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THIRD QUARTER CHECKUP

As with any checkup these days, whether it's with your car, your physical exam, or stock market performance, there are always so many charts placed in front of you that the effect can be dizzying, if not paralyzing. Greeting us as we enter the third quarter is the headline from the widely-followed Barron's magazine, "Market Dangers Lurking in the Second Half." Before long you gravitate towards the parade of negative headlines and charts flashing on the screen. The Hindenburg Omen, which has a remarkably dubious record for predicting market crashes, is flashing danger again, and disciples of the indicator point to other technical readings that suggest the market is due for a significant pull back. The celebrated investor, the late Sir John Templeton, would always say that we are inexorably attracted to bad news, that while it seems to be programmed into our DNA as part of our survival instinct, it clouds our ability to see clearly through the headlines. But then there are just as many technical charts that signal, perhaps after a summer retreat, that the markets are set to march higher again.

Regardless of whose opinion, or indeed second opinion we seek, the market has a way of reminding us who's in charge, in much the same way that Mother Nature can torment or delight us depending on her mood. And just because there's a scary list of potential worries that can upend the market, it doesn't mean that it's about to happen, nor does it mean that we shoot to new highs. This market has given new meaning to the word resilient, looking beyond geopolitical risk, worrying domestic political gridlock, and a central bank that seems intent on marching towards rate normalization despite an economic backdrop that refuses to gain meaningful traction. While corporate profits have provided a much needed strong fundamental underpinning to market performance, analysts are adjusting their estimates for the next earnings season with regard to currency

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fluctuations, oil prices, and the effect of higher wages on margins. Still, with the dog days of summer upon us, it's important to remember that in terms of seasonality, this is not, statistically, the market's strongest phase, and a pull back or two are as normal as summer thunderstorms, and actually help to cool things off, before entering a more welcoming fourth quarter.

Indeed, we begin the second half of 2017 with U.S. household income inching 1.4 percent higher to $94.8 trillion, due primarily to strong stock and mutual fund performance, while home values gained $499 billion. While this bodes well for consumer spending based on the 10 percent of the U.S. population that owns 80 percent of stock market holdings, outstanding student loans and auto loans dampen consumer discretionary spending, while health care costs continue to escalate. Still, if job creation continues to expand along with wage growth, the all-important consumer can still help propel the economy at the solid pace of the last few years.

THE WASHINGTON PERSPECTIVE - THE CLOCK IS TICKING

The hope for a 3 percent economy, however, needs corporate U.S. to engage in more spending for research, goods and services. House Speaker Paul Ryan, the champion of tax reform, said in a recent interview that you need tax reform if you want to reach 3 percent growth;

"I do believe tax reform is absolutely essential for getting faster economic growth that's durable, long-lasting."

Vice President Mike Pence, like Speaker Ryan, emphasized the need to pass tax reform by the end of 2017, and Gary Cohn, the top economic advisor to the president, said that the goal is to have a tax reform bill presented to Congress in early September. The passage of a newly revised health care bill would pave the way for tax reform because the bill repeals many of the taxes implemented by the Affordable Care Act, including a tax imposed on high earners who receive a high proportion of their income from capital gains. Moreover, in terms of pure politics, passage of the bill would lend confidence to the political process which witnessed the demise of the first attempt at "repeal and replace," as internecine politics within the ranks of the Republican Party made compromise seemingly impossible.

For investors, tax reform, coupled with regulatory reform, loom large as important catalysts for markets. Cynicism has seeped into the investor psyche as the president's repeated promises of a "big announcement" for tax reform fail to be delivered beyond a one page memo outlining a to-do list. The plan's wish list includes:

- Cutting large corporate rate cuts that ideally would bring the rate down to 15 percent from 35 percent;
- Collapse the number of tax brackets for individuals from seven to three, with corresponding levels of 10 percent, 25 percent, and 35 percent;
- Doubling standard deductions which are currently $6,350 for individual filers and $12,700 for married couples who file jointly;
- Keeping deductions for mortgage interest and charitable contributions, but eliminating many others, including the deductions for taxes paid to local governments and states;
- Repealing the Alternative Minimum Tax (AMT), which pushes tax payers into a category that calls for higher taxes;

- Repealing of the estate tax, which the president called the "death tax" on the campaign trail.

Key Republicans who will be drafting legislation have referred to the president's outline as "critical guideposts" as they seek to draft a plan that can be accepted by all factions within the party. Democrats have consistently labeled the outline as a plan to benefit the wealthy at the expense of the middle class.

