Insights: October 2016

Market Overview and Performance

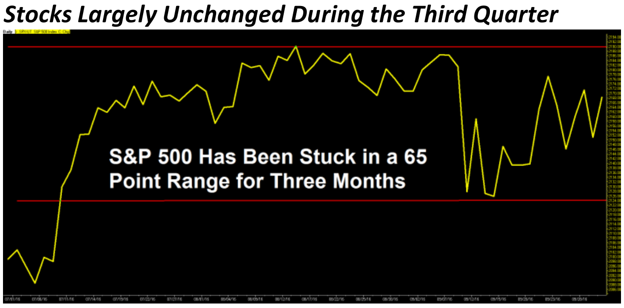
As the third quarter comes to a close, many of the themes we have written about all summer remain in place. After a relentless downward fall to start the year, markets recovered by the end of March and even managed to notch the first new all-time high in over 14 months by the end of June. And then…markets kind of stalled out. Over the last three months for example, the S&P 500 has been stuck in a rut so to speak, bouncing around in a tight three percent range. In reality, this is a surprisingly positive pattern. The fact that markets have remained calm and volatility levels low is a remarkable achievement given the litany of macro issues that have dominated the investment landscape this summer. While it is fair to say that uncertainties are ever present, the current list is rather long and frankly concerning. Unresolved challenges include the U.S. election, a potential Fed rate hike, European and Japanese central bank policies, negative interest rates; weakening global GDP and trade growth, poor corporate earnings, elevated stock valutions, European bank solvency issues, Brexit and oil price volatility. There are others as well but these known items are also compounded by unforeseen events like supply chain disruptions in shipping, terrorist attacks, deteriorating political relations and destruction from natural disasters like Hurricane Matthew. After a calm summer, it seems as if the potential for October to live up to its historically rocky reputation is as high as ever. The good news is that October has also historically marked the low before a year end rally, however, it remains to be seen whether that course of events will repeat again this year. As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.02	7.84
Russell 2000 Index	1.11	11.46
MSCI EAFE Index	1.23	**1.73**
MSCI Emerging Markets Index	1.29	**16.02**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.06	5.80
Barclay's U.S. Credit Index	-0.28	8.86
Barclay's Corporate High Yield Index	0.67	**15.11**
Barclay's Municipal Bond Index	-0.50	4.01
Macro Measures		
Gold	0.43	**24.16**
Crude Oil	7.92	**30.24**
CBOE Volatility Index	-0.97	**-27.02**
USD Dollar Index	-0.59	-3.37

September Themes – Markets Remain Sanguine Despite Uncertainties; Market and the Fed Anticipate a Rate Hike in December; Growth is Slowing both in the U.S. and Abroad; Hard Brexit Looks Like it May Become a Reality; Deutsche Bank Issues Take on More Urgency

As we said in our opening paragraphs, many of the themes we have been writing about this summer continued throughout the month of September. This certainly includes the quiet tone of the equity markets.

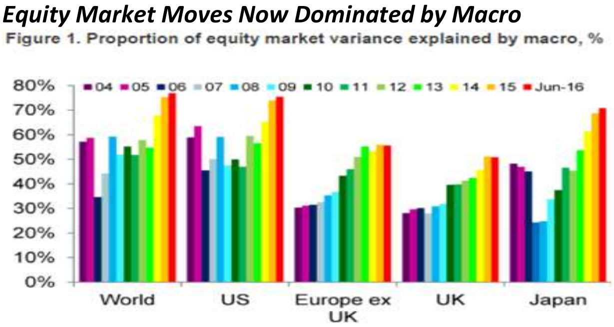
Stocks Largely Unchanged During the Third Quarter



Source: Thomson Reuters

Strategist Nick Colas at Convergex has suggested that this past quarter was the calmest three month period since 2005. As evidence of this, he points out that there were just 6 days when the market moved by more than one percent. That is well below average and far calmer than the first quarter when 26 trading days saw a move of over one percent. Seems odd given all of the unresolved issues swirling around at the moment, but as Citigroup points out in the chart below, uncertainty has simply produced inaction. Participants are locked into following macro events and developments rather than fundamental investment merits.

