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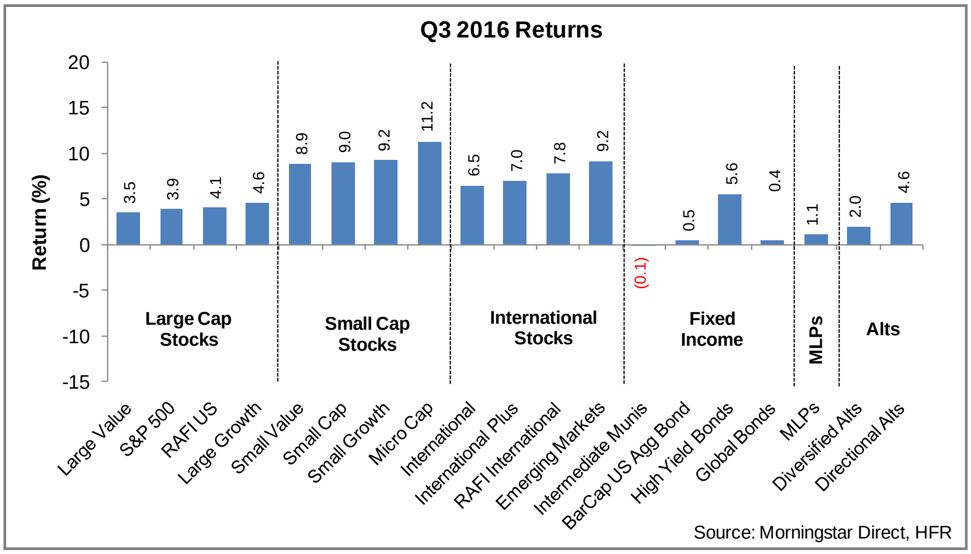
Third Quarter 2016 Investment Review & Outlook

To Our Clients and Friends,

Financial markets performed well in the third quarter, largely avoiding the volatility we observed in the first half of 2016. A "risk on" effect was clearly at hand, as riskier market segments such as small cap stocks and emerging markets generated near double-digit gains. A similar phenomenon took place within the market, as more economically sensitive sectors handily outperformed their defensive, yield-oriented counterparts. This was a dramatic turnaround from the first half of the year, when stocks in the utility and telecommunication sectors outperformed by more than 20%.



Interest rates initially pushed lower with such force that the 10 year Treasury yield reached an all time low of 1.37% in early July. This quickly reversed, however, causing losses for higher quality, longer duration bonds that are inherently more interest rate sensitive. Lower quality fixed income, meanwhile, experienced strong returns as default concerns (particularly in the energy sector) abated. Credit spreads (the yield differential between low grade corporate bonds and Treasuries) have narrowed by 4% since February, leaving high yield bonds up more than 15% on the year.

Much of the market's gains occurred shortly after "Brexit," the vote by United Kingdom citizens to leave the Eurozone. While the initial economic impact is expected to be relatively muted, the long-term, derivative effects of Britain leaving the Eurozone are unknown and potentially damaging. Global equities[1] have largely taken this risk in stride, however, rising 10.9% since markets bottomed two days after the vote.

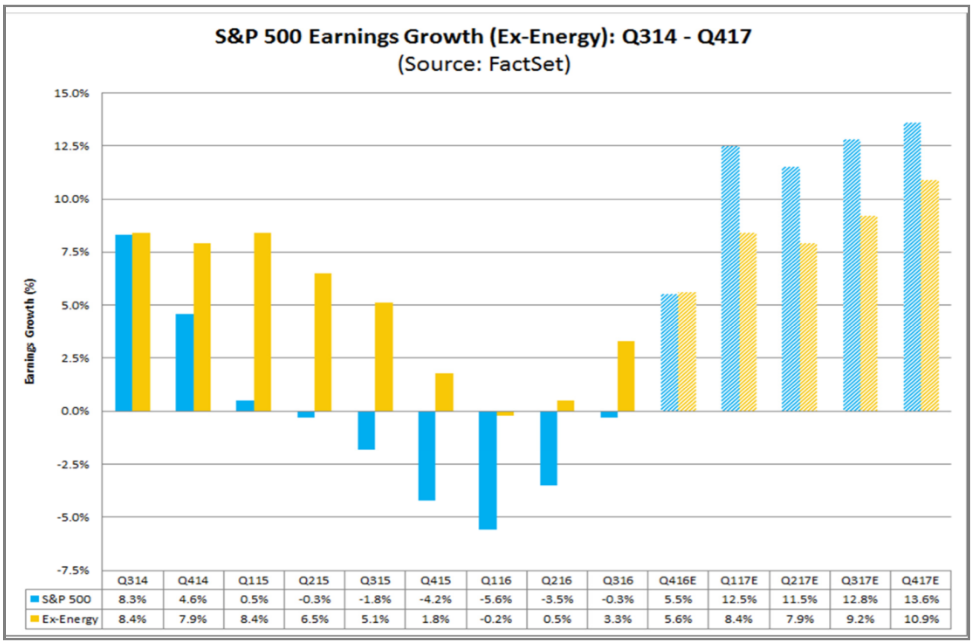
We suspect a big catalyst for those initial gains was simply investor expectations of more central bank accommodation amid a potential Brexit fallout – including a delay in any potential interest rate hike by the Federal Reserve. This, of course, is not an intrinsic reason for stocks to rise, but the influence of such factors on markets continue nonetheless. As time passed, however, and the immediate damage from Brexit appeared limited, central banks largely held off on new policy. Markets refocused on the

