The Ten Themes of 3Q 2016

U.S. stocks, as measured by the S&P 500, posted a gain of +3.31% during the third quarter of 2016. All of those gains came in the month of July as the index declined -0.12% in both August and September. The S&P 500 closed the 3rd quarter up +6.08%, so far, in 2016. Small cap stocks, as measured by the Russell 2000 index, had an even better third quarter rising +8.66% and are up +10.19% year-to-date (YTD).

Even though the 2016 gains appear average, it should not be forgotten how badly the year started. At one point in mid-January, U.S. stocks were off to their worst start in over 100 years. Therefore, we continue to point out how remarkable the bounce back in stocks has been. In fact, the S&P 500 has now rallied +18.54% from its February 11, 2016 closing low. Small cap stocks have gained +31.24% over that same time frame. What about bonds? The yield on a ten-year U.S. treasury bond opened the third quarter at 1.43% and finished at 1.61%. A main reason why U.S. bonds declined (i.e. price moves inversely to yield) is because of the increasing chance the U.S. Fed will raise interest rates in December. While interest rates are still, historically, very low, global fixed income investors can still turn to U.S. bonds given their more attractive yields compared to many countries in Europe and Japan, where rates are near zero or even negative.

Without question, the upward movement in stock prices has been influenced by global central bank policy. Central bankers have been a driving force for asset prices ever since the financial crisis of 2008. Over the past eight years when economic data weakens we have come to expect that a global central bank somewhere will step in and provide support. This is what Mario Draghi, head of the ECB, did in early March as many European countries were on the verge of entering into a recession. Additionally, our own central bank chief, Janet Yellen, decided to keep interest rates “lower for longer” to accommodate growth. These actions, by the ECB and the U.S. Fed, helped pave the way for the 2016 rally in stocks.

Our internal research is now finding that 1st half 2017 corporate earnings expectations may be too high. Therefore, we are growing concerned that much of the improvement in underlying macroeconomic expectations and, ultimately, stock prices could soon hit a brick wall. Therefore, we will be diligently analyzing the financial results of the major global corporations reporting this upcoming 3Q 2016 earnings season, searching for clues of any deterioration in EPS estimate trends. On a positive note, if the underlying improvement in earnings estimate revisions can continue, 1st half 2017 growth would be set to rapidly re-accelerate and stocks could be off to the races. While this is not out of the realm of possibility, our research indicates this positive outcome is unlikely. Stay tuned as we objectively measure and analyze the data and use it to position your portfolio into 2017. In the meantime, **here are the ten themes** that we believe **impacted financial markets the most during the third quarter of 2016.**

1. Brexit
2. Central bank support
3. Volatility
4. Earnings
5. Rally in stocks
6. Modest re-acceleration of growth
7. Technology boom
8. Presidential election
9. Fed and a looming interest rate hikes
10. Global performance

Brexit

In late June, by a slight majority, the people of England voted to invoke Article 50 and start the formal and legal process of leaving the European Union (EU). David Cameron, the prime minster of England, who wanted to remain in the EU, announced his resignation immediately after the vote. Many thought this was going to trigger a global recession and put financial markets in chaos. While it caused some angst, the fears quickly dissipated once investors understood that the Brexit vote likely has no material impact on global growth expectations.

