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Third Quarter 2016 Market Summary

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Third Quarter 2016 Market Summary

The third quarter brought a fair amount of headline news beginning with the spillover of the Brexit vote in the second quarter and ending with Deutsche Bank and the presidential debates. Despite the headlines, volatility was muted for much of the quarter and risk assets continued their strong performance from the lows set in mid-February. During the third quarter, equity markets performed well as investors are anticipating the rebound of corporate earnings in the fourth quarter. U.S. large company stocks, represented by the S&P 500 Index, ended the period up 3.9%. While U.S. small company stocks, represented by the Russell 2000 Index fared even better with performance of more than 9.0%. International equity markets even provided solid performance for the quarter with the MSCI ACWI ex US Index being up almost 7.0%.

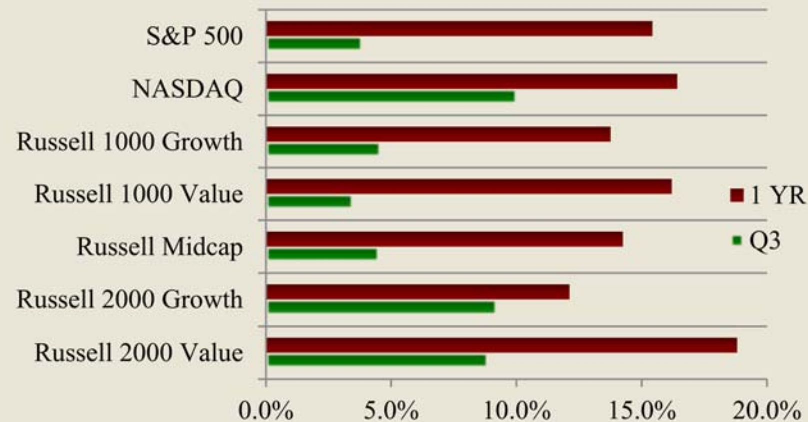
The Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was slightly positive during the third quarter even though long-term interest rates marginally increased, which negatively impacted returns. The credit areas of the bond market (i.e. investment grade corporates and high yield) experienced stronger returns during the period as credit spreads decreased. Municipals on the other hand generally had breakeven to slightly negative returns again due to rising interest rates.

One-year trailing performance has been quite strong across most equities and relatively decent across the bond markets. The high returns are a little deceiving as the period started at the lows of last year. Nonetheless, portfolios with a mix of stocks and bonds are finally beginning to feel the positive effects of diversification. This positive impact was particularly pronounced in the third quarter when U.S. small company stocks and international stocks actually outperformed U.S. large company stocks. This is a sharp contrast to calendar year 2015 when a narrow part of the U.S. large company stocks were slightly positive and the rest of the U.S. market was down as much as 7.0%. In addition, international equity markets were down as much as 15.0% and the bond markets were essentially flat.

There certainly may be some downside risk in the markets as investors brace for the uncertainty surrounding the elections. Nonetheless, we do not expect the election results to be a long term determinant of the market's direction nor a catalyst for a recession. We acknowledge that election trail politics can trigger strong emotions in people. However, often the campaign rhetoric differs from the policies pursued once the candidate is elected and in office. The democratic system of the United States, though not perfect, does a very good job of providing checks and balances that limit extreme policies.

We believe that the ongoing strength in the U.S. economy will be more affected if we see continued softening of consumer spending and/or a lack of improvement in corporate earnings and margins. Given consumers make-up more than two-thirds of the economy, this could be the next catalyst for a more prolonged pullback in the markets. Though, we don't yet see enough evidence to anticipate this will be occurring anytime soon. Of course, at some point a recession will definitely occur as economic expansions do not persist indefinitely.

