SCHNIEDERS
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Fourth Quarter Market Outlook 2017

The Stock Market

Common stocks have been favorable to investors during most of this year, to a point where many investors are questioning whether future increases in value can continue, or whether the market is headed for a fall. There are a number of factors to consider in order to answer the preceding question, as there are both tailwinds and headwinds to consider. In this report, we will outline some of our thoughts in addressing this question. The equity market has benefited from tailwinds, so let's begin there.

Tailwinds

A.) Earnings

As we have mentioned in previous commentaries, equity prices are primarily driven by earnings and by estimates of future earnings. As we release this report (October 5th), we will be looking for earnings season to commence shortly. Meanwhile, earnings reports released for the first half of 2017, have been quite good.

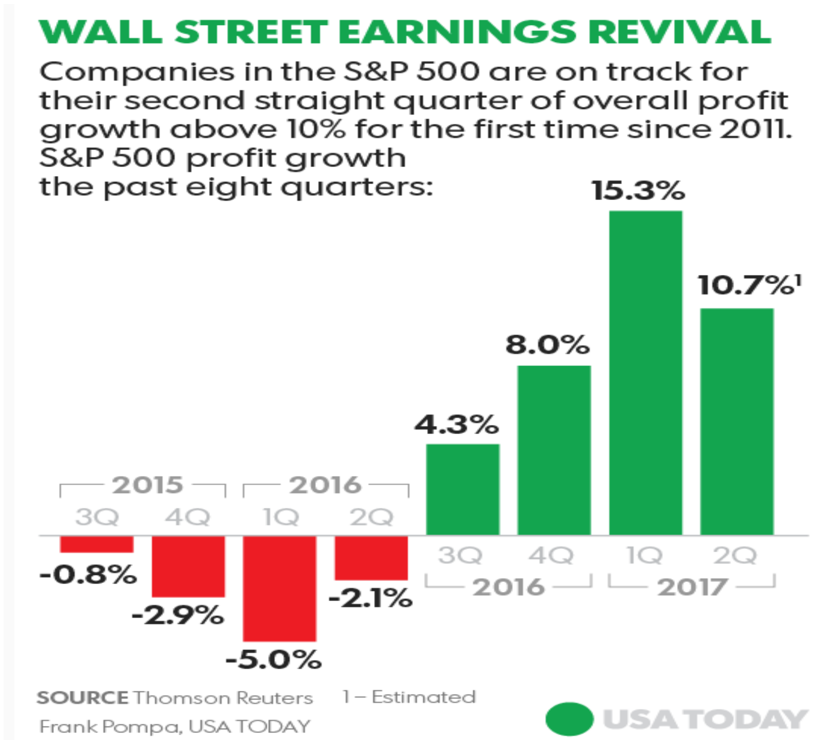
If you recall in January of this year, we published an estimate of what 16 leading brokerage firms predicted where the market might end at year end 2017. Their average estimates were an increase in price of 4.05% year over year. This was predicated on earnings estimates for 2017, however, actual corporate earnings have come in much better than expected with double digit gains.

According to Thompson Reuters, for the first half of 2017, of the 499 companies in the S&P 500 that to date through second quarter 2017, 73.1% reported earnings above analyst expectation and above its long-term average, which has led to a generously buoyant market for most of this year.

So that raises our question "Will the market continue its upward trend, and/or what can it do for an encore?" Further, "Can we expect a similar out performance of earnings in Q3 and Q4?"

We will find out the answer to that last question shortly, because corporate America, as mentioned above, will begin releasing earnings reports in the next three to four weeks.

