MARKET COMMENTARY & OUTLOOK

Third Quarter, 2016

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Q3, 2016 Commentary - Caution Ahead

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The Fed

A lot has changed since the third quarter of 2015, and, on balance, it has been positive. A little over a year ago, China was a large cloud over the global economy and markets. While some concerns remain surrounding China's economy, the global economy appears to be stable. Europe's economy has not contracted significantly following the United Kingdom's vote to leave the European Union; and while the final Brexit structure remains unresolved, we are hopeful that prudency will drive decisions. In the United States, economic growth remains positive, albeit slow. Despite the slow growth, the length of current expansion since the 2007-2009 recession (87 months) is the fourth longest since the early 1900s.

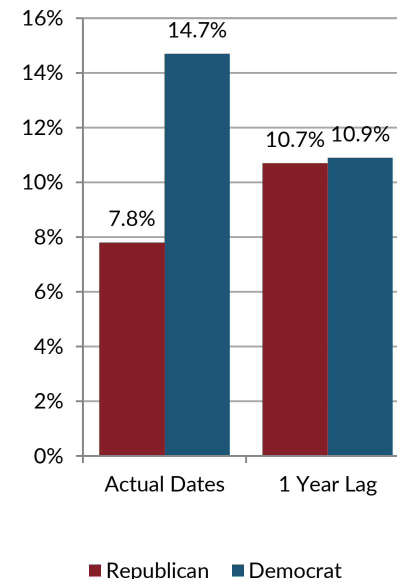
Despite these positives, we remain concerned that the investment markets are on borrowed time. The Federal Reserve (Fed) and their global counterparts remain the 'focal point' for the financial markets. After the Fed raised the target interest rate for fed funds by 25 bps last December, there was an expectation for four increases this year. To date, there have been no further increases as the Fed members have debated the strength of the economy and the impact of external factors such as Brexit. Since the Great Recession, the Fed has utilized monetary policy in an attempt to jump start an ailing economy. At the height of the banking crisis, their efforts can be credited with staving off a dire outcome. However, in our opinion, their prolonged use of monetary policy has not been effective in stimulating growth. During periods of economic crisis, easy monetary policy (lowering interest rates and increasing the money supply) entices people to accelerate spending and investment decisions. Future purchases that are being contemplated, became possible today. This accelerated activity can stave off a deep economic decline. Long term, however, an easy monetary policy does not create new activity, rather it borrows from future activity. As a result, all things being equal, future activity will be muted. Therefore, it is not surprising that the prolonged use of monetary tools have become less and less effective in generating real economic activity. Lower rates have, however, been effective at increasing investment returns but we question how much of the increased returns have resulted from true value creation as opposed to financial engineering. Lower interest rates have forced investors into riskier assets in the quest for higher returns. As more money has chased these opportunities, prices of these investments have risen. Companies have also taken advantage of lower rates by continually increasing their borrowings, often using these funds to buy back shares and pay dividends. All of this activity drives short term prices higher. However, this mismatch between value creation and price appreciation creates an overhang that will weigh on future returns. While we have been critical of the Fed's intervention in the markets, they have been left with little choice. With gridlock in Washington, there has been little in the way of a fiscal Policy response to the problems facing this country. With little fiscal policy response, the Fed has been backed into the corner they are in today. Raising rates, at this point, will create market volatility. In turn, this could reduce consumer confidence and negatively impact spending decisions. With already low economic growth, concerns about a recession will undoubtedly surface. On the other hand, if they do not raise interest rates, they will continue to penalize savers and they will be unprepared to fight off future risks. It is an unenviable situation which we have oversimplified for brevity purposes. Suffice it to say, without the appropriate fiscal response, we anticipate a rocky road ahead.