Central Bank support

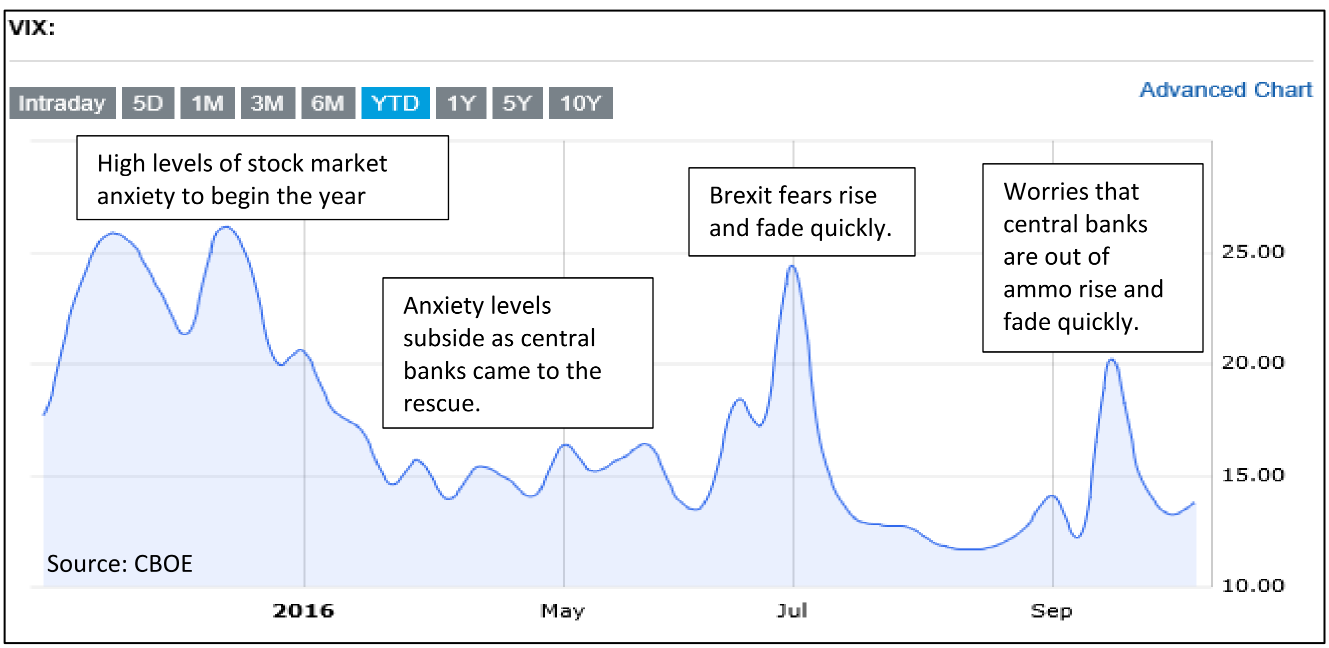
As we have stated, over the past eight years there have been times when macroeconomic and corporate earnings expectations have deteriorated. Normally, the weakening economic data signals the initial stages of a recession. However, the last eight years have not been normal because when the data turns south, we have become accustomed to central banks stepping in and providing support. They have done so by adopting ZIRP (Zero Interest Rate Policy) and providing massive amounts of stimulus into the economy under programs, such as QE (Quantitative Easing). In other words, the central banks have done everything in their power to prevent a recession from occurring over the last eight years.

This year has been no different. In early 2016, economic conditions began to weaken and the chances of a looming recession were rising. However in March, Mario Draghi, the head of the European Central Bank, announced plans to cut interest rates further into negative territory, increase its QE bond buying program and begin to provide, essentially, free funds to targeted financial institutions across Europe. In addition, the U.S. Fed, which was expected to raise short-term interest rates four times this year, has refrained from hiking rates in 2016. This “lower for longer” strategy with regards to interest rate policy has kept U.S. monetary policy accommodative and is a big reason why global stocks rallied in the third quarter and are up YTD.

Volatility

Volatility in financial markets spiked at the beginning of the third quarter on fears the Brexit vote would rattle financial markets. However, the investing seas grew quite calm during the summer and stock returns became somewhat boring. We believe the best way to meaure volatility is based on the Chicago Board of Options Exchange Volatility Index (or VIX), which can be seen below. This index is a guage of what markets believe stock market volatility will look like over the next 30 days based on trading activity on the exchange. Here is how the VIX has traded in 2016.

Chicago Board of Options Exchange Volatility Index (VIX)



Earnings

In July, a vast majority of companies reported their 2Q 2016 results. At first glance the numbers do not look great. Their collective earnings growth over the same quarter last year was only +2.0%. This is well-below the average earnings growth rate of +8.5% that we have tracked over the past twenty years. Top line sales only grew by +0.5%, as well.

So, given there was little or no growth, how could stocks rally so much? First you need to know that we just gave you static figures on sales and earnings growth. Financial markets are not static. They are dynamic and fluid, changing when new data impacts the direction of investor expectations on the future view of the economy.

