Quarterly Update & Economic Commentary—September 30, 2016

Quarter in Review

The markets started the third quarter on a high note with a strong July. In most asset categories, the rally continued through August and September. The S&P 500 finished the quarter positive by 3.85 percent and is positive by 7.84 percent year-to-date. Market leadership changed during the quarter. In the large cap space, growth stocks outperformed value stocks, a change from the last two quarters. Domestically, small cap stocks outperformed large cap stocks. The S&P SmallCap 600 returned 7.20 percent for the quarter and is positive by 13.88 percent year-to-date. Technology significantly outperformed all other sectors; the S&P 500 Information Technology sector returned 12.86 percent during the quarter, followed by financials, 4.59 percent, and industrials, 4.14 percent. The interest rate sensitive sectors, which were the top performers through the first half of the year, were the worst performers during the quarter. The utilities sector lost 5.91 percent and the telecom services sector lost 5.60 percent. International equities also had a strong quarter. The MSCI EAFE NR, which represents international companies domiciled in developed countries, returned 6.43 percent and the MSCI Emerging Markets (EM) index returned 9.03 percent. The emerging markets category has been one of the top performers for the year, currently positive by 16.02 percent.

Following the sharp decline in interest rates at end of the second quarter, interest rates steadily rose during the third quarter on improving economic news and rising expectations of a potential Fed rate increase. The increase in rates was a headwind for higher quality domestic fixed income securities. The flagship fixed income proxy, the Barclays US Aggregate Bond index, returned 0.46 percent during the quarter but is still positive by 5.80 year-to-date. The higher quality bonds performed worse and saw a decline in value through the quarter. The Barclays US Government Intermediate index lost 24 basis points but remains positive by 3.30 year-to-date. Consistent with the equity performance, the riskier segment of the fixed income market performed quite well — the Barclays US Corporate High Yield index returned 5.55 percent and is positive by a staggering 15.11 percent year-to-date.

The commodity sectors were quiet during the quarter but the year-to-date returns are relatively high. The energy sector was flat during the quarter but is positive by over 30 percent year-to-date. Metals were also quiet during the third quarter — Gold was just slightly negative, copper was slightly positive and silver returned 3.17 percent. Silver is the strongest performer for the year, up over 39 percent, gold is up over 24 percent and copper is up 3.16 percent.

The strong market performance in July favored riskier assets. The rally was driven by expectations that the Brexit vote would not be as impactful as initially discussed by politicians and business leaders. The unprecedented vote is still an important political and economic event; however, the direct impact of the Brexit will be phased in over time and will be mostly isolated to Britain's economy. There remains a good deal of uncertainty around this event, and the potential fallout of other EU nations voting to leave is a risk; however, the direct impact of this single event will be mainly felt by the people of Britain.

The markets also began to "price-in" a Hillary Clinton Presidency. After recovering from a series of alarming comments since early August, Trump lost ground with his poor performance during the first presidential debate. Many prediction experts give Clinton about an 80 percent probability of winning. It is not so much that the financial markets favor Clinton's policies, but rather that there is great uncertainty with Trump. Despite her lead in the polls, Clinton's favorability is among the lowest in modern presidential history. Questions around her integrity, the Clinton Foundation and even the transparency of her health record have made it difficult for voters to trust her.

The Federal Reserve held two meetings during the quarter. The committee decided to keep interest rates at their current level, but there continues to be a growing number of members believing a rate hike is appropriate. During the September meeting, there were three voting members who dissented and believed a rate hike was warranted. The Fed's comments following the meeting were bullish on the employment picture and on consumer spending; however they continue to have a concern over business spending and the inflation target. Given the upcoming election, it was not a surprise that the Fed decided to keep the status quo in the September meeting. Many believe the Fed does not like to move during an election year; however, the Fed has changed interest rates in seven of the past eight election years – the only election year in which it declined to move was 2012. With that said, it is hard to believe emotions are completely removed from the process, especially given all the negative talk coming from Trump regarding Chairman Yellen and the Fed.

Japan's central bank attempted "shock and awe" with their policy announcement in September but failed to generate the euphoria it hoped to attain. The central bank kept interest rates unchanged, but made a significant shift in policy by pegging the ten-year Japanese Government Bond (JGB) yield to zero percent and indicated it would also try to keep the short-end of the yield curve from rising. The central bank also said it is expanding its target of the monetary base until growth in the consumer price index (CPI) excluding fresh food overshoots its two percent target. They will continue to make JGB purchases in line with the current $787 billion annual pace. The bank's efforts have helped move the economy out of its deflationary period, but they have failed to drive inflation. With the central bank owning about 40 percent of the outstanding debt, some fear there will be limited supply for the bank to continue buying at its current pace much longer.

The markets performed well in Europe during the third quarter, but long-term risks persist. The unemployment rate in the Eurozone is around 10 percent. The varying degrees in unemployment is a major concern, in Greece and Spain the unemployment rate is around 20 percent with youth employment at 44 percent in Spain and 50 percent in Greece. At the other end of the spectrum, countries like Germany and the Czech Republic have unemployment rates around four percent. Inflation in the Eurozone remains low but stable. Year-over-year as of August, the inflation registered a 0.2 percent increase. In addition to the economic trouble, there is also rising concern around Germany's biggest bank, Deutsche Bank. Deutsche Bank's shares have come under pressure as analysts worried about the bank's energy sector exposure and liquidity. In late September, news broke that the U.S. Justice department was seeking $14 billion to settle a mortgage securities investigation. Deutsche has said it won't pay this amount and many believe it will be lowered through negotiations. There remains concern over the health of the bank, but consensus is that this will not result in a Lehman-like moment that spreads panic throughout the financial sector.

