

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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From the outset of this year, we were skeptical of the market bounce that followed the Trump victory. We said those gains could not be sustained without concrete policy outcomes from Washington. To the contrary, investors have looked past the political confusion. Their confidence is driven by the fundamentals of economic and corporate earnings growth. In addition, the economic news from international and emerging markets has been better than expected at the beginning of the year.

We are amused by the term TINA which means: *There is no alternative*. It occurs when investors realize that equities are the only asset class with the prospect of reasonable investment return. The other term we like is “market melt-up” – meaning the investor stampede not to miss the rising tide.

That said, our skepticism remains. We are concerned the market is overbought. There is nothing structurally flawed like the 2008 crisis. But we are likely to see modest market pullback in the months ahead. Stock prices are quite rich. We do not believe the economic fundamentals support future year gains similar to what we have seen in 2017. Given the political obstacles, we are not betting or investing on the chances for success of the Trump tax cut package. We are prepared to manage in a subdued market environment for the next several years.

In this environment, our skills will be tested. Remember the fundamental of: “Buy low, sell high”? We will be looking astutely to find those buy-low opportunities – where they may exist.

Equity Market: Driven by the fundamentals of the economy and corporate earnings, U.S. stock indexes showed impressive gains. The domestic story was aided by the international markets – which had their best quarterly performance since 1997. The star of the market was the Nasdaq Composite Index which posted a 7.3% gain in the third quarter and was ahead 21.4% for the year. Investors were attracted to the product innovations in technology. The impact was felt in the broader market indexes. The S&P was up 5.2% for the quarter and 13.4 % for the year. The Dow Jones Industrial Average increased 7.5% for the quarter and 14.7% for the year. The Russell 2000 index of small cap stocks was a strong performer in the quarter. It moved ahead 6.8% for the period and was up 11.1% for the year.

Fixed Income Market: In contrast, the bond market has been essentially flat. The yield on the 10-year Treasury was 2.33% at the end of September – versus 2.29% at the end of June and 2.44% at the end of 2016. (Yields move inversely to prices.) The certainty of gradual rate increases from the Federal Reserve should keep bond prices subdued. There is greater likely in the future for declines than for increases.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Industrials Composite PR	11.72
S&P 500 Index PR	12.53
Russell 2000 Index PR	9.85
NASDAQ Composite PR	20.67
EAFE Index NR	19.96
Barclays Aggregate Bond Index TR	2.26

source: Morningstar®

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices for 2017 year-to-date. Led by technology, the stock market moved steadily higher throughout the year to record levels. In contrast, the bond market was flat.

THE OUTLOOK

The Economy: Much of the investor confidence is rooted in the outlook for an improving economy. The U.S. GDP increased at an annual rate of 3.0% in the second quarter – much better than the weak 1.2% growth in the first quarter. Most economists now predict this pace to continue in the third and fourth quarters. Annual growth of 3% is markedly better than the 2% growth rate in most of the

years since the 2008/09 recession. What explains this uptick?

First, the labor market is stronger. Excluding September, when hiring was interrupted by the hurricanes, average monthly job growth in 2017 has averaged 170,000 net new jobs per month. The unemployment rate is now down to 4.2%. The labor force participation rate has edged over 63% for the first time in over a decade. Many employers report difficulty hiring people – especially in areas needing specialized skills. Wage growth has been more stagnant -- but many economists believe labor shortages may soon change that picture. Accordingly, consumer confidence and spending is strong and the purchase of durable goods like automobiles and appliances is rising.

Second, corporate earnings are healthy. According to Thompson Reuters surveys, analysts forecast a year-over-year earnings gain of 11.5% for the S&P 500 in 2017 and another 11.1% in 2018. This trend explains the higher level of business spending that also feeds economic growth,

The Market: Despite this economic good news, at Hudson Advisors, we are keeping our bullish impulses in check.