With that in mind, take into consideration that 1Q 2016 earnings growth fell by -1.5% which was the worst rate of growth we have measured in over seven years. So, 2Q 2016 earnings growth of +2% was actually an improvement from the 1Q 2016. What's more telling is that, at the beginning of 2016, stock prices were selling off to reflect weakening earnings. Instead, actual earnings and expected earnings have improved ever since mid-February 2016. This was a major influence on why stock prices have rallied over the exact same time frame.

As we begin this quarter, our research indicates a high probability that second half 2016 EPS growth rates will accelerate at a modest pace. This is the good news. The bad news is those improving earnings are likely already discounted into the markets and corporate earnings expectations for the 1st half of 2017 appear, by our measurements, to be too high. To keep the stock market party going, central banks may need to maintain their accommodative policies. If not, we believe the chances of a market pullback will rise.

Rally in stocks

Since mid-February 2016, a huge rally has been underway in global stocks that few are acknowledging as justified. Nevertheless, take a look at how much some major markets have rallied off their lows this year.

Country	Stock Index	Gains off 2016 Low	2016 YTD
Brazil	Ibovespa	55.66%	34.64%
Vietnam	Ho Chi Minh	31.40%	18.43%
U.S. Small Cap	Russell 2000 Index	31.24%	10.19%
Greece	ASE	28.27%	-10.43%
Hong Kong	Hang Seng	27.17%	6.31%
Philippines	PSEi	25.40%	9.75%
U.K.	FTSE	24.60%	10.53%
Canada	TSX Composite	24.34%	13.19%
Russia	MICEX	22.98%	12.30%
Indonesia	JSE Composite	21.54%	16.80%
India	SENSEX	21.41%	6.69%
Thailand	SET Index	21.10%	15.15%
Germany	DAX	20.09%	-2.16%
Taiwan	TSE	19.61%	9.94%
U.S. Large Cap	S&P 500	18.54%	6.08%
Mexico	Bolsa IPC	17.34%	9.93%
Spain	IBEX	14.83%	-8.01%
France	CAC	14.15%	-4.07%
Ireland	ISE	13.93%	-11.14%
China	Shanghai Composite	13.14%	-15.10%

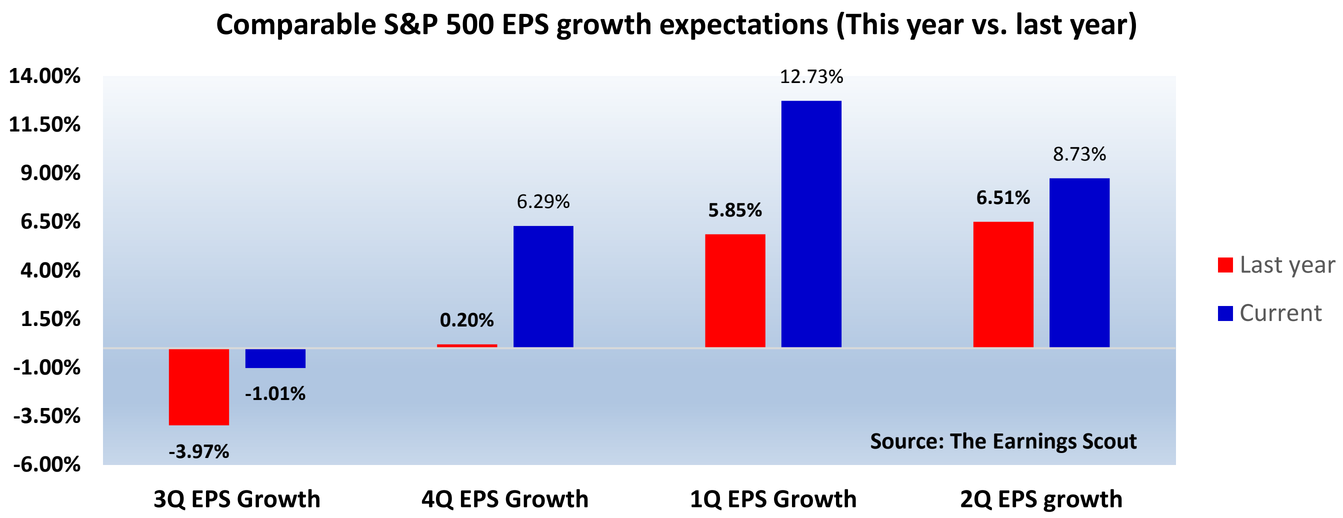
*Price change through September 30, 2016