[1] Defined as the MSCI All Country World Index

Federal Reserve's "will they or won't they" narrative (along with a vitriolic U.S. presidential election) and returns slowed in the latter half of the quarter.

Entering the final months of the year, there is unfortunately no reason to believe this hyper-focus on macro events will change soon. It goes without saying that any U.S. Presidential campaign will dominate the market news cycle, but the unconventional nature of this year's race has caused added anxiety for many investors. It is also increasingly likely that, based on economic data and Fed officials' own comments, the Federal Reserve will elect to hike short-term interest rates in December. We believe the impact of a mere 0.25% increase (as is widely expected) is more psychological than substantive, but sentiment has proven to be extremely powerful in the current environment. Other potential negative developments include an early December referendum in Italy regarding the powers of their central government. Rejection of the Italian proposal could cause the prime minister's resignation and reignite instability within the country's already fragile banking system.

In our opinion, the fundamental backdrop remains solid enough to absorb any unexpected outcomes – although it certainly wouldn't be without short-term volatility. The major statistics continue to show an economy that is growing, albeit slowly, without the traditional signs of excess that typically precede a recession. Real GDP growth picked back up to 2.9% in Q3 after three sub-standard quarters. Corporate earnings are also improving off their lows following a period of weakness. And while the absolute level of S&P 500 earnings will be flat to slightly negative in the third quarter, those figures are expected to increase substantially in Q4 as year-over-year earnings comparisons rebound for energy companies.



One factor we continue to watch closely is inflation. Consumer prices have tracked consistently higher over the past year and a half, with core CPI above 2.0% for nearly a year and headline CPI increasing almost 1.7% since January 2015. While not yet alarming, several factors could contribute to a continued move higher in inflation:

- **Tightening labor markets –** Improving labor markets and a relative lack of qualified applicants for open jobs (along with minimum wage hikes) appears to be filtering through to increasing wage data. The most recent government jobs report indicated average hourly earnings are at their highest level since 2010. This trend is relevant as wages are considered a key source of sustained inflation.
- **Energy price recovery –** Although somewhat more technical, in the coming months the year-over-year comparisons on energy prices will flip from a major negative to a positive within the

headline inflation measures. This should cause inflation to move sharply above the Federal Reserve's stated 2.0% target level.

- **Change in attitudes toward fiscal policy** – A general policy of austerity and budget hawkishness has caused a retrenchment in fiscal spending over the past several years. This has restrained economic growth and, in turn, inflation. With populist movements gaining traction in both the U.S. and abroad, it's conceivable that an increase in government spending could take place that may have a stimulative effect on the economy. The probability of such a shift is increased should Democrats wrest control of both houses from Republicans on November 8th (as of now, an unlikely outcome).

At this point, the evidence is not strong enough to conclude that a truly structural increase in prices is underway, but we do observe a market that seems to be severely underpricing the risk of higher inflation. The real concern is that if inflation does take root, the Federal Reserve may find itself scrambling to prevent further inflationary pressure – as is dictated by their explicit mandate. Aggressive, forced action by the central bank to curb rising inflation would likely have a negative impact on stocks, bonds, and economic growth.

The prevailing market opinion currently is that interest rates and thus inflation will remain "lower for longer," but the aforementioned factors do constitute a real and conceivable threat to that thesis. It is particularly relevant since current yield levels on quality, intermediate-duration bonds do not compensate investors for the risk of rising interest rates. We thus continue to recommend a bias toward lower duration, more credit centric portfolios in today's environment.

Finally, the aforementioned risk notwithstanding, we believe that resolution to several major sources of uncertainty over the coming months should be constructive for financial markets as we enter the New Year. Many investors have been sitting on the sidelines simply because of apprehension surrounding this year's election. Greater clarity on our country's political picture, along with an expected upswing in economic and corporate earnings growth, may prove to be a strong incentive for some of that cash to be put back to work. In a world full of concerns, this is a positive catalyst that should not be ignored.

As always, please reach out to us should you have any questions or concerns.

Kindest regards,
Your Investment Team
10/31/2016