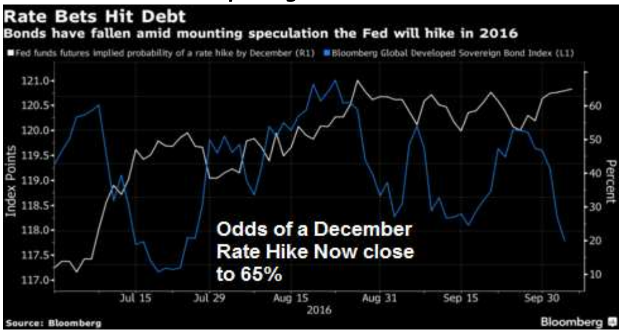
Equity Market Moves Now Dominated by Macro



Source: CitiGroup, Inc.; Bloomberg

One positive perhaps from the last quarter was the fact the markets seem to be coming to terms with the probability that the Federal Reserve will raise interest rates come December. While this has resulted in bond market yields moving higher and small losses for bond investor holding longer duration, it is a good sign that the rate hike will actually be "old news" by the time it becomes a reality and the market can simply move on.

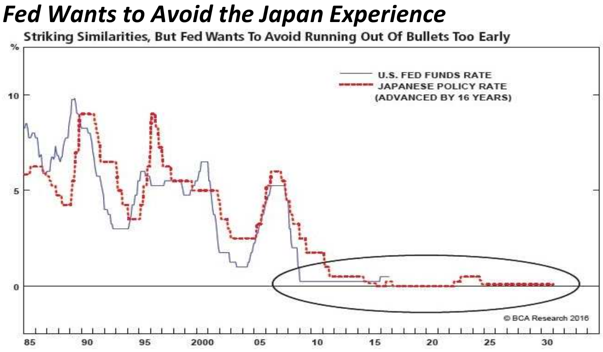
Market is Now Anticipating a Rate Hike in December



Source: Bloomberg

While it would undoubtedly be good for the market to absorb a rate hike in an orderly fashion, the Fed needs to act to "normalize" rates away from emergency levels only if the economy merits it and unfortunately, it seems they may have waited too long to act. As we have discussed over the past few months, there is ample evidence that growth in the overall U.S. economy is slowing rather than expanding. Ironically, if they were truly data dependent they would have raised rates long ago and not when things are cooling. But as BCA Research highlights, they are desperate to avoid the Japan scenario at all costs. This is especially true if the economy slides further and falls into recession in 2017.

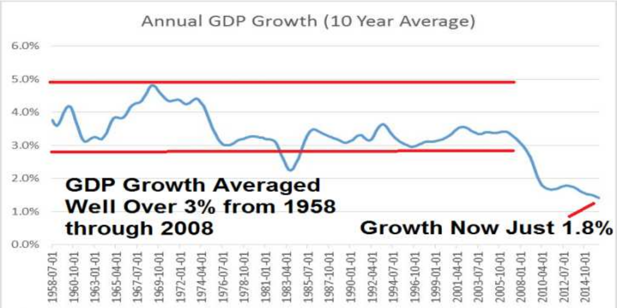
Fed Wants to Avoid the Japan Experience



Source: BCA Research

Simply put, the Fed wants to maintain the optionality of cutting rates should economic conditions necessitate. Japan was not able to do this and has been mired in a low rate environment and stagnant economy for 20 years as the previous chart details.

