2016 Third Quarter Review of the Markets

Index	3rd Qtr Return	YTD Return
S&P 500	3.85%	7.84%
MSCI ACWI Ex USA	6.91%	5.82%
Barclay’s Bond Index	0.46%	5.80%
Consumer Price Index	0.46%	1.24%

INVESTMENT COMMENTARY

Despite ending the second quarter with a “yes” vote on the referendum for Great Britain to exit the European Union (“Brexit”), both U.S. and non-U.S. equities rallied sharply during the first month of the third quarter with the stocks of smaller companies significantly outperforming larger companies. The S&P 500 ended the quarter up 3.9% while small cap stocks, as measured by the Russell 2000, returned 9%.

International stocks returned 6.9% for the quarter. While European equities did regain most of the footing they lost from the Brexit vote, Japanese shares led performance in the developed markets. Emerging markets had robust performance similar to the Japanese stock market.

While bonds had a very strong first half of the year, the Barclays Aggregate index posted a return of 0.5% for the third quarter. As stocks increased early in the quarter and the yield on the 10 year U.S. Treasury note lifted off of its all-time closing low of 1.37%, yields settled into a range between 1.5% and 1.6% until the Federal Reserve’s statement at the end of the quarter. Stable yields led to the lower returns for the quarter.

ECONOMIC OUTLOOK

During the Fed’s September statement, Chair Yellen informed markets that the Fed maintained its target rate for the federal funds rate. According to the statement, the case for an increase in the target rate has strengthened, but the committee is waiting for further evidence of continued progress toward its objectives. It is worth noting that three Federal Open Market Committee (FOMC) members dissented from the majority vote which suggests there may be division within the Fed in terms of the path forward. Much like the global investment community, it seems that the Fed is struggling to cope with the implications of a world in which nominal growth is low, interest rates are low to negative, debt levels are relatively high, and inflation continues to be subdued. It is possible that the Fed’s decision is aimed at avoiding creating friction in what seems to be a fragile and interconnected global economy.

Many believe that the FOMC inaction was due to the upcoming presidential election as the Fed’s desire to remain apolitical keeps them from changing policy so close to Election Day. If the Fed had sufficient data to warrant a rate hike in September, however, the inaction itself is of course a political move. Chair Yellen indicated that the November FOMC meeting is a “live” meeting (i.e., one at which the committee may decide to increase rates); however, if September’s rate hike was forgone due to potential political implications, it is safe to say the Fed is unlikely to act six days before

Election Day. This pushes the next potential for Fed action to their December meeting which means the federal funds rate will surely close out its 9th consecutive year at extraordinarily accommodative levels (well below 1%).

Recent news regarding woes at Deutsche Bank has raised questions about the bank, European financials, and the Eurozone equity markets broadly. These questions are valid as financials represent a larger part of European stock markets than U.S. markets. However, Deutsche Bank's market value has been in decline since 2009. While true that the bank has multiple unresolved regulatory issues, we do not think that the mantra "As goes Deutsche Bank, so go European equities" will start to prove out, at least over any meaningful time period.

INVESTMENT STRATEGY

We are often asked how the U.S. presidential election impacts our asset allocation. Unless and until a) we know who will win the election and b) the president-elect gives us a reasonably clear idea of their policies, the election does not materially impact how we invest client assets. Assuming for a moment that we knew exactly which strategies would perform best after a victory for each candidate (we don't), the investment world was reminded just a few months ago by the Brexit vote that making investment decisions based on political polls is a fool's errand.

Without a guide from politics, we are left making decisions based on something that has shown to be at least a little helpful over time: fundamentals. At this point, valuations on developed market equities are near long term averages and, when interest rates are taken into account, are reasonable. Intermediate term interest rates have moved between reasonable (albeit low by absolute standards) to all-time lows and back up again. We continue to buy insurance on equity positions (i.e., intermediate term U.S. Treasuries) where appropriate when rates are higher and sell that insurance when rates move lower. Corporate bonds in both the investment grade and high yield markets are earning a spread consistent with their long term averages.

In times of uncertainty, investors often tend to gravitate to safer investments (i.e., U.S. Treasury Bonds & "low volatility" defensive stocks). While these areas may seem to be attractive given the current environment, these presumed "safer" areas are currently towards the high end of their historical valuation ranges and are in many cases relatively expensive. Additionally, we continue to remain underweight in the higher risk/reward U.S. small cap stocks which, after a strong quarter, have seen their already lofty valuations skew even higher. Finally, we continue to largely avoid the potential minefield that is investing within emerging markets for all but our most aggressive investors.

As always, we continue to challenge our investment thesis in areas in which we are allocated and, perhaps more importantly, areas in which we have chosen to avoid. From our perspective, the opportunities to pick off low-hanging fruit, such as the opportunity we identified in high-yield ("junk") bonds earlier this year, seem to have largely dissipated. We continue to remind clients that we have reduced the level of risk across portfolios over the last 18 months and we are well positioned for a variety of possible outcomes. Furthermore, we also believe it is our responsibility to remind clients that, in the absence of major changes to the economy or to valuations, our expectations for returns across most asset classes are significantly lower than the returns experienced over the last several decades. We believe we are now very much in an environment in which we will have to grind out returns for our clients, fighting for every basis point as we strive to provide our clients with a diversified portfolio built to accomplish their long term financial goals.