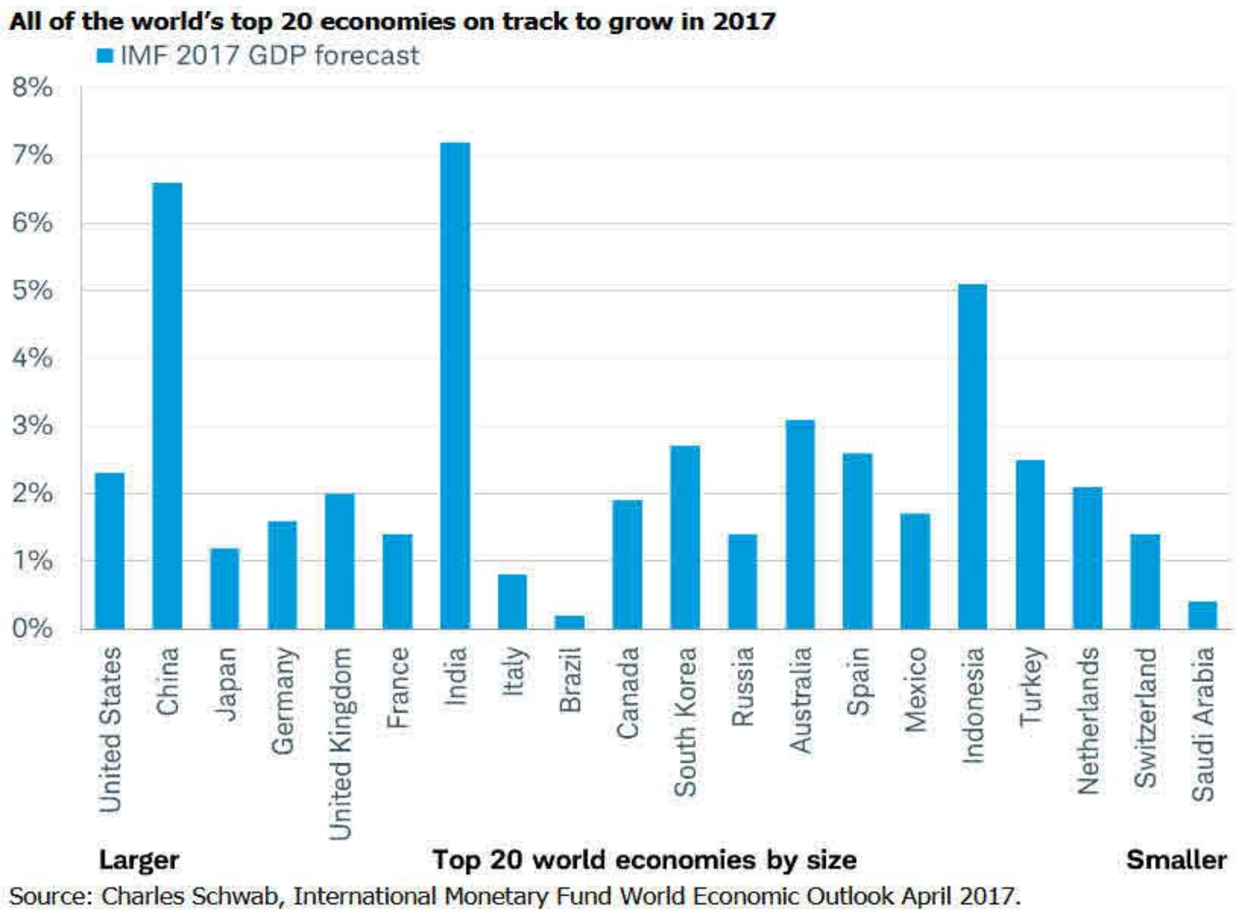
Absent any unusual occurrences, we believe that earnings will continue to be strong, albeit at a lower rate than in the first half, and if so, the market should tend to hold up as well.



We would add however, that in our opinion, the stock market is more likely to stabilize at or around current levels, as it digests the faster growth of U.S. companies during the first half of this year, rather than put on a new leg to the upside.

B.) Improving Global Economy

Another reason why the market could continue its upward climb, however, is that economic activity is improving on a world- wide basis, (see chart next page) and that seems to be reinforced by the up trending equity market not only in the U.S., but across the globe as well. In the European Union, the largest economic zone on earth, consumer confidence just hit a 17 year high. This is important because the average S&P 500 company gets close to half of their earnings overseas, so an improving global economy will help U.S. profits.



Apart from earnings growth, why is this happening? A major reason is that economic policies from Washington (for the most part) have been received favorably by the investment community. Most important, second quarter 2017 GDP numbers have now been revised upward to 3.1%. By comparison, the U.S. economy has only grown by an average of 2% over the past decade. Further, if the economy can continue to grow at or around the 3% number (which remains to be seen), it would help accelerate in the biggest tailwind of them all – that being the increasing possibility of major changes in our tax code.