Cohn, in introducing the outline in late April, said,

> ***"We have a once-in-a-generation opportunity to do something really big. The president is going to seize this opportunity by leading the most significant tax reform legislation since 1986, and one of the biggest tax cuts in American history."***

With the delay in the healthcare vote, Cohn reiterated that tax reform is on the agenda regardless of the vote on healthcare: "We are going to get to tax reform if this passes or doesn't pass." Following the summer recess, "We will be 100 percent engaged in tax reform."

Treasury Secretary Steve Mnuchin said the goal of the plan is to create jobs and economic growth.

Clearly there are concerns that the president, mired in the thick of ongoing investigations, won't be able to focus on the tax reform initiative, but it is also becoming clear that the Republican Party itself embraces the necessity of moving forward well before the 2018 Congressional election, while they still maintain control of both houses.

YELLEN CONTINUES TOWARDS RATE NORMALIZATION

Federal Reserve Chair Janet Yellen, known for her signature "gradual" approach to monetary policy, raised rates again this year at the June Federal Open Market Committee (FOMC) meeting. In addition, she suggested that another rate move is more likely than not this year, as well as the beginning of "Quantitative Tightening" (QT), the unwinding of the Fed's $4.5 trillion balance sheet composed of Treasury bonds and mortgage-backed securities. The Fed's balance sheet stood at just over $800 billion in December 2008, when then Chair Ben Bernanke began the Quantitative Easing (QE) program designed to ease financial conditions and help restore confidence in an environment scarred by the financial crisis. This followed interest rate reductions that had lowered its benchmark rate to virtually zero; QE is designed to further lower long-term rates. Bernanke recently wrote that

> ***"In a sense, the U.S. economy is 'growing into' the Fed's $4.5 trillion balance sheet, reducing the need for rapid shrinkage over the next few years. He projected that the Fed could require a balance sheet of nearly $4 trillion by 2027."***

Many analysts, as well as a number of Fed officials, predict that the Fed's balance sheet could still be close to $3.1 trillion by 2025. There remains the possibility that should the economy need help from the Fed, QE could be re-started to help boost growth.

Chair Yellen's statement before the June 14, 2017 press conference was emphatic in the belief that the economy is moving in the right direction: "Returning to monetary policy, for the past year and a half the FOMC has been gradually increasing its target range for the federal funds rate as the economy has continued to make progress toward our goals of maximum employment and price stability. Our decision today continues this process. We continue to expect that the ongoing strength of the economy will warrant gradual increases in the federal funds rate to sustain a healthy labor market and stabilize inflation around our two percent longer-run objective." With the Fed's projections of a solid, sustainable economic landscape, rate normalization remains the reasonable path.

Critics contend, however, that the Fed is in the process of making a serious policy error, that is, raising rates in a slowing economy, which could lead to a marked economic slowdown. They point to a range of indicators, most notably the 10-year Treasury yield, which continues to move to the lows of the year, although the yield has recently started to inch higher. Following the election, on the back of the pro-growth/pro-business Trump agenda, the 10-year yield jumped from 1.85 percent to 2.6 percent. Disappointment in Washington politics, along with mixed economic data releases, brought the yield back towards the two percent range. With rates low in Europe and Japan, global pension funds and insurance companies continue to invest in the U.S. treasury market, helping to push yields down. China, a major buyer of U.S. treasuries, has discussed the possibility of increasing its purchases this year and next. This too, would push yields down. If weak economic data were to persist, and in particular if labor conditions were to deteriorate, yields would continue to move lower, but the Fed would most likely pause in its path towards rate normalization.

The International Monetary Fund (IMF) recently upgraded its outlook for global growth, stating that gross domestic product (GDP) is moving higher in both developed and emerging markets. This represents a departure from the tone of previous reports in which financial crises, economic weakness, and lackluster and negative earnings releases dampened forecasts. A stronger global underpinning helps support financial conditions and earnings potential across the globe.

OIL IN THE NEWS AGAIN

The price says it all, as West Texas Intermediate Crude (WTI) moved into bear market territory in late June, losing as much as 20 percent since January. Despite the second attempt at a coordinated cut in production, OPEC finds itself in a world-wide glut of production. According to veteran oil trader John Kilduff, "The market is so oversupplied and worried about this condition persisting that it is ignoring, almost completely, the red hot geopolitical situation in the Middle East, which devolves from the top line rancor between Saudi Arabia and Iran. Normally, these factors would create a large 'risk premium' of a multiple of today's prices. And make no mistake, these tensions in the region present a type of potential energy for a formidable rally, if direct hostilities were to break out." Kilduff adds, "It may sound like heresy, but the best tactic for Saudi Arabia may be to unleash its productive oil capacity and crash the market. They are by far the low-cost producer, and an ultra-low price environment would harm their regional rivals, although Iran knows how to scrimp along very well after years of sanctions."