- Stocks are highly priced right now. The S&P 500's price/earnings ratio has a forward 12 month forecast of 17.9 – compared to the 10-year average of 15.1 The forward P/E on the Russell is 26.3 against an average of 21.3. It will take better earnings to improve these P/E ratios.

As result, we expect the market to move ahead more slowly for the rest of 2017. We will not be surprised at a modest pullback from current levels. Looking to 2018 and beyond, we expect subdued growth. As expressed, we cannot hope to just ride an ongoing wave. We expect to have to fish carefully for good stocks in much quieter waters.

OUR STRATEGIES

Asset Allocation: For clients investing new money, same as last quarter, we recommend 55% allocation to equities and the remaining portion to cash, bonds with shorter maturities, and alternative investments. We stagger the time period in which we reach that 55% level. For fully invested clients, we recommend to trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors getting our attention:

TECHNOLOGY: We are attracted to some bio technology companies that are developing new medical treatments for the aging baby boomers.

INDUSTRIALS: The rebuilding effort from the hurricane damage will be good for this sector – as well as the prospect of a national infrastructure program.

FINANCIALS: The large asset management companies offer some reasonably priced stock opportunities.

INTERNATIONAL: The recovery in the global markets gives us renewed interest in international exposure for our clients. Select frontier emerging markets are appealing again.

Other Investments: Our repeated aversion to bonds with long maturities remains firm. We still believe the risk of a sharp decline in prices is too great a risk for our clients. We prefer to find alternative investments such as the following:

- **REAL ESTATE LIMITED PARTNERSHIPS:** We can invest in interest bearing investments such as industrial real estate, hotels, and senior living facilities. This includes equity positions as well as debt opportunities.
- **MUNICIPAL TAX LIENS:** We prefer to find alternatives such as municipal tax liens to enhance yield in a portfolio.

Dow Jones U.S. Sectors Total Return (Percent Change for YTD, Ending September 30, 2017)

Source: Morningstar®

Oil & Gas	-7.56	Consumer Services	9.89
Basic Materials	16.94	Telecommunications	-4.32
Industrials	16.68	Utilities	11.89
Consumer Goods	10.90	Financials	12.18
Health Care	20.80	Technology	26.14

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Top 25 Performing Stocks through YTD 9/30/17 - US Listed companies with a market cap above \$5 Billion.

Source: Telemet ®

Issue	Name	Last	Mkt Cap	Net Pet Q	Industry Group
KITE	Kite Pharma, Inc.	\$179.79	\$10,281.00	300.96	Pharmaceuticals
EXAS	EXACT Sciences Corp	\$49.12	\$5,850.00	267.66	Biotechnology
SHCAD	Sharp Corporation	\$7.99	\$8,793.00	242.92	
GOL	Gol Linhas Aereas Intelgentes	\$22.89	\$15,895.00	236.12	Airlines
ALNY	Alnylam Pharmaceuticals	\$119.90	\$10,999.00	220.25	Biotechnology
NPSNY	Naspers Limited ADR Sponsored	\$45.19	\$14,239.00	209.1	Media
GRVY	GRAVITY Co., Ltd. ADS	\$32.44	\$112,711.00	207.49	Software
TAL	TAL Education Group ADS	\$34.19	\$16,897.00	192.43	Diversified Consumer Services
SHOP	Shopify Inc.	\$116.81	\$10,412.00	172.47	Internet Software & Services
WB	Weibo Corporation ADS	\$104.18	\$22,742.00	156.6	Internet Software & Services
CC	Chemours Company	\$53.44	\$9,876.00	141.92	Chemicals
HTHT	China Lodging Group, Ltd ADS	\$122.06	\$8,498.00	135.46	Hotels Restaurant & Leisure
WUBA	58.com Inc.	\$65.21	\$9,481.00	132.89	Internet Software & Services
ATHM	Autohome Inc.	\$58.27	\$6,735.00	130.5	Catalog Retail
YY	YY Inc. ADS	\$90.32	\$5,133.00	129.12	Internet Software & Services
OLED	Universal Display Corp	\$128.70	\$6,053.00	128.6	Electronic Equipment & Instruments
ACH	Aluminum Corp. of China Ltd.	\$23.13	\$12,513.00	126.54	Metals & Mining
DLAKY	Deutsche Lufthansa	\$28.76	\$13,360.00	123	
EDU	New Oriental Education & Techn	\$92.72	\$14,613.00	120.24	Diversified Consumer Services
YRD	Yirendai Ltd	\$45.53	\$5,502.00	119.74	
FIZZ	National Beverage Corp	\$110.56	\$5,151.00	116.44	Beverages
NRG	NRG Energy Inc	\$25.89	\$8,193.00	111.17	Independent Power Producers & Energy Traders
W	Wayfair Inc Class A	\$72.80	\$6,346.00	107.7	Catalog Retail
VRTX	Vertex Pharmaceuticals	\$152.51	\$38,451.00	107.02	Biotechnology
BLUE	Bluebird bio, Inc.	\$127.55	\$5,815.00	106.73	Biotechnology

