Central Banks Trump the Election

A prerequisite to understanding markets in recent years has been analyzing global monetary policy. Recently, there has been a growing unease regarding whether markets have become too dependent on central bank policy. The Bank of International Settlements (BIS), which is often called the central bankers' banker, expressed concern in its latest quarterly review over the degree to which central bank policy may be influencing asset prices. Potential signs that the Bank of Japan (BOJ) and European Central Bank (ECB) might alter their negative interest rate policies and large asset purchases contributed to a jump in global bond yields and recent market volatility. While monetary authorities may be starting to question the efficacy of negative interest rates and more openly expressing the limits of additional easing measures, we still expect central bank policy to remain extraordinarily accommodative for the foreseeable future.

Despite the recent jump in long-term interest rates, most developed markets are still reporting negative real (inflation-adjusted) yields. In late-September, the BOJ reiterated its commitment to aggressive easing policies by announcing its intent to focus on steepening the yield curve in order to offset concerns that negative interest rates were hurting financial stability and bank lending. In Europe, it could also be argued that a recent uptick in government bond yields could reduce scarcity concerns and make it easier for the ECB to extend its asset purchases well past the current March 2017 scheduled end date.

Turning to the U.S., the Federal Reserve did the expected in its September 21 policy statement by holding rates while further prepping the market for a potential hike in December. The Federal Open Market Committee (FOMC) statement utilized the same language to describe near-term risks to the economic outlook that were included in last year's policy statements just before the first rate hike, and 14 of the 17 committee participants expect one rate hike before the end of 2016. Due to its proximity to Election Day, the November Federal Reserve meeting is largely viewed as unlikely to result in a rate hike, and all eyes will now be focused on December's meeting. The longer-term outlook for rates, meanwhile, was again ratcheted down with the median assessment of Fed participants now only expecting two hikes in 2017. With the U.S. on an extremely gradual hiking path, and other major global central banks still committed to extraordinary and unconventional easing measures, increases in interest rates in the near-term are likely to be modest and financial conditions should remain relatively healthy. Looking further out, the possibility that surging global leverage will reach levels that cannot be sustained by current incomes in the face of even modest interest rate increases is growing and may be a risk for 2017 and beyond.

In the near-term, as investor turn their focus to the presidential election and its impact on fiscal policy, it is important to remember that historically, election years deliver a volatile but sideways market in the first half of the year, followed by strength in the second half. We would see any material sell-offs into the election as an opportunity to deploy any capital sitting on the sidelines. However, given our longer-term concerns regarding valuations, high global debt levels and a long running bull market by historical standards, we believe a moderate degree of caution remains advisable despite our generally optimistic near-term outlook.

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Global Economy

Following a weak first half of the year which saw the U.S. economy operating barely above stall speed, growth rebounded early in the summer. Gross Domestic Product (GDP) remains on track to grow 2.9 percent in the third quarter, according to the latest estimate from the Atlanta Fed's GDPNow real-time forecasting model. As a result, the fears of recession which contributed to extreme market volatility early in the year have receded. The Leading Economic Index (LEI) published by The Conference Board reached a new cycle high in July, and the recent steepening of the yield curve may partially reflect diminishing recession risks.

Exhibit 1 shows the peaks in the LEI over the past seven business cycles. Over that time, the LEI has peaked a median of 11 months before a recession began, ranging from as few as eight months to as many as 21 months of lead time from peak to recession. Although other metrics, including falling profit margins and negative capex growth, -which have warned of prior recessions - are still signaling that caution is prudent, the improvement in the LEI is one reason to conclude that near-term recession risk is not elevated.

Exhibit 1. Peaks in the Leading Economic Index

LEI Peak Date	Recession Start Date	Months From Peak to Recession
April 1969	December 1969	8
February 1973	November 1973	9
October 1978	January 1980	15
October 1980	July 1981	9
January 1989	July 1990	18
April 2000	March 2001	11
March 2006	December 2007	21
	Median	11

