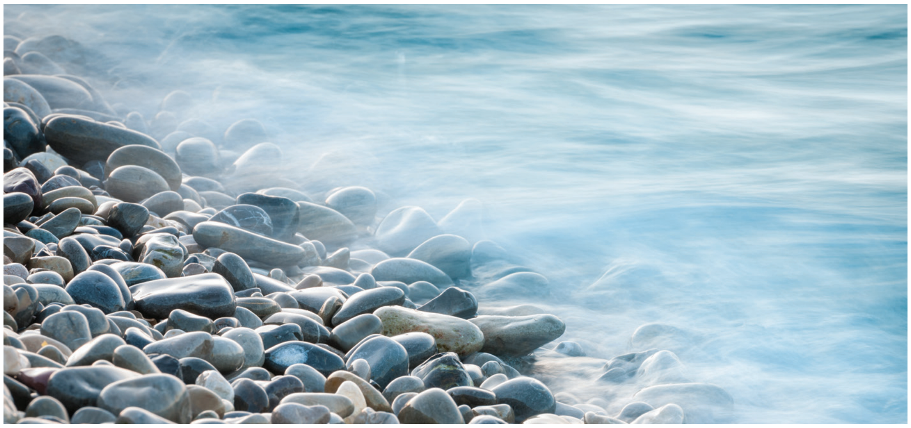
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



A Fine Line

"The only function of economic forecasting is to make astrology look respectable."

—John Kenneth Galbraith, economist

ANOTHER QUARTER HAS PASSED, and with it we have posted another solid round of returns. And yet investors are uneasy about the future trajectory of markets and the economy, looking for signs and symptoms that it could all be about to crash down. The apprehension is understandable, and maybe prescient. Since the Great Recession, the global economy has been in a state of flux with growth forecasts tending to be cut rather than raised. Central banks are experimenting with new policy tools however the majority of governments are holding back on fiscal stimulus. On net, these efforts have failed to revive the pace of world growth with the average increase in output between 2012 and 2017 falling short of gains in the pre-recession period. Factors that are beyond the control of today's policymakers have played a role in the slowdown in economic activity with the aging population changing the composition and growth of the labor force. Additionally, global economies and financial markets are much more closely integrated raising the risk that policy missteps in one country will have adverse effects on others.

As the saying goes, there is a fine line between love and hate, and likewise between expansions and contractions. It is a struggle to invest with conviction against this backdrop, and with the Great Recession now seven years behind us, the risks of a turn in the economic cycle, albeit as sub-par as this one has been, are rising. Making the investment terrain especially treacherous is the reality that valuations no longer provide a clear-cut and compelling reason to commit one's capital.

Both bulls and bears are frustrated as each struggles to paint an unblemished picture of the path ahead. The results of their battle can be witnessed in the sharp bursts of episodic volatility that have then been quickly reversed over the last year. For example, it was the worst start to a year ever for the bellwether S&P 500, which lost 10.5% in its first 28 trading days, only

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Markets once again proved their resilience in Q3 as Brexit concerns quickly faded and the Fed postponed the threat of interest rate hikes. With interest rates at generational lows, investment is being diverted into riskier assets to achieve a reasonable return.

2

The U.S. consumer is leading growth thanks to improvements in jobs, income, and wealth over the past year. The Fed remains in the wings, with rate increases not expected until December. P/E/ ratios may remain stable at current premium levels.

3

Central bank activity will continue to dominate the attention of investors in international markets, as Japanese stimulus reaches epic heights and Brexit unfolds in a fragile economic environment. It may not be enough to outweigh concerns over the growth outlook.

4

Emerging markets have once again found acceptance thanks to stabilized growth and commodities prices having found a floor. Reform agendas have inspired optimism over the future. Valuations are still inexpensive, and profitability has proved to be resilient.

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to bounce back and actually finish positive by the end of the first quarter. During the second quarter, the bounce in equities continued such that the S&P 500 made its first new all-time high in 14 months. The "Brexit" vote—the UK's decision via referendum to exit the European Union—caused a dramatic and steep sell-off in June, but one that was quickly reversed in July. In August the S&P 500 traded in its tightest monthly range in more than 20 years. But volatility has started to come back, as the S&P 500 closed at least half a percent higher or lower for eight straight days for the first time in eight months, wrapping up the third quarter of 2016.

What does the fourth quarter have in store? With a highly contested election coming (among other big events), it is likely to be anything but boring. For sure, there is momentum in this market, as the S&P 500 is up four straight quarters and 13 of the past 15, a pattern which has not occurred since the mid-1990s. And the good news is that historically the best quarter of the year is upon us. Going back to 1950, the final three months of the year are up 4.1% on average and higher nearly 79% of the time—making the fourth quarter the typically best time for equity market returns.

As for the fundamentals, the U.S. economy has now grown for 87 straight months, making this the sixth-longest period of economic expansion since the 1850s. And momentum seems to be gaining, not ebbing, as important metrics like employment, housing, and consumer spending have turned higher. The global economy is more uneven, but has key bright spots in areas like emerging markets where data has stabilized and seems to be staging a turnaround.

And yet the law of gravity has not been repealed. Economic growth and contraction have always alternated, and at some point we WILL experience a recession. That, of course, will impact stocks. Typically, equity indexes will fall in advance of and during a recession. Often a bear market, a period when stock prices drop by at least 20%, and a recession, will overlap one another.

Since 1926, stocks have fallen an average of 26.5% from the top to the bottom of the market around recessionary periods. For example, during the latest recession, from April 2008 to June 2009, stocks plunged more than 46% from peak to trough. But importantly, stocks do recover: Since 1980, U.S. stocks have returned an average of 93.1% in the five years after a recession while bonds have averaged returns of 46.6%.

The fact is that it is difficult, even for those who have devoted their lives to the study of economics, to accurately forecast recessions. Case and point: in April 2008, the consensus among economists was that none of 77 major economies would fall into recession in 2009. In reality, 49 of them did just that. Likewise, it is also extremely difficult to predict the market declines that typically accompany, and often precede, recessions. Because the ability to anticipate a recession and "time the market" is so difficult, the best strategy is one that focuses on long-term investment goals and diversification, with an emphasis on quality and price.

During the late stages of any economic expansion, temptation rears its head in the form of high recent stock returns. It is important to remember that stock returns, along with high valuations, often look strongest just before a recession—and that recessions generally spell the end of bull markets.

This is when many investors, chasing returns, make the classic mistake of buying stocks near their highest price. Too often, those same investors end up selling stocks near their lows.

The prudent approach for balancing risk and reward through changing economic and market environments is to develop, and stick with, a well-diversified portfolio. Impulsively increasing your stock allocation and assuming greater equity risk is likely ill-timed, as much of the gains may have been already realized.

To illustrate, consider a portfolio with a 75% allocation to the S&P 500 index and a 25% allocation to the Barclay's Aggregate Bond index.