We Got Caught Flat Footed

In the sport of ice hockey, getting caught "flat footed" means you are unable to react to a change in the direction of play because you were not anticipating the change. The US, in almost every way, has been caught flat footed. An aging population, increasing pressure from globalization, and a mismatch between worker skill sets and the jobs of the future are taking a toll on our workforce, on wages and on our economy. Discontent has taken hold and that discontent is manifesting itself in a variety of ways, most notably in our elections. While the candidates for President want you to believe they have the answer, they don't. There is no quick solution to be had. We no longer have the competitive advantage in certain industries, yet we remain hell bent on trying to compete in those areas. Rather, we should channeling our efforts and directing our workforce into areas we can excel. Doing so takes time and, when you are a politician always focusing on the next election, taking the long view does not serve your self interest. It is easier to find quick fixes and kick the real problem down the road for someone else to deal with. Borrowing from the future, whether in actual dollars or through procrastination, has become acceptable. The current state of our social programs are a shining example of this. Unfortunately, the future is fast approaching and the cost of not dealing with these issues in a substantive way is quickly coming into focus.

Republican vs. Democrat – What Have The Markets Preferred?

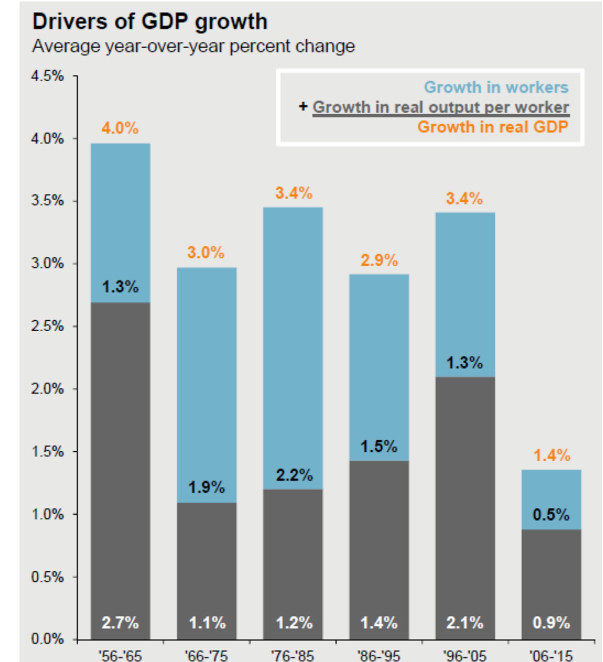
Since the inauguration of Dwight Eisenhower in 1953, the Republican Party has controlled the White House 36.02 years vs the Democrats who have controlled the White House 27.63 years. Over that period, the S&P 500 returned 14.7% with a Democrat as the President and 7.8% with a Republican as the President. However, the policies of a President don't have an impact day one. Rather, when there is a change in the White House from one party to the other, the policies of the prior party have a significant impact on the new administration in the first year. To account for this, we performed the calculation again using a one year lag. For example, with George W. Bush, we moved the start date for the 8-year market evaluation to 1/20/2002 instead of 1/20/2001 inauguration date. When you factor in the one year lag when there was a change in the political party in the White House, the return differential was insignificant.



