Review & Outlook

THIRD QUARTER 2017

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Review

The S&P 500 index made steady gains in the third quarter of 2017. Small and mid-cap stocks lagged somewhat early, but picked up in September, outperforming the S&P 500 for the month. Small cap sticks even did well enough late in the September to outperform the S&P 500 for the quarter.

Volatility, which can be thought of as a measure of market confidence, briefly intensified following North Korea's missile tests, but remains at historic lows. The markets even seemed to ignore the hurricane disasters, as the short-term costs were weighed against the positive economic activity generated by rebuilding. As has been the trend for the past few of years, any short-term sell-off was countered by renewed buying within a few days.

There appears to be a rotation from large cap growth stocks to small cap and value stocks taking place, which may explain why small and mid-cap stocks have started to perform better than the S&P 500 in recent weeks. Financials, which are well represented in the small cap space, have seen good performance lately, with materials and health care performing relatively well during the quarter.

Indices[1]	Total Return as of 9/30/2017 Q3 2017	Trailing 12 Months
S&P 500 Index (Large Cap)	4.32%	17.88%
S&P 400 Index (Mid-Cap)	3.10%	16.97%
S&P 600 Index (Small Cap)	5.62%	21.05%
Morningstar Short-Term Bond Index	0.39%	0.66%

Outlook

The domestic and global economies continue to grow at a slow, steady pace. With evidence of global strength, including fairly solid pricing gains in commodity sectors, international markets have continued to outpace the US markets, albeit more slowly with the depreciating US dollar. The financial sector, particularly the banking sector, seems to be well capitalized, and does not appear to be on a path towards a new crisis any time in the coming months. While stock prices remain at the high end of historical price-to-earnings ratios, stocks remain favorable to bonds, where real, inflation-adjusted returns are negligible.

Economic and market activity from June through the end of September has been marked by ongoing political uncertainty at the National level, hurricanes, and North Korean missile launches. While we can be fairly confident that the natural hurricane season will eventually wrap up, the political hurricane season is likely to intensify.

Looking to the end of the year, there are a number of issues to navigate at the Federal level. The debt ceiling will have to be raised so that the U.S. can pay interest on its debt. Failure to do so would likely create a negative shock for the markets. We will also see how the efforts at tax reform play out. Tied into this is the potential for large companies like Apple, Alphabet, and Cisco to bring off-shore cash onto their books. Many hope that this could spur millions of dollars in corporate investment, although it could just as likely result in significant special dividends to shareholders, and/or share buybacks. While there was much exuberance about cuts to regulations and taxes at the start of the Trump Administration, expectations have waned significantly in recent months, and there is debate about to what extent current equity prices have incorporated successful, substantial tax cuts.

As the expectations for significant tax cuts dim, so do expectations for aggressive interest rate hikes by the Federal Reserve. In general, the "lower for longer" outlook by the Fed has helped equity prices. But if there is significant progress made on tax reform, and that in turn stimulates the economy, it is likely that the Fed will raise interest rates sooner, quickly damping any excitement. A reasonable forecast to year end seems to be more of the same slow, steady growth that we have seen. Assuming a higher debt ceiling, we don't see any catalyst for a sharp market correction, but the upside is likely limited as well, and there is a plausible case to be made that we have seen most of the gains we will see for the year, with market returns significantly outweighing underlying economic growth year-to-date.

In Focus

As the markets continue to grind higher, clients often ask us if residential real estate is in another bubble. While we don't think that prices overall have reached unsupportable levels, this hurricane season has us thinking more about "under water" housing.

In this case, the issue is literally one of houses being under water. With climate models predicting larger storm events with greater amounts of water, flooding seems to be on the rise. Combined with a measured rise in ocean levels, it stands to reason that those at risk would want to have good flood insurance. At the very least, the banks holding those home loans should want the owners to have flood insurance.

There is a National Flood Insurance Program (NFIP) under FEMA that helps provide insurance to homeowners living in flood plains. As of March 2016, FEMA owed the treasury $23 billion for this program, suggesting that premiums are lower than the true market price. In other words, the Federal Government is subsidizing people who live in areas prone to flooding.[2] Recent flooding in Houston and Florida following Hurricanes Harvey and Irma surely added billions more to the NFIP deficit.

As it turns out, only a small percentage of those affected by flooding actually take advantage of subsidized insurance. Many homeowners are facing massive repair bills because they have no insurance at all.[3] Lots of these people have mortgages, which means that until the repairs are finished, the lenders' collateral is actually under water. If the owners of these mortgages are Fannie Mae and Freddie Mac, it is the Government who ultimately bears the risk. Here is another example of a government subsidy, in this case the government is subsidizing the mortgage loan industry.

If stronger storms and larger floods are the new norm, flood insurance could become more expensive, and the politics of Federal subsidies for affected homeowners will become difficult. If the subsidies end, flood and storm insurance prices could skyrocket, likely becoming unaffordable. If mortgages become impossible to secure, people will lose the ability to finance the purchase of property, potentially instigating a significant devaluation of underlying property values. This would trigger a massive political demand for some kind of government bail-out. However, any such solution would benefit only a particular region of the country, with the view that it was costing everyone else. This might be too much of a political challenge to overcome.

People often worry about events that are essentially impossible to predict (like natural disasters and geopolitical problems) and that have a very low probability of occurring, but which have large and far-reaching negative impacts when they do happen. In this case, the problems with flood insurance that we are describing seem to have a high probability of surfacing. Multiple flooding events at the same time, or within a short period of time, will cause the underlying financial structure to unravel. If problems arise slowly over time, the banks and insurance companies involved have time to work through the issues through creative forbearance and delayed write-downs. Some companies will fail, but they will be isolated and located within the affected regions. If there is not time for such a measured response, the impacts grow.

With such a high probability of occurring, we wonder if people are discounting the risks because they think the problems will remain only in the areas affected by floods. Most of us view the flooding in Houston and parts of Florida as tragic, but geographically contained. But in fact, we are connected financially. General tax revenues collected from everyone support the funds that provide subsidized insurance. In the event of a flood in these areas (a matter of when, not if), the money flows away from other government programs to the insurance and relief efforts, and problems at Fannie Mae and Freddie Mac ripple through the mortgage and housing markets. How far such regional problems might extend more broadly within the financial system depends on the nature of any hidden systemic risk.

We have not responded to these issues by buying or selling any particular securities. Nevertheless, we think the risk is serious enough that we will limit our exposure to small lenders and insurers working within the Gulf region. If you are looking to buy retirement property in the Gulf area, we strongly recommend that you research the flood risks you face, and make sure you have a good flood insurance policy. We have chosen to highlight this topic to illustrate the ways in which we look for hidden risks and cracks in the financial foundation so that you don't have to.

1. Index Return Source Data: S&P 500 Index, http://us.spindices.com/indices/equity/sp-500. S&P 400 Index, http://us.spindices.com/indices/equity/sp-400. S&P 600 Index, http://us.spindices.com/indices/equity/sp-600. Morningstar Bond Index: http://news.morningstar.com/index/indexReturn.html.
2. US. Office of Government Accountability. 2017 High Risk Report. http://www.gao.gov/highrisk/national_flood_insurance/why_did_study#t=0.
3. Walsh, Mary Williams. "Homeowners (And Taxpayers) Face Billions in Losses from Harvey Flooding." The New York Times, 28 Aug. 2017, www.nytimes.com/2017/08/28/business/dealbook/flood-insurance-harvey.html?mcubz=0.

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