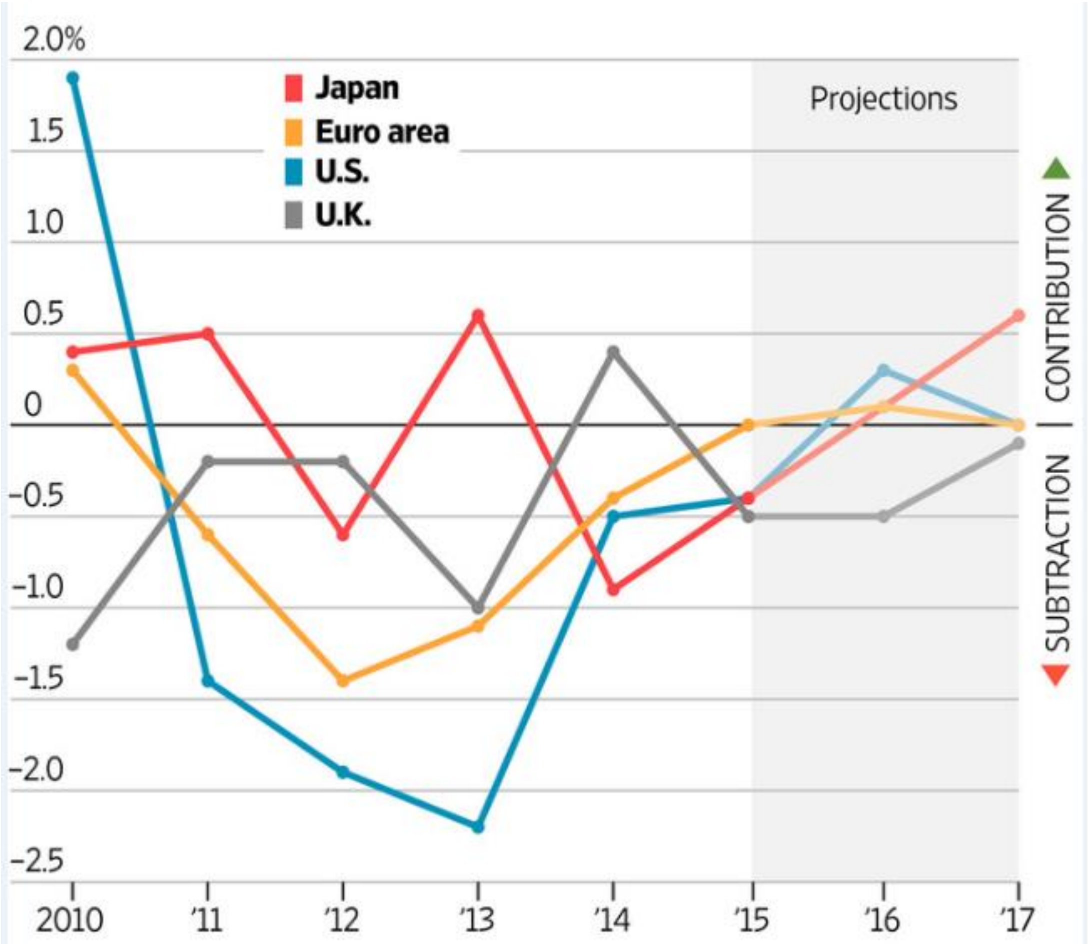
Source: The Conference Board; Ned Davis Research

While the third quarter's stabilization is encouraging, recent data suggests the economy is heading into the fourth quarter running at a somewhat subpar pace. Of particular note, the Institute for Supply Management (ISM) Non-Manufacturing Index for August dropped to its lowest reading since February 2010, indicating the services portion of the economy has lost significant momentum. Weak trends in fixed investment and temporary employment, both of which have historically shown a tendency to lead overall payrolls growth, suggest a generally strong labor market may be set to moderate as well.

Globally, the evidence is also somewhat mixed. The global OECD Composite Leading Indicator (CLI) registered its sixth straight gain in July to reach its highest level in a year, indicating brightening prospects for the global economy following a period of sustained deceleration and widespread concerns about the economic impact of Britain's "Brexit" vote to leave the European Union. However, the global CLI is still below its long-term average of 100, signaling growth is likely to remain below trend in the coming months. Emerging markets are providing some reason for optimism and it is noteworthy that all four BRIC (Brazil, Russia, India, and China) economies saw their composite leading indicators rise in tandem for five straight months, a first since 2009. The evidence, in aggregate, suggests the global economy has stopped deteriorating and a steady if not quite robust economic environment should provide a supportive backdrop for risk assets heading into 2017.

An important theme which could be greeted enthusiastically by markets heading into 2017 is a recent stealth turn in global fiscal policy into expansionary territory. In major developed market economies, long-term deficit concerns have resulted in fiscal policy (i.e. government spending) generally subtracting from near-term GDP growth since 2011. This appears set to change, as shown in the following chart.

Exhibit 2. Fiscal Policy Contribution to Growth



Source: The Wall Street Journal (09/14/2016)

In the U.S., partisan fights over the federal budget have been, at least temporarily, put on hold at the same time that the growth rate of state and local spending has been recovering toward pre-crisis levels. Concerns over the federal deficit and fiscal profligacy have been remarkably absent from this year's election rhetoric. This suggests that, regardless of the outcome of November's election, there may be a newfound willingness to pursue expansionary fiscal policy through increased federal spending and/or targeted tax cuts. Both presidential candidates have expressed support for a large boost to infrastructure spending, a possibility which could provide some support for equity prices in the coming quarters. Given already high levels of public debt and because fiscal stimulus may not reach its intended targets, increased government spending does not guarantee long-term growth, but the shift is likely to modestly boost short-term GDP measures and temporarily increase investor optimism.

Globally, Japan has recently indicated a willingness to de-emphasize concerns over its massive public debt in order to pursue new fiscal stimulus efforts. Ongoing large asset purchases by the Bank of Japan have diminished the amount of the country's debt load held by the public, helping alleviate concerns over the sustainability of its public finances. Similarly, Europe appears poised to shift away from the austerity measures that have characterized recent years, with even Germany seemingly ready to relax its stance. A global populist political wave, most emphatically represented by the "Brexit" movement in the U.K., also supports the view that global fiscal spending is likely to rise in the near-term.