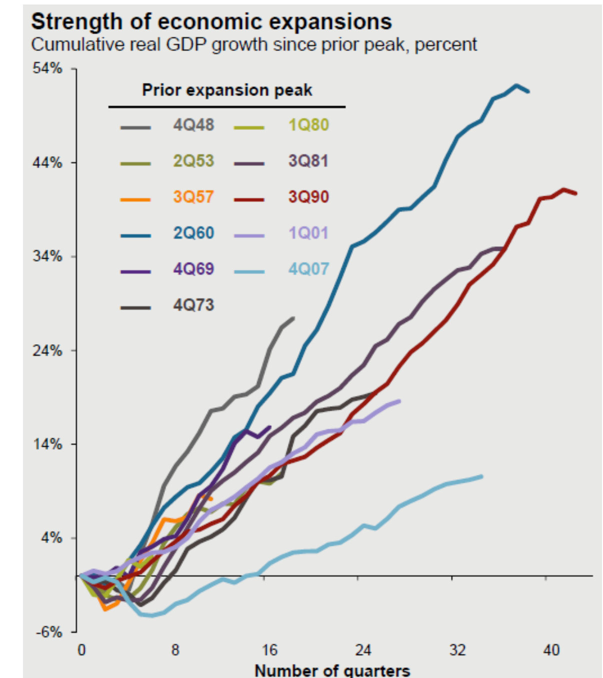
Commentary

- US economic growth remains positive, but below average. For the second quarter, Real Gross Domestic Product (GDP) increased at annual rate of +1.4%. While this is an improvement from the first quarter, the most recent reading is below the +2.1% quarterly annualized growth since the second quarter of 2009.
- The underpinnings for stronger economic growth appear to in place. Consumer confidence, which historically has contributed to increases in personal consumption, is high. Personal consumption, which accounts for approximately 70% of GDP, increased 3.6% over the last 12 months. In addition, personal income continues to increase at a rate (2.6%) that is greater than the rate of inflation. The latest inflation data for August showed year-over-year change in the Headline and Core CPI measures were 1.1% and 2.3%, respectively.
- Growth in 'workers' is integral to economic growth. As the chart to the right depicts, labor force growth has contributed between 32% to 65% of the growth in real GDP over the last six decades. Growth in nonfarm payrolls, per month, has averaged 191,700 and 203,900 over the last three months and twelve months, respectively. However, the reduction in the labor force from the aging baby boomers appears to have offset the strong growth in jobs experienced to date.
- Despite the growth in the labor market, the cumulative growth in real GDP during this expansion has been one of the weakest since the late 1940s (refer to the bottom right chart).
- Economic growth is expected to improve during the last two quarters of this year. According to the Atlanta Fed's GDPNow model, the forecasted growth rate for real GDP for the third quarter is 2.1%.[a]

(a) The Atlanta Federal Reserve's GDPNow forecast is a unofficial model that mimics the Bureau of Economic Analysis' methods for calculating GDP. Unlike the official GDP report, GDPNow provides updated estimates intra quarter. This estimate is as of 10/7/16.



Source: JP Morgan



Source: JP Morgan

Economic Statistics

	Current	One Year Ago
Real GDP Growth (Yr. over Yr.)	1.41%	2.61%
Unemployment Rate	5.00%	5.10%
Labor Force Participation Rate	62.90%	62.40%
Core CPI (Year Over Year)	2.30%	1.90%
Real Personal Income Growth (YoY)	2.14%	3.77%
10 Year Treasury Rate	1.60%	2.06%

Data Source: Federal Reserve

US Equity Market

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Commentary

- Small cap stocks, as measured by the Russell 2000 Index, outperformed large and mid cap stocks in the third quarter. After underperforming their larger cap brethren by 579 bps in 2015, the year-to-date return advantage for small caps is nearly 400 bps.
- From a style perspective, growth outperformed value across all capitalizations, as measured by Russell. Growth outperformed value by the largest margin in large cap (+120 bps), but the small cap Russell 2000 Growth Index's +9.2% return was double the return for the Russell 1000 Growth Index.
- The third quarter performance masked investor's focus on yield. Utilities and Telecommunications, which generally provide attractive yields and are often referred to as a bond replacement, were the two worst performing sectors in the index in the quarter, returning -5.9% and -5.6%, respectively. However, on a YTD basis, these higher yielding sectors are amongst the strongest performing market sectors. Equity investors' focus on yield is evident based on the performance the various yield bands outlined on the following page. Constituents of the S&P 500 Index with a dividend yield greater than 5% outperformed by a large margin. Within the small cap Russell 2000 Index, the focus on yield was not as significant.
- Do you remember FANG from last year? In 2015, the stock returns of Facebook, Amazon, Netflix, and Google (now Alphabet) boosted the S&P 500 Index return into the black. FANG stock performance this year has been volatile; however, their returns in the quarter ranked in the top 25% of the S&P 500 Index. FANGs contributed nearly 20% of the index's total return. With the addition of Apple, the performance of the 'FAANG' contributed 33.85% of the index's quarterly total return.
- The earnings outlook for the companies in the S&P 500 Index is expected to improve along with a stabilization in oil prices and the dollar (See chart lower right).