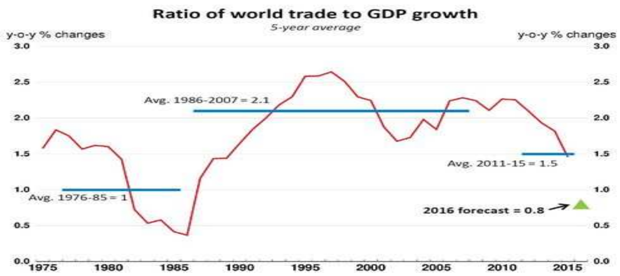
Fed Lowered Their Estimation of GDP Growth this Month



Source: Federal Reserve; Scott Ruesterholz

It is a hard position for the Fed since they themselves acknowledge a slowdown in the economy. After their meeting in September they released their updated projections which included both a near term and long term reduction in growth. In fact, for both measures the Fed suggests that growth will only be roughly 1.8 percent, far below the 3+ percent growth experienced over the previous 60 odd years. And it is not just the Fed that has lowered their expectations for growth. During September, the International Monetary Fund lowered its growth outlook for the U.S. as well. Additionally, the OECD lowered their outlook for both the U.S. (1.4 percent) and for world trade. The World Trade Organization published similarly lowered forecasts. As you can see from the chart below, strong global trade fueled the expansion of the global economy throughout the 1980's and 1990's, but now trade relative to output is at the lowest levels since the 1980's.

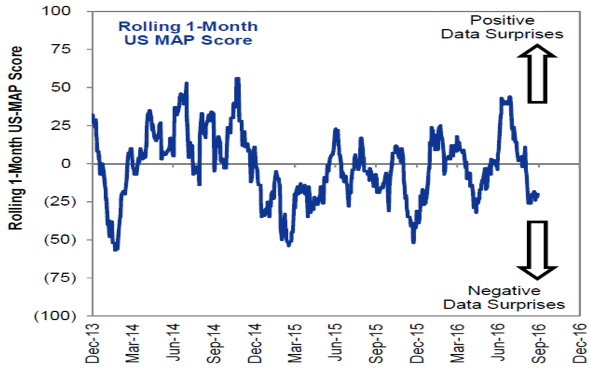
OECD Sees Global Trade Falling Back to Late 1980's Level



Source: Organization for Economic Cooperation and Development

And the data here in the U.S. is not showing signs of improvement. Quite the contrary in fact. Goldman Sachs, as well as others, combine many economy data points into one measure to try and ascertain trends and as you can see below, cumulative data has been weak.

US Economic Data Proved Disappointing in Q3



Source: Goldman Sachs Research

To give you a sense consider the following: U.S. manufacturing contracted in September; housing starts declined 5.8 percent; construction spending declined sharply year over year; new vehicle sales fell; consumer spending ex-healthcare and education declined 3.2 percent year over year; heavy truck sales declined by a whopping 29 percent. Taken alone, many of these items could be considered noise, but several have also proved to be very good warning signals of a coming recession. This has not gone unnoticed. In fact, BofA Merrill Lynch attempted to quantify this somewhat by assessing the current condition of five different recession markers. In their estimation, when taken as whole and if data trends continue, the U.S. could be entering a recession sometime around October 2017.

Recession Indicators Are Becoming More Pronounced

Table 1: Economic indicators vs recessions summary table

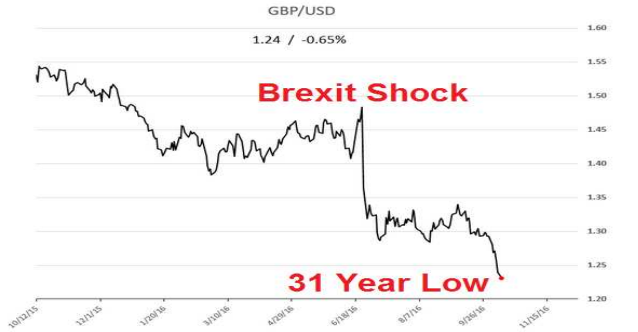
	2-10 yield curve	ISM	Building permits	Temp help job growth	C&I loan growth
Missed recession	0 out of 7	0 out of 11	1 out of 7	0 out of 3	1 out of 11
False signals	14%	15%	25%	0%	17%
Threshold	-0.1%	45	-22%	-4%	-0.5%
Current value	0.8%	52	0.2%	1%	0%
Precedes recessions	7 out of 7	4 out of 11	5 out of 6	1 out of 3	2 out of 10
Forecasted threshold cross	Feb-18	Feb-17	Nov-17	Jul-17	Oct-16
Max preceding/following[1]	23 / N.A.	14 / 10	17 / 0	2 / 7	15 / 15
Latest/earliest[2]	Jan-20 / N.A.	Apr-18 / Apr-16	Apr-19 / Nov-17	Sep-17 / Dec-16	Jan-18 / Jul-15
Average[3]	15	1	5	-2	-4
Estimated recession	**Apr-19**	**Feb-17**	**Mar-18**	**Jun-17**	**Jul-16**
Data since	Jan-62	Jan-48	Jan-61	Jan-83	May-47