Equity Markets

The year began with extreme volatility in the equities markets in the first quarter, which gave way to a trading-range environment in the second quarter. The third quarter saw a strong breakout in U.S. equities, with broad upside participation from global equity markets. The impressive breadth of this year's rally, including robust gains from emerging markets and U.S. small-caps, as shown below in Exhibit 3, has positive implications for the intermediate-term sustainability of the advance.

Exhibit 3. Equity Market Performance as of 9/19/2016

	Q3 2016 %	YTD 2016 %
Developed Foreign Equities - MSCI EAFE Index	5.0%	0.7%
Emerging Market Equities - MSCI Emerging Mkt Index	8.4%	15.6%
Global Equities - MSCI All World Index	3.5%	4.5%
US Equities - Russell 2000 (Small Cap)	7.3%	9.7%
US Equities - S&P 500 Index	2.4%	6.3%

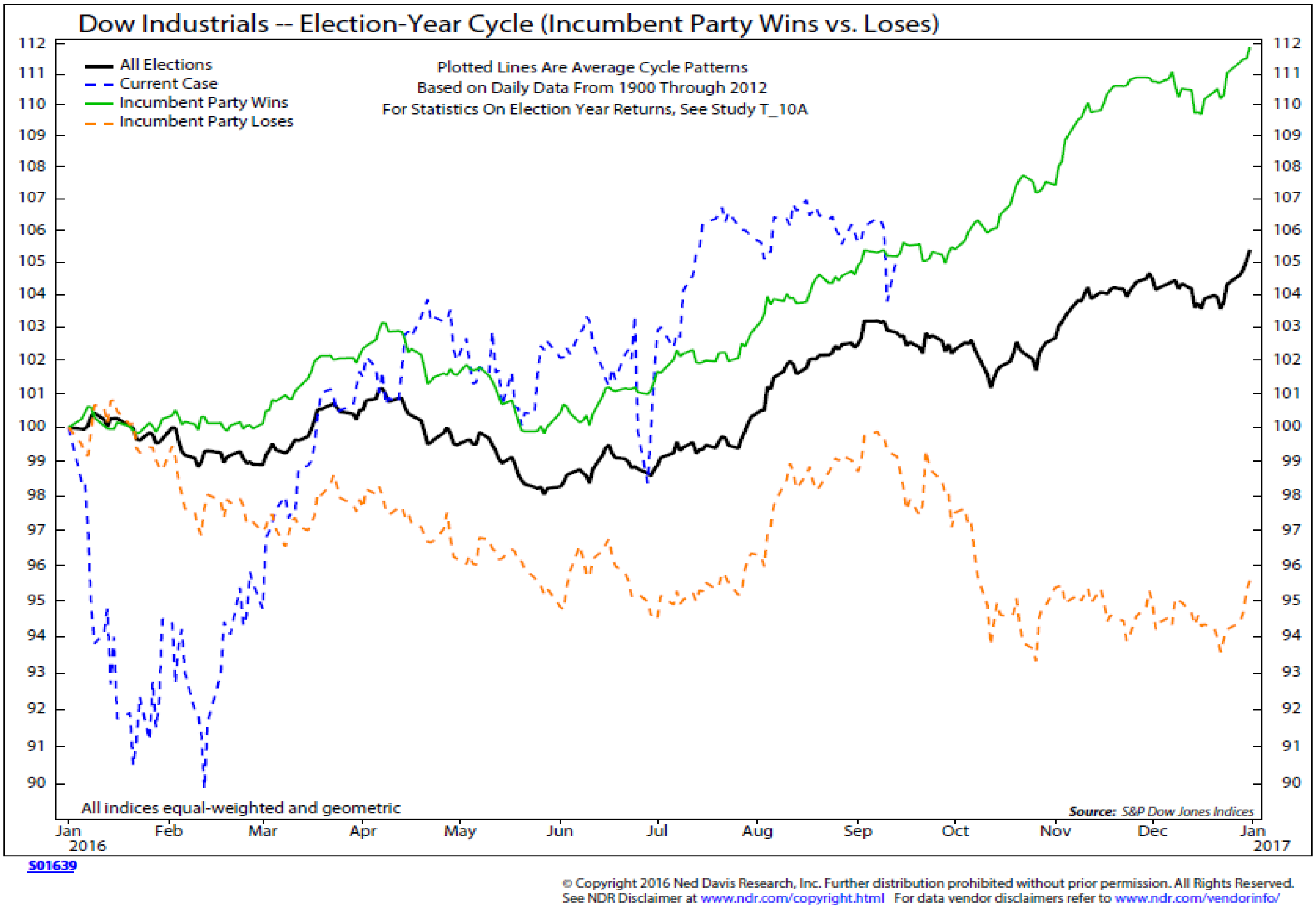
Source: Morningstar; as of 9/19/2016

Seasonality and the Election

One positive tailwind for equities in the fourth quarter is seasonality. Data compiled by Morningstar shows that stocks have done well historically over the final three months of the year with positive S&P 500 returns nearly 70 percent of the time in each month of the fourth quarter since 1980. However, election years have had a more nuanced seasonal track record, as shown in Exhibit 4. Historically, stocks have had stronger returns in the fourth quarter of presidential election years when the incumbent party wins and weaker returns when the incumbent party loses, possibly because investors have tended to be more comfortable with the status quo than with policy uncertainty.

