Third Quarter Newsletter

October 20, 2016

This fall, it's not just the leaves that are changing. In just a few short weeks, we will have a new President for the first time in eight years. Most of us will breathe a huge sigh of relief that the campaigning, ads and debates have finally come to an end, and hope that all the folks in Washington are getting on with the job they are all elected to do: running the country.

Many of you have asked us, as we ask ourselves, whether it matters, from the stock market's perspective, who fills the Oval Office in January. Not to sound equivocal, but we're not sure that it does. Indeed, a fairly strong argument can be made that it has been the appointed (rather than elected) Federal Reserve that has played a larger role in the stock market's performance since the financial crisis. In the absence of a coordinated fiscal policy to stimulate economic growth, it has been left to the Federal Reserve to use monetary policy—zero interest rates and a bond buying program—to prevent the economy from slipping back into the red. The consequence of the long duration of such an accommodative policy is inflated asset prices of all kinds.

Consider the fact that the negative events or data that ordinarily could send stocks reeling have failed to knock this market off its upward trajectory. China's slowdown, Brexit, contentious Presidential election? None of these have derailed the market's march higher. Although last year was nothing to write home about performance-wise, the S&P 500 still managed to eke out a barely positive result even after the market plunged 6% from August to October 2015. Likewise, after starting this year with an official correction of a 10.5% loss, the US market recovered to close the third quarter up 6% for the year. (Remarkably, even after all of this volatility, the US market is essentially flat in the past 18 months.)

What could be the trigger that finally puts a chink in the stock market's armor? Higher interest rates, for one. Remember when the Federal Reserve raised rates last time in December 2015:

The central bank not only pushed rates up a quarter of one percent but also indicated that it would raise four more times in 2016. That certainly played a large role in triggering the stock market sell off that lasted into early 2016 mentioned above. Thanks to that reaction, as well as fear of a Brexit contagion, the Fed didn't follow through on any rate hikes this year—yet.

Most Fed watchers now expect the central bank to move in December. Rates have been so low for so long yet have failed to produce their intended stimulus to the economy (the same is true with negative interest rates in Germany and Japan). This has the central bank concerned that unless rates move higher, it will have run out of tools to deploy if the US tips back into recession. In addition, raising rates would put more money in retirees' pockets who so heavily rely on their savings, which in turn could help the economy grow.

We are also struggling to find fundamental and quantitative catalysts for a bull market. As you've been hearing from us for a while now, neither the global economy nor the corporate earnings it generates have produced much to support a steady march higher in stock prices. Europe is struggling to produce a sustainable recovery, Japan is teetering on recession and U.S. growth has only been slightly above 1% so far this year. Similarly, US corporate earnings have continued to disappoint—declining year over year for the past five quarters. The rate of decline may abate now that oil prices have bounced back, but the fact remains that earnings probably won't be anything to cheer loudly about.

On the quantitative side, just about every measure that we – and most stock market analysts – rely on to judge the attractiveness of equities is at a relatively high level. Whether you analyze price to sales, the "Buffet rule," or price to earnings, the current valuation on stocks is well above average. The exception to this is dividend yield, which also helps explain to some extent what has propped up the stock market for so long (Again, thank you Federal Reserve). Indeed, with the S&P 500 dividend yield at 2.06%, the gap between it and the US 10–year Treasury yield of 1.69% is wider than it's been for most of the history of the relationship.

This is not to say we think we are in "bubble" territory which will end the same way bubbles often do—with a big crash. It just means that generally speaking we continue to be cautious about our overall allocation to equities at this point in time. While equities still play an important role in portfolios, we are somewhat below our long term target range, depending on each client's tolerance for volatility and risk. We have filled the gap with a three-part strategy: we have slightly increased our allocation to fixed income; we have allocated to hedging type vehicles like gold and alternative investments; and we are keeping cash on the sidelines with which we can be opportunistic when we see a pullback in equities. As always, our first and foremost priority is helping you reach your long term investment goals while managing risk and volatility.

While we are confident in the analysis behind maintaining a defensive stance on the current markets, we feel it prudent to discuss the potential opportunity cost of this caution as well. For example, our generally lower allocation to stocks should provide some downside protection in a market correction. However, if economic and earnings growth were to accelerate and drive markets higher, our equity positions should benefit, but not as much as they would if we were more fully invested than we are now. However, the cornerstone of attaining long-term goals is the preservation of capital during environments where the risks far outweigh the reward, and we feel that is the environment we face today.

As noted above, during the year, we increased our fixed income exposure, depending on each client's investment objectives and appetite for risk. And, generally speaking, because interest rates trended lower for most of the year, this has helped overall performance. While we expect the Fed to finally make another upward move in rates later this year, given the information at hand now, we maintain our position that any increase will be gradual and limited so that longer term yields remain relatively low. Our fixed income strategy continues to be one that takes a laddered approach: We spread our investment over staggered maturity dates in order to meet each individual client's cash flow needs and to manage interest rate risk.

As we approach the final months of the year, please let us know if there is any way we can be of help in the planning for your 2016 taxes. As always, we consider capital gains implications to all of our investment decisions. But please contact us if you have any questions in this regard. This is also the time to finalize charitable contributions you'd like to make for 2016. We welcome these kinds of discussions. Our role is to not only help you achieve your long term investment and retirement goals, but to also define purpose for your resources.

With warm regards,

Scott Upham, Managing Partner   Odette S. Galli, Partner   John D. Duffy, Partner