Source: Bloomberg

Modest re-acceleration in growth

Thanks to the accommodative actions of global central banks in early 2016, 2Q 2016 S&P 500 earnings growth re-accelerated and our research indicates that the 1Q 2016 is likely to be the low water mark for growth. Our reasoning for making this conclusion is based on the improving underlying earnings estimate trends over the past six months and where Wall Street growth forecasts currently stand.

Check out how S&P 500 earnings growth expectations compare this year (much higher growth anticipated) to last year to see that the rates of growth are set to accelerate even more in the second half of this year and into 2017.



Technology boom

During the third quarter of 2016, technology stocks saw significant gains. A big reason for the technology sector outperforming was because of Apple, which has a signifcant impact on the sector's return given its size, as it gained +18.25% in value over the three month period ending September 30, 2016.

Other technology stocks fared even better, but, given their smaller size, had less of an impact on the sector's overall return. The top five performing technology stocks during the third quarer of 2016 were: Seagate Technology (+58.25%), NVIDIA (+45.76%), NetApp (+45.67%), eBay (+40.54%) and Autodesk (+33.60%).

Sector	3Q 2016 return	*2016 YTD return
Information Technology	12.44%	11.12%
Financials	4.03%	-0.28%
Industrials	3.56%	8.92%
Materials	3.18%	9.59%
Consumer Discretionary	2.51%	2.41%
Real Estate	2.34%	2.34%
Energy	1.55%	16.04%
Health Care	0.52%	0.07%
Consumer Staples	-3.27%	5.42%
Telecom	-6.60%	13.79%
Utilities	-6.72%	13.09%
S&P 500	**3.31%**	**6.08%**

*Price change through September 30, 2016
Source: Bloomberg

Presidential Election

In just a few weeks, we will learn who our next president will be. In our view, a Donald Trump victory would likely be initially met unfavorably by the stock market. Why? Because of the uncertainty that surrounds Trump, himself, and markets hate uncertainty. This does not mean Trump would be bad for stocks long-term once markets can get a better feel for him. Hillary Clinton represents the status quo and since markets understand that better, she would most likely be better for stock returns in the near-term. However, this does not mean Clinton would be better for stocks over the long-term. The key is the uncertainty factor that is associated with Trump versus Clinton.

Fed and looming interest rate hikes

For the past two years, Janet Yellen, head of the U.S. Federal Reserve Bank, has been jawboning of pending interest rate hikes. Over those two years, though, we have only seen one rate hike of just 0.25% which came last December. This in addition to the ECB's failure to provide additional stimulus near this same time, was followed by one of the sharpest stock market sell-offs in over 100 years to begin 2016.

The Fed's rate hike contributed to macroeconomic expectations deteriorating soon after. Once the Fed saw this outcome, it refrained from raising interest rates again. Well, it looks like it could be déjà vu all over again this year as the Fed is, again, expected to hike rates in December. In fact, there is a 63% chance the Fed raises interest rates in December based on Fed funds futures pricing at the Chicago Mercantile Exchange.