As of September 18, Democratic nominee Hillary Clinton continued to hold a modest lead in national polls, which the historical pattern implies is bullish for stocks. A reversal in the polls followed by a win for Republican nominee Donald Trump may result in a somewhat weaker market environment in the fourth quarter. The longer-term impact on equity returns of whether the incumbent party wins or loses is much more ambiguous and is unlikely to alter our outlook for 2017 and beyond, unless very significant changes in public policy are enacted.

Exhibit 4. Dow Industrials Election Year Cycle



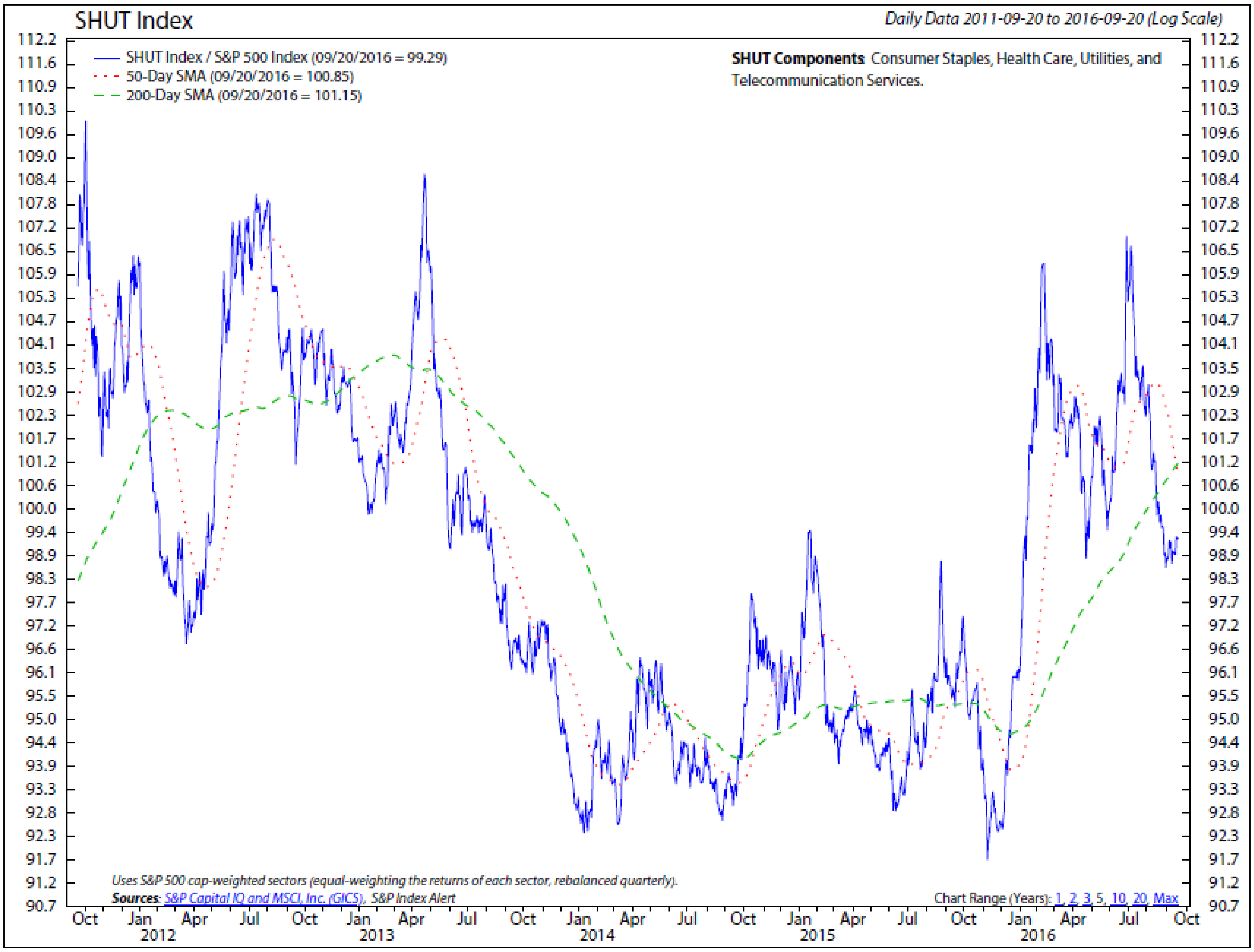
Source: Ned Davis Research

Change in Market Leadership

A notable positive for domestic equities worth mentioning is a recent change in market leadership. Over the past few months, investors have rotated out of defensive sectors and into more cyclical sectors that benefit when the economy is perceived as being healthy. Recent sector performance has been led by technology, financials, materials, and consumer discretionary stocks. After a strong first half of the year for less economically-sensitive sectors, consumer staples, healthcare, utilities, and telecom (known as "SHUT" sectors) have trailed the S&P 500 in the third quarter, as shown in Exhibit 5.