U.S. corporate tax rates at 35% are the third highest in the world (only Qatar and Puerto Rico are higher), and by far the highest tax rate in the industrialized world. Both Republican and Democrat leaders in Congress seem to agree that something needs to be done in what has become a cumbersome, complicated, and long overdue tax structure.

One element of possible tax change would accrue to large corporations, who in the aggregate, have over $2.5 trillion stashed away in foreign countries to avoid paying a 35% tax on its return to the U.S. If any significant part of this returns to the U.S., it will be a boom not only for the corporations to beef up their balance sheets, but also for the banks, which will have more money to lend and to do business with those who need capital to expand their operations.

There are other positive factors as well to help support the market. Employment continues to improve. The Commerce Department reports that jobless claims have remained below 300,000 for 134 straight weeks, the longest stretch since 1970. In addition, hourly wages are up, our trade deficit while still large, is down, and capital spending by corporations is improving.

Headwinds

Given the positive outlook above, what are the negatives? By far the largest headwind to the optimism reflected above, is how the Federal Reserve's plan to raise interest rates will unfold. While there have been two interest rate hikes in the past nine months (December 2016 and September 2017) rates are still at a low level. Currently the CD rates at banks are only 1- 1.5%, Treasury notes pay 1.75% on a 5 year Treasury, and 2.34% on a 10 year Treasury. In addition to the Federal Reserve's interest rate and balance sheet plans, current equity valuations as well as geo-political concerns may also act as headwinds to the market.

Federal Reserve – Interest Rate Hikes and Balance Sheet

We have opined in previous commentaries, and continue to believe that while interest rates will probably increase, the increase will be relatively minor. We say that because of the second major headwind we face which is the size of the U.S. debt. The U.S. now has a $20 trillion debt, ¾ of which has occurred in the past 16 years.

More important, the average interest cost on this debt is under 3%. Our concern is that the mere size of the debt makes it very difficult to manage fiscal policy. For example, each 1% increase in interest rates on a $20 trillion debt equals $200 billion a year – a staggering amount. So, we believe that rates will continue to rise, and that they may negatively affect equity prices, but we do not think interest rates will rise dramatically because of the large debt.

A) Interest Rates

Apart from earnings, stock prices historically are negatively correlated with interest rates. This is true for a couple of reasons:

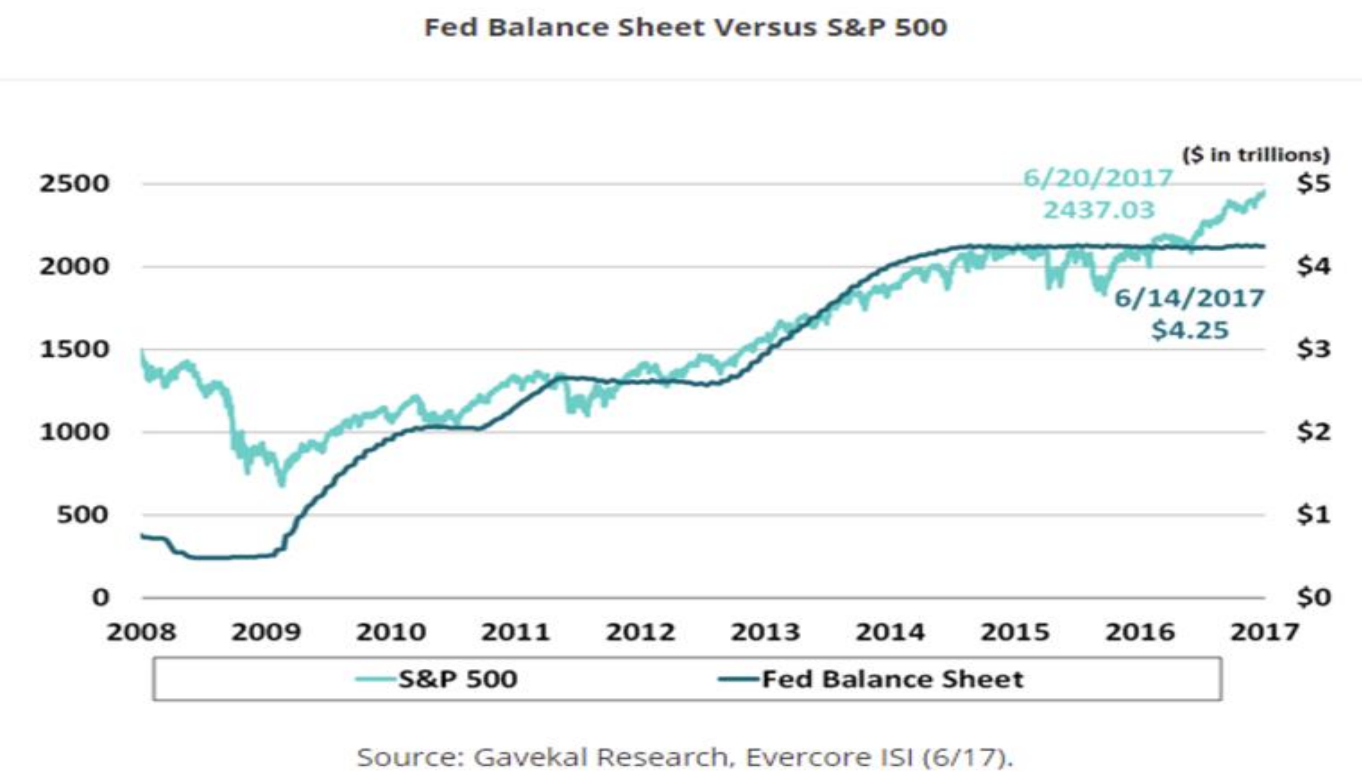
1. Bonds are considered safer than stocks, and in fact, if a company goes bankrupt, equity holders could be wiped out, while bond holders have a good chance of salvaging a portion of their investments.
2. When the Federal Reserve is in a money tightening mode, (which happens under a number of conditions) interest rates rise; and if and as they rise, bond yields become increasingly attractive, and investors begin to switch to bonds from stocks to lock in the higher rates.

As a backdrop to this discussion, bond yields are currently near record lows, and the Fed has stated publicly that they intend to tighten (increase) rates over the next 6-12 months.

On the surface, this would argue that it may be time to shift towards fixed income; except that there are other factors, including the large size of the federal debt, which would argue the rate increases will be constrained. In addition, while the Fed has publicly stated that they intend to raise interest rates, the market for longer term 10 year Treasuries has hardly budged. This implies that interest rates will not rise as far as in previous cycles.

B.) Federal Reserve Balance Sheet

Recall that the Fed went through a number of gyrations over the past decade, operating under the labels of “Quantitative Easing”, and “Operation TWIST” in order to salvage our banking system from a possible meltdown. These programs all ended up with the Fed buying securities from banks and other institutions, pushing free money into banks and other institutions in the process, in an effort to stimulate the economy. The stimulus worked, the nation avoided a depression, but the Fed's balance sheet exploded in size. Now the Federal Reserve is trying to unwind what it did.



NOTE: There has been a strong correlation between the Federal Reserve Balance sheet and the market upturn.

We have commented on these programs over the last few years, but at the end of the day, we have a central bank that is sitting with over $4 trillion of securities on its balance sheet (see above). There are roughly $2.5 trillion in U.S. Treasury obligations, and $1.8 trillion in mortgage backed securities. These monies have to either be redeemed, or sold, with the likelihood they will be sold $10-$50 billion at a time over the next few years. Our concern with this agenda is that it puts pressure on bond prices, which in turn will cause interest rates to rise. If interest rates rise too much, the equity markets will decline as investors seek safer bond yields, the federal budget deficit will increase with higher interest rates, and the pace of economic growth will slow as the cost of borrowing increases.