U.S. oil production has increased in the Gulf of Mexico and from the shale producers, adding to the worldwide glut of supply. Expectations are that U.S. production could reach 10 million barrels per day by the end of 2017, from the 9.3 million barrels a day produced today.

Technical analysts are on both sides of where oil is headed, lower before turning higher, or on the cusp of moving higher. To be sure, weaker prices help the U.S. consumer with discretionary spending, and U.S. producers have cut costs dramatically since 2014. At the same time, the producers that survived OPEC's earlier coordinated cut in production began utilizing up-to-date technology to extract oil at a lower price and are operating at much more efficient levels. Of course, the Saudis want, indeed need, higher oil prices for the partial initial public offering of Saudi Aramco in 2018, and the question remains how they raise the price of oil. With Brent Crude oil slipping below $45 a barrel in late June, the value of Aramco is considerably less than initial expectations for the deal, which valued the company at around $2 trillion. The newly named crown prince, Mohammed bin Salman, will most certainly try to orchestrate a deal to push prices higher to support a strong offering.

Saudi Arabia's energy minister recently told an energy conference that

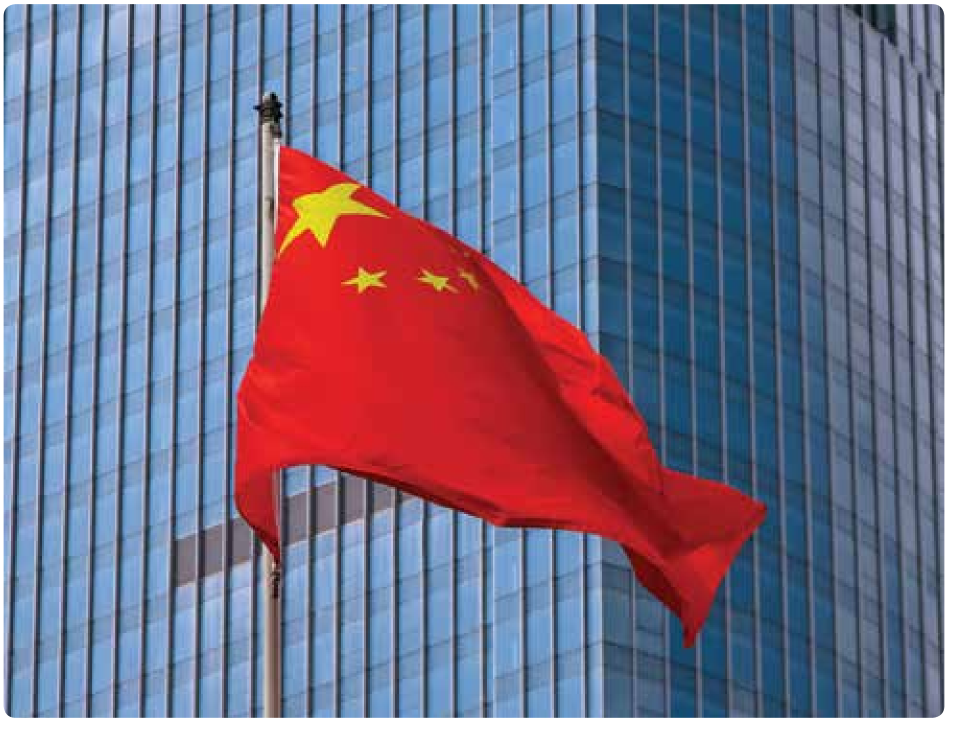
> ***"History has demonstrated that intervention in response to structural shifts is largely ineffective."***

Supply and demand ultimately are what determines a commodity price. Projections from the International Energy Agency point to stronger global demand, but supplies from non-OPEC producers will rise faster than demand. Not surprisingly, the U.S. Baker Hughes Friday rig count report is a much anticipated - and market moving - report on how U.S. producers are gearing up production.

So far, at least, the weaker prices haven't sparked a major sell-off in global equity markets. In the high-yield market, which suffered when prices first collapsed following the cuts in production, weak producers are out of the market, and high yield has held up. But in terms of geopolitical risk, lower oil prices can dramatically hurt already fragile economies in the Middle East, Africa and South America and foster domestic upheaval.

CHINA'S DEBT SPARKING CONCERN

With China's debt growing substantially over the last decade, reaching 257 percent of GDP according to the Bank for International Settlements, from 152 percent of GDP at the start of 2008, primarily because of credit given to government-owned companies, concerns are mounting that this could lead to the next global financial shock. In addition, individual and corporate debt has also escalated, adding to worries over the state of the world's second largest economy. Most of the debt was accrued by the government as it sought to insulate the country from the economic shock waves unleashed by the financial crisis. A $600 billion stimulus package helped create jobs as infrastructure spending was boosted significantly. The funding was distributed into the economy through loans coordinated by banks, rather than from the government directly. Debt was also issued on the local level with the creation of separate entities that issued bonds. Banks have seen a rise in bad debts, but the lack of transparency makes it increasingly difficult to gauge exactly how dire the situation is. Still, the rise in debt since 2007 is what concerns analysts.



