“Most things I worry about never happen anyway.”

Tom Petty

U.S. stocks have soared over 250 percent since their March 2009 lows. There has been plenty to worry about since the Great Recession such as Fed policy, Brexit, N. Korea, and political turbulence just to name a few. Yet, investors who stayed the course these last eight years have been rewarded as worries often haven’t materialized. In this edition of *Market Monthly*, we continue to focus on big picture opportunities (the forest) and remain undistracted by worries (the trees). Successful investors proactively confront challenges and march on. As we exit this traditionally weak calendar season for stocks and enter the historically positive fourth quarter, we remain optimistic as we prepare for 2018.
Summary:

Economic expansion: All 46 countries monitored by the OECD (Organization for Economic Co-operation and Development) are experiencing economic growth this year for the first time since 2007. Manufacturing data reflects the top 10 countries in expansion territory are all European. Recession risks remain low, and we appear to be on solid footing with improving trends heading into 2018.

Washington Watch: Odds of a December rate hike by the Fed have increased with a small uptick in August inflation data. Washington punted the debt ceiling issue forward until December, which buys time to “negotiate” a tax package. Recent bipartisan conversations between President Trump and Democratic leadership signal the urgency to get a tax deal done before 2018 midterm elections.

Equity Update: We remain in one of the most explosive bull markets in history yet, this bull market remains highly unpopular with anticipation of a “correction” dominating many investment discussions. Our glass remains half-full as we address common concerns. Corrections can be healthy to wring out the excess but bull markets don’t die solely due to overvaluation, political turmoil or old age. With no recession in sight, we think this bull still has some life left in it. Stay invested.

Bond Update: Concerns about N. Korea and hurricanes Harvey and Irma caused a temporary risk-off trade into bonds the last few weeks with 10-year U.S. Treasury Notes threatening to break below 2 percent. As fears have subsided, rates have regained their tight trading range of 2.15 percent – 2.35 percent. Shifting policies in Washington will have significant influence on U.S. bond markets.

Economic expansion:

Hurricane Season: The safety and well-being of our families, friends, clients and colleagues affected by hurricanes Harvey and Irma remain our top priorities. All are in our prayers as hurricanes are first and foremost, a human event.

For investors, the House overwhelmingly approved hurricane relief and a debt limit extension in a refreshingly bipartisan effort. We draw some broad economic conclusions based on a history of six costly hurricanes dating back to 1992:

- Quarterly GDP growth was higher for each of the next four quarters in five of the six cases
- The S&P 500 was higher two months later, four months later and a year later in five of six cases
- Hurricane Ike was the only exception above as it occurred literally three days before Lehman failed

The chart below illustrates a comparative history of how previous storms have impacted U.S. GDP.
Harvey and Irma combined could shave up to .75 percent off Q3 GDP growth with only Katrina having greater economic impact. Historically, any negative economic impact from a hurricane tends to last no more than one or two months, and markets tend to look past noisy, short-term economic data. We don’t think this time will be different.

Above Trend Global Growth: The most recent estimate of Q2 U.S. GDP was revised up to 3 percent and was led by consumer spending. This is the fastest pace of growth in over two years. Global GDP casts a wider net including 46 countries and is expanding at an even faster 3.5 percent pace. The OECD Composite Leading Indicator (CLI) measures forward-looking trends that can offer useful insight. Recent data shows the following:

- The share of countries with new orders exceeding inventories is 100 percent (highest in seven years)
- Purchasing Managers Index (PMI) of manufacturing activity is at its highest since May 2011
- The share of individual countries in expansion territory is 96 percent
- Share of countries whose PMIs are higher than a year ago is 93 percent

Bottom Line: We are at the midpoint of this economic cycle when growth tends to plateau. We expect this cycle will continue to support corporate earnings for now, but the rate of acceleration will likely slow as the cycle matures.

Washington Watch:

Fed Policy: The Fed meets this week and is expected to proceed with steps toward shrinking their bloated balance sheet. Firmer inflation data released last week (PPI and CPI) bucked the recent trend of disappointing data and has increased the odds of a December rate hike. Lumpy economic data in the next month or two resulting from Harvey and Irma could cause the Fed to hit the snooze button, but as long as inflation data continues to firm in the coming months, the Fed will continue tightening into 2018. News will soon turn to anticipated Fed appointments including Janet Yellen’s replacement or her re-nomination. Stay tuned.

Tax Policy: Tax reform has become the top priority in Washington. We will watch closely to see if rhetoric nudges closer to reality over the coming weeks. At the highest level, the discussion can be broken into two pieces:

Timing: With the extension of the debt ceiling until December, tax reform discussions will accelerate. The debt ceiling and deficit are critical parts of tax-reform calculus. Opinions are divided on whether the extension will accelerate tax reform or delay it.

Tax reform has shifted from a 2017 item to a “get it done before the midterms” priority. Since 1900, first-term
presidents have lost 19 House seats, on average, in their first midterm election. The losses have tended to be greater when a president has approval ratings below 50 percent such as President Obama in 2010 and President Reagan in 1982. If midterms were held today, it would be a coin toss with Democrats potentially having the edge to retake the House since current presidential approval ratings are below 50 percent. Timing on tax reform will be a factor in the midterms.

Substance: Most investors are concerned with just two things as it regards tax reform.

- How does it impact my tax bill?
- How does it impact my portfolio?

We will cover the first question at a later time as tangible details surface. The answer to the second question can be seen in the chart below.

![S&P 500 Performance Before & After Prior Tax Cuts & Reform](chart.png)

The above chart reflects the performance of the S&P 500 index before and after the last four tax-reform acts in 1981, 1986, 2001 and 2003. The dark blue line simply represents the “average” trend 12 months before and 12 months after the passage of tax reform. The vertical dotted line represents when reform was passed. The state of the world is different under each era, but in the past, markets had mixed results leading up to the passage of tax reform and positive results immediately after.

