August 2017

Market Index	August Change	Year-to-Date
Standard & Poor's 500	0.3%	11.9%
Dow Jones Industrial Average	0.7%	13.0%
NASDAQ	1.4%	20.4%
Russell 2000 (small company)	-1.3%	4.4%
MSCI EAFE (international)	0.0%	17.5%
Barclays Aggregate Bond Index	0.9%	3.6%

Monthly Update

An Unusually Volatile August

Most years, August is a quiet month for the stock market. It is peak vacation time for traders and investors which often results in limited volatility and very low trading volume. Volatility was already low heading into the month, and there was very little expectation for that to change. Much of the focus was being placed on September when Congress is scheduled to return from recess. Not until then was the action in Washington, D.C. and consequently the financial markets expected to ramp back up. But the relatively little-changed return numbers for the Dow and S&P 500 belie the fact that August turned out to be quite eventful.

The S&P 500 moved by 1% or more four times in August, as many times as it had in all of 2017. The August 17th drop in the Dow ended a 63-session streak without a move of more than 1%, the longest since 1995. While not an extremely volatile month for trading, this caught many off guard who expected a tranquil month. Some of the volatility may have been exacerbated by the lower trading volume, but given the events that took place it's not difficult to see why it picked up.

Politics, War Drums, and Weather to Blame

Unsurprisingly, political turmoil played a part. When a U.S. President threatens "fire and fury like the world has never seen," the market pays attention regardless of whether such a threat is justified or advisable. The fact that the market did not react more severely is yet another display of its tendency to cut through the noise to the economic impact of alarming headlines. Still, safe haven assets like bonds, gold, and utilities stocks (the best performing sector in the S&P 500 for August) benefited from the turmoil.

In addition to the North Korea tensions, prospects for legislative breakthroughs seemed to dim further as President Trump engaged in several spats with Republicans in Congress. The infighting has injected more doubt into the ability for Republicans to agree on a significant tax reform package. Still, the President and his team will meet with Congressional leaders in early September to continue working on the details.

Monthly Update (continued)

There is little expectation of meaningful change to the tax code for individuals, but there is some expectation of a reduction in the corporate tax rate, along with the potential for some type of repatriation holiday whereby corporations could bring cash held overseas back to the U.S. This would presumably allow for more capital investment, hiring, dividends, or stock buybacks.

Hurricane Harvey made its impact most tragically in the lives and property of those affected in the Houston area. The powerful storm is shaping up to be the most costly from an economic standpoint since Hurricane Katrina. The damage roiled the energy markets, as roughly one-fifth of the U.S.'s refining capacity was slowed or stopped altogether by the storm and subsequent flooding. Crude oil prices actually sagged as demand expectations fell along with energy stock prices. But prices at the pump jumped quickly as supply of refined products was cut off. Insurance stocks also suffered as the insurable damages are expected to be immense. To make matters worse, Hurricane Irma was gathering strength in the Atlantic and headed for the southeastern United States.

Stocks Supported by Positive Economic Data, Falling Dollar, Corporate Profits

In spite of all the negatives, broader large cap stock indices generally managed to post gains in August, and the NASDAQ hit a new high. Solid economic data is one reason, as it has continued to demonstrate the general economic health of the U.S., and increasingly that of Europe and other parts of the world. As a result, consumer, technology, and health care stocks have continued to benefit. In addition, the U.S. dollar has been falling, particularly against the Euro, which supports U.S. corporate profitability and has supported stocks. Finally, stocks have received some limited support from the expectation of a tax reform deal this fall, albeit for a less impactful package than initially promised.

Washington Remains in Focus

The coming months are sure to be action-packed for Congress. There are several key items on the agenda in addition to tax reform, namely, a debt ceiling increase and either a budget or a continuing resolution. Interestingly, the need to pass an aid package for hurricane relief may serve to ease the passage of some or all of these items, depending on how they are grouped. The Fed is also likely to generate headlines on two fronts: policy decisions and changes to the lineup of Fed decision-makers.

In terms of policy, investors are watching how the Fed will react to recent readings of subdued inflation. Some at the Fed have voiced concern that these low levels of inflation are reason enough to hold off on further rate hikes and to delay trimming the balance sheet. Others say that the tightness in the labor market should be enough to keep raising rates.

The market is far behind the Fed. The Fed has penciled in one additional rate hike this year and four hikes next year, but the market for Fed funds futures is predicting just one more hike in the next two years. The Fed is faced with an important decision – continue with rate hikes in the face of softer inflation to prevent overheating, or delay tightening and risk future imbalances.

In the midst of this policy uncertainty there are several vacant seats on the Fed's board, and Fed Chair Janet Yellen will reach the end of her term in February 2018. President Trump is expected to nominate a replacement instead of appointing Yellen to another term. The early frontrunner had been his chief economic adviser Gary Cohn, but an apparent rift between the two has cast doubt on his appointment. Whoever the next chairperson is, he or she will have significant influence on the direction of monetary policy.