Major Market Averages

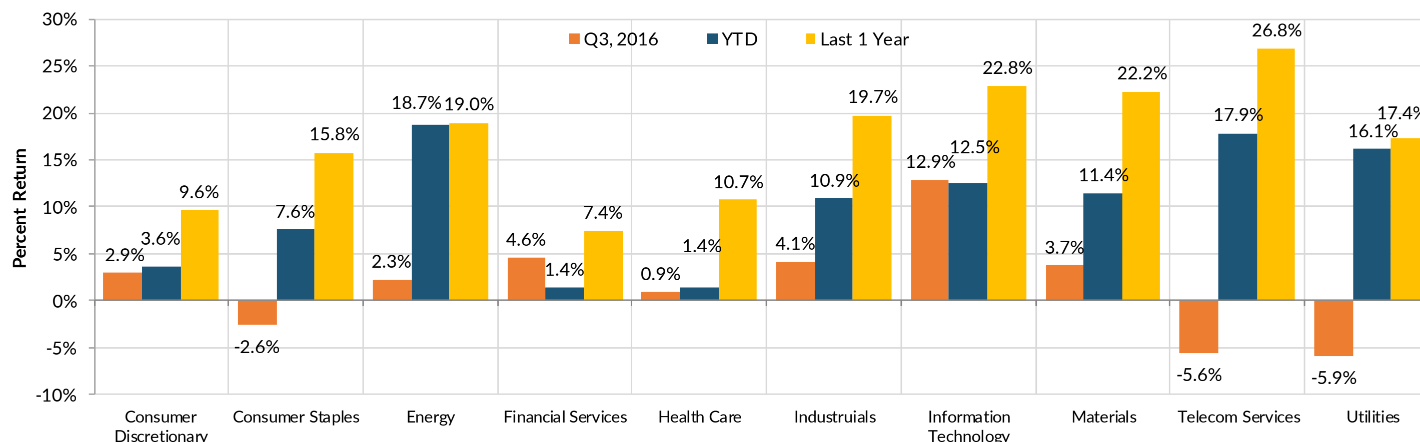
	Q3, 2016	YTD	Trailing 1 Year
Russell 3000	4.4%	8.2%	15.0%
FTSE RAFI 3000	4.4%	9.9%	15.9%
Russell 3000 Equal Weighted	9.4%	13.1%	17.8%
S&P 500	3.9%	7.8%	15.4%
Russell Mid Cap	4.5%	10.3%	14.2%
Russell 2000	9.0%	11.5%	15.5%

Data Source: Morningstar

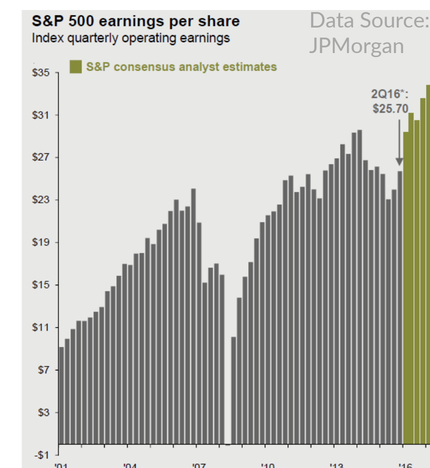
Russell 3000 Style & Cap Summary

	Mo.	Qtr	Value		Core		Growth	
Large	Jul	Q3	-0.21%	3.48%	0.08%	4.03%	0.37%	4.58%
	Aug		0.77%		0.13%		-0.50%	
	Sep		2.90%		3.81%		4.72%	
Mid	Jul	Q3	0.42%	4.45%	0.20%	4.52%	-0.05%	4.59%
	Aug		-0.21%		-0.25%		-0.29%	
	Sep		4.24%		4.57%		4.95%	
Small	Jul	Q3	0.79%	8.87%	1.11%	9.05%	1.44%	9.22%
	Aug		2.49%		1.77%		1.06%	
	Sep		5.40%		5.97%		6.54%	

S&P 500 Sector Performance



S&P 500 Earnings Per Share



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YTD Return By Dividend Yield (Russell 3000)	Avg. Weight %	Return %	Contribution to Return %
Dividend Yield [2.94 - 26.67]	25.6%	14.25%	3.47%
Dividend Yield [2.03 - 2.94)	24.4%	8.51%	2.07%
Dividend Yield [0.00 - 0.87)	26.5%	5.21%	1.47%
Dividend Yield [0.87 - 2.03)	23.1%	4.75%	1.09%
Attribution Total	99.7%		5.24%