Diversification delivers over a full market cycle

	Before Market Peak	After Market Peak		
	Five years prior	One year	Three years	Five years
Stocks	126.8%	-14.1%	5.6%	90.4%
Bonds	38.2%	8.4%	30.9%	88.6%
75% Stocks / 25% Bonds	101.4%	-8.8%	11.6%	91.1%

Stocks are represented by the S&P 500 Index and Bonds by the Barclays Aggregate Bond Index. Recessions since 1976 are used to calculate the average returns.

SOURCE: Bloomberg.

This chart shows historical performance of a diversified portfolio for five years just before the top of the stock market during a U.S. recession and just after the top of the stock market for recessions dating back to 1976. As you can see, an all-stock portfolio appears to be preferable right before a recession, based on trailing five-year returns.

But stocks underperform significantly during a recession. In the five years following a recession, a portfolio of 75% stocks and 25% bonds outperforms a 100% U.S. stock portfolio. Although a more aggressive, U.S. equity only portfolio may outperform a diversified portfolio prior to recessions, the diversified portfolio has a steadier overall performance through market cycles typically.

The takeaway is clear: rather than chasing returns and increasing allocations to stocks at the top of the market, set a diversified strategy for the long term, and stick to it. And the same holds trust in reverse: rather than fearing market downturns and decreasing allocations, stay invested. This is especially true when you have equity market investments that have return patterns designed to provide relative protection in down markets.

GLOBAL ECONOMIC OVERVIEW: Picking up Steam

THE DOMESTIC ECONOMIC ENVIRONMENT, although still below optimal levels, is beginning to show signs of acceleration. In the U.S. so far, Brexit has had little economic effect. Economic conditions are currently favorable, with, among other things, continued low interest rates; an improving employment situation; strong vehicle sales; and a steadily recovering housing market. The upcoming U.S. presidential election could potentially create unforeseen disturbances to the growth outlook, but so far none are apparent. The Bureau of Economic Analysis reported its third estimate of second quarter 2016 gross domestic product (GDP) of 1.4%, higher than both the prior estimate of 1.1% and the 0.8% reading of the first quarter. The employment situation showed marked improvement, with an average of about 232,000 jobs added each month. The unemployment rate was moderately higher at 5.0%.

Globally, the situation is a bit less rosy. The Brexit result has created a significant amount of uncertainty over what the ultimate impact will be from an economic standpoint. In addition, political effects stemming from Brexit in other European Union countries, such as Germany and Spain, are beginning to percolate. GDP growth in the Eurozone shrank to 0.3% in the second quarter from 0.5% in the first quarter. In China, the economy is slowing due to structural adjustments that will take time to play out. Asian economies generally have slowed as global demand for the region's exports has waned. Other emerging economies, including those in Latin America, are beginning to stabilize, but may remain under some pressure as a result of slackening demand for commodities. Although recent trends have not been favorable, it is expected that global economies will begin to pick up steam later this year and into 2017, partly on the tailwind of acceleration in the U.S. economy.

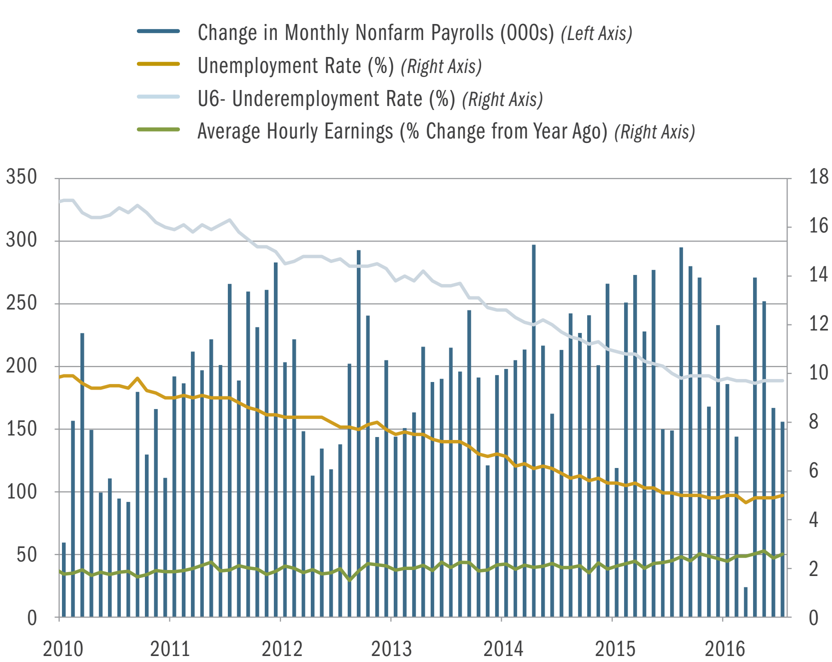
U.S. ECONOMY: Consumer Catalyst

WHILE SECOND QUARTER REAL GDP grew at just a 1.4% annual rate, marking a third consecutive tepid quarter, there was cause for optimism in the details. Consumption, which comprises a little over two-thirds of GDP, grew 4.3% in real terms, its second-strongest quarter since the crisis, while changes in inventories subtracted -1.2% from headline growth. Business investment rebounded but was still soft, a cause for concern if it fails to strengthen as headwinds from low energy prices and a stronger U.S. dollar fade. Residential investment declined in the quarter, but the housing market remains overall very strong with new home sales up 20% over the last year and national home prices higher by 5%. Looking ahead, a solid labor market, rising real wages, and buoyant consumer confidence show consumer fundamentals remain rock solid which is critical for future GDP growth.

Defying expectations of a slowdown, the U.S. economy created 156,000 new jobs in September, driven by gains in service payrolls. The three-month average increase in payrolls stands at a very healthy 192,000 and the six-month average at 169,000. Jobless claims extended the trend of below 300,000, a streak not seen since 1973. While the unemployment rate ticked up to 5%, it was for the good reason that the labor force participation rate rose in the month. Even better, there are 5.9 million open jobs and the job openings rate is at a 15-year high, showing signs of slack remain on the supply side.

As strong as the employment data has been, wage growth, or lack thereof, has confounded a translation into strong, consistent consumer spending, until now. Indeed, annual data released by the U.S. Census Bureau in September showed that real median household income increased by 5.2% in 2015, the largest one-year

U.S. labor market rock solid



SOURCE: Bloomberg.

increase in the 48-year history of the data series. This increase returned the median, which had its pre-crisis peak in 2007 and overall peak in 1999, to its 2006 and 1998 levels. It was particularly encouraging that income gains were broad-based—across all income levels and all headline demographic groups, and were especially strong for lower income groups, which experienced the biggest percentage declines in household income from peak levels of the late 1990s.