Equity market valuations are looking a bit "stretched" and the markets seem to be pricing in earnings expansion over the next few quarters, which may or may not occur. Add to this the issues with the health of European banks and the U.S. election cycle; there is definitely some reason to expect short-term volatility to increase. However, looking back over the past several years, similar arguments could have been made and were being made by many analysts. Valuations are not a great short-term indicator and historically can stay high, or low, for much longer periods than people anticipate. Not to mention, the U.S. economy is exceptionally resilient and the Fed Reserve looks to be in no position to aggressively transition away from their easy money policies.



HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of third quarter 2016 real GDP, an annual rate increase of 2.9% from the preceding quarter. The estimate was higher than the 2.5% growth rate analysts were expecting.
- The University of Michigan Consumer Sentiment Index final reading for September was 91.2, which was a decrease from the previous quarter. Consumer sentiment remains high despite leveling off during the past year.
- The ISM Manufacturing Index retreated during the quarter from 53.2 in June to 51.5 in September. The ISM Index has stabilized at moderate levels after recording consecutive months of concerning data to start the year. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In September, the Conference Board Leading Economic Index increased 0.2% month-over-month to 124.4. The Index has increased gradually over the past year showing steady, but slow growth in the economy.
- The price of WTI Crude Oil was $47.72 at the end of September, which is 1.1% lower than $48.27 at the end of June. The price of Brent Crude Oil increased 0.4% in the quarter to $48.24. The price of oil is starting to find an equilibrium around $50. Supply and demand factors could still lead to a price increase or decrease of 25%; however, markets are balancing under the new and lower cost of production.
- In September, headline CPI increased 1.5% year-over-year, up from an increase of 1.0% in June. Core CPI, which does not include food and energy, had a 2.2% increase. Inflation levels have remained low over the past year and have been less than historical averages and the Fed's 2% inflation target.

HOUSING

- Preliminary existing home sales decreased in September with an annualized rate of 5.47 million units from 5.57 million units in June. The September annualized rate is 0.6% higher than the 5.44 million units in September 2015. The strength in home sales that we saw throughout 2015 has cooled over the past few quarters.
- Median existing home sale prices decreased during the quarter. However, the preliminary prices for September were 5.6% higher than the levels of one year ago and have been trending up since the beginning of 2012.
- New home sales increased during the quarter with a seasonally adjusted annual rate of 593k homes sold in September versus 558k in June. On a year-over-year basis new home sales increased 30% in September. The housing sector has been very strong the past few years with increasing sales and home prices.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose 5.2% year-over-year in August.

EMPLOYMENT

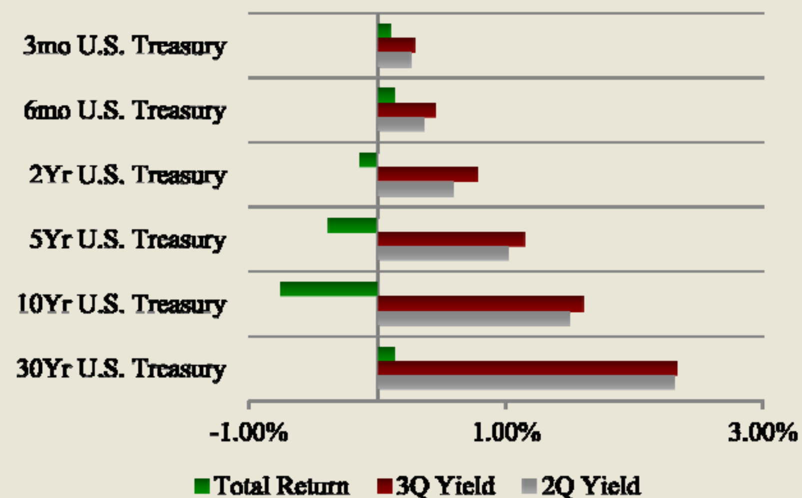
- The labor market has generally been positive the past year as the unemployment rate has fallen and wages have increased. During the quarter, nonfarm payrolls averaged 192,000 jobs added per month, which is roughly the same as the third quarter in 2015.
- The unemployment rate rose to 5.0% from 4.9% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1973.

