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2016
3rd QUARTER

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The Equity Market

More of the Same

By Sarah Potter
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Given that our investment outlook from a macro perspective is a reflection, in many ways, of the world at large and the events, sentiments, and news circulating the globe, it should come as no surprise that this quarter has been a continuation of many of the same themes we've been seeing for several months. Because the quarter was mostly characterized by riding the proverbial waves of the first and second quarters, we've been staying on course and remaining poised for future opportunities and threats.

Here at Home

As we've talked about in recent newsletters, it seems like for every positive development, there is a less positive one to mute our progress, and vice versa. Slow and steady remains the mantra, and the expectation at this point, for the United States economy.

We're continuing to trudge through the mud, though. The ISM manufacturing index (a gauge of factory activity on the national level) has jumped around the last few months (rising in September above August's seven month low), but revolving around a level consistent with a 1.5-1.6% growth rate in the economy. Yes, it's growth, but very slow growth, and a bit slower than what was predicted at the start of the year when numbers like 2%-2.5% were being thrown around.

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Vince Russo,
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The Bond Market

3rd Quarter Overview

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The following chart shows interest rate movements over the quarter. Interest rates moved up slightly with shorter maturities rising a bit more than longer ones. Bond performance favored corporate bonds of longer maturities.

Maturity	US Treasury Curve 09/30/16	US Treasury Curve 06/30/16	(Change) 09/30/16-06/30/16
2Y	0.762	0.582	0.18
3Y	0.875	0.693	0.182
5Y	1.149	1	0.15
7Y	1.422	1.279	0.143
10Y	1.594	1.47	0.125

The best performing sectors of the Barclays U.S. Aggregate index (broadest of the Barclays indices) were the Investment Grade: Financial Institutions - Long with a return of 2.82% and the Investment Grade: Industrial - Long which returned 2.75%. The worst performing sectors were U.S. Treasury: Long with a return of -0.36%, followed by U.S. Treasury: 20+ year with -0.30%. Within the investment grade sector, the lower end of investment grade outperformed. Baa rated bonds returned 1.94%, compared to Aaa rated bonds with 0.10%. Our benchmark, the Intermediate U.S. Government/Credit, returned 0.16%. High yield bonds continued to show strong performance. The Barclays U.S. Corporate High Yield index returned 5.55%. The continued outperformance of longer duration bonds, particularly in the corporate sectors, leads us to believe the market isn't terribly concerned about inflation or rapidly rising interest rates.

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Therefore, the remainder of the year will have to do pretty well to make up for the rather slow start. September's uptick in the index did seem to be backed by strong data and positive reports (generally, rising orders and decreasing inventories, which was a significant improvement from the prior month and one that should carry through the remainder of the year). However, it's worth noting that such positivity was coming from limited sources. Over half of the factory subsectors didn't report growth for the month, but those who did expressed pretty strong optimism. Perhaps this is why the Fed continues to express caution about our health in this way.

We can't forget, too, that investors and consumers alike don't love uncertainty, and the more policy uncertainty there is, the larger the drag felt on growth. This has always been true with speculations about Fed action (such as questions of whether we will see a December rate hike, which is currently tracking at about a 60% chance according to investors), but this year has an extra dosage of uncertainty, thanks to the impending presidential election (the silver lining is that such uncertainty should dwindle post-election or at least into 2017).

The Election

The next time you're reading our quarterly newsletter, we'll have a new President of the United States. And as I just suggested, the market is looking forward to that time, as well, as a break from the instability we're likely to see in the couple of months surrounding the election on November 8 and its short-term aftermath.