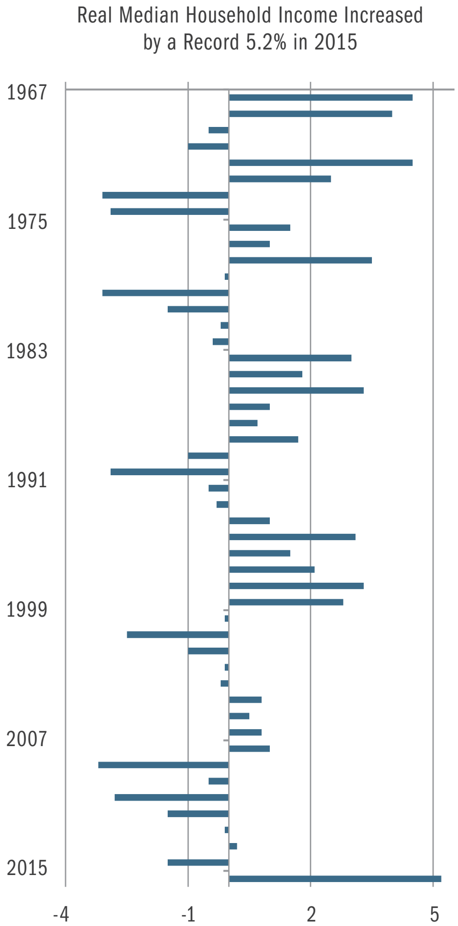
And while confidence does not necessarily have a 1:1 correlation with spending, the U.S. economy is making robust gains in consumer sentiment. Following an increase in August, when the Conference Board's consumer confidence index jumped to 101.8 points, consumer sentiment among U.S. households rose further in September. The indicator climbed to 104.1 points, the highest reading since August 2007. Strong consumer sentiment suggests consumer spending will continue to support economic growth.

In terms of the business sector, the Institute for Supply Management (ISM)'s manufacturing index increased more than expected in September and returned to expansionary territory, after a temporary setback in August. The indicator jumped from 49.4 in August to 51.5 in September and also beat market expectations of 50.5. This brought the ISM index just above the 50-threshold that indicates an expansion. The ISM service sector reading likewise recovered from an August dip, climbing from 51.4 to 57.1 in September. However, both CEO and small business owner optimism is notably down, thanks to worries over Brexit and China in the first case, and the implications of policy change stemming from the U.S. presidential election in the second.

For these reasons and more, the Federal Reserve again elected to pass on an interest rate hike in September, indicating they are "waiting for further evidence of continued progress". With the presidential elections in November, most market participants believe the Fed will wait until December to make a decision to raise interest rates. However, it is worth noting that core inflation rose in August at the fastest pace seen in six months, up by 2.3% year-over-year through August.

On balance, there are many reasons to be optimistic about the domestic economy, including improving job growth, a sustained recovery in housing, finally rising consumer incomes, and high levels of consumer confidence. In addition, households have taken advantage of years of low interest rates to lock in low mortgage payments and still maintain an adequate level of savings. Many economists believe that employers will continue to add about 180,000-200,000 jobs per month into 2017, and that the unemployment rate will trend back down to 4.7%. And while the FOMC is likely to resume raising interest rates again by the end of the year, the prospect of the hike has been clearly signaled, and seems to have been digested by the markets. The impact of the U.S. presidential election on the markets is a wild card, but markets are an excellent discounting mechanism, meaning any dislocation occurring as a result of the outcome may be short-lived, much like Brexit's impact. There are certainly other ongoing risks, such as the threat of terrorist activity and unforeseen setbacks in either the domestic or global recoveries, but for now it would seem an end to the economic recovery is not yet on the horizon.

Growth in household income finally finds traction



SOURCE: Bloomberg.

DEVELOPED INTERNATIONAL ECONOMIES: Uncertainty Reigns

THE PROGRESS OF BREXIT discussions and central bank activity will continue to dominate the attention of investors in the final quarter of 2016 and into 2017. Recently, British Prime Minister Theresa May announced that the UK would trigger Article 50 of the Lisbon Treaty by the end of March 2017, marking the official start to the negotiation process to leave the EU. Prime Minister May reiterated her determination to prioritize immigration control, which will likely inhibit full access to the European single market. In response, the British pound fell over 2% to its lowest level against the U.S. dollar since 1985. While the recent announcement provides clarity around when negotiations will begin, the hard stance creates profound uncertainty around how businesses will operate within the UK in the future.

Compounding Brexit concerns will be

the risk that nationalist parties could do well in a number of key upcoming elections. Shadowed by the populist and anti-establishment Five Star Movement, which seeks a referendum on the use of the euro, the Italian government is the first in line, with a vote on constitutional reform due in early December. By threatening to resign if the reforms are rejected, Prime Minister Matteo Renzi is taking a gamble. Italy's economy is fragile and the banking sector remains vulnerable to any further uncertainty and a lack of clarity on funding.

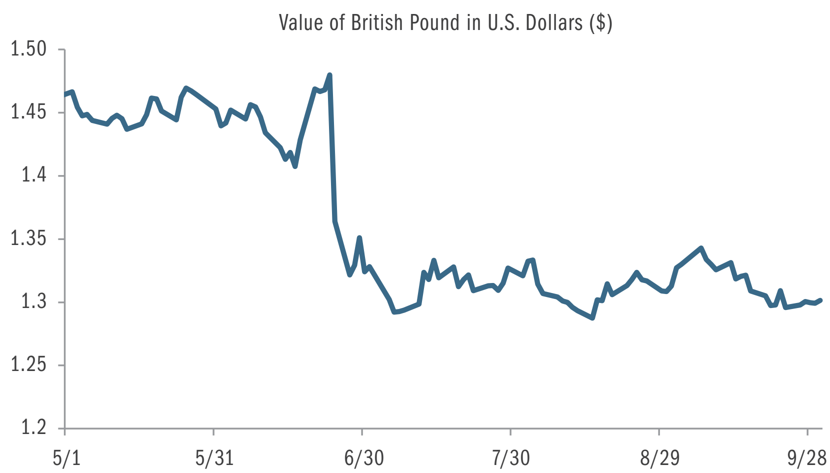
In 2017, France, the Netherlands, and Germany will also hold elections. All represent possible outcomes that could impact the future stability of the European Union. The poor showing of German Chancellor Angela Merkel's Christian Democratic Union party in recent state elections has shown the limits of the electorate's patience. Her immigration policy was the catalyst for the defeats and has added to the euro-scepticism that has been nurtured by austerity and recession. At 30%, German voter satisfaction with the ECB is below the 35% European average and domestic political pressure for change continues to build.

Meanwhile, further east, the EU's fractures are intensifying with member states Hungary and Poland. With unanimity among the twenty-seven members needed to make changes to the EU structure, it is unlikely that a number of the adjustments demanded, including stripping the European Commission of some of its powers, will occur. An intransigent EU leadership pitted against more skeptical national governments may result in a degree of governmental paralysis and put further integration on hold.

Against this backdrop, the European Central Bank (ECB) is playing a critical role in stabilizing the bond market and keeping corporations and investors engaged. As such, markets are of the belief that it will be critical for the ECB to extend its quantitative easing program beyond March 2017, originally indicated as the end date for ECB action. They certainly have justification for doing so, with inflation reported in August at only 0.2%, far below the ECB's 2.0% target. Economic growth in the Eurozone remained subdued on a year-over-year basis in Q2, expanding 1.6%, the same rate as Q1. Construction remained weak and retail sales growth decelerated year over year from mid-2015. While the unemployment rate had been slowly edging downward, at 10.1%, the Eurozone has a long way to go to reach prerecession employment levels.

