Quarterly Market Commentary & Outlook

3Q 2016: Oct. 4, 2016

Investors in the third-quarter of 2016 had little to complain about in terms of performance. Global equities provided positive returns along with most credit segments of the fixed-income markets. The quarter got off to a choppy start following the June 23 Brexit vote, but then recovered with domestic equities reaching new highs and enjoying remarkable tranquility by mid-summer. Uncertainty over central bank decisions in Europe and Japan caused some jitters in early September, but investors mostly shrugged those off by the end of the month.

Among domestic equities, the S&P 500 provided a 3Q total return of 3.8% with a notable shift in leadership toward growth-oriented stocks and away from higher dividend-producing sectors. The technology sector won hands down, appreciating 10.2%, while utilities, which had been on a tear earlier in the year, slid about 6.6%. The utility sector's year-to-date gain remains enviable at 13.2%, topped only by the energy sector's advance of 17.1%. The worst-performing sectors year-to-date are financials and healthcare, both essentially flat, while the overall S&P 500 is up 7.8% on a total-return basis.

A risk-on preference during the quarter also prevailed outside of the U.S., with developed international equities up 6.4% and emerging markets (EM) equities up 9.0%, both expressed in U.S. dollars. While concerns about a hard-landing in China contributed to turmoil earlier in the year among many EM trading partners, recent Chinese economic data and a rebound in certain commodities provided some grounds for optimism.

A preference for risk also prevailed in fixed income for the quarter, with the U.S. high-yield sector returning 5.5%, lifting its year-to-date performance to a whopping 15.3%. Notably, bonds in the energy sector have gained as rising crude prices have lessened the vulnerabilities. Overseas, EM debt continued its climb during the quarter, with an impressive year-to-date return of 14.8%.

INDEX PERFORMANCE DATA

	3Q 2016	YTD 2016	5-Year Annualized
EQUITY RETURNS			
Dow Jones	2.11%	5.07%	10.86%
S&P 500	3.85%	7.84%	16.31%
Russell 2000	9.05%	11.46%	15.76%
MSCI ACWI	5.30%	6.60%	10.59%
MSCI EAFE	6.43%	1.73%	7.36%
MSCI Emerging Markets	9.03%	16.02%	3.02%
OTHER			
MSCI US REIT	-2.50%	8.60%	11.30%
Bloomberg Commodity Index	-3.86%	8.87%	-9.33%
HFRI FoF Index	2.04%	-0.59%	2.51%

	3Q 2016	YTD 2016	5-Year Annualized
FIXED INCOME RETURNS			
Barclays Aggregate Bond	0.46%	5.80%	3.07%
Barclays 1-10 Year Municipal Bond	-0.11%	2.58%	2.93%
Merrill Lynch High Yield Master II	5.49%	15.32%	8.21%
Citi World Government Bond	0.12%	6.84%	4.32%
JPMorgan GBI EMBI+	4.04%	14.77%	7.72%
Barclays TIPS	0.96%	7.27%	1.92%

Source: FactSet

Note: HFRI FoF Index data as of 8/31/16

While investors clearly demonstrated confidence during the quarter, the reasons are less clear. The fact remains that a number of secular trends remain firmly entrenched, indicating a future of slower global growth compared to recent decades. Among these trends are aging populations and slower productivity growth. The severity of the 2008 global recession continues to limit consumers' willingness to spend and corporations' desire to expand capital investments. Borrowers and lenders alike remain relatively cautious, and global trade has declined notably in conjunction with growing protectionist views.

Central bankers, meanwhile, appear to be growing weary of their role as the sole bastion of stimulus. In September, both the European Central Bank (ECB) and the Bank of Japan (BOJ) announced policy changes that would focus less on specific amounts of asset purchases and more on targeted outcomes: higher inflation on the part of the ECB and higher bond yields on the part of the BOJ. Many economists and market strategists are questioning whether the post-recession medicine of near-zero interest rates and explosion of central-bank balance sheets has run its course with few, if any, remaining benefits to be had. Increasingly, central bankers are suggesting that fiscal spending should carry the baton for economic stimulus.

Perhaps the markets have remained positive because certain other worries have subsided to some degree. As examples, the negative effects of the Brexit vote have been tame so far, China's economy shows signs of stabilizing, oil prices have recovered from their lows, and interest rates are likely to remain subdued for multiple years. Additionally, U.S. corporate earnings are expected to improve through year-end, and even the labor participation rate has picked up slightly. Fed Chair Janet Yellen stated recently that the U.S. economy continues to strengthen and implied that it could justify a rate hike in December. While the outcome of the U.S. Presidential race remains uncertain, markets may be somewhat relieved by the improbability of either party achieving a filibuster-proof super majority. Markets appear to be acting as though an extension of a Democratic-led executive branch and a Republican-led Congress would be the preferred outcome.

Some of our near-term concerns include the possibility that ramifications from Brexit may be harsher than currently anticipated, that developed countries' economies will remain sub-par, and that financial-sector problems, such as Deutsche Bank's tenuous capital structure and Wells Fargo's improper business practices (in establishing unauthorized customer accounts) may erode confidence in the overall financial system.

Since developing our tactical allocations for 2016, we have maintained our overall exposure to equities while increasing our tilt toward domestic equities and reducing our international equity exposure. We have lowered our allocation to fixed-income and permitted cash to rise somewhat over the course of the year. Although our expectations for traditional asset class returns are somewhat subdued over the short-term, we continue to believe in the value of staying invested over the long term and of diversification to augment risk-adjusted returns.

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