Third Quarter 2016 Financial Market Commentary

October, 2016

A Quarter to Remember for Global Stocks

The Risk-On trade continued during the third quarter helping to push the S&P 500, Dow, and NASDAQ indices to record highs and lifting investor optimism that the seven year bull market will continue despite uncertainty regarding future Federal Reserve interest rate hikes, weak global growth, Brexit (the British exit from the European Union), and the November U.S. presidential election. It was the best quarter of the year for stocks and marked the fourth consecutive quarterly gain for the S&P 500 Index.

As investors searched for earnings and growth, the Telecom and Technology sectors led the way during the quarter while the more defensive sectors such as REITs, Utilities and Consumer Staples declined. Emerging Market (EM) stocks led all risk-based assets higher as investors sought relatively attractive dividend yields. EM stock performance was followed closely by U.S. Small Cap and International Developed Market stocks. The bond market was led by investment grade U.S. Corporate Bonds and Mortgage-Backed securities while U.S. Government and Municipal bonds were flat to slightly down **(See Tables #1 and #2)**.

TABLE #1: 2016 3rd Quarter and 1 Year Ending September 30th - Asset Class Index Total Returns*

	Large Cap Stocks	Mid-Cap Stocks	Small Cap Stocks	Int'l Stocks	Emerging Stocks	Intermediate Bonds	High Yield Bonds	Real Estate (REITs)	Preferred Stocks	Commodities	Cash
3Q 2016	3.85%	4.14%	9.04%	6.49%	9.14%	0.19%	5.32%	-1.21%	1.22%	-4.15%	0.10%
YTD 9/30/16	7.79%	12.40%	11.45%	2.19%	16.29%	4.25%	14.57%	12.31%	6.37%	5.30%	0.24%
1YR 9/30/16	15.37%	15.33%	15.46%	7.10%	17.20%	3.56%	12.17%	20.94%	10.05%	-12.21%	0.27%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

TABLE #2: 2016 3rd Quarter and 1 Year Ending September 30th – Bond Sector Index Total Returns*

	U.S. Treasuries 1-10yr	U.S. Agencies 1-10yr	Corporate Bonds 1-10yr	Mortgage-Backed Securities (MBS) 0-10yr	Municipal Bonds 1-10yr
3Q 2016	-0.25%	0.02%	0.97%	0.61%	-0.04%
YTD 9/30/16	3.33%	2.31%	6.18%	3.72%	2.25%
1 YR 9/30/16	2.43%	1.76%	5.81%	3.66%	2.95%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

Since the financial markets' sharp retreat in January and February, stocks, bonds and many emerging market assets have rallied, delivering solid performance in a year in which many portfolio managers' expectations started out very low. The continued rebound in most risk-based assets occurred during the quarter despite concerns about valuations, future Fed interest rate policy, who will win the November U.S. presidential election, what will Brexit mean to the global economy and financial markets, and when will global growth and corporate earnings improve.

During the quarter we completed three tactical moves across asset allocation strategy accounts. First, in mid-July we increased our exposure to international developed market stocks by buying more VEA (Vanguard FTSE Developed Markets ETF). The purchase was funded from cash (money market sweep fund). More than three weeks after the U.K.'s Brexit vote and financial markets had calmed with some even making new all-time highs in price. Although investors are still faced with a great deal of uncertainty regarding if/when and how the U.K.'s withdrawal from the European Union will play out, the fact that economies in the U.S., Japan, and much of Europe were mildly accelerating before the Brexit vote and that central banks across the globe have pledged to keep interest rates low should be supportive for international developed market stocks.

At the end of August, we eliminated exposure to U.S. Large Cap sector ETFs XLP (Consumer Staples SPDR) and XLV (Health Care Select Sector). Proceeds from the sales were invested in cash. Our reason for the sales was two-fold. First, stocks had been relatively flat over the previous four weeks with consumer staples and healthcare stocks being two of the three hardest hit sectors. Investors seem to be forecasting stronger economic growth which favors cyclical stocks such as energy, industrials, finance, and technology companies over more defensive sectors such as staples, healthcare, and utilities.

Lastly, near the end of September we increased exposure to U.S. Large Cap stocks by initiating a position in the Energy sector ETF – XLE (Energy Select Sector SPDR). The purchase was funded by cash. The probability of the next Federal Reserve rate hike coming by the end of the year rose to over 60% following the September 21st Federal Open Market Committee (FOMC) statement. Three voting members dissented from the majority view to hold interest rates unchanged. While the committee recognized that the case for rising rates had strengthened, it decided to hold of on a rate hike for the time being. The FOMC reiterated that borrowing costs will probably rise at an "only gradual" pace. They also reduced their median projection of the long-term interest rate to 2.9% from 3% percent in June. This estimate shows how high officials think rates can climb, so its downgrade indicates a shallower interest rate hiking cycle.

The Fed's revision to its long-term outlook for interest rates adds to the optimism over stimulus policies from global central banks and should warrant favoring a pro-growth investment stance. Therefore, we increased risk-based asset exposure by making a direct investment in the global energy sector via XLE. Energy stocks currently trade at cheap relative and absolute levels, while long-term price momentum is on the rise.

The key drivers to stock market performance over the remainder of the year will be what the Fed does regarding future interest rate policy and the impact of economic growth, the price of oil, and the value of the U.S. dollar upon corporate revenue and earnings.

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The pace and magnitude of Fed interest rate increases will be extremely slow and low due to low inflation, economic weakness in Europe, Japan, and China, reduced investment demand relative to desired savings, and our belief that the U.S. and global economy can't withstand successive series of interest rate increases over the next year or two. It is hard to raise interest rates in a world where everyone else is cutting rates and global demand is weak. The Fed should wait until inflation has actually risen above 2% before it further tightens monetary policy. Similar to last year, December could be the next meeting where the Fed raises interest rates.

Bond yields will not rise in a lasting way until global economic growth and inflation turn markedly higher. The financial markets are likely to be volatile heading into the U.S. presidential election and the Federal Reserve's decision in December whether to raise interest rates. However, with major economies in Europe and Japan still using negative interest rates to try to restart weak economic growth, Treasury bond yields should remain at exceptionally low levels by historical standards.

As for stocks, despite lofty valuations, a slow growing economy, a slowdown in share buybacks and dividend growth, and a high level of political uncertainty, we continue to believe that stocks will outperform bonds and cash this year. Stock prices should continue to grind higher because with bond yields near historic lows and weak economic growth in Europe and Japan, there are few alternatives to stocks. Greater stability in the U.S. dollar and oil prices could help corporate earnings beat lowered expectations.

Although volatility has been extremely low thus far this year, it could certainly be on the rise. We will use any correction as a buying opportunity to increase exposure to risk-based assets as we continue to favor a pro-growth investment stance.

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