Much can and will happen between now and Election Day, and what we know is that the more uncertainty there is heading into the election, the more volatility the market will probably experience surrounding it. And similarly, any time there are events that *surprise* investors, the market tends to react with a bit of volatility as the event is absorbed (i.e. remember the debt ceiling, the fiscal cliff, and Brexit?) The mere fact that we won't be electing an incumbent into office holds uncertainty in and of itself. In fact, in these kinds of election years where brand new candidates are running for office, historically, the S&P 500 index has lost 4% on average since 1928, according to Bloomberg, far worse than election years in general. We recommend the faint of heart look ahead to 2017 which, again from a historical perspective, might experience a decent market rally from the relief of political uncertainty. However, the takeaway in all of this should be that causality is near-impossible to assign, given all the other confounding factors affecting the markets.

In order to shed light on the kinds of theories and conclusions that spring up during this exciting time, we can take a look at market behavior surrounding the first presidential debate on September 26. According to polls, Donald Trump's odds of becoming President dropped slightly in the aftermath of the debate, while Hilary Clinton's rose, and additionally, during that time, futures markets rallied marginally. Some analysts and researchers have suggested, therefore, that the markets are favoring a Clinton presidency, at least based off investor behavior surrounding the debate itself, and the fact that stocks rose in those specific segments of the debate deemed "wins" by Clinton or, alternatively, "misses" by Trump. Based off this theory, a Trump win would probably surprise the markets, since they may be pricing in what is believed to be the more likely outcome based on polling and the large number of undecideds that Trump would have to win to take office at this point. As we mentioned in a previous newsletter, there is also an added element of mystery with Donald Trump's candidacy, given that from a market perspective that prefers predictability, Trump's lack of precedent in politics makes it difficult for investors to glean much of what the future might entail.

Further, election cycles and market performance are just as difficult to pin down with any amount of certainty. There have been theories of how the president's party and the makeup of congress impact the markets, but upon further examination, it's discovered that the underlying health of the economy is probably the larger culprit.

As we said, it would be foolish to draw any large conclusions given all of the factors at play globally, the subjectivity of much of the polling that exists, and how much can change between now and Election Day. But we know it is interesting food for thought, nonetheless, and certainly a topic on many people's minds.

For the record, the election is one example of an issue impacting near-term swings in the market and volatility in those sectors most susceptible to policy changes, and certainly one we will be watching, but not one that will likely impact our overall economic outlook or investment philosophy.

Around the World

Just as we anticipated would be the case after the referendum vote last quarter resulted in Britain bidding farewell to the European Union, Europe's sentiment has been one of fragile resilience. Some recent data suggests that Britain has seen some strengthening since Brexit with regard to manufacturing PMI (a commonly used indicator of economic health) and consensus estimates for real GDP growth for the year. Markets have also seemed to digest the news of the breakup, but that's not to say that investors are shaking it off entirely. The world is likely to keep its guard up while the next couple of years of Brexit negotiations take place and the impacts on nearby governments and economies are sorted out—after all, the true test comes when the theoretical exit becomes a reality. And we all know that there is no precedent for an exit from the EU, so there is a lot of unknown surrounding the event and any possible "contagion" that could spread as a result.

As further shake up to the geopolitical scene (and therefore, the markets), the next year will see national elections in Italy, France, and Germany. Italians face a constitutional referendum this December, while France's presidential election begins in April of 2017, and Germany's parliamentary election will be in late summer or early fall of 2017.

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However, what is somewhat surprising is the outperformance of lower quality credit, especially in light of recent developments within Europe's banking system. Perhaps it is too early for markets to be concerned with the Deutsche Bank developments or the solvency issues surrounding the Italian banking sector, but those concerns will not go away without government intervention or central bank support. While the possibility of another financial market shock cannot be fully dismissed, it is unlikely. If the capital markets have learned one major lesson since the Lehman Brothers failure in 2008, it is that systemic risk (domino effect of bank failures) is *real*. The solution is politically charged and would be highly unpopular. Bank bailouts are not fair, but the alternatives are far worse.