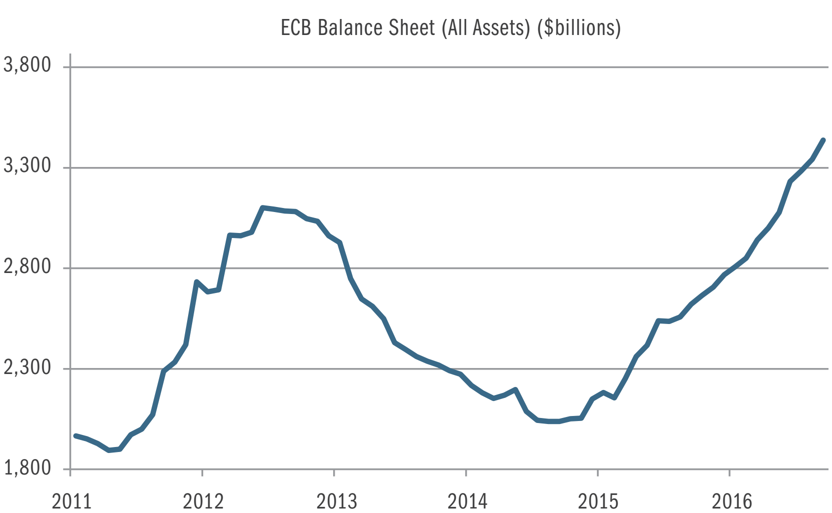
As for the UK, the economy appears to have emerged from Brexit without suffering an immediate detrimental economic setback. Real GDP grew 0.6% on a sequential basis in the second quarter. However, the economic outlook has deteriorated significantly since voters decided to leave the EU in the June 23rd referendum. Uncertainty surrounding the timing of the exit, as well as the future of their trade agree-

British pound sinks as Prime Minister May signals Article 50 to come in March



SOURCE: Bloomberg.

The pressure is on for the ECB to continue to expand its balance sheet



SOURCE: Bloomberg.

ments and immigration rules, will continue to discourage investment spending in the UK. As a result, most economists expect UK GDP could fall slightly more than 1% on a peak-to-trough basis over the next three quarters.

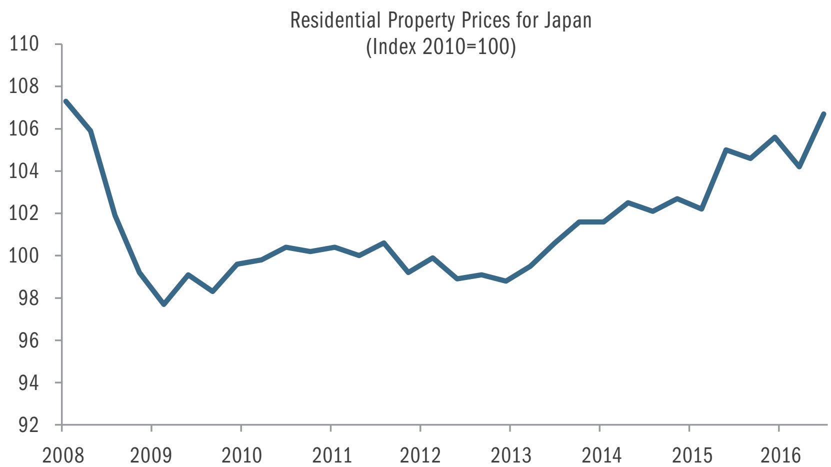
In response to this deteriorating outlook, the Bank of England (BoE) has cut its benchmark policy rate by 25 bps to 0.25% from 0.50%. The BoE also expanded the size of its government bond buying program, which now includes corporate bonds. Continued accommodative monetary policy should lift the overall CPI inflation rate, at least in the near term, due to higher prices of imported goods.

Moving over to Asia, afer a somewhat slow start to the year, Japan is poised to exceed growth expectations, thanks to an improving economic landscape, tight labor markets, rising real estate prices, and accommodative monetary and fiscal policy. Japan's Purchasing Managers Index (PMI) data has been positive, and wage growth continues to trend upward with both base wages (+2%) and bonuses (+1.5%) showing evidence of strength. As for employment, some economists are predicting that 2.5% unemployment rates in Japan are possible in the coming year. Service sector industries continue to boom: of particular note, highly successful efforts to deregulate and boost inbound tourism have prompted the government to further open the hotel industry and provide favorable visa status to a substantial portion of overseas workers seeking opportunities. It appears that Japan will achieve its lofty inbound tourism goals well ahead of the 2020 Olympics.

Thanks to the Bank of Japan's (BoJ) negative interest rate policy, the housing market has experienced a huge lift reflected in rising real estate prices. It is especially encouraging to see price increases also in the countryside, where a significant amount of the demand is from buyers looking to take advantage of inbound tourism growth.

The BoJ's policy support is at the heart of this turnaround, and their heroic efforts continue with new measures announced this quarter. The first, referred to as yield curve control, aims to target the interest rate on the longer end of the curve at zero with bond purchases. Secondly, the Bank pledged to let inflation overshoot the target—effectively committing to be slightly irresponsible. Finally, the BoJ tweaked its QE allocation, aiming to buy more short-term debt to help steepen the yield curve and reweighing ETF purchases towards the domestic oriented Topix index away from the export-heavy Nikkei. The BoJ did not lower interest rates, suggesting that such a move remained a "possible option for additional easing." Also on the horizon and raising the prospects for Japanese growth is President Abe's long-advertised massive fiscal stimulus program, said to include infrastructure spending projects like a magnetic-levitation train line connecting Tokyo and Osaka and earthquake-related reconstruction in the southern Japan, as well as cash handouts of ¥15,000 each to 22 million low-income people.

Policy accommodation boosts residential real estate in Japan



SOURCE: Bloomberg.

BoJ adds yield curve control to NIRP and QQE

SOURCE: Bloomberg.