This change in sector leadership is important because it may reflect increasing confidence in the economic outlook and the sustainability of the current bull market. The impact on overall S&P 500 returns when economically sensitive sectors are leading is also much greater, due to relative sector weightings. For example, technology and financials, which have been two best performing sectors in the third quarter (as of 9/19), represent nearly 34 percent of the S&P 500 index. However, utilities and telecom, which led all sectors during the first half of 2016, represent only 6 percent of the S&P 500. Other 'risk on' asset classes have led the market during the third quarter, including U.S. small cap and emerging market equities.

Exhibit 5. Defensive Sectors Begin to Lag



Source: Ned Davis Research

Further Upside Likely

In our view, despite some ongoing long-term concerns, the weight of the evidence continues to support a cautiously optimistic positioning heading into 2017. The prospect of global fiscal policy turning from a headwind to tailwind for near-term growth is likely to be a net positive until deficits again become a concern and/or interest rates move markedly higher. Encouragingly, the global economy appears to have stabilized and investor sentiment has not reached the type of exuberance often seen at bull market peaks. An optimistic case for emerging market equities is also now justifiable, supported by improved current account positions, stable public debt levels, a range-bound U.S. dollar, and still attractive valuations which help mitigate concerns over alarming increases in private market debt.

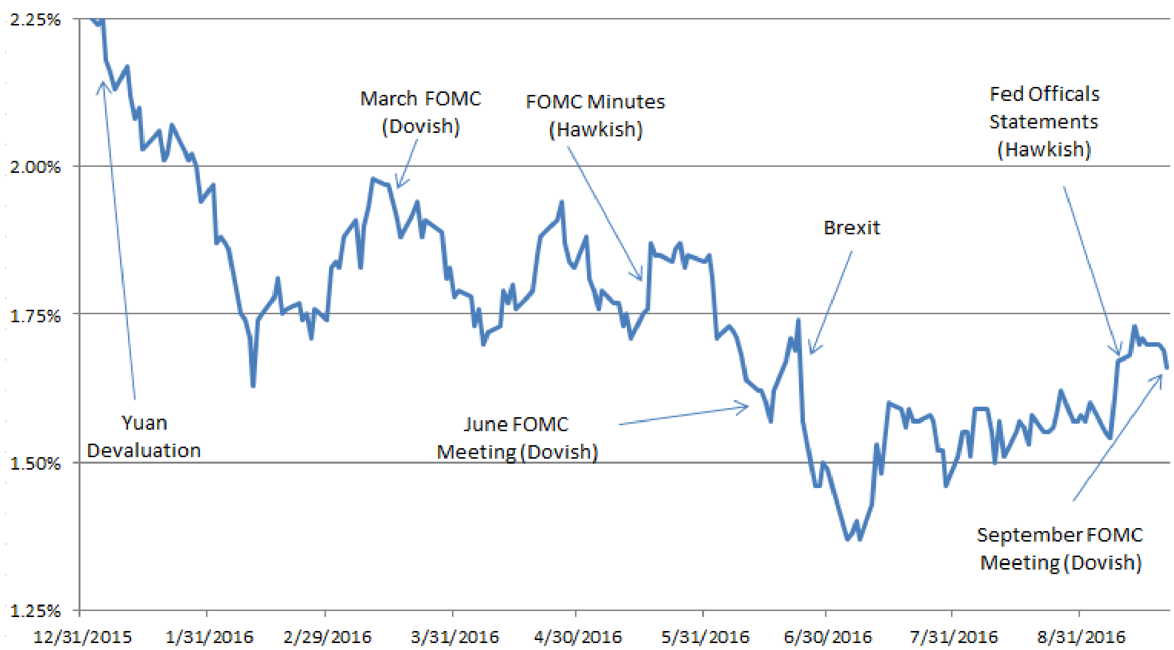
Along with seasonal tailwinds, these factors are likely to limit the magnitude of near-term corrections and should help keep equity markets in a slow grind upward during the fourth quarter. That said, economist Kenneth Arrow once noted that “vast ills have followed a belief in certainty,” and we live in highly uncertain times. In light of our longer-term concerns regarding asset valuations, very high global debt levels, including a recent surge in corporate leverage ratios, and a bull market getting long in the tooth by historical standards, we believe a moderate degree of caution remains advisable despite our generally optimistic near-term outlook.

Fixed Income Markets

Interest rate markets at the beginning of the third quarter were dominated by news surrounding the United Kingdom's vote in late June to leave the European Union. The global and U.S. fixed income markets witnessed a flight to safety in the opening weeks of the quarter, with the yield on 10-Year Treasurys hitting an all-time low of 1.361 percent in early July. After the initial decline in bond yields, investors became more comfortable with the likelihood that a global recession will be averted, given added central bank easing in continental Europe and in Britain, as well as continued accommodative policy in Japan and the United States. As shown in the Exhibit 6 below, bond yields trended slightly higher as result, with the 10-Year Treasury yield range-bound between 1.5 and 1.6 percent through early September. Thereafter, rates moved sharply higher to above 1.7 percent, following hawkish comments from U.S. Fed officials on September 9, which prompted an increase in the implied probability of a short-term rate hike. The fear of a rate hike faded gradually and, after the Fed announcement on September 21 to leave the Fed funds rates unchanged, the 10-Year yield stabilized around 1.60 percent. Looking forward, based on comments from the Fed, we believe the Fed is leaning toward a hike in December, but with a continuing bias toward a very gradual path of further hikes.

