GLOBAL ECONOMIC RECOVERY DRIVES INTERNATIONAL OUTPERFORMANCE

As the synchronized global economic recovery gathered momentum, international stocks outperformed their U.S. counterparts for the third quarter in a row. The MSCI ACWI Ex-US returned 6.3 percent during the quarter compared to the Standard & Poor’s 500 Index’s 4.5 percent gain. Within international markets, emerging market stocks rose 7.9 percent, handily outpacing developed market stocks, which saw a 5.4 percent gain. Emerging markets benefitted from U.S. dollar weakness, strong oil prices, and improving global growth. An improving political backdrop in Brazil and investments in infrastructure in Russia drove outsized returns for the quarter. Within developed markets, Eurozone countries continued to benefit from improving economic data and a dovish European Central Bank along with increased political stability as recent elections highlighted a preference for continued membership in the European Union. Stocks in Italy did the best as investors cheered the state bailout of undercapitalized banks.

U.S. equity markets provided positive returns during the third quarter of 2017 as solid earnings and stronger oil prices were paired with revived reflationary expectations. The prospect of comprehensive tax reform also materialized as investors began to look past repeated, unsuccessful attempts to reconfigure the Affordable Care Act. Against this backdrop, the technology sector led with an 8.6 percent gain as strong ongoing business fundamentals and robust consumer demand began to align with the prospect of a more favorable tax rate that could incentivize technology companies to repatriate some large off-shore cash balances. Health care stocks fell back from the prior quarter’s outperformance and posted a gain of just 3.7 percent thanks to uncertainty over government legislation. A partial reversal of a six month decline in oil prices underpinned a 6.8 percent gain in the energy sector, while the industrial and material sectors did well as global industrial demand was forecasted to increase. A strengthening U.S. economy ultimately driving higher interest rates led to renewed interest in financial stocks and conversely caused interest-rate sensitive sectors such as utilities, real estate, and consumer staples to underperform.

Since small capitalization stocks disproportionately benefit from a lower tax burden, these companies outperformed relative to their large company counterparts as the specter of tax reform drove renewed interest and increased confidence in a favorable outcome for smaller companies.

BONDS: FED PLANS ITS EXIT

In September, the Federal Reserve announced that it will begin unwinding its $4.5 trillion balance sheet in October of this year. Following the financial crisis, the Fed purchased government bonds to help lower long-term rates and to signal to the market that it was determined to fight deflationary forces. With the global economy on a path towards growth and reflation, the Fed is preparing to normalize interest rates in the U.S. The unwinding is expected to be gradual and incremental in an attempt to cause minimal impact to financial markets.

The Fed did not change the fed funds rate in September; however, in her most recent speech, Fed Chair Janet Yellen presented arguments for a gradual increase in the fed funds rate and the Fed’s intention to not wait for inflation to reach its 2 percent target. The Fed maintained its outlook for hitting one more time in 2017 and at least three additional hikes in 2018. Following her speech the bond market raised the probability for a December 2017 rate hike to 77 percent from a low of 20 percent earlier in the year.

The fixed income markets were off to a strong start early in the quarter but rates began rising in September following the Fed’s announcement and Ms. Yellen’s speech. Signs of a globally synchronized recovery and inflation in Europe and Japan also hurt global bond
markets. The yield curve moved slightly higher in a parallel move across the entire yield curve. Yield on the 10-year Treasury bond, which had fallen close to 2 percent after weak inflation readings and hurricanes Harvey and Irma, rose to end the quarter 3 basis points higher at 2.33 percent. All major fixed income sectors posted positive returns for the quarter. The Bloomberg Barclays Aggregate index returned 0.85 percent. Risk on sentiment helped credit sectors outperform government bonds. The Bloomberg Barclays US Credit index returned 1.35 percent and the Bloomberg Barclays High Yield index returned 2.2 percent for the quarter. Investment-grade credit spreads started the quarter at +115 basis points and then tightened to +108 by the end of the quarter. In the high-yield sector, option adjusted spread started the quarter at +364 basis points and tightened to +347 at quarter end. Spread compression for CCC and lower-rated bonds helped the high-yield sector outperform all other sectors.

**COMMODITIES: OIL PRICES BOUNCE BACK**

Stronger than expected demand helped oil prices bounce back from the lows of June. A synchronized global recovery and lower oil prices drove demand growth from 1.3 percent in March to 3.2 percent in July, pushing crude oil prices higher by 10.9 percent in the third quarter. Signs that U.S. shale production had not increased supply as quickly as the market had anticipated also supported the increase in the price of oil. The rig count in the U.S. dropped by 6 in the quarter and the U.S. Energy Information Administration moderated its projection for U.S. production for 2018.

There may be a limited upside to oil prices as higher prices have inevitably brought on more rigs and higher production in the U.S. shale region in the past.

**OUTLOOK: PASSING TAX REFORM COULD PUT A WRINKLE IN THE BULL MARKET**

While stocks have delivered strong returns in 2017 amidst a synchronized global recovery, Congress’ inability to pass a tax reform package has the potential to damage those returns. In September, President Trump and Republican leaders unveiled a framework for reforming the tax code. Investors are expecting successful passage of a tax reform bill that would further improve growth and corporate earnings. However, Republican leaders and Donald Trump have not yet agreed on the details of that bill — such as whether the cuts should raise deficits and debt, how the tax cuts would be paid for, and whether the cuts should be temporary or permanent. The failure to repeal and replace the Affordable Care Act is fresh in investor minds, and if the bill cannot pass or if there are significant delays or changes that make the cuts much more modest, it could add to volatility in the stock market later this year or early next year.

On the positive side, a “goldilocks” investment environment of low interest rates and inflation, solid earnings growth across multiple sectors, and consistent consumer demand has benefitted global stock markets. Asian economies continue to leverage strong industrial and technology demand from developed markets, while the European Central Bank’s efforts in strengthening the Eurozone economy have begun to bear fruit. We believe these existing tailwinds are well established and likely to support continued outperformance in equities. Supportive valuations, improving economic fundamentals in Europe and Japan, a weaker dollar and stable oil prices should benefit both international developed and emerging market equities. At Alerus, we are overweight in international equities in our long-term portfolios.

We anticipate the Federal Reserve to raise interest rates by 25 basis points in December and continue to unwind its $4.5 trillion balance sheet by scaling back reinvestments in treasuries and mortgage-backed securities. The central bank accumulated its balance sheet during three rounds of purchases known as quantitative easing. As this additional supply comes into the market, long-term rates have the potential to rise. As we see further improvements in European economies, the European Central Bank is anticipated to scale back its bond purchases beginning early 2018, which has the potential for rates to go up in Europe. At Alerus, we are underweight in fixed-income in our portfolios. Within fixed-income, we anticipate credit and high-yield sectors likely to outperform government bonds.

The markets do not expect the removal of monetary accommodation by central bankers to foreshadow a rapid rise in overall interest rates as evidence of inflation remains scant across the developed world. However, job growth and wage growth in a low-growth U.S. economy could lead to higher inflation in 2018. With the Fed determined to increase short-term rates and unwind its balance sheet, a sudden and unexpected rise in interest rates across the yield curve poses the greatest threat to this bull market.

**KEY RISKS:**

**U.S. Policies** – failure to pass tax-reform bill in Congress  
**Economy** – low unemployment and wage growth cause inflationary pressures  
**Federal Reserve** – tightening and balance sheet unwind  
**Geopolitics** – escalation with North Korea