Lower for Longer

In our effort to inform clients about what market events have affected their portfolios, we spend a great deal of time on those events that impact economic conditions. We focus on elements of our economy that historically have affected growth and inflation, and consequently, interest rates. Because what happens in our economy is also affected by events globally, we have expanded our focus on global events. So, it is not surprising that we cover many of the same topics quarter to quarter.

As we mentioned above, this past quarter saw interest rates increase slightly across the entire yield curve. After the initial negative market reaction to the "Brexit" vote, markets have reassessed, so far, the implications surrounding the United Kingdom's decision to leave the European Union. While the vote does create uncertainties about the economic prospects for Great Britain, its full impact will not be truly felt until it comes closer to implementation. The biggest uncertainty initially was about the "contagion effect" on the rest of the EU, or the fear that other nations would consider breaking away from the Union, leading to instability of the common currency and global markets. While that scenario is highly unlikely, it is still a concern that could reappear in the future as more and more member nations question the policies that threaten their sovereignty.

The market's reactions to Brexit are only partly attributable to this quarter's reversal in the direction of interest rates in the U.S. What are some of the other factors affecting interest rates?

GDP (Gross Domestic Product) has improved slightly over the past quarter. However, our rate of growth is terribly anemic when compared to other economic cycles. As a point of reference, the average GDP annualized rate of growth for the 30 year period from June 1988 to June 2008 (just prior to the financial market upheaval) was 3.0%. Since then, our economy has only grown an average of 1.3% annualized. It's no wonder that this economic recovery doesn't *seem* like a recovery. Personal consumption over the quarter remained fairly steady at just above 4%. In a consumer driven economy such as ours, this has become an important component of economic growth. Over the same 30 year period, the average rate of personal consumption measured 2.8%, and since June 2008 we have still only averaged 1.6%. So, while consumption has improved, it has not yet translated into robust economic growth as measured by GDP. The lackluster growth is primarily attributable to negative rates of private capital investment. Over the last year capital investment has *decreased* by 2.1%. Interest rates, while having modestly increased over the quarter, are still quite low. Actual growth rates (and expected growth) for our economy have been quite low and interest rates will continue to reflect those expectations.

Measurements of inflation have also been relatively tame over the last quarter. While there has been a modest increase in annualized rates of inflation, there could be the potential for more inflationary pressure as the price of oil stabilizes, or as oil producers attempt to reduce supply. While the core CPI (ex food and energy) is above the 2% target that the Federal Reserve maintains as an average inflation goal, the PCE core measurement is still below that target.

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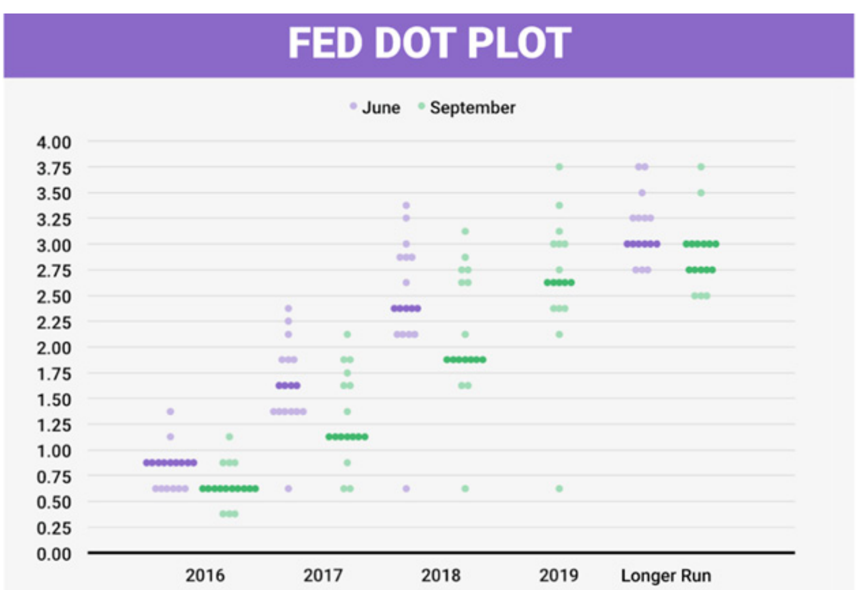