DOMESTIC CORPORATIONS

- Corporate operating earnings in the second quarter were higher than the previous quarter. Earnings are expected to rebound in the second half of the year as lower oil prices and weaker foreign currencies should have less of an impact on year-over-year earnings growth than past quarters.
- Operating margins have retreated from highs the past year and a half but remain well above historical averages. Margins could continue to be pressured if interest rates rise and wages increase.
- Forward and trailing P/E multiples are slightly above historical averages.
- The U.S. dollar has been roughly flat vs. major currencies the past two quarters after depreciating in the first quarter. Many investors are forecasting the U.S. dollar to resume appreciating as other central banks around the world are providing monetary stimulus.

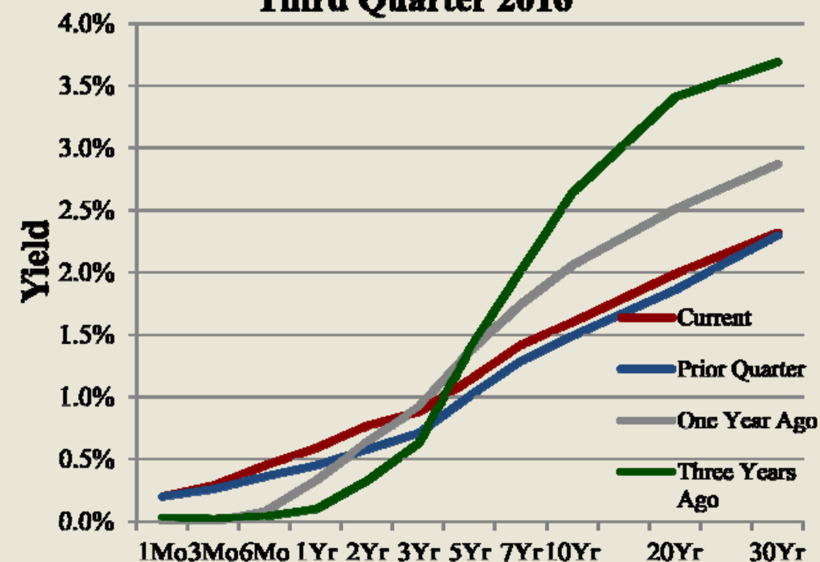
FED POLICY

- In September, the Federal Open Market Committee (FOMC) announced they would leave the federal funds rate at 0.25% - 0.50%. The announcement to leave rates unchanged was expected by the market. The economy is expanding moderately and is supported by an improving housing sector and consumer spending. However, growth has not been as strong as anticipated despite the "supportive" policies by the Fed. The Fed has been forecasting a rate hike in December but many investors question whether the data, which the Fed has been dependent, warrants a rate hike.
- Central bank policies around the world have had a great impact on the equity and fixed income markets, despite being unable to raise economic growth. The lack of policy success likely means central banks will continue to experiment with monetary policy; however, governments will turn to fiscal policy with the hope of stimulating their economies.