CHINA & EMERGING ECONOMIES: Moving Forward

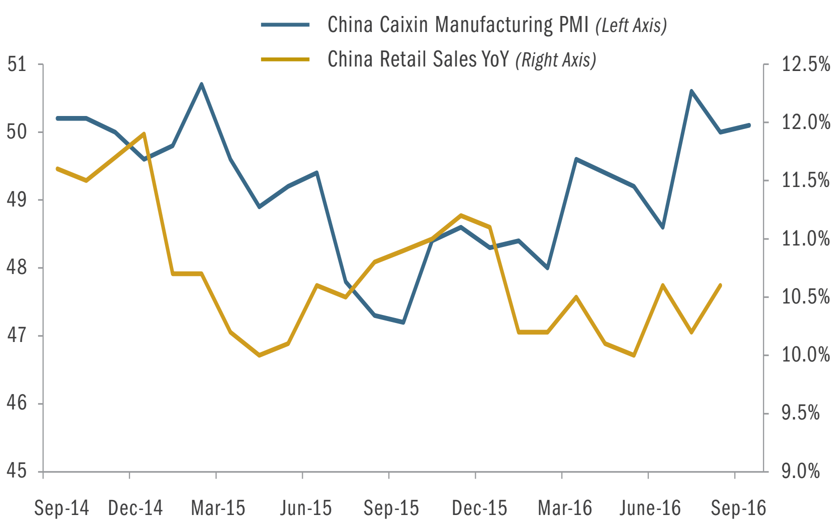
DESPITE THE EQUITY MARKET collapse last fall, the Chinese economy seems to have achieved a soft landing. Real GDP grew 6.7% in the second quarter on a year-over-year basis, unchanged from Q1. Growth in the "secondary" sector, which combines the industrial and construction sectors, strengthened to 6.1% from 5.8%. The recent stability in the industrial sector would appear to reflect renewed strength in Chinese exports. Moreover, consumer spending would seem to have remained resilient as growth in nominal retail spending stayed above 10% in the second quarter. Unfortunately, though, a dark spot for China's outlook has been the continued slowdown in investment spending.

Supercharged, double-digit economic growth rates are not likely in the foreseeable future due to this slowdown. If there is any bright spot, it is that relative stability in the exchange rate and in the level of foreign exchange reserves in recent months suggest that the surge of capital outflows that occurred last year have slowed.

Outside of China, emerging markets offered many headlines in the quarter that had little to do with economics. For example, we kicked off July with uncertainty after there was an attempted military coup in Turkey. Indeed, on July 15, a group of primarily low- to mid-level Turkish military officers attempted to overthrow President Recep Tayyip Erdogan and his Islamic-oriented Justice and Development Party (AKP). The coup failed, as support for the military intervention was so limited that even the major opposition parties were against it. However, Erdogan and his cabinet appear to be using the failed coup as justification for repressive measures against the Gulen movement, a moderate Islamic group led by Fethullah Gulen, a cleric who lives in exile in the U.S. Erdogan has clearly consolidated his power at the expense of governmental checks and balances. His popularity has increased since the failed coup and the risk of political instability has decreased as Erdogan has become more powerful. In the very short term, the government is not planning to push forward a new election or try to reform the constitution; however, the government may extend the State of Emergency, which is due to expire on October 25, which may be a moment of uncertainty in the month ahead.

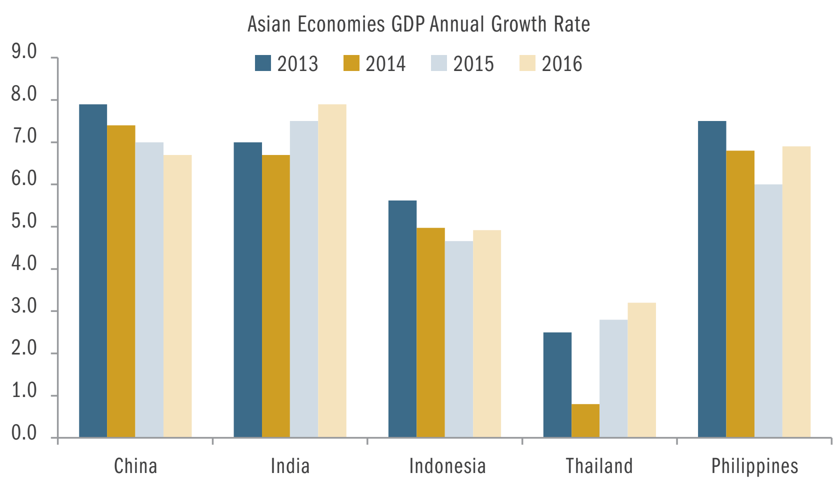
In contrast to these tumultuous events in Turkey, Brazil offered a welcome respite, pulling off a successful summer Olympics whose most visible incident of corruption came from the U.S. Olympic swim team. The Brazilian government officially impeached, and later formally removed, Dilma Rousseff from office. President Michel Temer, Rousseff's former vice president, is now at the helm, and has the formidable task of pushing through reforms on public spending to bring deficits under control.

Chinese economic growth evens out and edges higher



SOURCE: Bloomberg.

Asian growth outlook supports stabilization



SOURCE: Bloomberg.

In South Africa, the ANC party had its worst electoral outcome in August due to scandal and rising discontent over the economy. President Jacob Zuma has been accused of using taxpayer funds on his private home and for allowing insiders to benefit financially from government connections (Zuma has denied all charges). Worse, the ANC party appears to be divided, as Zuma openly battles with Finance Minister Pravin Gordhan, who is under police investigation.

In India, President Narendra Modi made progress in his efforts to improve the country's business environment. A recently approved and comprehensive single indirect Goods and Services Tax (GST) is expected to replace the complex, multi-layered taxation system that represents about fifteen types of taxes (central excise, custom and service tax, states' VAT, entertainment and luxury tax, and various surcharges). GST is a destination-based, consumption tax expected to be levied on the customer for goods and services at the final point of consumption rather than production. It should reduce the amount of bureaucratic red tape in the process, simplify the movement of goods between states, and may even boost manufacturing and exports. The government is aiming to implement the tax in April 2017, but it must still decide on the appropriate GST rate, and all twenty-nine states must pass their own GST laws. State autonomy is very important in India, and one of the points of contention for the GST has been that the tax revenue collected would go to the state where the product is consumed, not where it is produced. Many states fear losing control of this revenue and are pushing to be compensated for the lost tax revenue. India's central administration has agreed to reimburse all states for a period of five years and may impose a surcharge on interstate sales, with the proceeds going to exporting states. As with all of Modi's reform measures, this tax strives to facilitate a better allocation of capital, as well as the improving efficiency of domestic production and exports.

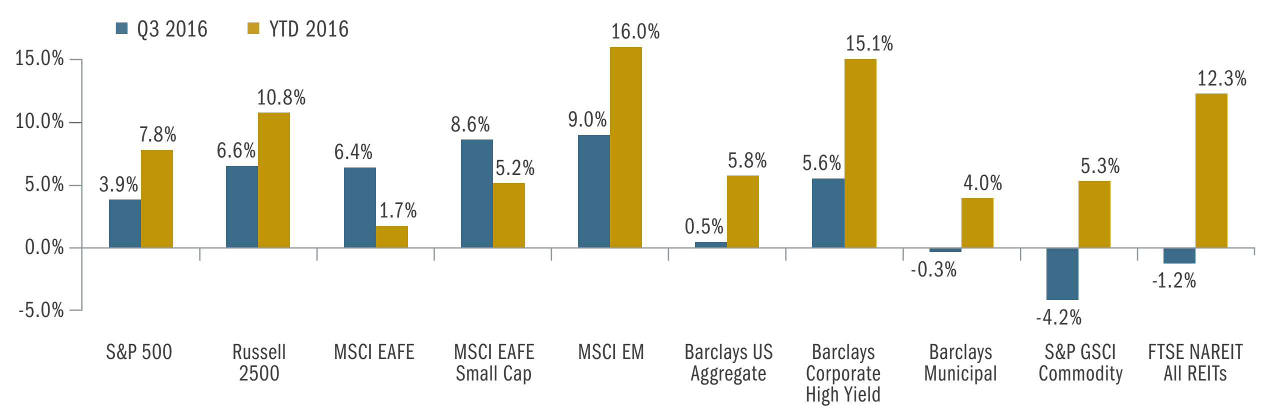
Finally, in the Philippines, President Rodrigo Duterte won a landslide victory in May 2016 on a platform of "inclusive growth" policies that encompassed higher infrastructure spending, job creation, and lower poverty. While the Philippines has one of the highest growth rates in Asia, it also has one of the highest poverty rates. It is also ranked 90th (out of 140 countries) in the world for infrastructure by the World Economic Forum. Duterte's administration is planning to widen its deficit target to fund infrastructure spending by addressing delays in its public-private partnership (PPP) program. It plans to target seventeen PPP projects worth 580 billion Philippine pesos for bidding before the end of 2017. With public infrastructure representing 26% of the proposed 2017 budget, Duterte is committed to raising infrastructure spending to 5.0% of GDP this year, up from just 2.2% in 2012. He aims to reach 7.0% by the end of his six-year term.