Market Capitalization (R 3000)	Avg. Weight %	Return %	Contribution to Return %
Mega Cap (>$100 Billion)	37.3%	4.8%	1.79%
Large Cap ($20 Billion < x <$100 Billion)	32.8%	5.3%	1.75%
Mid-Large Cap ($10 Billion < x <$20 Billion)	10.2%	6.4%	0.66%
Mid Cap ($5 Billion < x <$10 Billion)	7.6%	6.7%	0.51%
Small-Mid Cap ($2 Billion < x <$5 Billion)	7.0%	7,22%	0.50%
Small Cap ($500 Million < x <$2 Billion)	4.0%	12.7%	0.50%
Micro Cap (< $500 Million)	0.8%	15.6%	0.12%
Total	**100.0%**		**5.83%**

Data Source for all data in tables: Morningstar

Top Weights	Weight	Return	Contribution
Apple Inc	3.06%	20.40%	0.59%
Microsoft Corp	2.35%	14.68%	0.32%
Exxon Mobil Corp	1.97%	-4.78%	-0.10%
Johnson & Johnson	1.78%	-0.35%	-0.01%
Amazon.com Inc	1.57%	17.01%	0.26%
Facebook Inc A	1.52%	12.36%	0.18%
General Electric Co	1.52%	-2.29%	-0.04%
Berkshire Hathaway Inc B	1.46%	1.65%	0.02%
AT&T Inc	1.38%	-3.47%	-0.05%
JPMorgan Chase & Co	1.26%	9.66%	0.12%

Top Contributors	Weight	Return	Contribution
Apple Inc	3.06%	20.40%	0.59%
Microsoft Corp	2.35%	14.68%	0.32%
Amazon.com Inc	1.57%	17.01%	0.26%
Facebook Inc A	1.52%	12.36%	0.18%
Alphabet Inc A	1.22%	15.66%	0.18%
Intel Corp	0.89%	19.12%	0.16%
Alphabet Inc C	1.19%	13.62%	0.15%
Bank of America Corporation	0.81%	19.20%	0.14%
Qualcomm Inc	0.47%	28.99%	0.13%
JPMorgan Chase & Co	1.26%	9.66%	0.12%

Top Detractors	Weight	Return	Contribution
Bristol-Myers Squibb Company	0.58%	-26.14%	-0.18%
Exxon Mobil Corp	1.97%	-4.78%	-0.10%
Wells Fargo & Co	1.18%	-4.97%	-0.06%
Verizon Communications Inc	1.17%	-4.65%	-0.06%
AT&T Inc	1.38%	-3.47%	-0.05%
Altria Group Inc	0.69%	-5.89%	-0.04%
Coca-Cola Co	0.91%	-3.98%	-0.04%
Dollar General Corp	0.13%	-25.12%	-0.04%
General Electric Co	1.52%	-2.29%	-0.04%
The Kroger Co	0.17%	-18.27%	-0.04%

US Equity Market Valuations

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- Equity index valuations are elevated. Depending on the index and the valuation metric, one could argue whether equities are extremely overvalued or 'fairly' valued. Valuation is not binary (i.e., good or bad) and it is also contextual. Furthermore, there have been studies that show over the short run, changes in equity multiples is a primary determinant of performance.

- In prior commentaries, we have noted the disconnect between the rise in equity prices and growth in company fundamentals. A potential contributor to this disconnect is the growing level of investment over the past several years, in index-based mutual funds, and exchange traded funds (ETFs). For the example, for the trailing three-year period, approximately $107 billion dollars in aggregate has flowed into the Vanguard 500 Index Fund, the iShares Core S&P 500 ETF, and the SPDR S&P 500 ETF. As investors shift assets into passively-managed funds, prices of the constituents in the index are pushed higher due to the higher demand, regardless of the underlying fundamentals.

