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SEPTEMBER 30, 2016 INVESTMENT MARKET COMMENTARY

Stocks continued a fairly orderly ascent in the quarter ended September 30th, while bonds were generally flat. After a mostly quiet summer, market volatility returned late in the quarter due mainly to concerns associated with the upcoming presidential election, softening economic data and, most importantly, the timing of when the Federal Reserve will raise interest rates. Remarkably, US stocks remain near record highs, despite these important areas of uncertainty.

For several years, the prices of most 'risky' assets have benefitted from the unprecedented low interest rate environment. **Many investors have opted to buy certain stocks as bond proxies in lieu of settling for lower yielding 'safe' alternatives. Consequently, equity valuations continue to track above historic norms**, with the overall market P/E ratio at roughly 20x versus the long-term average of 15x. **This condition can persist going forward, and potentially become more stretched, so long as the monetary backdrop remains highly accommodative**. However, as noted below, this unusual market climate presents an overarching risk, that being when and how interest rates ultimately transition back to more normal levels.

It is Hard to be Too Bullish…

Following the early year stock swoon, it has become increasingly difficult to find compelling value as 2016 has moved along. The most basic reason is that prices have risen in the face of deteriorating expectations for corporate earnings growth. The fundamental backdrop is not buoyant as reflected in the following facts:

- In the US, annual GDP growth has not exceeded 3% (the long-term average) for over a decade. Of late, growth has slowed further. When reported in coming weeks, corporate profits will have declined for the sixth consecutive quarter. This level of profit weakness has historically presented a challenging environment for the stock market;
- US debt now exceeds 100% of GDP (highest percentage since 1950), putting extra strain on an already stressed economy;
- Home ownership is lower than any time since 1965, and labor participation remains well below acceptable levels;
- Certain key interest rates around the globe are negative, a situation that has never occurred before. This development reflects the difficult financial backdrop confronting investors and policy makers alike.

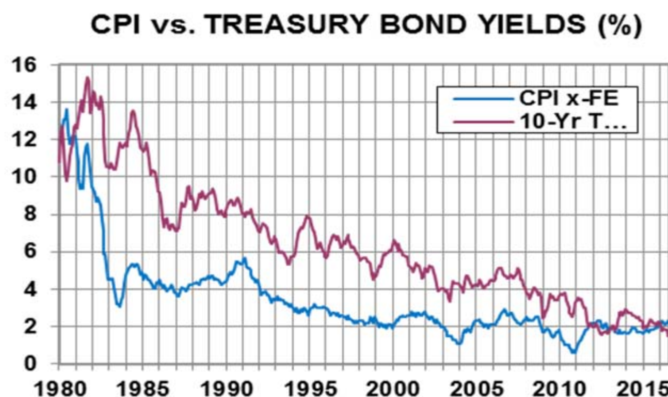
…But it is also Hard to be Too Bearish

While there is no shortage of issues for investors to fret over, the equity market continues to scale the proverbial 'wall of worry'. **Through unprecedented monetary initiatives, including bond buying programs**

and negative interest rate policies, central bankers are desperately seeking measures to rouse slumbering global growth. Unfortunately, these actions have not generated the economic development and inflation rates that authorities have targeted. However, **what the policies have accomplished, and the concomitant reason why we are wary about market valuation generally, is a lengthy stretch of higher stock prices**. It can be plausibly argued that central bank activities have deferred long-term pain for the benefit of short-term gain, as asset prices have grown in the face of mediocre economic activity. However, **we must respect the Fed's determination and tenacity to bolster stock, bond and real estate prices, and acknowledge that the timing of when their efforts shift or run out of steam cannot be predicted. Moreover, Chairwoman Yellen recently suggested that the Federal Reserve might add stocks to the list of allowable asset purchases, just as the Japanese and Swiss central banks have done, which would provide another layer of support for equity prices.**

The Big Picture

If a photo is worth a thousand words, the chart below provides a stark illustration of the unusual circumstances currently facing investors. For decades, the 10-year US Treasury rate has exceeded core inflation (CPI excluding food and energy) by roughly 2-3%, whereas today the inflation rate is higher than the bond yield. This means that 'real returns' (meaning yield levels adjusted for inflation) are negative for these bonds.



As noted, **the interest rate environment largely explains why, in recent years, stock valuations have persistently remained above historic precedent. This pattern may continue as many investors now perceive equities as the primary source to generate acceptable income and longer term return.** However, once the time-honored principal of properly compensating bond investors for inflation risk returns, and yield levels increase accordingly, companies will be required to provide meaningful earnings and cash flow growth to justify elevated valuations. **A stock market correction stemming from rising interest rates should neither surprise investors nor be reason for undue concern. On the contrary, we would appreciate the opportunity to purchase fixed income securities that offer reasonable yield, and stocks that provide more compelling risk/reward scenarios.** The ultimate return to a normal relationship between inflation, interest rates, and stock valuations will be fundamentally positive from a long-term investment perspective.