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Third Quarter 2017: Scary World, Sturdy Market.

Against the back drop of natural disasters, accelerating terrorist activity, escalating tensions between the U.S. and North Korea, dysfunction in Washington and mass shootings, the markets have behaved remarkably well. Year-to date, the NASDAQ leads the major indexes up 20.67% while the S&P 500 is up 14.24% and the Dow up 13.37%. For the third quarter, the NASDAQ rallied 5.79%. The composite began the quarter slightly below its 50-day moving average line, a cause for concern. The tech-heavy index tested the 50-day line several times during the quarter, but repeatedly found support there, marching repeatedly to new all-time highs. A strong and rising 50-day line is the hallmark of a strong market. The NASDAQ was somnolent during September rising only 1.1%. Since the index had been the leader year-to-date, its lethargic early fall behavior was cause for concern for some. Adding to worries, historically September is frequently a weak month in the market. The S&P 500 fared better in September rising 1.9% and the Russell 2000 small cap index rose a robust 12% versus its August low, suggesting that investors, while shunning large cap OTC stocks, were embracing risk driving up the prices of smaller company stocks. Some saw the Russell outperformance as an indication of a mean-reversion trade wherein recent underperformers overtake winners in prior periods.

At the end of the third quarter, the NASDAQ had only two distribution days in the prior five weeks and was trading in a confirmed uptrend. By contrast, on June 30 the index carried a load of six instances of institutional selling and was trading under pressure indicating that traders were cautious. Despite the September lull and heavy distribution at the beginning of the quarter, the NASDAQ powered on to six-straight monthly gains by the end of the quarter. Another positive technical metric is the position of the NASDAQ's advance-decline line. The A-D line compares volume on advancing issues versus declining stocks in recent weeks. In fact, over the past six weeks the NASDAQ's a-d line has been rising faster than the index itself. While the conversation questioned the sustainability of the advance, market metrics suggest that market condition was still strong.

On the earnings front, indications are that third quarter profits will be good, following a strong second quarter. According to Capital IQ, the consensus estimate for Q3 revenue growth is 5.7% and earnings to grow 4.8%. While generally solid earnings are expected for the third quarter, portfolio stocks are expected to do even better. One of the criteria used to select stocks is current quarter earnings' percentage increases. The hurdle rate is 25% or better. Portfolio stocks have, by in large, met that criterion in recent quarters. Many have repeatedly far exceeded the 25% rate in many of the past few quarters. They look to repeat their outperformance in the third quarter. In some cases earnings have dropped below the 25% rate in a given quarter only to recover the rate in the next. In other cases, such as Apple, the company establishes earnings acceleration on its way to eclipsing the 25% rate. In the last four quarters Apple's earnings progression was -15%, +2%,

+11% and most recently +18%, in other words, acceleration. With the new iPhone 8/8+ and iPhone X about to be available, analysts project that earnings will grow 22% in '18. For '18, the top 10 earnings gainers held in portfolios, are expected to increase to a projected increase of 22% for Apple and Celgene to a high of 118% for Amazon. Among other projected earnings winners, Netflix is expected to grow earnings 74% in '18, Nvidia +41%, Alibaba +33%, Alphabet +31%, Adobe +23% and Facebook +21%. The main reason earnings expectations are so high is because each of these companies is doing something new, creating demand for products or services that change how we do many things including shopping, driving, communicating and interacting. They develop treatments for serious diseases. In short, they innovate.

The current market has favored the stocks of such large cap, liquid names including the much-discussed FANG names, all of which portfolios hold. There are many positives in the current environment including improving employment and GDP, a strong market, hopes for a better tax structure for investors and companies, especially those which hold a great deal of cash overseas. On the other hand, we live at a time of great uncertainty, so it pays to be on the outlook for what can go wrong. It is difficult if not impossible to know what world events could significantly upset the market. Many worry that the market will have trouble if the Fed raises more aggressively than currently expected. It's likely that whatever upsets the market is not listed among the current worries. However, the clustering of distribution days or a break among current leaders will presage a meaningful decline. For now that is not a concern, but as always I will be on the alert for changes in the outlook.

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