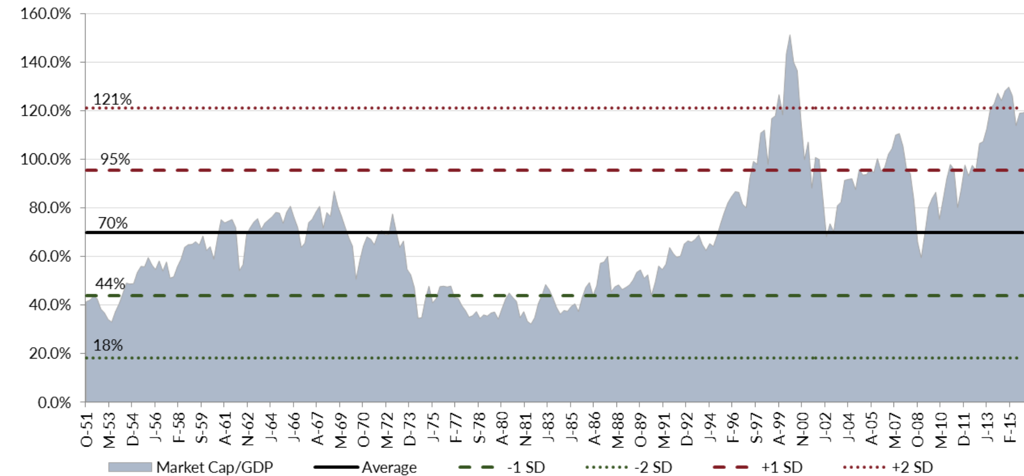
- A measure of market valuation is the Buffett indicator, which compares the market value of equities to Gross Domestic Product. Using data gathered since 1951, the current market is one of the most expensive markets over the last 65 years, rivaled only by the tech bubble on 2000.

- Even though there are several price metrics that are above their respective historical average, there are some metrics that are below average. For example, the dividend yield and the Price/Book ratio indicate the S&P 500 is attractively priced from a historical perspective.

- Despite these somewhat contradictory measures, we believe the equity markets remain overvalued, due in large part to the accommodative policies of the world's central banks.

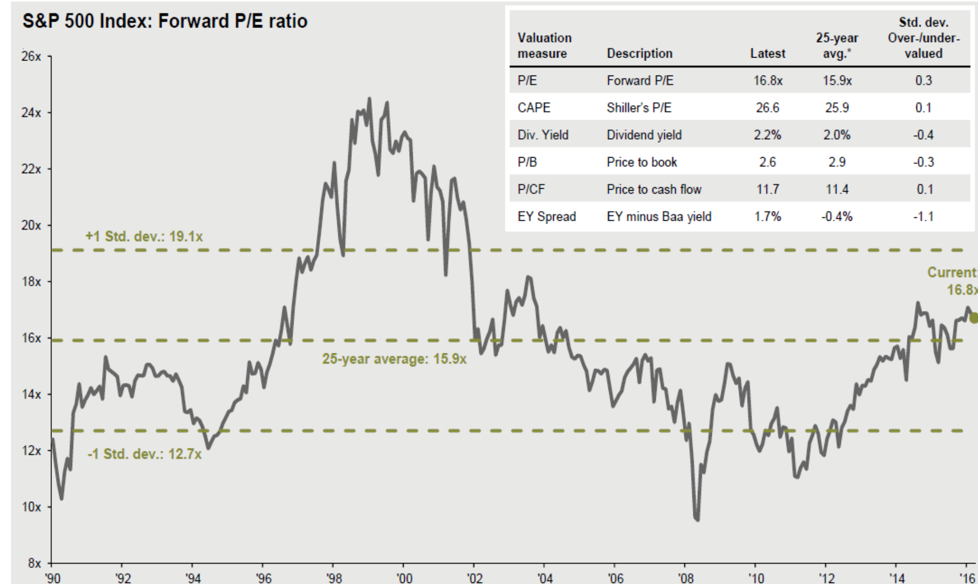
The Buffett Indicator

The Buffett indicator, made popular by Warren Buffett, compares the market cap of the US equity market to US Gross Domestic Product. The numerator for the equation is the Market Value of Equities Outstanding as reported by the Federal Reserve. The denominator is Nominal Quarterly GDP.



