost 14% for the past 12 months.

While we believe the bull market will continue through the next several quarters, we continue to view the equity markets as overdue for a typical bull market correction and are holding more cash than normal in most accounts. Potential causes of a correction could be a failure to pass corporate tax reform, a military confrontation between the U.S. and North Korea, negative consequences from the Fed's tightening process, or a significant slowdown in corporate earnings. With the market's forward P/E sitting at 17.7 (compared to the five-year average of 15.5), valuations are already on the high end and any of these events could stagger or, in extreme cases, end the current bull market. However, barring unforeseen developments, we likely would view a correction as a welcome buying opportunity for long-term investors.

Bond markets also held up well in the quarter with largely flat returns across fixed income segments, as more modest expectations for the path of interest rate hikes in coming years benefitted the asset class. In September, the Fed signaled that it will begin unwinding its portfolio of bonds purchased during the quantitative easing stimulus of the past decade, which will tend to cause rates in the marketplace to creep higher. In addition, the Fed has projected one additional hike of the Fed Funds rate prior to year-end and continuing the deliberate path of rate hikes into 2018. We, therefore, remain cautious with respect to our fixed income allocations and intend to focus on diversification of our clients' interest rate risk over the medium-term.

Going forward, we'll be closely following whether corporate tax reform negotiations in Washington can lead to a more competitive corporate tax regime and a repatriation holiday for corporate cash balances held overseas. We'll also be watching how the Fed undertakes its well-telegraphed tightening process. However, as the economic cycle continues to mature, the Fed's monetary policy will be less important than economic and business fundamentals in dictating market performance. Therefore, investing in attractively valued companies that can demonstrate fundamental earnings growth will be of paramount importance for equity returns in the post-recovery phase of the current cycle.

Impact of Key Developments in the Quarter

Tax Reform Moves to the Top of the Legislative Agenda

After taking a backseat to healthcare legislation at the start of 2017, tax reform moved to the forefront in the third quarter. Republicans released the first formal tax reform framework at the end of the quarter. Among other things, the proposal includes:

- Reducing the top corporate tax rate to 20%, which is more consistent with other countries
- Reducing the top personal income tax rate to 35% (from 39.6%) and reducing the number of tax brackets to three (12%, 25% and 35%)
- Doubling the standard deduction to $24,000 for joint tax filers and reducing the number of itemized deductions (including the state tax deduction) along with the alternative minimum tax
- Eliminating the estate tax and generation skipping transfer tax

As expected, there is partisan disagreement over many aspects of the tax plan, but there appears to be some bipartisan support for a reduction in the corporate tax rate and incentives for the repatriation of corporate profits from overseas. Reasonable corporate tax reform can be a fiscal stimulus for the U.S. economy and also greatly benefit shareholders of companies with foreign profits. As the Fed continues to unwind its monetary stimulus measures, fiscal policy will have to play a greater role in promoting the U.S. economy and making the U.S. an attractive place to form businesses and invest. If and when corporate tax reform is passed, it may ultimately benefit long-term equity investors like our clients through higher earnings potential for many of the businesses we invest in.

Further, corporate tax reforms could benefit businesses and industries that are unable to take advantage of certain tax credits and deductions, specifically the financial sector. This sector stands to benefit due to the high effective tax rate for many banks because they do not take advantage of research and development tax credits, which currently are included in the tax reform proposal, nor do they have manufacturing or other operations that generate a lot of depreciable assets.

There is a push to pass corporate tax reform prior to year-end (next year is a Congressional election year), but it will be difficult to do so due to the many special interests that underlie the current tax code and disagreements that currently exist between parties and even within the parties. Additionally, tax cuts on the corporate side will be affected by any proposed tax cuts to individuals and the amount of lost revenue from the cuts to both individuals and corporations. The equity markets seem to have priced in the likelihood that corporate tax reform will be passed in 2017 and a failure to do so could lead to increased volatility and a temporary market correction towards the end of the year. We would view any such correction to be a buying opportunity as the odds would still be in favor of an eventual passage of some tax reform package. Ultimately, the political negotiation process throughout the fourth quarter will likely cause the resulting tax package to look significantly different from any initial proposals, so investors will need to wait for the results of the political process to play out to assess its impact.

Geopolitics Take Center Stage as Crisis on the Korean Peninsula Develops

So-called "black swan" events are by definition hard to predict, but a military confrontation on the Korean peninsula would certainly qualify. Rhetoric between the U.S. and North Korea has worsened over the third quarter, with North Korea testing the patience of the U.S. and its allies with missile tests and provocations. Unless North Korea is intent on its own annihilation, it is unlikely that they would attack the U.S. or its allies first. However, the U.S. is backed against a wall due to the North Koreans progress in its pursuit of a nuclear weapon that can reach our borders. Increased sanctions have the ability to cripple the meager North Korean economy, however it is necessary for China, as its primary trade partner, to comply with sanctions or risk a trade dispute with the U.S. There are no easy solutions to this crisis and the international community undoubtedly wants to avoid a military solution to deal with the Kim regime.

The markets have taken the news of each missile test and escalating rhetoric with relative calm, expecting that North Korea will not actually act on its words. Clearly, the North Koreans have a history of saber rattling in an effort to demonstrate strength to its own people and scare the international community from striking first. However, a military confrontation with North Korea would certainly stimulate renewed volatility and a significant market correction.

