Economic & Market Commentary

Continuing the trend of the prior quarter, the third was a quiet period for most financial assets. Other than the Brexit hiccup in late June into July, equity markets were about flat, ending the quarter with the S&P 500 up 3.8% and other indices in line. Small and mid-cap stocks once again turned in better results, as they have all year. Likewise, value outpaced growth for the nine months, on the back of the energy rebound and the performance of high yielders (utilities and telecoms), as investors scrambled for income. Global equities reversed their inferior position of last quarter, as two thirds of the markets monitored by ***The Wall Street Journal*** were ahead of the S&P 500. Bonds, except for high yield, reversed their prior quarter's outperformance, and returned little this period. Only corporate and high yield bond returns were ahead of stocks going into the final quarter.

Our baseline view of the investing landscape has not changed from what it has been for the past several quarters. We are in a below trend growth environment, with U.S. real growth of about 2% and global real growth about 3%. U.S. job growth continues at a decent pace (156,000 for September), consumer balance sheets have been repaired and wages are beginning to grow. Interest rates are low and, even if the Fed raises the Fed Funds target in December (which the current odds favor), they will remain so for some time. In addition, energy prices remain reasonable. Inflation is also contained, and shows little sign of acceleration, so there is no evidence of recession around the corner. As a result, the U.S. consumer should be able to continue to spend enough to provide modest GDP growth.

Brexit is still on the horizon, but to date the vote has had little impact on the U.K. or the rest of Europe – other than a large decline in the value of the British Pound (down about 17% since the vote). However, the Brexit process has not yet begun. Prime Minister Theresa May recently announced that Article 50 of the Lisbon Treaty won't be invoked until March 2017, which starts the 2 year process of unwinding the U.K.'s membership in the E.U. She has made noises about having a "hard" Brexit, which could be messy. The point here is there is a long way to go, and it's far from clear that the process will be smooth. This leaves ample room for increased uncertainty, which implies increased volatility.

The other fly in the ointment at this point is corporate earnings. We are in reporting season again, and the expectation is for U.S. corporate earnings to be down for the sixth consecutive quarter. S&P 500 earnings peaked in 2014 and have been down most quarters since. Granted energy sector earnings have been the major drag (last quarter was -2.9%, but ex. Energy was +1.0%) but most companies' guidance has regularly been reduced. Current forecasts are for positive growth in the final quarter, and the year coming in at $115-$119 per share. That puts the S&P close to 18X earnings – not particularly cheap. For 2017, the consensus estimates are for +13-14% growth, which we think is too aggressive, so disappointment could be a risk. The other risks we enumerated in our previous quarterly Commentaries have not been dealt with and are still lurking.

To this view of the current situation should be added the obvious fact that next month we have an election that could dramatically alter the longer term outlook. Who will become our next president will be determined in the next few weeks. As this is written Hillary Clinton has the lead in the latest polls (but remember the "wobbly pencils" in Brexit). Whether the polls hold and Trump loses, one thing is clear – "Trumpism" is with us and must be confronted. The populism that Trump represents is not unique to the U.S. In recent years it has found its way across the globe – France, Netherlands, Italy and finally Brexit. Nor is it a new political concept, but goes back to Roman times and found favor in Machiavelli's 16th century Florence, 18th century France, and 19th and 20th century U.S. Populism has historically been a movement to mobilize the population against the "elites", and has recently gained increased influence through Euroskeptics, the Tea Party, Bernieism and Trumpism. The financial crisis of 2008, and impatience with the stagnation of living standards (globalization and inequality), a crisis of national identity and culture (immigration) and the revival of nostalgia (the desire to return to a former, simpler life), brought it to its current crescendo, and the rise and pervasiveness of social media, with its attendant anonymity has kept it in the forefront. Our newly elected leaders will be forced to listen to this anger and deal with the grievances, or, as some have said, there will be permanent risk to our liberal capitalistic democracy.

We won't know how this problem will be addressed and what the investment implications will be until well into 2017, as we have little detail about plans at this stage. There are, however, some things that are clear. Monetary policy has reached the end of its effectiveness. Liquidity injections and low interest rates served to stave off potential disaster during the financial crisis, but also penalized savers, and inflated financial assets, adding to the problem of inequality. Fiscal policy, which has largely been absent, now must be relied upon to help create jobs and generate incomes. Both Trump and Clinton seem to agree on the need for large infrastructure spending, which would be a step in the right direction. Beyond that there is little about which we can make judgments at this time. We do know that the current economic landscape is less than robust. We have excess capacity across enough of the economy that inflation should not present a problem for some time (+2% inflation), which also means pricing power will continue to be subdued. Combined, these factors lead to a nominal growth rate of GDP (and corporate revenues) of about 4%. We also know that the corporate profits share of GDP has been high, while labor's share of GDP has been low. Redress of the populist's grievances could negatively alter this relationship. The pendulum has swung too far and reversion to the mean could well take place over the next several years. If policies are put in place to deal with these issues, we could well have a disappointing outlook for corporate profits for a few years. Whether this happens remains to be seen, but it represents another risk to the longer term investment outlook. The bottom line of this discussion is that the risks have been ratcheted up over the past several months, adding to the potential for increased volatility going forward. However, our Growth at a Reasonable Price (GARP) investment strategy of purchasing the common stock of companies, with strong financial characteristics and competitive advantages, when they are trading a discount to our estimate of fair value is generally less volatile than the broad market. At the same time, we will try to use market setbacks to improve the risk/return profile of our clients' portfolios.