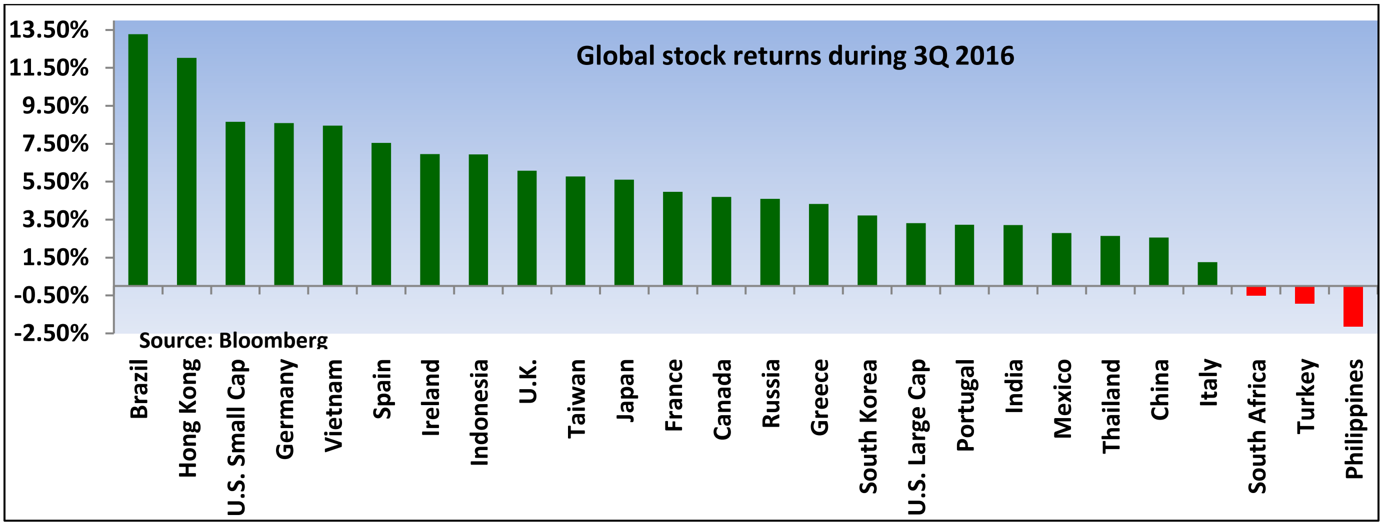
Global stock market performance during 3Q 2016

Country	Stock Index	3Q 2016 return	*2016 YTD return
Brazil	Ibovespa	13.27%	34.64%
Hong Kong	Hang Seng	12.04%	6.31%
U.S. Small Cap	Russell 2000 Index	8.66%	10.19%
Germany	DAX	8.58%	-2.16%
Vietnam	Ho Chi Minh	8.46%	18.43%
Spain	IBEX	7.55%	-8.01%
Ireland	ISE	6.95%	-11.14%
Indonesia	JSE Composite	6.94%	16.80%
U.K.	FTSE	6.07%	10.53%
Taiwan	TSE	5.77%	9.94%
Japan	Nikkei 225	5.61%	-13.58%
France	CAC	4.97%	-4.07%
Canada	TSX Composite	4.70%	13.19%
Russia	MICEX	4.60%	12.30%
Greece	ASE	4.32%	-10.43%
South Korea	KOSPI	3.72%	4.20%
U.S. Large Cap	S&P 500	3.31%	6.08%
Portugal	PSI	3.22%	-13.47%
India	SENSEX	3.21%	6.69%
Mexico	Bolsa IPC	2.78%	9.93%
Thailand	SET Index	2.65%	15.15%
China	Shanghai Composite	2.56%	-15.10%
Italy	MIB	1.25%	-23.43%
South Africa	FTSE/JSE All Share	-0.51%	2.48%
Turkey	BIST 30	-0.94%	7.11%
Philippines	PSEi	-2.14%	9.75%

*Price change through September 30, 2016

Source: Bloomberg

Global stock market performance during 3Q 2016



Conclusion

Our overall view on financial markets is becoming increasingly more cautious as we enter into the fourth quarter of 2016. Our research indicates the rise in stock prices over the past seven months has been justified. But, the rally could soon come to an end if the positive effects from central bank policy start to fade. It may get worse if the central banks start making monetary policy more restrictive for growth. Remember, the Fed is expected to raise interest rates in December. Last year they did just that and what followed in markets did not work out so well. We are having a hard time finding many reasons that this year would be any different with regards to the market's reaction to a rate hike.

While we are not, yet, calling for any change in our target allocations, we are watching the results of the early 3Q 2016 reporters very closely to determine if there is any deterioration in economic conditions. It is possible that earnings and economic conditions continue to improve and would be very bullish for stocks. However, at this point, we believe that is an unlikely scenario. Regardless, we will not speculate and will measure and analyze the data first to determine how to position your portfolio for the remainder of this year and into 2017. Stay tuned.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

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