While the rhetoric and threats are unnerving, it is impossible to invest around geopolitical black swan events such as a nuclear confrontation between the U.S. and North Korea. Situations like this crisis demonstrate the need to establish a long-term investment plan that is intended to ride the waves of the market and outlast temporary geopolitical uncertainty. To illustrate, the equity markets have withstood numerous geo-political shocks in recent years from crises in Russia, Greece, the U.K., China, and Italy while reaching the new highs seen this quarter. In hindsight, any panic selling of equities in response to these crises would have been a poor investment decision. While we acknowledge that the threat of war with North Korea is a different animal altogether, market history indicates that sticking with a long-term investment plan is the best path forward in the face of uncertainty.

Update on Monetary Policy Developments

As we've discussed before, the U.S. economy has begun to show the fruits of the Fed's post-recession stimulus measures – specifically, unemployment has decreased significantly and the labor market is at or near full employment. GDP grew at an estimated 3.1% in the second quarter, corporate earnings are back on a growth trajectory (with third quarter year-over-year earnings growth of 4.2%) and estimates of S&P 500 earnings indicate 11% earnings growth for the upcoming fourth quarter. In the third quarter, the number of S&P 500 companies revising their current quarter earnings guidance upward was well above average and approaching a record high. In particular, earnings in the technology and healthcare sectors appear to be picking up steam, with the recently volatile energy sector weighing on overall S&P 500 earnings growth.

Despite these economic gains, there is room for improvement. While unemployment has fallen, the quality of jobs created, participation rate, hours worked and productivity continued to lag the improvement in the overall unemployment rate and inflation remains low. As we discussed in last quarter's letter, we believe that lower quality jobs, a lower participation rate, an increasingly global employment pool and technological advances all have led to fundamental deflationary pressures.

Fed Chair Janet Yellen effectively conceded in a September press conference that the persistence of low inflation is increasingly hard to explain by citing "temporary" deflationary events and that sluggish inflation may require a lower terminal interest rate. To this end, the Fed intends to continue its rate normalization process by gradually increasing the Fed Funds rate (currently at a range of 1 – 1.25%) an average of 2 to 3 times per year until reaching the terminal rate currently projected to be 2.75%. This lower rate projection has important implications for the economy as well as bond investors. Among other things, the lack of a rapid increase in interest rates implies that bond investors likely need not fear a sudden collapse of bond prices. So long as the economy is improving at a reasonable pace but not over-heating, the Fed has no incentive to rapidly raise rates. However, fixed income will likely under-perform other asset classes throughout the rate normalization process as bond prices decline in higher rate environments. Equities will continue to out-perform as long as corporate earnings continue to grow and the economy is strong enough to withstand the higher rate environment.

Developments in Key Investment Themes

The Financial Sector Stands to Benefit from Recent Developments in Monetary Policy

The financial sector improved in the third quarter as the Fed reiterated its intention to continue with modest interest rate hikes at steady intervals over the coming quarters. Overall higher rates allow banks to generate more net interest income, which is a positive for bank shareholders. Further, growth in the economy could lead to higher borrowing, more trading and more assets for banks to manage. On the flip side, the slow path of rate hikes in combination with modest GDP growth in recent quarters has caused short-term rates to rise more than long-term rates thereby causing a flattening of the yield curve. Since banks borrow in the short-term and lend over the long-term, a steeper yield curve is more beneficial than a flat yield curve. Regardless, we continue to favor the financial sector for equity investors and believe that interest rate developments this year as well as potential corporate tax reform will lead to continued out-performance of the sector in the years to come.

Apple Delivers Much-Awaited New Products

A top portfolio holding for the RDM Large Cap Value Equity composite is Apple. The release of three new iPhones, including the much-awaited iPhone X, as well as improvements to the Apple Watch and Apple TV, were announced in the third quarter, as expected. While Apple stock had run up significantly year-to-date in anticipation of the latest iPhone, the stock pulled back somewhat after the announcement in a classic "buy on the rumor, sell on the news" trade, declining up to 8% in September. Further, reports of production delays caused traders to adjust their earnings expectations as the possibility for supply problems could push a greater portion of the new iPhone sales until after the holidays.

We view Apple as a key portfolio holding for our long-term investor clients and do not anticipate making significant changes to our position in response to the latest product announcements. We see the business as generating significant profits long-term as the Apple hardware products are complimented increasingly by services revenue generated from owners of those products. Further, the interdependency of each product leads to high switching costs and sticky customer relationships, entrenching the company with its customers despite the technological advancements of its competitors. With a huge cash pile and reasonable stock valuations, we believe the stock is a key holding in the technology sector.

Dow and Dupont Complete Merger

Dow Chemical and Dupont have been large holdings for years and, with the completion of the companies' merger in the third quarter, the combined entity (DowDupont) is now a top holding in client portfolios. The combined company will eventually split into three companies, with the exact composition of those companies still being hashed out both internally and with activist investors. Prior to the merger, Dow was up 16.5% for the year and Dupont was up 14.5% on expectations that the combined company will take advantage of synergies from combining its operations and then splitting to three companies. We have held or added to our positions in these companies based on these same expectations. While we do not try to trade around significant company events, we look to add to good companies that may benefit from mergers or breakups, and we are optimistic that DowDupont fits in both categories.

As usual, we value and appreciate any comments.

RDM Capital Associates, Inc.