GLOBAL MARKET OUTLOOK: Something for Everyone

THE THIRD QUARTER had something for everyone. In July, the bulls gloated as the S&P 500 soared to multiple record highs after Brexit concerns quickly faded in the rear view mirror. In August, the markets displayed their typical summer doldrums with low volatility, sideways price action, and tight trading ranges. In September, the bears briefly poked their heads up to remind everyone prices can also go down when volatility comes out of hibernation. In the end, the markets once again proved they are resilient, and it was an especially profitable period for well-diversified multi-asset strategic investors in global equity markets.

The resiliency comes from favorable market fundamentals and accommodative central bank policies around the globe. The ECB maintained their benchmark rate at 0%, and have the markets whispering and

Markets maintain momentum in the third quarter

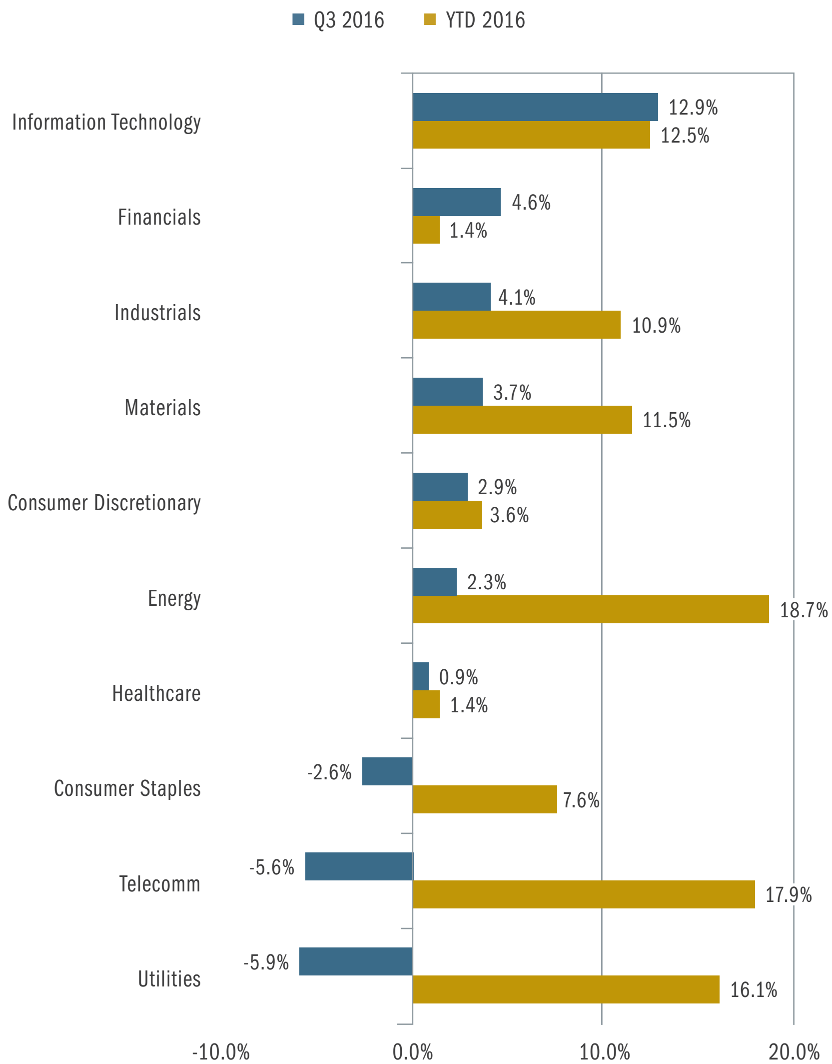


SOURCE: Bloomberg.

hoping for an expansion and extension of their current QE program. In Japan, negative interest rate policy (NIRP) and qualitative and quantitative easing (QQE) were joined by a new program of yield curve control. The BoE announced QE and that it would drop its benchmark interest rate to 0.25% from 0.50%, its lowest level ever; they also started a new funding program that offers lenders cheap four-year loans in order to lend to households and businesses. Finally, in the U.S., the third quarter passed where the threat of a 25 basis point rate hike remained just that—a threat. While the Fed claims to be non-political, they know an election is just around the corner and would prefer to remain neutral. We expect a 25 basis point hike in December after the dust settles.

With yields at such low levels, it was hard for fixed income to compete with equities, though the high yield segment did a truly admirable job and is a top performer this year. Alternative investment categories lost some steam in the third quarter, but have delivered strong performance statistics in 2016.

Bond proxies rolled over while information technology, financials, and industrials won the day



SOURCE: Bloomberg.

U.S. stocks continue their ascent; dividend stocks fall out of favor

U.S. EQUITY MARKETS quickly shrugged off the Brexit referendum that occurred late in the second quarter. After plunging several percentage points following the announcement that the U.K. would be exiting the European Union, stock prices reversed course at the beginning of July, resuming their previous uptrend and carrying the S&P 500 to a record high. Investors were also heartened by improving news on the employment front, which is believed to presage acceleration in a recovery. The S&P 500 Index finished the quarter with a gain of 3.9%.

More than in recent prior quarters, the sectors exhibited substantial dispersion in performance, making sector allocation and security selection extremely important. The performance disparity between the best- and worst-performing sectors during the quarter was more than 1600 basis points. Information technology, financials, and industrials were the strongest performers, delivering gains of 12.9%, 4.6% and 4.1%, respectively. The telecommunications services, utilities, and consumer staples sectors were the poorest relative performers, posting losses of -5.6%, -5.9% and -2.6%, respectively. These bond proxies reversed their marked outperformance during the first half, when the probability of another rise in interest rates this year had seemed remote.

Within the large cap segment, growth stocks significantly outperformed value stocks, not surprising given the sector rotation noted. Small cap stocks, as represented by the Russell 2000 Index, vastly outperformed large caps, ending with a total return of 9.1%. Small cap growth performed better than small cap value.