[1]Max number of months preceding/following a recession
[2]Latest/earliest recession start date
[3]Average number of months preceding (following) a recession
Source: BofA Merrill Lynch Global Research US Equity & Quant Strategy, National Bureau of Economic Research, Federal Reserve Board, Institute for Supply Management, Census Bureau, Bureau of Labor Statistics

Source: BofA Merrill Lynch Global Research

Trying to put an exact date on the timing of the next recession in the U.S. is somewhat of a fruitless exercise; however, it is concerning that more signs of a slowdown are appearing at a time when the issues in Europe are becoming more acute.

Decline in Pound Reflects Hard Brexit Concerns



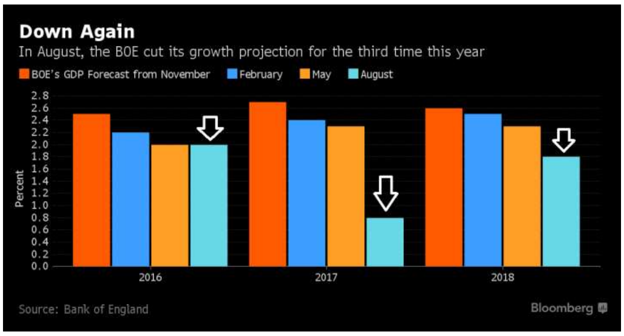
Source: Daily Shot

After the initial surprise and subsequent relief rally following the Brexit vote in late June, the market consensus seemed to be that perhaps the event would not be as tumultuous as feared. Fast forward three months and that sense of ease has all but disappeared. As one can clearly see in the chart above, the British pound took a hit after the surprise vote in favor of Brexit, however a period of calm seemed to stabilize the currency for most of the quarter before "hard Brexit" impacts appeared to become the most likely outcome.

In the first week of October, U.K. Prime Minister Theresa May announced that "change has got to come" and that she would trigger Article 50, the motion to leave the EU, by March of 2017. This was not welcome news to the market particularly in light of further comments that she would prioritize immigration control rather than the single market access during negotiations. This is in direct conflict with the mandate of the European Union. The prevailing view is that the EU will be very, very rigid on this issue and many leaders including France's President Hollande confirmed as much stating, "Right now, Great Britain wants to leave but not pay. That isn't possible." As a result the Pound tumbled to a 31 year low. Even if all parties could come to terms in fairly short order, any Brexit deal would also have to be unanimously approved by all 27 remaining EU governments, each with veto power.

At the same time unfortunately, the immediate consequences of Britain leaving the EU have come to fruition as well. The Bank of England recently reduced their growth projections for the third time this year, notably ratcheting down 2017 expectations to below one percent.