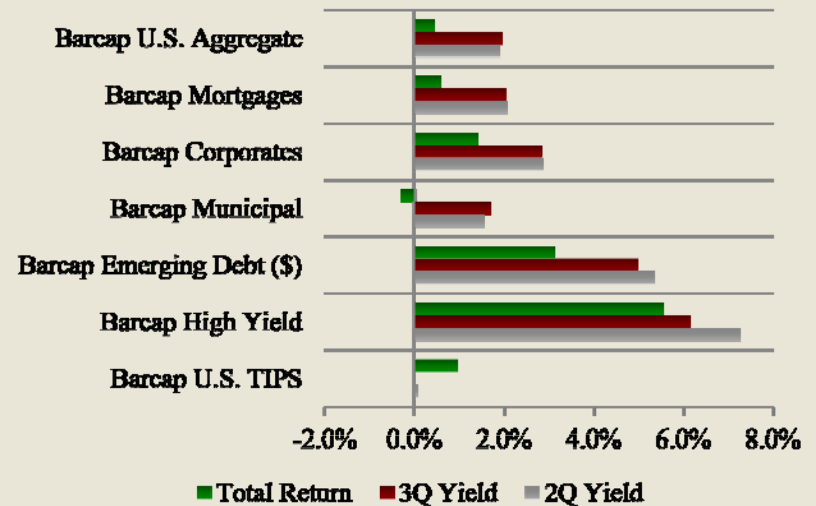
FIXED INCOME

- Yields increased quarter-over-quarter causing the yield curve to flatten. The long end of the yield curve has decreased considerably over the past few years as there continues to be concerns about slow economic growth. However, short and intermediate term interest rates have increased in anticipation of a possible rate Fed funds rate hike in December. Short term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- Despite the low rates of Treasuries and other developed sovereign debt, investors continue to buy fixed income. Flows into fixed income investments have been positive this year; whereas equity fund flows have been negative. Many institutional mandates require income and investments that are defensive in volatile markets. Thus, technical factors may still support bond prices.



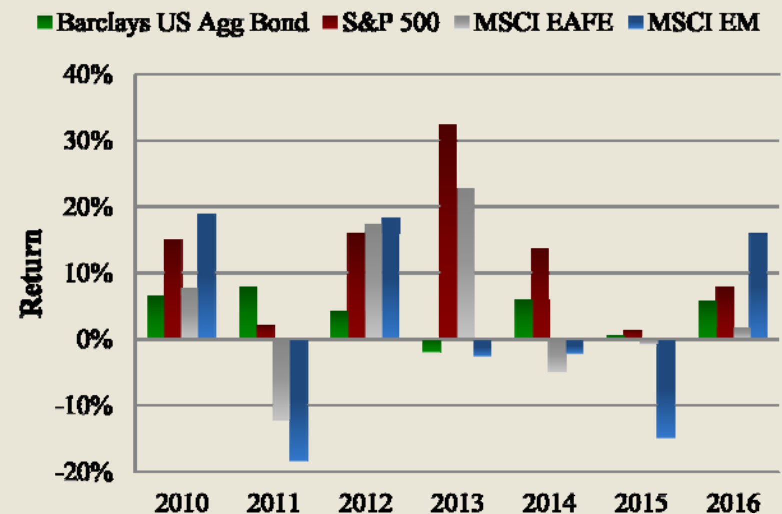
FIXED INCOME (continued)

- Returns across fixed income sectors were generally positive, particularly in credit sectors such as corporates and high yield. Returns were hurt by higher interest rates but were benefitted by narrowing credit spreads. The Barclays U.S. Aggregate was up less than half a percent during the quarter. Municipal returns were slightly negative due to rising rates and technical factors like increased bond issuances during the quarter. Fixed income returns will face a headwind if global economies are able to sustain low growth as interest rates may slowly move higher.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are starting at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. However, spreads in credit sectors are near historical averages which could benefit credit returns if the economy continues to grow.



