October 2016

Quarterly Commentary

Positive momentum continued for US equities through Q3 with the S&P 500 index up 3.8% for the quarter and now 7.8% for 2016. These favorable returns were supported by modest underlying earnings growth along with an expansion of the P/E multiple investors have been willing to pay. We have positioned our clients' portfolios defensively heading into Q4 as we expect repercussions (volatility) from the election as well as potential adjustments to imbalances we see in the markets.

Neither candidate in the presidential election is particularly attractive for equities; however, both candidates have proposed some fiscal stimulus in the form of infrastructure spending. In the likely event that Congress and the Presidency remains split, we still see the opportunity for this investment to promote additional growth in the economy.

The Federal Reserve keeps talking about raising interest rates; however, their QE program continues to hold down long-term interest rates. The real 10-year Treasury bond interest rate (subtracting out inflation) is negative. This is not healthy for the financial sector in the same way it is not healthy for a saver – why lend money if you're paid back with cash that has less purchasing power?

In Japan and Europe, the central banks have realized their unprecedented negative-interest-rate policies have led to unintended outcomes. European and Japanese stocks (especially bank stocks) are down this year by 6% and 12%, respectively. Japan has reversed some policies but Europe remains frozen, as one of their largest banks, Deutsche Bank, is now worth about 1/10th of Bank of America.

We also have concerns that the extraordinary central bank asset purchases (quantitative easing) implemented globally to promote growth since the financial crisis, have also served to create significant imbalances in the financial markets – i.e. bonds are far too expensive relative to equities because central banks have been buying bonds without regard for price. The US Treasury Bond yield curve is much flatter today than three years ago because the long end has fallen, even though inflation has remained at about the same level.

As monetary policy necessarily shifts around the world, the impact will affect interest rates, liquidity, currencies and market valuation dynamics. The absolute changes may not amount to much very quickly but the inflection to a slightly more restrictive monetary policy framework will likely increase market volatility. Unless growth picks up, we're doubtful that earnings multiples can continue to rise leaving future equity appreciation entirely dependent on underlying earnings growth.

Despite our concerns, we remain confident in the continued modest growth of the economy and in the underlying businesses of the companies we own in our client portfolios. Looking forward to 2017, earnings growth overall may accelerate as the energy sector returns to being a positive earnings-growth contributor. We like cash-rich, dividend-growth franchises with long-term perspectives and see these classes of equities as the least risky investment alternatives in today's market. If valuations decline from today's slightly expensive levels, we would be inclined to add to our equity allocations.

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