Looking ahead, the U.S. equity markets will have to contend with both the results of U.S. presidential election and a potential change in interest rate policy. Even with these headwinds, we believe U.S. stocks are attractive and expect P/E ratios will be stable at current premium levels given historically low interest rates projected to move only modestly higher.

Developed international equities rally in relief but the forecast is cloudy

INTERNATIONAL STOCKS delivered better performance than U.S. equities overall, led by a surge in Asian issues. Even though economic data in many regions remains listless, foreign central banks, including the European Central Bank, continue to implement aggressive monetary policies. At the same time, lawmakers around the world have been urged by the heads of the central banks to enact fiscal policy reforms to spur demand. Against this backdrop, international stock indices were almost uniformly higher. The MSCI EAFE Index of developed markets stocks advanced by +6.4%, while the MSCI EAFE Small Cap Index rose 8.6%.

Eurozone equities made gains in the third quarter, which was marked by significantly lower volatility than in prior months. Stocks were supported by a generally encouraging second quarter reporting season, as economically-sensitive sectors such as information technology, consumer discretionary, and materials advanced strongly. While financials were positive in the quarter, Deutsche Bank was under siege after U.S. authorities demanded $14 billion to settle the sale of mortgage-backed securities prior to the global financial crisis. Despite Deutsche's insistence that it would negotiate the fine lower and did not need a state bailout, concerns about bank capitalization for Deutsche and the entire European financial system remain.

After a convincing win for Prime Minister Abe in the Upper House elections, markets were buoyed by his promises of a significant fiscal spending package, and the BoJ's extraordinary monetary interventions. As in Europe, the more cyclical areas of the market moved to market leadership positions, while food and pharmaceutical stocks underperformed.

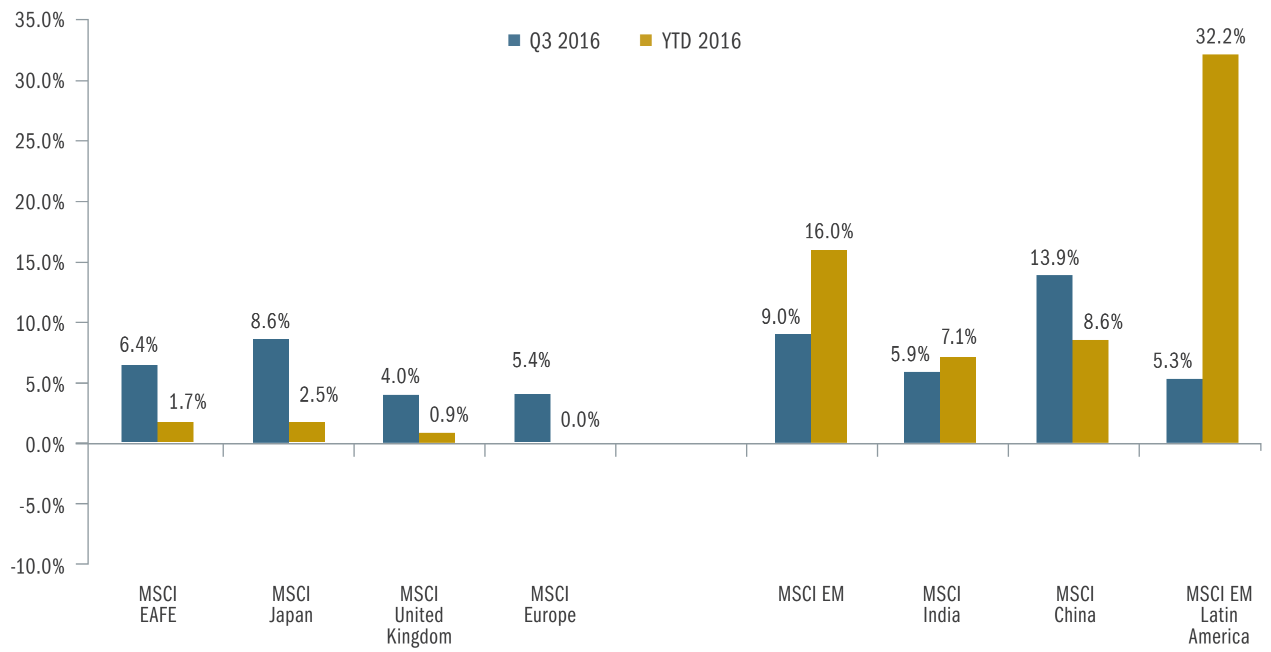
UK stocks performed well against a more stable domestic political backdrop following the confirmation of Theresa May as prime minister. The relief rally was broad-based, with UK financials a particular standout, as internationally-focused banks like HSBC announced plans to return excess capital to underline the recovery in its balance sheet. Investor sentiment was further lifted by the prospect of a potential renewal of merger & acquisition activity after semiconductor design specialist ARM Holdings was acquired by Japanese technology company SoftBank.

Looking ahead, it cannot be understated that Brexit looms as a notable disruptive economic factor for the Eurozone. It is potentially an existential threat to the ultimate hegemony of the European compact, the long-term viability of the euro, and London's status as a premiere global financial center. For sure, we welcome the short-term strength in UK and European equities, but believe the future outlook is cloudy. More than ever, it would seem there will be a benefit to the selectivity of active management to navigate what is likely to be treacherous terrain.

Emerging markets continue their comeback

EMERGING MARKETS have been a bright spot for investors in 2016, and the third quarter only continued that trend. The huge rally in Brazil's stock market and currency continued as the perceived resolution of the country's political crisis, with the

Post-Brexit, international and emerging market equities surge



SOURCE: Bloomberg.

embattled president being impeached and eventually replaced, seems to have calmed global investors to some degree. Rising commodity prices also helped. They also helped Russia and Canada, whose markets and currencies have rebounded this year as well.

However, Brazil and Russia were not the only emerging markets providing strong gains in 2016. Many Asian emerging stock markets and currencies have also posted strong returns for the year to date. Chinese equities saw some of Asia's largest gains in the quarter, thanks to stabilizing growth and rising expectations that more easing from the People's Bank of China (PBoC) will be forthcoming towards the end of the year. Hong Kong likewise rallied on these expectations. Other Asian markets like Korea, Taiwan, Thailand and Indonesia got a boost from the Fed's delay, while India was heartened by the passage of the much-awaited Goods & Sales Tax bill. Only the Philippines struggled due to unpredictable policy from new President Rodrigo Duterte and relatively expensive valuations.

Fixed income focuses on central banks

THOUGH THE U.S. 10-YEAR Treasury yield closed the quarter near 1.6%, barely budging from the prior quarter close, volatility was high in the period. The 10-year yield marked a low point of 1.37% on July 5 immediately following Brexit; a high of 1.73% occurred on September 13 as several Federal Reserve Governors discussed a greater likelihood of a rate increase at the September meeting than what the markets were expecting. However, markets turned around later in the month after the FOMC meeting revealed the Fed's expectations for an extraordinarily slow march to higher rates. Also driving the demand for bonds was the BoJ's announcement to limit further curve steepening, as it set up for a powerful source of demand for intermediate-maturity bonds.