With Treasury yields rising, performance of longer duration U.S. government bonds is negative leading into quarter end.

Exhibit 6. 10 Year Treasury Yield



Data Source: U.S. Department of the Treasury

In summary, while this appears to be a tumultuous period for rates, yields are currently trading at levels similar to where they ended the first quarter of the year. Rates also remain well below levels from the beginning of the year, when they traded around 2.25 percent. Looking at the shape of the yield curve, a flattening which occurred mid-quarter corrected itself in September, and the quarter end reflected a parallel shift as the whole curve shifted up by roughly the same amount. The exception was the very front of the yield curve, where one-month Treasurys have moved very little since the beginning of July. Despite the fluctuation in yields this year, we continue to believe that yields will be range-bound over the long term and that, currently, we are probably near the middle of the range.

Investment-grade and below-investment-grade credit spreads (yield difference between similar maturity US Treasurys) narrowed during the quarter and are currently trading near one-year lows, but we should note that this is an elevated measure, as the one-year period excludes a rate widening that began last August. Looking longer term, spreads are close to averages and respectably above the multi-year lows seen in 2014. Despite the move higher in Treasury rates, the narrowing of credit spreads this quarter offered support to credit-sensitive bonds. Sectors with more credit exposure fared well, and below-investment-grade/high yield bonds performed better than investment-grade bonds for the quarter. In our view, credit spreads are reasonable now and probably toward the center of their range. From this point on, spread tightening may offer only a modest cushion to rate increases, as increased corporate issuance may offset the still high demand from investors in search for yield. As growth remains positive, inflation subdued and financing rates are reasonable, we believe that below-investment-grade/high yield bonds may still have potential to outperform. We continue to favor credit, as the extra yield from the credit risk can buffer against rising interest rates.

News sources may suggest we are in the later stages of the current credit cycle, but this cycle has been extended by the extremely accommodative central bank stances around the globe. Economic growth in the U.S., albeit slow, will likely persist and we have not observed elevated corporate risk taking as evidenced by the leveraged buyouts that we have seen at the end of prior cycles. Since the financial crisis, companies and investors have been more cautious. There is a fairly recent trend of companies increasing leverage, so this is something we are watching, but we feel credit is still attractive relative to Treasurys.

From an interest rate sensitivity perspective, we continue to prefer below-benchmark duration. Although the shorter end of the curve may be more volatile, its sensitivity to rising interest rates is lower. The market has priced in little inflation risk, but there is a likelihood that inflation may move modestly higher from here, as the influence of 2015's depressed energy prices fades in the coming months. Shorter-dated portfolios may also be less sensitive to inflation surprises and this is another reason we prefer to keep a higher proportion of portfolios in short-term bonds.

The municipal bond markets continue to benefit from high retail demand. Municipal bonds are attractive for investors in higher tax brackets, but there currently does not appear to be any substantial cross-over opportunities for non-taxable accounts. Fundamentals remain strong for municipals as economic improvement and higher employment are boosting the coffers of local and state governments. However, municipal bonds have higher duration in general and remain sensitive to interest rates, so a rapid rise in rates would impact this market more than Treasurys. A slower moving, somewhat range bound environment in rate increases, as we expect, may limit some of the municipal bond gains going forward, but is unlikely to be detrimental to the sector's returns.

Over an extended period of time, foreign bonds may offer diversification from rising U.S. interest rates. Negative and zero interest rate policies around the globe are a concern, though. The BOJ recently announced its new policy to focus more on the yield curve, keeping the 10-year part of the curve near zero, the front-end negative and the long-end positive. This may limit the application of negative rates as policy. But we should note that the policies applied are still experimental and, as central banks tinker with new approaches, there may be higher potential volatility in the international markets. The US dollar has stabilized (dollar strength over the past couple years were a headwind), but with yields at these levels, foreign bonds can be relatively unattractive.