Data Source: Federal Reserve

S&P 500 Valuation



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.8x	15.9x	0.3
CAPE	Shiller's P/E	26.6	25.9	0.1
Div. Yield	Dividend yield	2.2%	2.0%	-0.4
P/B	Price to book	2.6	2.9	-0.3
P/CF	Price to cash flow	11.7	11.4	0.1
EY Spread	EY minus Baa yield	1.7%	-0.4%	-1.1

Source: JP Morgan

Commentary

- Both developed and emerging market equity returns improved in the quarter and outperformed the U.S. equity indexes. For the third consecutive quarter, the MSCI Emerging Markets Index outperformed the MSCI EAFE Index (Developed Countries). The average quarterly outperformance in 2016 has been 442 bps.
- The rally in emerging markets has been fueled, in part, by a stabilization in commodity prices, a lack of US interest rate increases that has resulted to a stable-to-weakened dollar, and a somewhat less pessimistic view on global growth. The best performing country was Brazil, which has benefitted this year from new government leadership and stabilizing commodity prices.
- In a reversal from the second quarter, a weakening US currency over the last three months contributed to higher returns for investments in several developed and developing market countries. Dollar weakness added approximately 50 bps to the MSCI All Country World Index ex USA. (“ACWI ex. US” – See table lower right).
- While UK Prime Minister May has not enacted Article 50 of the Lisbon Treaty, to initiate the process for the United Kingdom’s departure from European Union, the currency depreciated significantly during the quarter due to the uncertainty surrounding the future of the UK.
- Similar to US equity valuations, valuations for non-US developed and developing markets are elevated. At the end of the quarter, the P/E ratio, based on the estimated earnings for the next 4 quarters, for the MSCI EAFE Index and MSCI Emerging Markets Index were above the average for the trailing 10 years. However, in relation to the global equity market, as measured by the MSCI All Country World Index (MSCI ACWI), both segments of the international equity market are cheap. The MSCI ACWI (which includes US Stocks) is trading at 16.1 times forward earnings, while the EAFE and EM are trading at 14.5 times and 12.4 times forward earnings, respectively. In the context of the global equity market, these valuation differences correspond to a 10% and 23% discount, respectively. Year-to-date through the third quarter, it appears the valuation for the EAFE index is more inline with fundamentals than the EM index. Based on data from Bloomberg, since 12/31/15, the forward P/E for developed market index has declined 3.9% on a 3.1 percent increase on estimated forward earnings, while the valuation for the developing markets index has increased 12.0% on a 1.6 percent increase in the estimated earnings for the next four quarters.

Major Market Averages

	Q3, 2016	YTD	Trailing 1 Year
MSCI EAFE	6.5%	2.2%	7.1%
MSCI EAFE Value	8.1%	1.4%	4.2%
MSCI EAFE Growth	5.0%	3.0%	9.9%
MSCI EM	9.2%	16.4%	17.2%
MSCI ACWI Ex. USA.	7.0%	6.3%	9.8%

Data Source: Morningstar

Regional & Country Performance

	Local	USD	Impact Of US Dollar [a]
MSCI ACWI Ex USA	6.49%	7.00%	0.51%
MSCI Europe	5.70%	5.45%	-0.25%
MSCI Europe Ex UK	5.13%	6.09%	0.96%
MSCI United Kingdom	7.02%	3.99%	-3.02%
MSCI Pacific Ex Japan	6.55%	8.21%	1.66%
MSCI Japan	7.35%	8.76%	1.40%
MSCI France	5.21%	6.43%	1.22%
MSCI Switzerland	2.15%	2.66%	0.51%
MSCI Germany	8.76%	10.02%	1.26%
MSCI Canada	6.29%	5.04%	-1.26%
MSCI China	13.94%	13.96%	0.02%
MSCI India	4.49%	5.92%	1.44%
MSCI Brazil	12.93%	11.37%	-1.57%
MSCI Russia	7.74%	8.90%	1.16%

Data Source: Morningstar

Assumes Gross Reinvestment Of Dividends

(a) Impact of Dollar: A strengthening dollar (represented as a negative return) has a negative impact on foreign returns as those returns are converted from foreign currency to US dollars. A weakening currency (represented by a positive return) has the opposite effect.