Outside of government bonds, corporate credit and high yield bonds performed well in the quarter, even as so-called bond proxy equities declined. These gains were especially impressive against a backdrop of massive supply. Indeed, high grade new issue supply volumes were $144 billion in September—a new record for the calendar month. The riskier parts of the bond market continued to perform the best: high yield bonds climbed over 5.5% and are up over 15% year-to-date, led by lower quality and commodity-related issues. Emerging market debt is another bond market segment that has benefitted from a reach for yield and recovering commodity prices.

Finally, turning to municipals, the yield on the BofAML Municipal Market Index is only 1.80%, demonstrating a profound lack of coupon cushion that is problematic for returns in a time period of potentially rising interest rates. Accordingly, municipals experienced a negative return for the third quarter and in September. The longer duration part of the market was hit especially hard, which is challenging as durations today are significantly longer than in earlier periods when the Fed was raising the federal funds rate. Indeed, in the third quarter and in September, returns from the longest maturity municipal bonds were twice as negative as returns from one- to three-year maturities.

Credit spreads starting to feel stretched

Current and Historical Spreads (%) (2006-2016)					
	High Yield	Corporate	MBS	Global	Agencies
High	1348	481	132	124	83
Average	602	186	53	63	31
Low	285	91	14	26	13
Current	480	138	14	43	31

SOURCE: Bloomberg.

Hedged strategies hit a high note

HEDGE FUNDS CONCLUDED the quarter with strong equity market outperformance in September, expanding the positive performance differential over global equities and narrowing the year-to-date differential with U.S. equities. With equity markets near record highs, expectations for near-term U.S. rate increases and U.S. election uncertainty dominating the coming months, hedge fund performance, especially in event driven and equity hedge strategies, has redeemed prior bad acts. Global macro strategies continue to struggle to time their hedges right in a market whipsawed by the unpredictable.

Commodities flounder on agriculture

COMMODITIES GAVE BACK some of the gains made in recent quarters, with agriculture the weakest link thanks to declines in soybeans, wheat, and corn. Favorable weather conditions in the U.S., which suggested that global supply may remain plentiful, served to push prices lower. Energy was also lower in the quarter, despite the news that OPEC announced an outline agreement to a production cut. Gold was weak, largely due to profit-taking after its huge surge, while industrial metals were positive thanks to gains in nickel and zinc, which rose on concerns of a supply disruption in the Philippines. Though gold lost 0.7% for the quarter, it is the top-performing commodity this year, rising 23.3% in a reflection of the significant amount of investor angst underpinning the market these days.

Real estate roiled by rising interest rate risk

REITS UNDERPERFORMED broader equity indices during the quarter but still managed to eek out positive returns reflecting a more risk-seeking environment, while stocks with smaller market capitalization but high leverage and volatility outperformed. Hong Kong delivered the real estate market's strongest returns, supported by the reemergence of mainland Chinese investors buying into Hong Kong real estate stocks. UK and continental European real estate also performed well, rebounding from their Brexit-induced losses of the previous quarter as initial data suggested limited economic impact thus far from the aftermath of the Brexit vote. As for property types, industrial and retail properties were the best performers given their defensive nature, while owners of office properties and self-storage gave back some of their earlier gains.

Looking ahead

AS THE MARKETS enter the home stretch of 2016, expect the unexpected. Valuations in the stock and bond markets look rich by historical standards. If third quarter earnings beat expectations and interest rates remain low, then the market becomes fairly priced and the bull market can move forward.

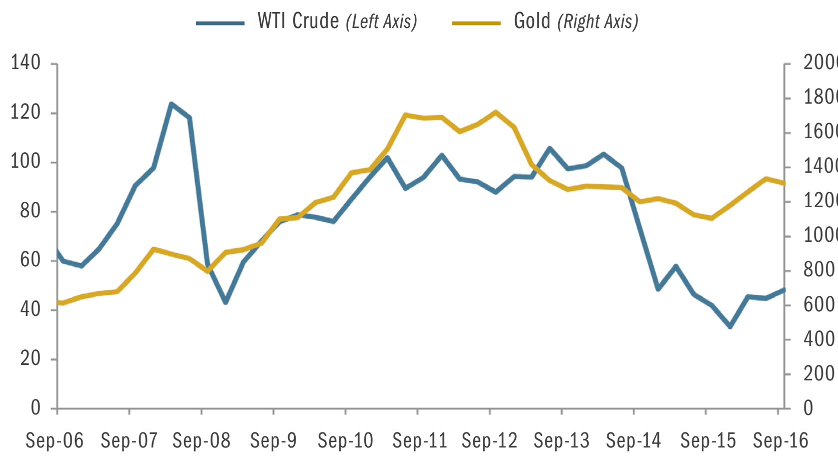
Of course the biggest event for investors to consider in the fourth quarter is the U.S. presidential election. Markets have expressed some preference for the decreased uncertainty of a Clinton presidency so far, though the weak likeability of both candidates raises concerns. Furthermore, political risk is not limited to the U.S. In addition to pre-Brexit planning in the UK over the next several months, the Italian constitutional referendum in late December has the potential to force a leadership change and hamper already lackluster economic growth in that country.

The upcoming FOMC meeting will also drive markets during the fourth quarter. We believe a rate hike may be unlikely just before the election at the November 2nd Fed policy meeting. We see a hike as likely at the December 14th meeting, although it is possible that European banking fears, a policy mistake at home or abroad, a sharp deterioration in the U.S. economic data, or a flare-up of China's bad debt problem may provide cover for the Fed to hold off. Global central banks will also garner attention: the Bank of Japan meets on November 1 and December 20; the European Central Bank meets on December 8; and the Bank of England on December 14.

Finally, optimism is widespread ahead of the OPEC meeting on November 30, following the verbal commitment from members to agree to production cuts to help support prices. Odds favor a deal and we expect oil prices to potentially move higher in the intermediate term, although the risk that the deal falls apart could create a bump in the road.

Undoubtedly, it has been a good year to own financial assets. However, we want to caution that any signs of an economic slowdown or central banks raising interest rates could derail the bulls. In addition to the fundamentals, the market will be handicapping the elections, geopolitical events, market technical factors, the October effect and everything else rolling through the news cycle. Although we are looking for equities to end the year with mid-high single-digit gains, leaving them about where they are right now, the potential for more gains is always possible. A large sell-off during a fourth quarter that is not related to a recession is very rare; however, that does not mean stock market gains will come easily. As we continue to await the outcome of the U.S. presidential and other elections and key central bank meetings, we suspect more bouts of episodic volatility are likely in store. However, recession risk remains low for now, and equity markets remain the much more compelling investment opportunity, provided your investments are prudently balanced and diversified to weather these uncertain times.

Energy and precious metals power commodity returns in 2016



SOURCE: Bloomberg.

SOURCE ON ALL GRAPHS: Bloomberg.