Source: Federal Open Market Committee via *Business Insider*

Central banks and policymakers around the globe (Europe, China, India) have continued to stimulate their economies with easing, to which we've grown quite accustomed over the last several quarters. This may help, in turn, to stimulate global growth, especially if it's in conjunction with slightly higher oil prices as we've been seeing lately, the aforementioned resilience/stabilization in the euro zone, and acceleration in China's economy. Speaking of China, things have been looking brighter for the struggling region. The country's manufacturing PMI has improved along with nominal GDP growth. However, there is still a chance of further slowing, which is why global growth stands on fairly shaky ground in the near term (clearly, it's resting on quite a few variables).

The Name of the Game

This quarter has given us more of the same: investors seeking income in equities as an alternative to the traditional bond route that hasn't been able to provide great yields, and it therefore hasn't been the road less traveled in a long time. Equity income stocks are still outperforming more growth oriented ones, and it is dividends making such equities attractive to investors. S&P 500 index dividends increased 5.2% year-over-year in the third quarter, putting the yield at about 2.1% (about .5% above 10-year Treasury note yields, which is a pretty large spread, historically). We've made some tactical changes in our investments in light of this, while considering geographical and sector exposure, as well. While we still think there are fairly valued stocks and plenty of opportunities for making money, many stocks are expensive with less appealing valuations. Therefore, *earnings* continues to be the name of the game this year, where the stock market is largely dependent on company earnings for appreciation and growth. We maintain the same outlook about this year's stock market performance overall as we've had in the two previous quarters which is that it probably won't be anything to write home about. But it's a positive market, and one with opportunities in individual names, so we remain steadfast in our view on stocks.

End

Some of the modest increase in interest rates over the quarter can be attributable to a slightly higher trend to measured inflation. Inflation expectations as measured by the difference in Treasury Inflation Protected Securities (TIPS) and nominal U.S. Treasury notes have also shown a modest increase over the quarter. The implication for the 5-year notes (TIPS vs Non TIPS) at the end of the quarter is approximately 1.51% compared to 1.41% at the end of June, an increase of 0.1%. For the 10-year notes, the expectations went from 1.43% to 1.60%.

The Federal Reserve Monetary Policy

Over the past quarter the Federal Open Market Committee (FOMC) has met twice, resulting in no change to current policy for the fed funds overnight lending rate. The target rate remains between 0.25% and 0.5%. Since the last change to policy in December 2015, the markets have been keenly attentive to the rate's future path. Perhaps one of the best indicators of expectations for future monetary policy is the committee members' own forecast for said rate. The now well-known "dot plot" (page 3) has become the market's favorite gauge to gain insight into the committee's thinking on economic growth and interest rates. While we don't believe that the dot plot can be used to anticipate the exact timing of changes in monetary policy, we believe that the *trend* is indeed important.

The above dot plot chart is a comparison of each committee member's expectation for the appropriate fed funds rate at the end of each respective year. The darker dots represent the median value of those forecasts. The most interesting observation is that the committee members' forecasts of the appropriate fed funds rate are significantly lower at the September meeting than they were in June. At June's meeting, the dots indicated a fairly benign path for rates in the future. The median FOMC member expected rates between 0.75% and 1% by the end of 2016, suggesting two more rate hikes this year, and then rates eventually rising to around 3% in the longer term. The September plot is even more benign. The median FOMC member forecasts rates between 0.5% and 0.75% at the end of 2016, which would imply only one more increase in 2016. In the longer term, Fed members see rates around 2.75% or 3%, which is about 0.25% lower than June's forecast. More importantly, the median dots suggest a slower pace of rising rates than the June projections. Lower for longer!!

End