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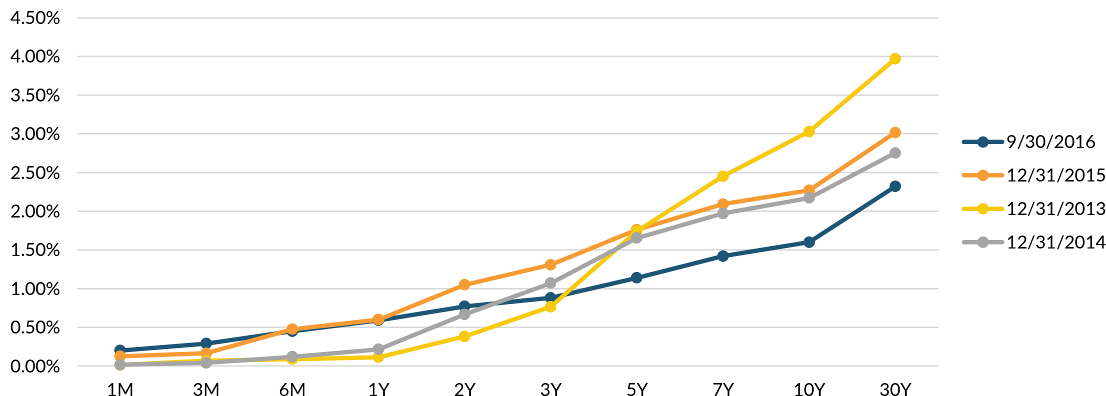
Commentary

- For the quarter, the Barclays Aggregate Bond Index returned +0.46%, with the best performing being investment grade corporate bonds.
- The yield on the benchmark 10-Year Treasury increased 11 bps to 1.60% during the quarter. However, the largest increase occurred in the 2- and 3-year maturities. Many fixed income investors follow the movement in the 2-Year yield to gauge the market's expectations for a change in the fed funds rate.
- The yield differential between the 10-year and 2-year Treasury maturities is also followed by many market observers to gauge bond investors expectations. Some perceive a tightening of the spread to indicate an increase in recession risk. To provide some context, an inverted yield curve (i.e., higher yields for short maturities than longer maturities) has been a precursor to recessions in the past. At the end of the third quarter, the spread was 83 bps, which is the smallest yield differential since October 2007. Since December 2015, the spread has declined 39 bps.
- Based on the performance of the corporate indexes, fixed income investors were fixated on yield. Corporate bonds outperformed treasuries for the quarter and low quality, high yield bonds outperformed high quality bonds by a significant margin.
- Monetary policies around the globe have not produced the desired effect of higher economic growth. In the United States, since the last recession that ended in June 2009, the growth in Gross Domestic Product (GDP) has been one of the weakest since World War II.
- As we have previously stated, not only has loose monetary policies not had the desired economic impact, but it has also created artificially high asset prices, even in fixed income. Treasury yields and credit spreads are near all-time lows.

Yield Curve Movement



Data Source: Bloomberg, Federal Reserve

Major Market Averages

	Q3, 2016	YTD	Trailing 1 Year
BofAML US Treasury Bill 3 Mon	0.10%	0.24%	1.68%
Barclays US Govt/Credit 1-3 Yr	0.02%	1.68%	3.30%
Barclays US Govt Interm	-0.24%	3.30%	6.66%
Barclays US Govt/Credit Interm	0.16%	4.24%	4.24%
Barclays US Govt/Credit	0.40%	6.66%	5.86%
Barclays US Agg Interm	0.31%	4.10%	3.57%
Barclays US Agg Bond	0.46%	5.80%	5.19%
Barclays Global Agg Bond	0.82%	9.85%	8.83%
Barclays US Treasury	-0.28%	5.07%	4.09%
Barclays US Treasury US TIPS	0.96%	7.27%	6.58%
Barclays US Corporate IG	1.41%	9.20%	8.56%
Barclays High Yield Corporate	5.55%	15.11%	12.73%
Barclays Municipal	-0.30%	4.01%	5.58%
Barclays Municipal 7 Yr 6-8	0.07%	3.29%	4.60%

Credit Quality

Barclays US Corporate Aaa	0.53%	8.71%	9.27%
Barclays US Corporate Aa	0.48%	6.80%	6.79%
Barclays US Corporate A	0.90%	8.01%	7.89%
Barclays US Corps Baa	2.06%	10.79%	9.47%
Barclays US High Yield Ba	4.36%	12.29%	12.13%
Barclays US High Yield B	5.70%	13.52%	11.26%

Data Source: Morningstar

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