Financial Services Advisory
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Market Rotation Continues
September Market Review—October 10, 2017

Stocks continued to advance in the third quarter, with the S&P 500 index rising about 4%. That is a pretty strong result for the period, especially as August and September are historically the weakest-performing months of the year. If the S&P can post a 4% gain during this traditionally modest quarter, what might the market bring in the fourth quarter, which has generally been strong?

That the overall market hasn't had even a modest pullback in well over a year worries many observers. Markets tend to move in a saw-tooth fashion, rising and falling within an overall upward path, but this year the declines have been almost non-existent. So, while this pattern reflects a fairly complacent market, when we talk with our clients, as well as other professionals, this relative calm makes many of them nervous.

What we at FSA have noticed is that, while a broad index such as the S&P 500 has moved fairly consistently this year with only modest declines, there is more turbulence under the surface. For example, both energy stocks and telecommunications stocks are down in double digits for the year, while real estate and consumer products stocks are up only modestly. Even the high-flying technology sector has not been immune to market rotation. In June, technology fell 5%, while the broader S&P 500 index was flat.

More recently, we are seeing further evidence of what some observers refer to as "rolling corrections" because they occur sector by sector rather than across the entire market at once. Small-cap and energy stocks, which have languished all year, suddenly started to perk up in late August and have outperformed the broader indices by a wide margin. Financial stocks also have begun to show signs of life. On the other hand, health care and technology stocks have underperformed in September.

These rotations make it more difficult to ride the trends of the various sectors, but they do give the market a way to throw some cold water on areas that have heated up, and they offer new areas to capture investor interest. Through it all, the broader indices may continue to march ever higher.

Prospects Through Year's End

Our outlook to the end of the year is much the same as it has been throughout the year. Overall, general stock and bond trends are pretty healthy, which is why the money market allocations in FSA portfolios are so low. Republican moves to lower tax rates will contribute to a bullish mood on Wall Street, if—and it's a big if—Congress can get the legislation passed.

On the other hand, the Federal Reserve seems determined to stay the course on bumping up interest rates. They have been kept artificially low to help encourage economic growth, but now the Fed believes the economy is strong enough to carry on without the added boost from low interest rates. So far, the modest increases have had no negative impact on the economy. The risk is that the Fed could push future rates up too quickly and tip the economy into recession. This is not a concern for the next three months, but it's something to watch for in 2018.

Also, the big wild card for the market is some kind of shock to the system from left field. Ongoing tension with North Korea is one example. So far, the markets have not flinched at the growing war of words between the United States and North Korea, but if either side took some type of threatening action, the markets would likely react negatively—certainly at first.

So, as long as the band is playing, we'll keep the portfolios on the dance floor. However, we plan to stay near the exits in case the music stops.

Portfolio Review

Below, we review first quarter results in FSA's six broad investment strategies. Keep in mind that because we manage clients' portfolios individually, the results for your particular account may differ somewhat from the averages.

Income (Strategy 1)

In spite of concern over the future of bonds, they continue to post modest gains. Performance has been relatively strong in some areas, such as high yield corporate and high yield municipal bonds. The Income portfolios hold about 55% in these types of funds. The portfolios remain fully invested, with a money market allocation below 5%.

Income & Growth (Strategy 2)

This strategy continues to post moderate gains, with a balanced allocation of 50% stock oriented funds and nearly 50% in bond funds. During the quarter, we sold the global bond fund and replaced it with a domestic fund that owns mortgage-backed securities (high quality bond fund).

Conservative Growth (Strategy 3)

This balanced strategy continues to be weighted more heavily towards equities. Trading activity was relatively light in the third quarter, but the overall allocation to equities now stands at 70%, with the money market allocation below 5%.

Core Equity (Strategy 4)
This all-equity strategy retains its fully invested position. During the quarter, we sold the industrials and consumer discretionary sector funds while adding basic materials and financial services sector funds. The internet sector fund and the international funds posted the best returns for the quarter.

Tactical Growth (Strategy 5)
As our most actively traded strategy, Tactical Growth not only follows the broader trends of the market, it can also look for turnaround opportunities. With stock market volatility so low, we have added a fund that will increase in value when volatility increases. This could happen if investors became more nervous. We also sold the real estate fund, while adding a utilities fund. Finally, we increased both the emerging markets fund and the biotechnology fund. The money market allocation is below 5%.

Sector Rotation (Strategy 6)
This all-equity strategy continues to be concentrating in the growth-oriented sectors for 2017, not surprising, given the strong performance by such areas as technology and health care. Energy stocks are not correlating with the overall market and thus are not currently included in the portfolios. That correlation could increase in the coming weeks or months. For October, the portfolio consists of biotechnology, basic materials, transportation, technology, electronics, and internet.

Please remember to inform us of any changes in your life that could affect your investment objectives.

FSA Investment Team