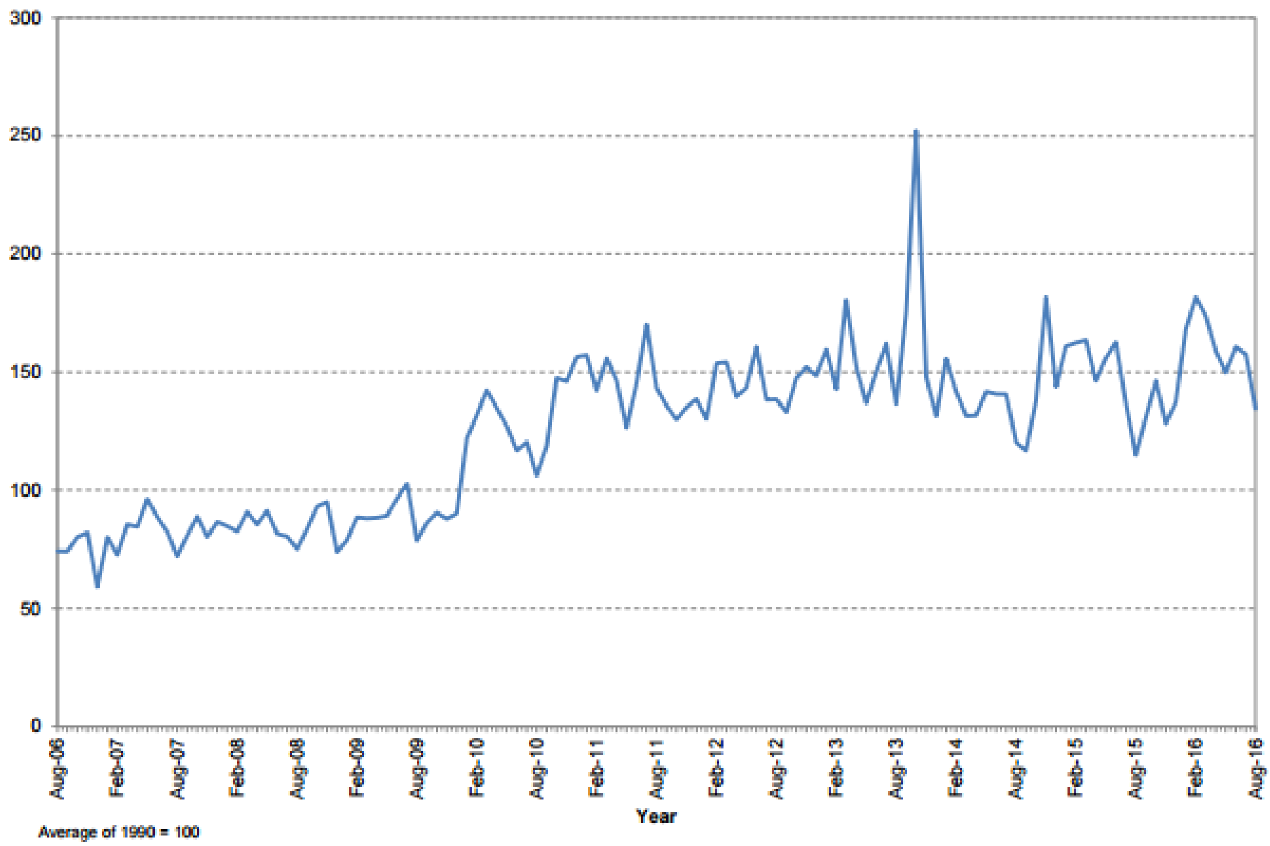
Risks to Our Outlook

The current state of the global economy and financial markets may be succinctly described as resilient, yet fragile. Throughout 2016, investors have teetered between optimism and pessimism while trying to make sense of mixed economic data, geopolitical events and central bank policy. At the start of the year, debates over Fed policy trajectory, a global economic growth slowdown and a collapse in commodity prices ruled conversations. Over the past two quarters, markets have moved higher as central bankers reaffirmed their commitment to accommodative monetary policy. Economic output has trended lower yet stayed positive, and global interest rates have remained historically low. With risks dissipating, major domestic indices have all posted record highs. Further declines in S&P 500 earnings and revenue and a surprise vote by the U.K. to leave the European Union on June 23 did little to unsettle the upward path. In looking forward, we are optimistic, but are mindful of the following risks:

Politics

- On the ballot, we have two presidential candidates with very different opinions on policies that could potentially influence the economy. If polls remain close going into November 8, there stands a chance for a meaningful drag on economic output in an already fragile environment. Some estimate - especially in elections where there is a vast difference on policy and platforms - growth could be reduced by as much as half a percentage point per quarter. This uncertainty has significant influence over consumer spending habits and corporate willingness to invest ahead of potential new tax rules or government regulations.
- The current state of political uncertainty can be seen in the Federal Reserve Bank of Philadelphia Partisan Conflict Index. The index measures the frequency of political disagreements at the federal level by the frequency of newspaper articles. According to the index creators, a spike in the reading can equate to a monthly private business investment decline of 1 percent. An uptick in this index may signal economic weakness ahead. Exhibit 7 below shows the current elevated reading of this index and the high-water mark set during the 2013 fiscal cliff government shutdown.
- In 2017, there are influential elections taking place internationally. France is set to hold presidential elections in the Spring, and Germany will hold general elections in the Fall which could test public confidence in Chancellor Angela Merkel. Merkel's re-election is arguably one of the most important in the European Union, as she has been a pillar of stability for Germany and the overall region.