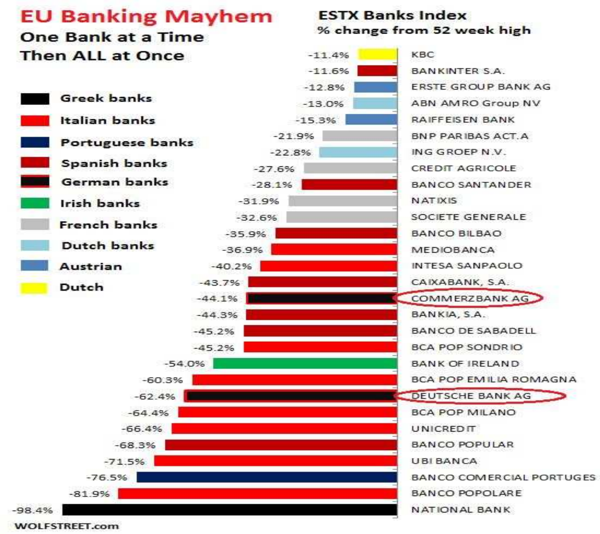
Bank of England Sees Slowdown Worsening



Source: Bank of England; Bloomberg

A report by TheCityUK, a think tank research organization, also showed that a hard Brexit could cost the U.K. up to 75,000 jobs and $13 billion in tax revenues. That is quite a high price to pay. To compound the problem, Europe broadly is not providing much of a cushion. In September, the Euro-Area Purchasing Mangers Index, a measure of economic activity, slowed notably. Brexit will only exacerbate this trend as the continent heads into a spring with political votes looming in Germany, France, Italy and Spain.

Investor Capital Continues to Flee from European Banks



Source: www.wolfstreet.com

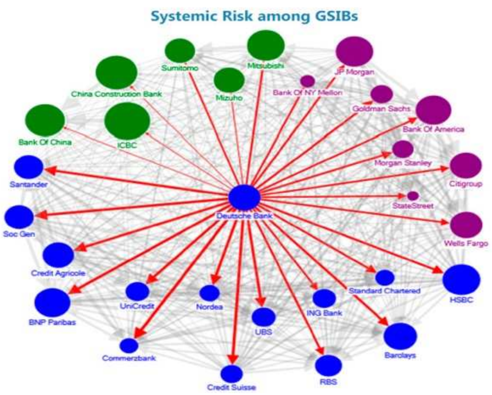
On top of the Brexit obstacles, it was also a challenging month for European banks, particularly Deutsche Bank (DB). We have written earlier this year about the devastating declines in the value of European banks as seen on the previous page, but during September DB was also hit with a $14 billion dollar penalty from the U.S. Department of Justice over improper selling of mortgage securities. This unforeseen development severely rattled investor confidence in the already shaky institution and the cost of insuring positions via credit default swaps soared to near record levels.

Credit Default Swaps on DB Spiked in September

Source: www.boursorama.com

While DB has been a concern for much of the year, it is now apparent that they desperately need to restructure their business and their balance sheet - two things that require time and capital, and they possess neither. Over the past four years or so, the bank has recorded a cumulative net after tax loss of roughly 3.8 billion Euros. They simply cannot survive without some form of intervention. And letting the bank fail is not an alternative according to the International Monetary Fund.

DB "Most Important Contributor to Systematic Risk"



Source: International Monetary Fund

The main concern is DB's leverage ratio, or the size of its "risk cushion" relative to its exposure or amount of risk. Right now their leverage ratio stands around 3.5 times. Under Basel III standards, the absolute minimum level would be 3 times – the U.S. Federal Reserve has a minimum of 5 times for the 8 "systematically important" U.S. banks. As it stands now, DB has no mechanism at its disposal to keep the leverage ratio from falling further. Essentially there are only three alternatives: 1) let the bank fail (not a realistic option); 2) a government bail-out funded by tax dollars; or 3) a bail-in where current debt is converted into equity. For its part, DB is doing its best to raise additional capital through asset sales, but even if those proposed were completed successfully, the bank would be well short of its estimated 40 billion Euros of required new capital. With Angela Merkel adamantly suggesting that the government won't bail out the bank (if push comes to shove they would still do it), the most likely option is a bail-in where the bank is declared non-viable, equity holders, lower level debt holders and uninsured depositors wiped out while senior debt is converted. Regardless of the ultimate details leading to resolution, it will be a difficult path forward over the next six months and one that will likely keep investors cautious when assessing the entire Euro-area.