**Bottom line:** Tax reform is not priced into U.S. stocks as the “Trump Trade” from 4Q last year has been completely unwound since 1Q this year. Passage of tax reform is a market positive.

**Equity Update:**

**An Unloved Bull:** Rarely has a bull market been so unpopular. In fact, Goldman Sachs in a recent report labeled this market as a “tormented bull.” There are many arguments for this that may best be summed up as follows.

*Since the Great Recession many investors have become jaded and simply don’t trust good news.*

Earnings: The global earnings environment mirrors the global economic environment and remains the best in years. We acknowledge it is late in the cycle but there is room to run. In the U.S., after a two-year earnings recession ended in September 2016, we have experienced double-digit earnings growth. As prior weak quarters from 2016 roll off the books and are replaced with better 2017 results, we expect earnings growth to remain positive but grow at a
slower pace.

Valuations: Valuations are a primary concern right now for U.S. stocks with prices stretched at almost every metric. The primary things supporting these valuations are continued low interest rates, record earnings, lack of investor euphoria, a strong consumer, potential tax reform and a weaker dollar for U.S. multinational companies. Valuations may prompt a short-term correction but they do not cause bear markets.

Old Age: This is the second longest running bull market on record only behind the dot-com era. That alone could cause a market pause or even a slight correction due to investor angst but bull markets don’t die of old age. This is a fully valued market with positive economic fundamentals. It is not a bubble.

Correction Fears: The memory of the Great Recession is fresh enough that many investors now ask: “When will a correction occur?”

With respect to the emotions that 08-09 invokes and the acknowledgement of the extended bull market we have seen the last eight and a half years, we offer an analogy for investors with a long-term view.

*Sitting on the sidelines and not investing due to fears of a correction is like leaving your car in the garage instead of driving it for fear of an accident.*

Bottom Line: Market corrections should be expected but not timed or anticipated. We acknowledge it has been 14 months since a 5-percent correction and 19 months since a 10-percent correction. This is a late-stage bull market, but the current economic backdrop is more supportive on buying any dips than it is timing a correction. Be thoughtful, have a plan and use asset allocation as your seat belt to reduce risk.

Results and Possible Index Changes: As the chart below shows, August was a benign month for equity returns. International performance leads the way for 2017 but with a caveat. Over half of this year’s 17.05-percent international equity returns are due to a declining dollar. This should be viewed as a bonus and not an expectation. Additionally, U.S. growth has far outpaced value as a style in 2017, but there are potential changes on the horizon by both Standard & Poors and MSCI index providers.

These index providers are contemplating significant changes to their indices that shift names like Google and Facebook from the Tech sector to a newly reconstituted Communications Services sector adding to the likes of AT&T and Verizon. In addition, names like Disney and Comcast would also be added to this sector. The implications are not negative, but they are significant as it regards resulting sector composition, especially for growth indices. We will provide more information as it becomes available.
**Bottom Line:** Underlying economic strength and corporate fundamentals continue to support stock prices for now. Corrections are a natural market occurrence and cannot be timed. Economic growth is the bedrock of all bull markets, and today global economic growth is broad based and recession risks are the lowest in years. Stay invested.

**Bond Update:**

In August, bond markets experienced a classic “risk-off” return bounce. The drop in rates from 2.3 percent to 2.12 percent in August helped the 10-Year U.S. Treasury mark an impressive 1.62-percent gain. North Korea, Washington, hurricane season and stock market correction fears combined to shift markets into a “de-risking” mode as funds flowed into U.S. Treasury notes. In our view, hedging risk is the primary reason to own U.S. Treasuries at this time with better yields to be found elsewhere.

Global economies remain in expansion mode with central bank policies in various stages of transition. Investment grade corporate bonds; municipal bonds; fixed-rate, preferred stocks; and emerging market debt all offer higher yields than U.S. Treasuries but with different risk trade-offs. After several years of significant after-tax yield advantages for municipal bonds, a more traditional relative yield relationship between municipals and treasuries has been restored. After-tax yields on municipal bonds vs U.S. Treasury notes for those in higher tax brackets are quite similar out to five years. Maturities of 10 years and longer clearly favor municipals for high tax bracket investors.

As we digest future Fed decisions and proposed tax reforms at this late stage of the economic cycle, it becomes increasingly important to strike the right balance between all fixed-income asset classes in building total bond portfolios. Constructing actively managed multi-asset, fixed-income portfolios can have a significant impact from both a total return and risk management standpoint.

Bond returns have surprised on the upside in 2017 despite two rate hikes. As the chart below illustrates, domestic bond returns have been led by the high-yield and municipal sectors. Global bond returns have also generated attractive returns with much of those returns coming from a decline in the U.S. dollar.
Final Thoughts:

We think stock returns will outpace bond returns for the next 12 months.

- Market corrections are a natural occurrence to be expected, not timed.
- A bear market is fed by a recession and none is on the horizon.
- Earnings growth is expected to continue but at a slower pace.
- Bond yields should remain range bound until sustained inflation begins to appear.
- N. Korea remains a hot spot and will do what they can to cripple the Winter Olympics host country, S. Korea.
- Fed appointments will move center stage soon and rate normalization efforts will continue.
- Investment themes around tax reform will develop as the debate heats up in coming months.

Focus on the big picture and not the daily distractions.

Stay positive, stay invested!

Sources: Strategas Research Partners, Evercore ISI, FactSet, Goldman Sachs Global Investment Research, Morningstar
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