Economic and Market Review

Economy – After a solid 2nd Quarter, a number of economic indicators softened during the course of the past quarter. Housing sales and starts, business surveys and retail sales all slowed modestly during the quarter while employment showed little evidence of gaining any momentum from the tepid growth of the last several years. There were potentially some subtle shifts in the economic backdrop as a tightening labor market did draw workers back into the labor force and wages showed modest increases. Inflation also displayed signs of stirring from its long doldrums, registering readings in the low 2% range in 2016 after three years of being below 2%. The economy continues to struggle with weak demand, low productivity despite all the efforts by the Fed to spur growth. Finally the election continues to surprise and amaze with no clear choice emerging and a wide range of potential economic impacts. Markets have held up reasonably well despite the uncertainty.

Interest rates – Interest rates began the quarter near all-time lows (10 Treasury – 1.37% on 7/8/2016) and drifted upwards during the quarter, anticipating a potential rate hike by the Federal Reserve in September. Mixed economic results during the quarter caused the Fed to hold rates steady, which pushed rates down slightly. Bond prices reacted negatively, especially at the long end, for example the Vanguard Long-Term Bond ETF (BLV) was down over 2.5% for the quarter. December is the next potential opportunity for the Fed to raise rates as the November meeting is off the table given the election. The Fed remains “data dependent” so economic indicators leading up to December will play a major role in Fed actions and create volatility in the fixed income markets leading up to the meeting.

Equity Markets – Equity markets turned in a decent quarter with the S&P 500 up 3.9% and now posting a 7.8% gain for 2016. Smaller stocks performed slightly better while growth stocks outperformed their value counterparts. Overseas equities did even better as developed markets rallied, +6.4% for the MCSI EAFE, and are now in positive territory for the year. Emerging markets continued to rally as the MCSI EM Index was up 9.0% and is now up 16.0% for the year.

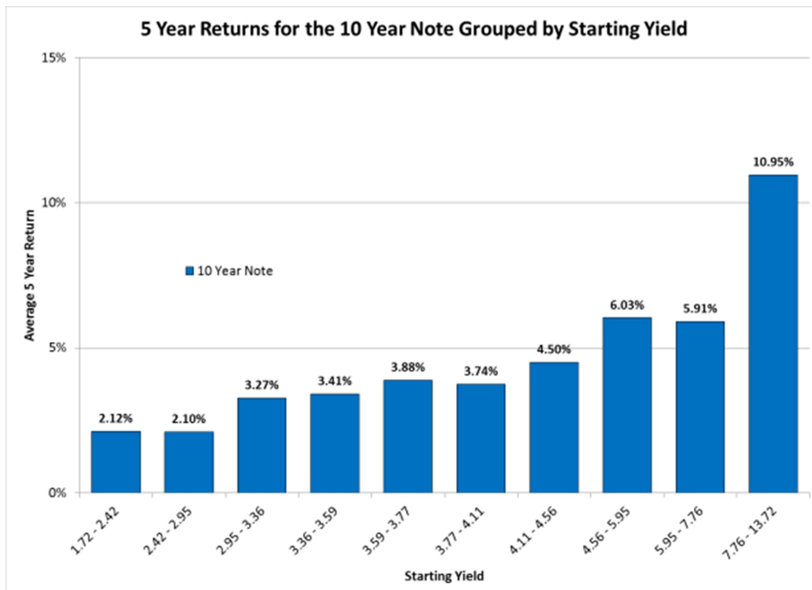
Commodities – Both Crude oil and Gold were volatile during the quarter but ended up being flat for the period holding the strong YTD gains. The US dollar remained strong as investors worldwide sought the safety and relatively high yields of US bond market.

Outlook

Economy – The US economy is at a crossroad in many respects. The long and slow recovery is finally beginning to lead to some tightness in the labor market and modest inflationary pressure. The Fed is leaning towards rate hikes. Beyond presenting a contrast in style, the election also represents two distinctly different economic visions which is getting lost in all the noise associated with the political process. While the economy appears to be on reasonably solid footing, there remains a tenuous nature to the recovery which may be tested as the Fed begins to raise rates. Central bankers are also beginning to understand some of the negative feedbacks of low/zero/negative interest rate policies as bankers struggle to generate returns in spread businesses and savers struggle to contribute to demand given the low returns on their investments. All in all there are few givens in the current economic outlook which is odd considering the limited potential of available investment opportunities at the present time.

Equity Markets – Stock market valuations remain elevated in the US but help may be on the way. Earnings growth shows signs of reacceleration after several quarters of softening. The Energy sector was largely responsible for the recent earnings disappointments as Crude oil prices collapsed. Energy companies have readjusted their spending and oil prices have rebounded and stabilized which is leading to a recovery in oil company earnings. Even with the potential for an earnings rebound, long term prospects for US stocks are muted by tepid economic growth, mediocre earnings growth and valuations at the high end of historical norms. Foreign markets, developed and emerging, continue to offer attractive valuations after years of underperforming the US markets. Threats of major economic fallout from Brexit and/or unraveling of Deutsche Bank pose potentially dangerous idiosyncratic risk.

Fixed Income – Income oriented investors are faced with difficult choices, low current yields and potential principal losses driven by higher rates. While equity profits are driven by multiple factors (economic growth, earnings, dividends and valuation), fixed income returns are primarily a function of a single factor, yield. A review of 140 years of bond data provided by Prof. Robert Shiller from Yale University shows the five year forward return to the 10 year Treasury Note is directly correlated to the yield at the begin of the period. The average 5 year return to the 10 year Note for the lowest decile of starting yields (1.72% - 2.42%) was 2.12% while average return for the top decile was 10.95%. With current yields below the lowest decile range, long term fixed income investors should have very modest return expectations. This has important implications for asset allocation as a big portion of typical 60/40 allocation should not be expected to deliver more than two percent return, which makes it very difficult for the overall portfolio to deliver the types of returns investors have become accustom to over the years.



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