One last item of note as we start October is the third quarter earnings season. With valuations at worryingly high levels and earnings expectations seemingly at a very unrealistic 14 percent for next year, a weak earnings season could initiate a difficult period for stocks. Even if aggregate earnings match the consensus of -2.1 percent for 3Q (which Goldman Sachs views as unlikely given the factors below), it would mark the 6th consecutive quarter of earnings declines. That is one indicator that has never been witnessed outside of a recession.

3Q Earnings Season Vulnerable to Disappointment

Macro factors impacting earnings surprises

		Average			Impact on
Factor	**Measure**	**3Q 2016**	**3Q 2015**	**Change**	**surprises**
US growth	Current Activity Indicator (CAI)	1.7 %	2.4 %	(72)bp	**Negative**
Interest rates	US 10-Year Treasury yield	1.6 %	2.2 %	(66)bp	**Negative**
Oil price	Brent crude ($/bbl)	$47	$52	(9)%	**Positive**
US Dollar	GS USD TWI	111	108	2 %	**Negative**
EPS estimates	3-mo consensus bottom-up EPS revisions			(3)%	**Negative**

Source: Goldman Sachs Research

Going Forward

In spite of the quiet trading environment this summer, our outlook remains the same. As we approach the historically volatile October period, we feel that the risk of a market correction is now more elevated than at any other time in the last twelve months. The issues surrounding European banks and Eurozone growth in general have not improved in any meaningful way. Additionally, the economic data in the U.S. appears to be telling us that growth is slowing - all at a time when equity valuations are expensive and the Fed is desperately trying to increase interest rates. As a result, we are positioned defensively in our portfolios with cash levels at a high point for the year in anticipation of a decline that we feel will present a good re-entry opportunity for gains toward the end of the year.

Within equities we continue to favor the large cap segment of the U.S. market. Traditionally defensive sectors such as utilities, consumer staples and telecommunications that have dominated market performance for the first half of 2016 remain very expensive in our view. The same can be said for small cap companies which have benefitted from a "risk-on" posture in the market this summer. Conversely, we feel that the risk/reward proposition in the technology, health care and financials sectors is much more appealing due to their lower valuation and higher growth rates.

Outside of the U.S., we have for quite some time argued for an allocation to Europe based on its improving economic environment broadly and the extremely accommodative measures of the European Central Bank. In light of Brexit and the banking issues across the continent, we are less constructive on the area and will be looking to reduce exposure. Japan continues its efforts at reforms that are risk-asset friendly, propping up equity prices this year despite the headwind of a strengthening currency. While the market was by and large disappointed with the lack of an announcement regarding further stimulus at the BOJ's September meeting, we will be monitoring developments particularly in light of the recent strengthening in U.S. dollar.

After an extended period of underperformance, emerging markets are becoming more of an interest. As a whole, they have performed surprisingly well in 2016 rising over 16 percent, however headwinds remain in place. Most notably, slowing growth in China combined with slowing growth in Europe and the U.S. could quickly reverse those gains so we prefer to monitor further before increasing exposure. Despite their strong move higher this year, emerging market stocks still remain attractively valued when compared to other regions.

Traditional fixed income is now very, very expensive relative to history as a result of the distorted demand dynamics that are the result of central bank asset purchasing actions. However, we do think it is prudent to maintain exposure to bonds in an uncertain environment. In a rising interest rate environment, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has provided stable returns in a year with increased uncertainty levels.

With regard to commodities, the oil market is suffering from oversupplied conditions and prices of the commodity have moved lower from their June peak as a result. The potential implementation of the OPEC production cuts could reverse that trend. Additionally, as energy companies begin to roll off the effects of the collapse in oil that occurred from late 2014 into 2015, their earnings should begin to increase again which could present an opportunity as we look to 2017. Thus far in 2016, gold has been the one asset class to both serve its purpose as a diversifier and provide attractive returns. Given the macro outlook, we are not buyers of gold for fundamental reasons however we have maintained a small position in certain portfolios as a hedge which has performed well year to date.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.

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