Third Quarter 2017 Review

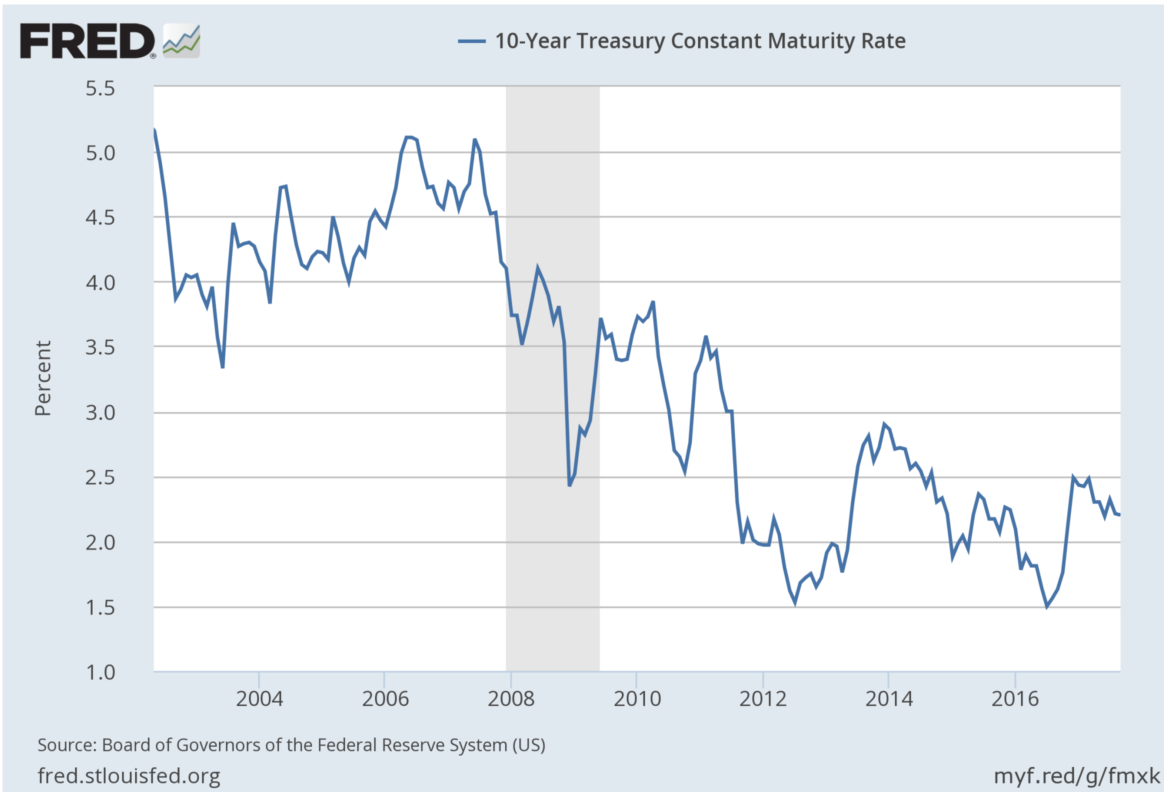
	Close	Total Returns	
	9/29/17	3rd Quarter	2017 Year-to-Date
Standard & Poor's 500 Index	**2,519**	**+4.48%**	**+14.24%**
Dow Jones Industrial Average	**22,405**	**+5.58%**	**+15.45%**
NASDAQ Composite Index	**6,495**	**+6.06%**	**+21.67%**
Dow Jones Global (ex U.S.)	**254**	**+6.16%**	**+21.58%**
Barclays Aggregate Bond Index	**2038**	**+0.85%**	**+3.14%**

What's new and different that can be said about a market that goes up every month without a hint of turbulence? The skeptics point to North Korea tensions, dysfunction in Washington, and high stock valuations. But as the strong market returns indicate in the table above, the optimists prevail. In this *Outlook* we will explore the apparent complacency and optimism that embodies financial markets and how we are managing portfolios.

The Market's Sunny Disposition

Perhaps no issue is more important to bond and stock investors at this time than interest rates. The issue is simple: when will bond yields reach a level high enough to halt the rise in stock prices? The low interest rate policy of major central banks has been one of the most important catalysts for the long-standing bull market. Although the low rate policy started to be reversed more than a year ago, the impact on markets has been negligible. The three increases in the Federal Funds rate since late 2016 have had no impact on stock prices this year. The same lack of impact is true for longer term bond yields. The 10-year U.S. Treasury yield of 2.3% is actually lower than it was at the start of the year. The yield on intermediate Treasuries is only marginally above the dividend yield on stocks and apparently not enough to dampen enthusiasm for stocks.

The real test for stocks will be if, and when, rates move higher as the Federal Reserve currently projects. The Federal Reserve ("Fed") now predicts that they will raise short term rates to 2.1% by the end of 2018 and to 2.7% by the end of 2019. The strength of the markets in the face of these projections suggests that investors both believe and applaud this gradual increase. As can be seen in the chart below, it was only a decade ago that 10-year Treasuries yielded 4.5%. Are investors too complacent that interest rates could return to more historically normal levels, say 4-5% -- levels that would offer more competition to historically low stock yields of 2%?