Fixed Income Market & Strategy Review

Bond markets performed well over the third quarter with the Bloomberg Barclays US Aggregate Bond Index returning 0.46%, to bring its year-to-date (YTD) return to 5.80% as of September 30th. Despite the solid return this quarter, there was considerable volatility in bond prices and yields over the past three months, as investor sentiment on whether or not the Fed would raise the Fed Funds target rate continued to swing back and forth. At the beginning of the third quarter, bond markets were still digesting the highly surprising Brexit vote for the United Kingdom to leave the European Union and market expectations for a Fed rate increase in 2016 were at just 9% (with an almost equal percentage expecting a rate cut)!

In July, the bond market began to calm down while recognizing that the United Kingdom leaving the EU would not as disruptive as initially thought. This realization along with improving US employment figures (a surprisingly strong 252,000 increase in jobs during July) caused the expectations for a Fed rate increase at its September meeting to swell to over 55% by late August. This expectation was further encouraged by hawkish statements from Federal Reserve Bank regional presidents and by Chair Janet Yellen herself. She stated that a September rate increase was a very real possibility in her closely watched Jackson Hole policy speech at the end of August.

Despite the growing consensus for a September rate hike, we believed that the economic data did not support nor mandate a rate increase at that time. The jobs report for August revealed an increase of only 151,000 jobs, which was below the 180,000 consensus expectations. (The August figure was later revised to a gain of 167,000 jobs). In addition, the most recent inflation figure before the September Fed meeting (as measured by personal consumption expenditures) was just 0.8%, which was still significantly below the 2% inflation rate targeted by the Fed. If the Fed were to raise rates in September, we believed it would not be because the economic data warranted it, but rather because they bowed to the increasing political pressure to “normalize” interest rates. Just as we thought it would not be prudent for the Fed to raise rates ahead of the Brexit vote, we similarly believed it would be equally unwise to raise rates ahead of the upcoming Presidential election.

To the surprise of many and disappointment of some, the Fed chose not to raise interest rates at the September meeting. We now expect a rate increase following the Presidential election, most likely at the December Fed meeting. There is an increased consensus among the Federal Reserve board members that the US economy can handle a 25 basis point increase. Inflation moved up to 1.0% in August from 0.8% in July. In addition, while the September jobs number (156,000 increase in payrolls) was lower than expected and far from spectacular, it was just enough to limit any Fed worries that a rate hike would be harmful to employment or economic growth. The most recent estimate of GDP growth for the 2nd quarter was 1.4% and key Fed officials, NY Fed President William Dudley and San Francisco Fed President John Williams, have publicly stated that they expect GDP growth will accelerate meaningfully in the 2nd half of this year, which is why they believe it’s time to increase interest rates in the United States.

It is important not to underestimate how important the targeted inflation rate is to the Fed. Chair Janet Yellen recently stated that she believes running the US economy "hot" could fix some of the damage (lower labor participation rate and capital spending) caused by the Great Recession and accelerate the economic recovery that has been remarkably slow compared to historical economic recoveries. She believes that some upward pressure on inflation would result in increased business sales, spurring additional capital spending and hiring by companies, which, in turn, would hopefully raise wages and draw in idled workers currently sitting on the sidelines. This insightful statement tells us that while the Fed is anxious to raise rates, they will not do so if they believe it will choke off economic growth or slowly building inflation. In fact, we believe the Fed would prefer to have inflation slightly higher than their 2% target rather than below it. Notwithstanding Chair Yellen's recent comments on the benefits of a hot economy and letting rates remain lower for longer, this does not mean she is not prepared to raise rates in December; rather, the takeaway should be that the Fed will continue with its cautious and carefully measured approach towards rate increases.

We continue to believe that corporate, agency and mortgage securities offer better return opportunities relative to Treasury bonds and plan to gradually add exposure in those sectors. YTD corporate bonds have been the strongest performing sector of the Bloomberg Barclays US Aggregate Bond Index, returning 6.6% compared to 3.7% for mortgage pass-through securities and 3.4% for agency bonds. The goal is to maintain a high credit quality portfolio while adapting the portfolio composition to this ultra-low interest rate environment in order to earn additional yield. We are comfortable with our overweight position in corporate bonds given the slowly improving economy, growing profits/cash flows generated by companies and strong corporate balance sheets. Municipal bonds have performed quite strongly this year so that the bond prices have increased and investment total returns offered are lower. We continually evaluate the after-tax returns of comparable credits for taxable and non-taxable securities in order to obtain the highest after-tax return available for clients. Portfolios are structured so that we have cash becoming available at regular intervals to invest at higher yields as rates rise.

While anticipating a December rate increase, we still believe rates will remain lower for longer, particularly when compared to historical levels. During the third quarter, the yield curve further flattened, meaning that the additional yield an investor earned for buying longer maturity securities decreased slightly. For example, the spread between 10-year and 2-year Treasury bonds fell 6 basis points during the quarter and is now 83 basis points compared to a historical average of 165 basis points over the past 5 years. We do expect this trend to begin to reverse as more investor sentiment incorporates the very high probability that the Fed will raise rates in December. We are carefully balancing the attraction of going slightly further out on the yield curve to pick up higher yields, with the recognition that the benefit of doing so is limited right now, particularly with interest rates most likely heading higher.