Quarterly Economic Update 3Q 2016

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The quarter in brief. Brexit proved to be a non-factor as investor optimism drove markets into "risk-on" mode, propelling market returns higher in Q3.

Economic news. The Bureau of Economic Analysis reported its estimate of Q2 GDP of +1.4 percent, slightly higher than the Q1 level of 1.10 percent. That marks the third consecutive quarter below 1.5 percent. Soft business spending continued to weigh on growth even as energy prices and the U.S. dollar stabilized. Consumer spending again provided the bulk of the growth, up 4.3 percent, the second strongest quarter in nearly eight years.

Consumer optimism has been instrumental in keeping the U.S. economy afloat. The Conference Board announced that the Consumer Confidence Index increased in September (104.1) and is now at its highest level since the recession – the primary drivers being a better labor market and rising net worth.

According to the Bureau of Labor Statistics, the U.S. added an average of 191,000 jobs per month in Q3, a level above the year-to-date average of 178,000, but below 2015's average of 229,000. The unemployment rate crept back to 5.0 percent in September, due in large part to a rise in the workforce participation rate. There were over 5.5 million job openings at the end of Q3, the highest level since 2001, and average hourly earnings continued to creep higher.

The U.S. Census Bureau released its annual report showing that median household income increased 5.2 percent in 2015, the largest one-year increase in nearly 50 years. More importantly, gains were consistent across all income levels and demographic groups. Additionally, aggregate household net worth now stands 31 percent higher than before the recession, mainly due to a remarkable rebound in household financial assets (investments and housing).

Manufacturing expanded in September as the ISM Manufacturing report registered 51.5 percent, rebounding from a low of 49.4 percent in August. While not great, a reading above 50 percent indicates that the manufacturing economy is generally expanding and would indicate the weak August number was an aberration.

The Fed postponed a rate hike for the third consecutive quarter, leaving the target fed funds rate at .25 percent to .50 percent. While the U.S. labor situation remains solid, weaker economic growth globally, and low rates abroad, gave cover for the Fed to do nothing. While the Fed considers the risks to the economy to be "balanced", the futures market is now assigning a 70 percent probability of at least one increase by the end of the year.

Fears of a post-Brexit world quickly evaporated as the consensus view was that any fallout from the U.K.'s vote to leave the EU would be more local and less disruptive to the region. British Prime Minister David Cameron resigned and the U.K. reiterated their intention of leaving – a process likely to take two years. While fears have subsided, the International Monetary Fund still expects global growth to slow to 3.0 percent in 2016 with a more subdued outlook for developed economies relative to emerging markets.

The presidential election is only weeks away and the U.S. electorate will be choosing from two of the least popular candidates in U.S. history. While much of the discussion has been about personality and demeanor, little has been said about economic policy. As you would expect, the policy platforms are miles apart, but are consistent with traditional party lines. The polls are showing Clinton with an ever-growing lead and traditional Republicans are beginning to worry about "down-ticket" casualties. If Brexit taught us anything, it is that polls don't always get it right. We will see in short order.

Markets. Markets quickly recovered from the initial shock of the U.K. referendum, as lower interest rates, further monetary stimulus by foreign central banks, and encouraging economic data put investors in an optimistic mood. Stock prices reversed course at the beginning of July, eventually pushing the S&P 500 to a record high (2,190.15) on August 15, before leveling off by quarter's end. This enthusiasm created a full risk-on rally that pushed most asset classes higher. The S&P 500 Index finished the quarter with a solid return of 3.9 percent, but small cap stocks (Russell 2000 9.05 percent) were up the most, a clear benefactor of the risk-on environment.

Index Performance	Q3 2016	Q2 2016	YTD
Domestic Equity			
S&P 500	3.85%	2.46%	7.84%
Russell Mid Cap	4.52%	3.18%	10.26%
Russell 2000	9.05%	3.79%	11.46%
International Equity			
MSCI EAFE	6.43%	-1.46%	1.73%
MSCI Emerging Markets	9.15%	0.80%	16.36%
Fixed Income			
Barclays Aggregate	0.46%	2.21%	5.80%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Though economic data in many countries remains low, aggressive monetary policy outside the U.S. helped international stocks outpace U.S. equities in Q3. Modest currency appreciation also helped boost gains in U.S. dollar terms. The MSCI EAFE Index of developed markets stocks advanced 6.43 percent. Japan (8.76 percent) was the strongest and Europe (5.45 percent) was the weakest. Emerging markets performance was up big, as the MSCI Emerging Markets Index gained 9.15 percent.