Financial markets apparently are not anticipating any dramatic changes in policy as a result of the changing makeup of the Federal Reserve. The seven member Washington Fed board is currently only half stocked and Chairperson Janet Yellen's term ends in February of 2018. The market appears to assume that a change in the Fed's leadership and composition will continue to favor low rate policies. Time will tell. Secondly, inflation has been below the stated targets of the Fed -- literally a "mystery" to Chairperson Yellen. Unless inflation picks up considerably, the market appears unwilling to anticipate significantly higher rates, such as 10-year U.S. Treasury rates in the 4% range.

Not only are investors taking some increase in interest rates in stride, but they are anticipating a healthy bump in earnings from possible tax legislation. We think the market response to the election results has been based on a view that the Republican platform would be very pro-business. The market further concluded that the pro-business platform would translate into higher earnings. Although the Republicans appear divided on many issues, the market believes that tax cuts are in the offing. Tax cuts are the most important legislative issue to the market and lower rates would be a boost to earnings. In fact, we think the market has already anticipated a positive earnings impact in 2018 and 2019 -- another reason for the market's most recent strength.

Finally, investors seem to assume that high stock valuations by themselves will not result in a significant market decline. As long as the outlook for rates is not too threatening and the prospect for a pickup in earnings is most likely, investors seem to accept the higher valuations as evident in the current market. In this climate of continued low interest rates and moderate global economic growth, investors can sit on their hands and rationalize higher valuations as simply borrowing from future returns. No reason to sell, just borrowing from future gains.

Like the Weather, Market Conditions Ultimately Change

As we mentioned previously in the *Outlook*, we think interest rates are the subject most likely to influence markets. **We also think the trend in interest rates is easier to predict than the levels that rates will ultimately reach.** Rates went much, much higher in the inflationary period of the late 1970s and early 1980s than predicted. And they have fallen much, much lower than predicted in the last few years. Although the Fed has a dominant effect on short term rates, the financial markets will have something to say with respect to intermediate and long term rates. This is particularly true at this juncture because the Fed is on the cusp of starting to reduce its portfolio of fixed income investments. Bond bulls have been correct so far in assuming rates would only increase gradually to moderately higher levels. We would be less confident in that assumption going forward as the Fed unwinds its novel experiment.

Making Adjustments After a Long Bull Run

As we have referenced in previous *Outlooks*, the macroeconomic environment of interest rates and economic growth is of great importance to financial markets but far from the only influence on stock and bond prices. We have already mentioned potential tax legislation, but there are countless other factors. For example, we are keenly focused on the competitive dynamics affecting specific companies and industries where we have made investments for clients. In last quarter's *Outlook*, we mentioned the burgeoning competition amongst the technology leaders and the importance to the market if these behemoths start to affect each other's profitability.

We are mindful that valuations are high and that no market in modern history has produced ten straight years of positive returns (next year would be number ten as long as this year remains positive). When we construct a portfolio, we diversify the holdings across a mixture of companies with high growth and those that are more mature with steady growth. In a bull market like today's, many of the fastest-growing companies, such as Facebook and Google and their smaller brethren, have appreciated the most. In some cases the increase in their valuations has exceeded the increase in their respective earnings. On the margin, we are finding it very hard to identify opportunities in high growth areas. When individual positions become outsized, say in the 7% range, we look to trim holdings where valuations are stretched. We do not own any securities that we think will sink on the weight of their own overvaluation, but it makes sense to pay greater attention to valuation risk at this point in the market cycle.

By way of summary, both the U.S. bond and stock markets have exceeded all but the most bullish expectations for the year. Entering the year, investors were nervous about interest rates moving higher, elections in Europe, histrionics in the Beltway, and simmering trade and international tensions. None of the worst case outcomes have occurred. With the U.S. economy nearly in full recovery mode and the Fed starting to tighten, similar gains going forward would most likely depend on a significant earnings benefit from tax changes. That would be the frosting on the cake. It is hard to imagine more positive news.

Bob Milnamow
President and
Chief Investment Officer
October 2017

*The **Standard & Poor's 500 Index** is an unmanaged broad-based index that is market weighted and used to represent the U.S. stock market. It includes 500 widely held stocks. Total return figures include the reinvestment of dividends. "S&P 500" is a trademark of Standard and Poor's Corporation.*
*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.*
*The **Nasdaq Composite Index** is the market capitalization-weighted index of approximately 4,000 common equities listed on the NASDAQ stock exchange. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.*
*The **Dow Jones Global (ex U.S.) BMI** (Broad Market Index) comprises the S&P Developed BMI and S&P Emerging BMI, and is a comprehensive, rules-based index measuring stock market performance globally, excluding the U.S.*
*The **Barclays Aggregate Bond Index** is a market capitalization-weighted index. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.*

Important Disclosures:

1. *This presentation may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.*
2. *Historical performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor.*
3. *Investment in securities involves the risk of loss of interest and/or initial investment capital.*
4. *Nothing in this presentation is intended to be or should be construed as individualized investment advice. All content is of a general nature. Individual investors should consult their investment adviser, accountant, and/or attorney for specifically tailored advice.*
5. *Any links to outside content are listed for informational purposes only and have not been verified for accuracy by the Adviser. Adviser does not endorse the statements, services or performance of any third-party vendor without specifically assessing the suitability of a third-party to a client's or a prospective client's needs and objectives.*

BARRETT
ASSET MANAGEMENT, LLC
SINCE 1937
90 Park Avenue
New York, NY 10016
(212) 983-5080 Fax (212) 953-3240
WWW.BARRETTASSET.COM