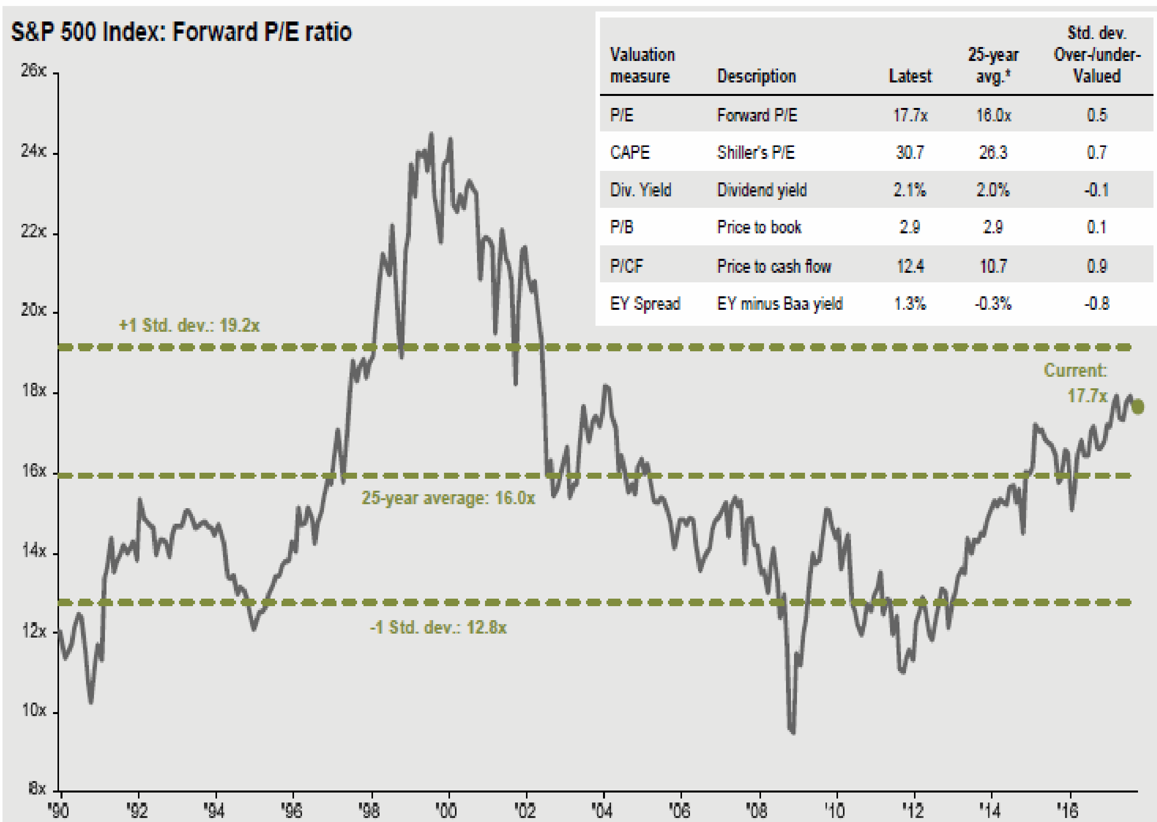
So we see this as a potentially delicate situation; one that could cause us to adjust our viewpoint on both the equity and debt market, depending upon the approach of the Fed to deal with this problem, along with the time span required to do it.

As of this date, the Fed indicated they intend to begin reducing their balance sheet in the fourth quarter of this year, starting with an objective of liquidating $10 billion per month (October until December) and then adding an additional $10 billion per month per quarter, and thereafter until it ultimately reaches $50 billion per month.

So it's all about timing, and how the Fed communicates and executes its plan to the financial world. The good news is that everyone knows that some kind of pairing down of their balance sheet has to be done, so some part of what's coming has already been factored into the markets pricing mechanisms. And it is a good sign that the Federal Reserve now believes the economy is strong enough to unwind the stimulus, but their plan has never been done before (especially on this scale) so they will have to be very careful not to unwind too much too soon.