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Source: Telemet ®

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TEVA	Teva Pharmaceutical	\$18.82	\$19,121.00	-48.08	Pharmaceuticals
BHGE	Baker Hughes, a GE Co. Cl A	\$36.67	\$15,602.00	-43.56	Energy Equipment & Services
MAT	Mattel Inc.	\$15.68	\$5,374.00	-43.09	Leisure Equipment & Products
UAA	Under Armour, Inc. Cl A	\$16.71	\$7,358.00	-42.48	Textiles & Apparel
AAP	Advance Auto Parts Inc	\$98.98	\$7,311.00	-41.47	Specialty Retail
M	Macy's Inc.	\$21.05	\$6,411.00	-41.22	Multiline Retail
KR	Kroger Company	\$20.56	\$18,289.00	-40.42	Food & Drug Retailing
MKTAY	Makita Corporation	\$39.94	\$5,421.00	-40.31	Machinery
EEP	Enbridge Energy Partners	\$15.90	\$5,192.00	-37.6	Oil Gas & Consumable Fuels
HP	Helmerich & Payne Inc	\$50.02	\$5,431.00	-35.37	Energy Equipment & Services
LB	L Brands, Inc.	\$42.72	\$12,126.00	-35.12	Specialty Retail
CVE	Cenovus Energy Inc.	\$9.87	\$7,485.00	-34.77	Oil Gas & Consumable Fuels
PAA	Plains All American Pipeline	\$21.29	\$15,429.00	-34.07	Oil Gas & Consumable Fuels
SCG	Scana Corporation	\$48.55	\$6,939.00	-33.75	Multi-Utilities
APC	Anadarko Petroleum Corp	\$49.27	\$27,609.00	-29.34	Oil Gas & Consumable Fuels
EVHC	Envision Healthcare Hldg Inc.	\$44.85	\$5,419.00	-29.14	Health Care Providers & Services
APA	Apache Corporation	\$45.44	\$17,310.00	-28.41	Oil Gas & Consumable Fuels
HES	Hess Corporation	\$45.69	\$14,522.00	-26.65	Oil Gas & Consumable Fuels
SMI	Semiconductor Manufct Intl ADS	\$5.59	\$5,620.00	-26.64	Semiconductors and Semiconductor Equipment
AYI	Acuity Brands, Inc.	\$169.66	\$7,142.00	-26.51	Electrical equipment
SABR	Sabre Corporation	\$18.45	\$5,142.00	-26.05	IT Services
NBL	Noble Energy Inc.	\$28.21	\$13,725.00	-25.88	Oil Gas & Consumable Fuels
MOS	Mosaic Co. (The)	\$21.76	\$7,639.00	-25.81	Chemicals
CLR	Continental Resources, Inc.	\$38.29	\$14,367.00	-25.71	Oil Gas & Consumable Fuels
TLSYY	Telstra Corp Ltd ADS	\$13.57	\$33,771.00	-25.68	Diversified Telecommunication Services