The markets have favored emerging market stocks so far in 2016. Despite some of the headline risks—a coup attempt in Turkey, an indictment in an impeachment trial of Brazil's President in August and, of course, the geo-political concerns in Russia—emerging market stocks have performed strongly. The impressive returns could be a result of a number of factors. In addition to these stocks having more attractive valuations, many emerging market countries have positive sovereign debt yields, which draw in more capital from abroad. Furthermore, many economists believe that several emerging market countries are positioned for strong relative growth in the years ahead. The middle class is growing in many emerging markets, which bodes well for these economies. The strong returns will continue to cause investors to look more closely at emerging markets.

A Look at the Numbers

Name	3rd Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	2.78	7.21
S&P 500 TR USD	3.85	7.84
S&P MidCap 400 TR	4.14	12.40
S&P SmallCap 600 TR USD	7.20	13.88
NASDAQ Composite TR USD	10.02	7.09
MSCI EAFE NR USD	6.43	1.73
Barclays US Agg Bond TR USD	0.46	5.80
Wilshire US REIT TR USD	-1.21	9.75
IA SBBI US 30 Day TBill TR USD	0.06	0.14

Forecast in Brief

Barring any unexpected event, the biggest headline story of the fourth quarter will be the outcome of the U.S. elections. This election is different from many prior elections as both candidates have failed to receive consensus from traditional party bases. Donald Trump has rallied a segment of the Republican Party and has a passionate group of supporters but he continues to lack the support of many moderate republicans. Hillary Clinton has the support of the Democratic Party, but there remains a lack of energy around her and the Bernie Sanders supporters have failed to support her.

Donald Trump represents the biggest risk to the markets, for one because of his "speak before you think" mentality and also because he represents change, while Hillary poses the least risk to the markets because of her support of the status quo. Most polling estimates continue to show Hillary in the lead and probably will up until the election. However, if the Brexit vote has taught us anything, it is that polls don't always get it right. Only the votes on Election Day matter. Given the growing sentiment of anti-establishment, protectionism and heightened security, it remains a real possibility that Donald Trump becomes the next President. It is very disappointing that neither candidate is talking about solving the growing debt issues of the country or the long-term sustainability of the entitlement programs.

Although a Trump victory would likely put more stress on the markets, it's not a good reason to change investment strategy. One of the advantages of the U.S. Constitution is its built-in checks and balances, which occasionally frustrate voters by producing gridlock, but are beneficial by preventing any one person from enacting catastrophic policies.

In addition to the Presidential races, the election for Senate seats is also extremely important. Currently, Republicans control both the House and Senate, which makes it very difficult for a Democratic president to move his or her agenda forward. The Republicans will likely retain control of the House; however, the power balance in the Senate is much more vulnerable to changing hands. The Presidential race will receive most of the headlines, but the control of the Senate race will impact how much the next President can get done in the next two years. Based on the number of democrat-controlled seats up for re-election, the Senate will most likely move back to Republican control during the 2018 mid-term elections.

Outside of the U.S. elections, the Fed will have two more meetings before year-end. First, they meet the week before the election, which for obvious reasons will result in no change to policy. They will meet again in December. Assuming the economy and the markets do not take a sudden downturn, it is widely expected that a 25 basis point rate increase will occur in December.

There may be a small hit to economic growth due to the impending election, due to the uncertainty of future policy. Businesses are hesitant to grow inventories or commit to other capital expenditures until they get more clarity about the policies from Washington. Despite this, the employment picture is continuing its recent positive trend and economic growth is mild but steady. Just after the quarter ended, the latest monthly jobs report showed an addition of 156,000 non-farm jobs across the country. This report missed forecasts by about 20,000, but still represents growth and was furthermore buoyed by promising wage growth.

The end of the quarter means that corporate earnings season is near. According to FactSet, the earnings of companies in the S&P 500 are expected to decline by 2.1 percent. If the final earnings for the third quarter declines, it will mark the first time the index recorded six consecutive quarters of year-over-year declines since they began tracking the data in the third quarter of 2008.

Global growth in developed countries outside of the U.S. is expected to remain slow and dependent on central banks. It is believed that both the Bank of Japan (BOJ) and European Central Bank (ECB) will continue do whatever is necessary to keep their economies from deflation and a recession. The real question is whether the actions of central banks are enough anymore. Both the ECB and BOJ will need to be creative. The markets were unimpressed with Japan's recent policy change and negative rates in both regions do not seem to be working.

The next catalyst to help the slow global growth will need to come from fiscal, not monetary policy. The U.S. has the ability to initiate fiscal stimulus but both republicans and democrats seem unwilling to collaborate with each other. Certain countries in the Eurozone, most notably Germany, can also institute fiscal stimulus.

As of this writing, the U.K.'s new Prime Minister, Theresa May, has said she would move forward with invoking Article 50 by the end of March 2017. Article 50 is the mechanism that will officially begin the process to allow Great Britain to leave the Eurozone. Assuming she makes this deadline, it is still expected to take at least two years for the country to be officially out of the European Union. The main concern is the impact of trade, especially to the terms under which Britain will export to countries in the EU. Future agreements will probably not be as favorable as in the past, but trade will continue. We expect to see continued pressure on the pound which will benefit Great Britain's exporters.

The recent market movements around Brexit exemplify the importance of staying the course. The sharp market decline following the surprising news provided sentimentally-driven investors a reason to reduce risk, however, the markets showed their resilience once again and moved higher despite the uncertainty around Brexit. As we move closer to the election, it is important to remember either candidate could win, but be careful not to overreact if you get surprised or if your choice for the next President does not win. Much of what is discussed on the campaign trail is rhetoric but may vary greatly from what they focus on or are able to influence once they are in the Oval Office.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure that it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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