The yield on the 10-year Treasury note ended the quarter at 1.60 percent, up from 1.49 percent on June 30. The possibility of another round of Fed tightening forced the yield curve to flatten slightly with rates on shorter-term maturities rising more than longer-term maturities. As for total returns, the Barclays Aggregate Bond Index was up .46 percent while credit focused indices like the Barclays U.S. Corporate Index (1.35 percent) and the JP Morgan High Yield Index (5.49 percent) did much better.

S&P 500 Sector Performance	Q3 2016	Q2 2016	YTD
Consumer Discretionary	2.94%	-0.91%	3.64%
Consumer Staples	-2.63%	4.63%	7.55%
Energy	2.26%	11.62%	18.72%
Financials	4.59%	2.12%	1.40%
Healthcare	0.94%	6.27%	1.37%
Industrials	4.14%	1.40%	10.87%
Information Technology	12.86%	-2.84%	12.51%
Materials	3.71%	3.71%	11.45%
Telecommunications	-5.60%	7.06%	17.86%
Utilities	-5.91%	6.79%	16.13%

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Rotation away from traditionally defensive groups explained the significant variation in returns across economic sectors in Q3. The return difference between the best (Technology) and worst sector (Utilities) was over 18 percent. In a striking contrast to prior quarters, economically sensitive sectors provided new leadership with Technology, Financials, and Industrials the strongest performers, delivering gains of 12.86 percent, 4.59 percent and 4.14 percent, respectively.

Outlook. The market has shown remarkable resiliency, rebounding from double-digit losses, rallying an impressive 18 percent from the February 11th low. At the same time, we've seen three consecutive quarters of negative earnings growth and U.S. GDP growth has remained below 1.5 percent, leaving many investors skeptical of the durability of this bull market.

So, if the market is so hated, why does it keep going up? The simple explanation is low interest rates and a lack of better options. Investors are being forced to take on more risk to meet their targeted rates of return, thus allocating capital to equities and other high-risk asset classes like High Yield and REITs, ignoring the fact that these asset classes come with severe volatility. In a low-rate low-return world, it is capital flows that seem to be driving performance.

As such, equity valuations have risen to their highest absolute levels since the financial crisis. Low interest rates have boosted stock prices, especially high dividend-paying stocks. These "bond proxy" stocks, like Utilities, Telecom, and REITs, are now trading at extreme valuations. Even a modest rise in growth/inflation could weaken the returns in these sectors. This would normally be worrisome, but in a low-rate low-return world, it doesn't seem to matter. For equities in general, investors are still compensated for taking on equity risk when compared to the expected return on other asset classes. It is just at expected-return levels that are less than normal, and with leadership coming from different sub-groups.

The market already seems to be pricing in a Clinton victory. Political gridlock (Clinton/Republican Congress) is what the market expects. The reaction to anything other than that could be dramatic. The election clearly will be in the forefront in the coming weeks. However, monetary policy, global growth expectations, and Q3 earnings results will also play a major role in determining the market's direction.

The Russell 2000 Index measures the 2000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell Midcap Index measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks of the Russell Midcap Index are also members of the Russell 1000 Growth Index. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The MSCI EAFE index is an unmanaged aggregate of 21 developed country indices that collectively represent many of the major markets of the world. MSCI Emerg Mkts is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The Barclays US Aggregate Index covers the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS, and CMBS. It is not possible to invest directly in an index. The statements and opinions expressed in this article are those of the author as of the date of the article. These views should not be construed as investment advice. Content and/or statistical data may be obtained from public sources and/or third party arrangements and is believed to be reliable; however we make no representation as to its completeness or accuracy. The underlying assumptions and the views are subject to change. All economic and performance data is historical and not indicative of future results. Investors have the opportunity for losses as well as profits. The market indices discussed are unmanaged and can't be invested into directly. Investors should consult their financial advisor for guidance concerning their particular situation.