Capital Economics, a research organization, issued a report underscoring that China's debt has risen more quickly

> ***"than almost any other major economy on record, and it represents the biggest risk facing emerging Asia."***

The consensus among analysts is that Chinese authorities can avert a hard landing because the debt is nearly all state owned, allowing the government more flexibility in managing a crisis, something that wasn't possible in the U.S. during the 2008 sub-prime crisis. Recently, a regulatory probe conducted by the China Banking Regulatory Commission is investigating the high leverage associated with many of the country's leading companies, companies that have been active overseas acquirers. The purpose of the probe is to control "systemic risk" in the financial system. Four of the largest companies being investigated are responsible for purchasing $56 billion worth of companies during the past five years. One of the companies, Anbang, an insurance company, bought the Waldorf Astoria in 2015 for $1.95 billion and added to its foreign portfolio with the purchase of a Dutch insurance company, office buildings in New York and Canada, and a $6.5 billion acquisition of Strategic Hotels & Resorts. The chairman of Anbang has been placed under detention as the company's records are pored over by authorities.

Along with regulations to curtail activities by private citizens to take out large sums of money for overseas purchases, primarily real estate, questions are surfacing about the role of Chinese funding in global mergers and acquisitions. While these probes should help stem corrupt business practices, a slowdown in China's participation in global finance could lead to slowdown in deal making, as well as bringing pricing down along with it.

The MSCI emerging market index announced in late June that mainland Chinese A-shares will be added to its benchmark index. Initially, 222 China A Large Cap stocks will be added gradually beginning in 2018. MSCI has worked with China for nearly four years to help them prepare for inclusion in the index, with corporate governance and lack of transparency the primary causes of investor concern.

CLIMBING THE WALL OF WORRY

Markets are always climbing the proverbial wall of worry; it's what gives markets opportunities. The worries are highlighted on the internet, and shouted over and over by the media. One of the most enduring sentiments from veteran market traders is that "it doesn't matter until it matters." It sounds rude and abrupt, but the prevailing idea behind it is that trading and investing would never happen if worry paralyzed us. That said, it's always prudent to watch for signs that "it's about to matter." In June 2007, two subprime-based hedge funds managed by Bear Stearns were closed. In August 2007, BNP Paribas, a major French bank, was forced to freeze $2.2 billion worth of funds as subprime problems began to seep into the overall global financial system. The bank's statement was a precursor to the larger problems that were about to unfold:

"The complete evaporation of liquidity in certain market segments of the U.S. securitization market has made it impossible to value certain assets fairly, regardless of their quality or credit rating."

Central banks, including the Federal Reserve, injected funds into the financial system and stock markets started climbing higher, while a major investment bank sent out a note to clients that it was time to go overweight in equities. Yet, signs in the credit markets suggested that it "mattered."

Short of a major financial calamity that causes serious collateral damage, the biggest single worry for investors is the business cycle and any signs that we're headed into a recession. So far, the economy is solid although not stellar. Economic data will paint a picture of whether or not the economy is on a healthy trajectory. Moreover, company reports will offer a picture of demand as they discuss their top and bottom lines and issue guidance on what they see on the near-term horizon. Pieced together, these reports offer a cogent mosaic of the health of the global economic landscape.

Despite the Federal Reserve's newly found resolve to bring rates to a "neutral" stance, Chair Yellen, at her core, remains data dependent, and will pause if the need arises. The European Central Bank, while seemingly inching closer towards less accommodation, remains committed towards

providing liquidity, as does the Bank of Japan. Continued central bank accommodation helps keep global financial conditions benign, offering support for global markets. If we get help from Congress, so much the better for small business owners, large corporations and the average working American.

The third quarter surely has many issues lurking about, but it also has many positive factors working in its favor. A portfolio that offers diversification for those things that keep us up at night, as well as those things that demonstrate the strong, capitalist nature of our economy should help keep us all insulated from the possible return of volatility in the market’s least favorite season.

References include the following: Associated Press (AP), Bank for International Settlements (BIS), Barron's, Bloomberg, Capital Economics, CNBC.com, Cornerstone Macro Research, The Federal Reserve, Financial Times, Goldman Sachs, The International Monetary Fund (IMF), Evercore ISI Research, Morgan Stanley, The New York Times, Renaissance Macro Research, Reuters, and The Wall Street Journal

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