C.) Valuation

Another headwind facing the market is valuation. According to William O'Neil + Co, the current Dow Jones Industrial Average rally is the second longest on record without a 5% correction. Market valuation can be measured in many ways, but the most widely used measure is the P/E (price/earnings) ratio. The current rally in stocks has outpaced earnings growth and as a result P/E ratios are now above historical averages. Low P/E ratios can signal value, while high P/E ratios can signal a company is overpriced. Thus, higher prices without corresponding earnings growth lead to higher P/E ratios. If a company has a price of $20 and earnings of $2 per share, the P/E ratio would be 10. In other words, if an investor were to buy an entire company priced at $20 a share, and earning $2 per share, per year, an investor would get all their money back in ten years. A twist on this metric is the forward P/E, which replaces the trailing earnings per share with analyst projected earnings per share. JP Morgan reports that the historical forward P/E ratio for the S&P 500 (500 largest stocks) is 16.   Currently this forward ratio is close to 18. Thus, this is signaling that a lot of good news is already priced into the market. In the chart below, other popular valuation metrics are listed with both the P/CF (Price/Cash Flow) and the Shiller CAPE (Cyclically Adjusted Price to Earnings) flashing warning signs.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.7x	16.0x	0.5
CAPE	Shiller's P/E	30.7	26.3	0.7
Div. Yield	Dividend yield	2.1%	2.0%	-0.1
P/B	Price to book	2.9	2.9	0.1
P/CF	Price to cash flow	12.4	10.7	0.9
EY Spread	EY minus Baa yield	1.3%	-0.3%	-0.8

Source: JP Morgan

Geopolitical Risk -North Korea

(Many clients have asked about North Korea and how this might affect the Equity and Bond Markets)

The Stock Market has not assigned a large possibility to the threat of a nuclear war with North Korea, even though the media has talked much about this possibility.   Obviously, if a nuclear exchange did take place it would be catastrophic for both people and equity valuations.   We do not know what is going to happen in the Korean peninsula, but we do believe the options for both sides are limited, based on what we do know.

A first strike by the United States is both risky and improbable because North Korea has dug in 15,000 cannons and rocket launchers into the mountainous landscape that are only 35 miles from the glass skyscrapers of Seoul, South Korea. Even if the U.S. were able to target and find all of North Korea's nuclear arsenal, and kill their leader (Kim also uses stunt doubles for many public appearances), it is unlikely the United States could take out all of the artillery surrounding South Korea before Seoul is leveled using simple cannons (Huffington Post). Thus, a military option in North Korea could quickly escalate in the loss of lives and cost.

Likewise, we do not see a North Korean first strike either. North Korea only has a few missiles and nuclear warheads. The United States has thousands of nuclear warheads and would almost certainly launch a massive and lethal counter strike. Not only this, the United States now has several layers of missile defense that can shoot down incoming missiles, while North Korea has no such system. Thus, it is probable that a North Korean attack on the USA would be unsuccessful, but the counter attack from the USA would be fatal.

