



# OUR VIEW



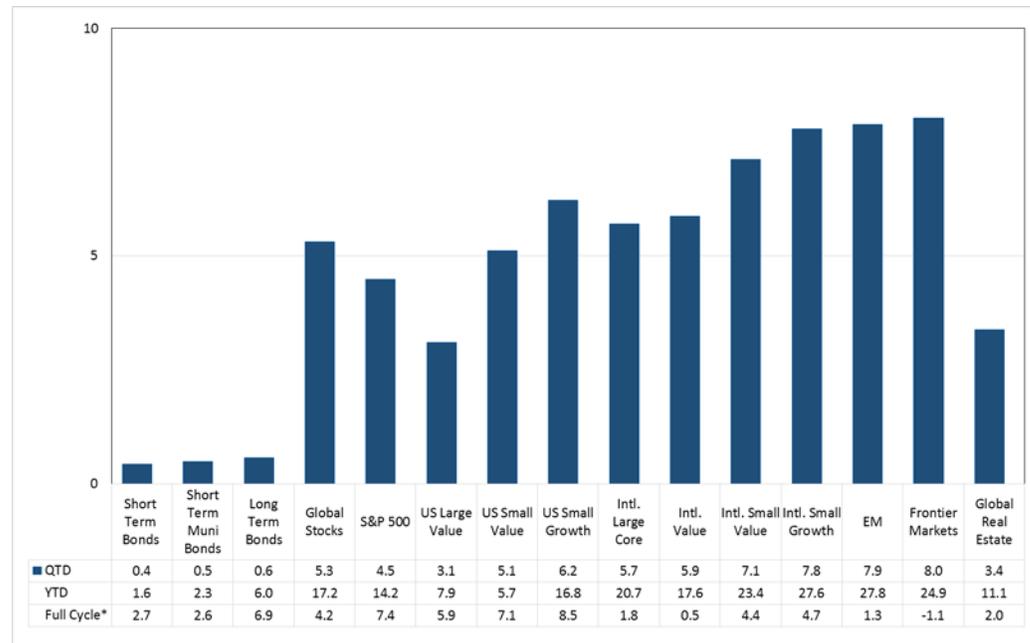
## Third Quarter Review

The third quarter was full of sound and fury in the world, but markets were surprisingly calm. Solid economic growth boosted corporate earnings, while inflation remained under control in most of the world. Equity markets responded to economic strength, looking past the geopolitical noise during the quarter.

Global equities, as represented by the MSCI All Country World Index, gained more than 5% for the quarter and more than 17% for the first three quarters of the year. U.S. equities continued to surge, with the S&P 500, Dow Jones Industrials and Nasdaq Composite Indexes all reaching record highs during the quarter. Emerging markets equities rose nearly 8% during the quarter and approximately 28% for the year-to-date period through the end of the quarter. European equities were also among the strongest performing segments of the market.

Value stocks trailed growth stocks for the first three quarters of the year, however, U.S. small cap value stocks staged a strong comeback in September amidst optimism about potential tax cuts. In sector terms, U.S. technology stocks gained more than 8% during the quarter and more than 27% for the year-to-date period through the end of the quarter. Healthcare, despite uncertainty about the Affordable Care Act, was also a strong performer during the quarter. The energy sector, the worst performer for the year, rebounded during the quarter in the aftermath of Hurricane Harvey. Consumer staples lagged during the quarter as the only sector to provide negative returns.

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TFC Chart- Historical Asset Class Returns as of September 30, 2017

Source: FactSet Data

\* Full Cycle is the annualized return from October 2007 peak to present.



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Most segments of the bond market offered low, but positive performance during the quarter despite losing some ground in September. 10-year Treasury yields were volatile, but finished the quarter at 2.3% which was near the level of the prior quarter. Beyond the Treasury market, U.S. high yield and emerging markets bonds had another strong quarter.

## TFC Portfolio Performance

TFC client portfolios benefited from strong global equity markets and allocation to international equities during the quarter. TFC's international small company holdings were particular standouts. U.S. value stocks were out of favor for most of the quarter, and were generally a drag on performance. U.S. real estate holdings struggled to provide positive returns, but non-U.S. real estate picked up some of the slack. The Walthausen Small Cap Value Fund was a relative bright spot in a challenging segment of the small cap universe. TFC's holdings in mostly high-quality, shorter-duration fixed income investments provided positive albeit unexciting returns during the quarter.

The rising equity tide lifted TFC client portfolios for the first three quarters of 2017. International equities led the way, with international small company and emerging markets equities the strongest performers. U.S. value stocks have lagged this year, but we believe that value will return to form over the long-term and provide some defense in a market correction. Fixed income provided a moderate amount of return during the first half of the year, with mortgage-backed and municipal bond holdings the best performers. Bonds may not offer a compelling value today, but offer an important source of income and offset some of the risks of equities.

## Economic and Market Outlook

The U.S. is entering the 99th month of economic expansion, the third longest expansion in history. Given the age of the expansion, it's logical to examine potential catalysts that would disrupt the economic expansion and trigger a bear market in equities. A **bear market** is a period of several months or years, typically coinciding with recessions, in which securities prices consistently fall. A bear market may develop in the not-too-distant future, but with most economies growing at an above-trend pace and inflation remaining low, the bear may stay in hibernation longer than many people expect.