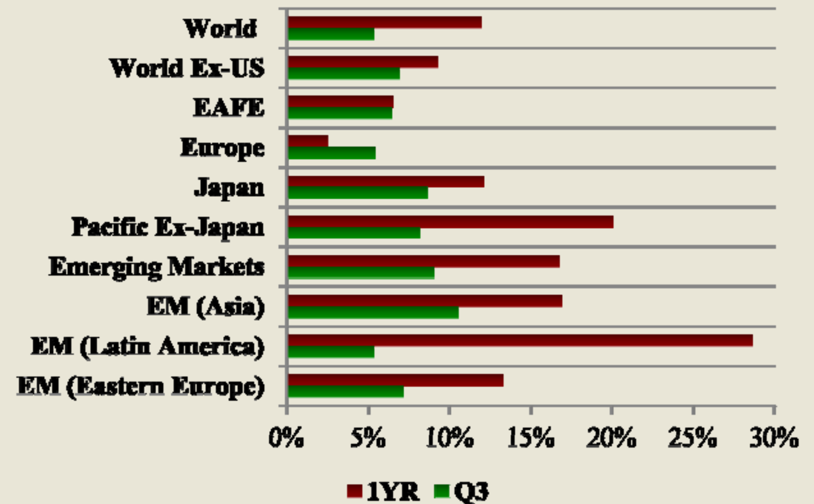
EQUITIES

- Risk assets continued their strong performance from the lows set in mid-February as volatility was low for most of the quarter and investors anticipated a rebound in corporate earnings in the fourth quarter.
- U.S. large caps have dominated returns relative to other asset classes for the past three consecutive years, which is uncommon. This trend has changed this year as a diversified portfolio has provided solid returns. Asset classes such as emerging market equities, REITs, and fixed income have performed well YTD.
- After a strong bull market in equities since 2009, future long-term returns are expected to be lower than historical averages as earnings growth remains sluggish and valuations are slightly higher than average. Volatility should continue for the remainder of the year and into 2017.



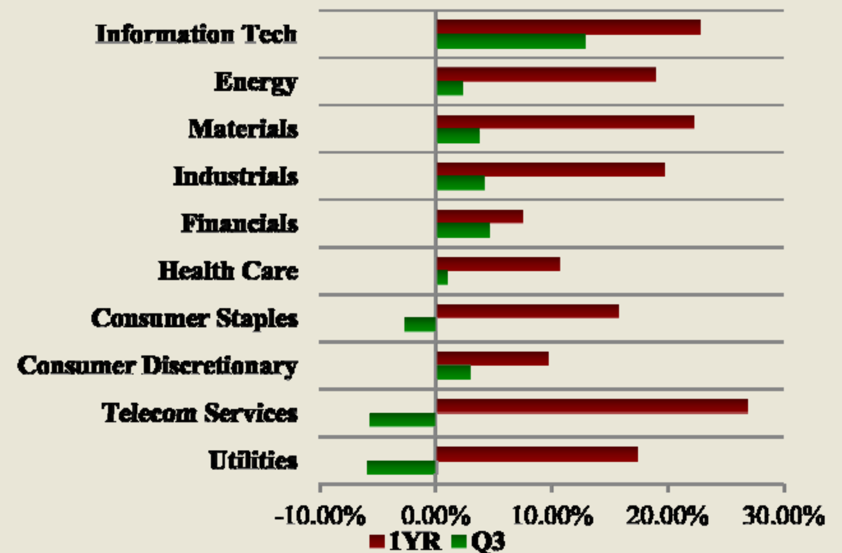
INTERNATIONAL EQUITIES (continued)

- Developed international stocks performed better than U.S. domestic equities. The MSCI EAFE index of international markets stocks increased 6.4% during the quarter. On a year-over-year basis, the EAFE is up 6.5%.
- Emerging market stocks had a strong quarter, outperforming developed markets. The MSCI Emerging Markets Index increased 9.0% in the quarter and has increased 16.8% return over the past year. Stronger returns have been due to stabilization in economic growth expectations and commodity prices. Emerging markets have also benefitted this year as the U.S. dollar has depreciated.
- European and emerging market companies have had declining earnings since 2011 which has hindered equity performance during that period. As the uncertainty in these regions subsides and they begin to recover from economic slowdowns and structural changes, their equity performance may be attractive relative to other asset classes.



DOMESTIC EQUITIES (continued)

- The Russell 1000 Index of large capitalization stocks posted a total return of 4.0% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 14.9%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 9.1% during the quarter. On a year-over-year basis, the index has increased 15.5%.
- Economically sensitive sectors outperformed during the quarter as investors are looking forward to earnings growth in the fourth quarter. After falling for the first half of the year, interest rates rose during the quarter which hurt the Utilities and Telecom Service sectors. Technology was the best performer during the quarter. Growth outperformed value across market caps. The shift away from high yielding equities towards more cyclical sectors benefitted active managers.



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