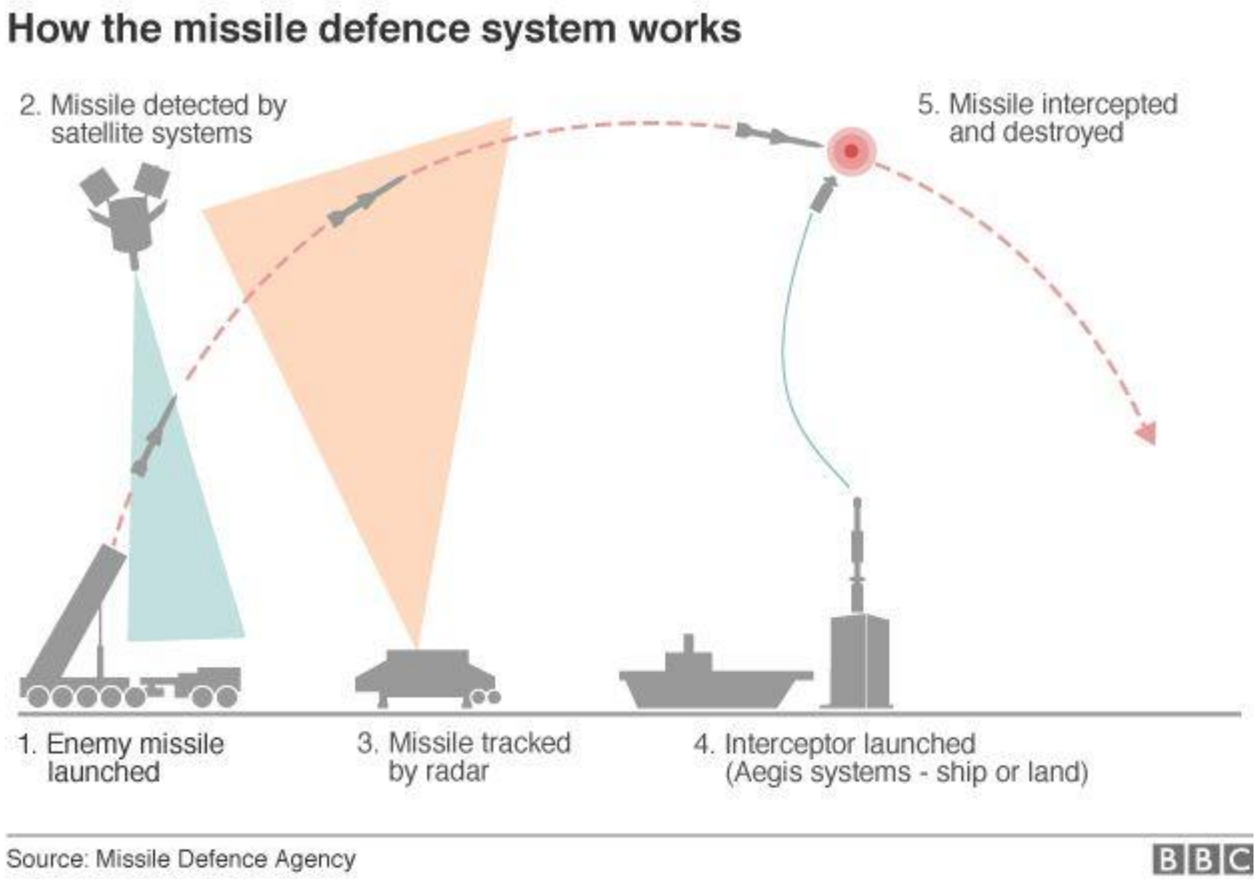
U.S. Missile Defenses

The most well-known missile defense system in the world is the Patriot Missile Defense system which was used with great success in the 1991 Gulf War. It has now been proven in combat by five different nations and has been used in more than 200 combat intercepts against unmanned aircraft, cruise missiles, and ballistic missiles (Raytheon Corporation). Patriot missiles are now deployed at U.S. military bases in South Korea, downtown Tokyo, and Guam and are used for limited, short -range area defense.

The next layer of Defense is the THAAD (Terminal High Altitude Area Defense) which is designed to shoot down ballistic missiles by running into them. The THAAD has an estimated area of defense of 125 miles and an altitude of 100 miles (both are estimates, actual details are classified). Lockheed Martin Corporation also boast that the system has a 100% success rate in test, but it has not been used in war time. U.S. Navy also deploys a similar system on its Aegis missile defense destroyers. (Aegis was the shield used by Athena –god of war) Currently, Aegis destroyers are stationed along the coasts of South Korea and Japan.

So, for local area defense, and short range missiles the U.S. defenses are quite good. However, the continental United States is protected by the Ground-Based Midcourse Defense System which has suffered from cost overruns and numerous technical difficulties. The system is a wide area defense system and is composed of 36 missile interceptors based in Alaska and Vandenberg Air Force Base, California. The operation of the system has recently been turned over to Boeing Corporation, and the system itself has only shown about a 50% success rate in missile testing. Even though the system has a limited number of interceptors, it is still likely to be enough of a deterrent for North Korea, which still has not perfected its ability to launch a missile with the range and accuracy to hit a target in the United States.

We also think the chances of the USA or it allies of intercepting a missile test by North Korea is low because there are only a limited number of interceptors and commanders do not want to waste them on missiles that are not pointed at actual targets. In addition, commanders do not want to reveal any operation details about their capabilities such as how many interceptors are used to shoot down a missile, when is the missile engaged, what altitude is it engaged, or any other details that may allow North Korea to make a stronger attack in the future. So, expect more missile tests from North Korea, more sanctions from the West, higher levels of tension, and more funding for missile defense, but no nuclear war.



So, going forward market participants will most likely continue to ignore North Korea and focus on corporate earnings growth, and the Federal Reserve's interest rate and balance sheet policies. Even though the Fed has forecasted one more rate hike this year, we too will be closely watching what the Fed does in the next few months, as we believe that will be the key as to the future direction of both equity and debt markets.

As always, we thank you for your continued support.

Sincerely,

William H. Schnieders Principal	James F. Schnieders, CFA Principal	John C. Schnieders, CFA, CFP® Principal