Although the current expansion is noteworthy for its length, it is also the weakest expansion in the last six decades, with average GDP growth of 2.1%. The weakness of the expansion may reduce the risk that the next bear market will resemble the severity of the “dot-com” bubble or Global Financial Crisis. The dot-com bubble was caused by excessive capital spending and irrational stock market valuations in the late 1990s. Residential real estate boomed in the 2000s, and the combination of a real estate boom and excessive leverage helped to cause the Global Financial Crisis. The 1990 recession isn't top of mind today, but it also had roots in financial institutions weakened by real estate excesses. The culprits then were commercial real estate and savings and loan institutions. There are few signs of the imbalances that caused recessions in 1990, 2000 or 2008. Capital spending remains subdued by historical standards, despite fears that a spending boom would result from the extraordinary monetary policies adopted after the Global Financial Crisis. Housing starts are far below the peak reached in 2007, and today are rebounding from a highly depressed level. Lenders have become much more disciplined, requiring higher credit scores and more equity. There are risks in certain subsets of the economy, including student



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loans, auto loans and the energy sector, but nothing that approaches the systemic magnitude of the dot-com bubble or Global Financial Crisis. Valuations may be high, but for the most part are below the irrational levels reached during the dot-com era.

Although asset bubbles or leverage-induced recessions are what many investors fear, the next recession is more likely to be caused by an overheating economy or by central bank tightening to rein in inflation. Fed policy remains the most-likely catalyst for a recession and bear market. The Fed is starting to reduce the size of its \$4+ trillion balance sheet, and rates could rise unpredictably in response to implementation of the balance sheet reduction plan. The likely change in leadership at the Fed is another risk factor, with Janet Yellen's term expiring early next year. President Trump has several seats on the Fed to fill, and some of the potential candidates favor a rules-based approach to monetary policy. A rules-based approach could lead to a more dramatic move upward in rates, which would increase the likelihood of a recession and bear market. Rising inflation is a risk, particularly if a tightening labor market leads to a more widespread and rapid acceleration in wages than we are observing today. However, inflation is likely to "grind" higher rather than move too sharply, giving central banks the latitude to raise rates in a gradual manner.

The U.S. economy recovery is in late cycle, but U.S. corporate earnings continue to grow at a brisk pace. Economic growth in much of the rest of world is still accelerating. European growth continues to improve, as declining unemployment, increased business investment and stronger global trade are boosting corporate earnings. Japan is benefiting from the synchronized global economic recovery, while demonstrating surprisingly stronger domestic consumption. Chinese growth was strong in the first seven months of the year, but is expected to slow moderately in the remaining months of the year. A more dramatic decline than expected in Chinese growth is a risk we are monitoring, as is the escalating conflict over North Korea's nuclear adventurism.

European political risks have eased, but long-term risks remain. Although developments in Spain are in the headlines, we see Italy and Brexit as the most significant risks for Europe. In Spain, the Catalan conflict is likely to remain a political crisis rather than turn into an economic one. Spain's economic recovery has outpaced its Euro Zone peers since 2013, despite an extended period of political deadlock. There are constitutional and economic considerations that make a negotiated solution likely between Catalonia and the central government. The Brexit situation remains unresolved, with uncertainty about whether Theresa May will retain power long enough to lead the UK through Brexit talks. The Italian economy – despite its recent cyclical recovery – remains a Euro Zone laggard due to high debt, low competitiveness and political uncertainty. Italy's lack of meaningful supply-side reforms has led to a multi-decade decline in productivity growth. The loss of market share of Italian exporters is one of the most pronounced globally, while Spain's share has held up well. In the words of Lombard Street Research, "Italy remains the euro area's problem child."

## Closing Thoughts

Overall, the continuation of a "Goldilocks" economy – "not too hot, not too cold" -- supports a bull market that could extend well into 2018. Growth could potentially accelerate if reflationary policies such as tax reform provide a boost in the latter part of 2017. However, given the long bull market and elevated valuations in the U.S., the risk of a recession is a possibility that shouldn't be ignored.



Overzealous policy tightening still represents the greatest threat to a pro-risk stance, but with economic data positive and inflation subdued, the Federal Reserve may have the luxury of taking a slow and steady path. As the last few years have shown, moderate growth, dovish central bank policies and low inflation have been an ideal backdrop for stock market investors.

In the near-term, a correction may be more likely than a bear market. A stock market correction is commonly defined as a market decline of 10% from its 52-week high. Most investors welcome a market correction during a bull market, as corrections allow the market to consolidate before moving toward higher highs. Corrections are a normal occurrence during bull markets, and the current bull market is no exception. Other than the 2011 correction caused by the downgrade of U.S. government and European government debt, corrections since the Global Financial Crisis have been reasonably shallow and short-lived. Even the 2011 market correction was relatively brief, providing buying opportunities in a long-term bull market.

We are not complacent about the prospects for the stock market. Although the bull market may continue into 2018, we expect lower future returns from equities given elevated valuations, demographic pressures and debt burdens. All good things must come to end, and a bear market is likely when we think beyond the near-term time horizon. We continue to be aware of the potential for an economic downturn, policy mistakes, or geopolitical conflict that would accelerate the timing of the next bear market. We are monitoring the risks outlined above and will be reviewing client portfolios individually for rebalancing opportunities. As always, we welcome your comments and questions.

Sincerely,

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