Exhibit 7. Partisan Conflict Index (August 2006-August 2016)

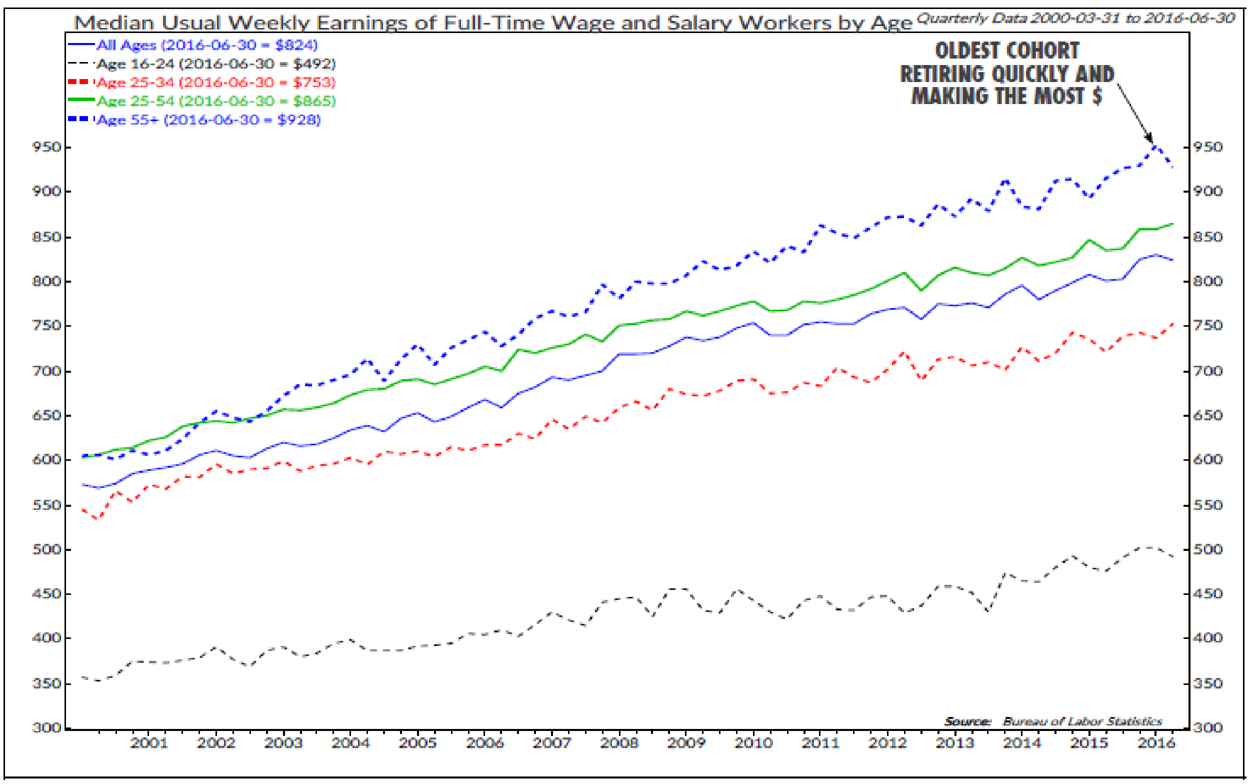


Source: The Federal Reserve Bank of Philadelphia, August 2016

Global Growth and Central Bank Efficacy

- As discussed in our previous outlook, the central bank toolkit is running low and some are questioning whether policy makers still have the power to stave off a future economic downturn, given the already low range of interest rates.
- The Federal Reserve conveyed that the case for a rate hike had "strengthened", and our expectation is that they will increase the target federal funds rate at the upcoming December meeting. However, domestic and global economies remain on delicate footing and the effectiveness of central bank policies is in question.
- Domestically, U.S. GDP only grew 1.0 percent in the first half of this year, and the sharp declines in August ISM manufacturing and non-manufacturing readings are signs of weakness.
- Wage and income growth has been slower than desired. The domestic labor market, although certainly adding jobs, has not created high-paying opportunities. The Bureau of Labor Statistics projects half of the 10 fastest growing jobs will pay less than $25,000 a year, and the pay for 75 percent of these jobs will not exceed the mean annual wage of $35,540. Exhibit 8 below shows that people making the most money are rapidly retiring. Both these trends in the labor market may suggest that inflation is unlikely to reach the Fed's 2.00 percent mandate in the near future.
- Japan's mixed monetary policy has done little to stimulate growth or increase inflation (or inflation expectations). Following their September meeting, BOJ officials moved to a more experimental monetary policy, as they announced their new objective to overshoot their 2 percent inflation target. Results remain to be seen, but as efforts continue to fall short, market participants grow skeptical of this and other central banks' ability to stabilize markets.

Exhibit 8 Median Usual Weekly Earnings of Full-Time Wage and Salary Workers by Age



Source: Ned Davis Research

Investment Implications

Historically, election years deliver a volatile, but sideways market in the first half of the year, followed by strength in the second half. We would see any material sell-offs heading into the election as an opportunity to deploy any capital sitting on the sidelines. Without a domestic recession, we expect the secular bull market to continue, albeit with more measured gains. We believe we will be bound within a trading range, but that we will still see some modest upside for the year. We would not recommend drastic deviations from long-term stock/bond targets.

Slow economic growth may continue to favor growth over value styles. However, this is the longest run of growth outperforming value since 1969, and value is growing increasingly attractive on a relative basis. We also see sector rotation as an important theme, as money flows out of expensive sectors, such as staples and utilities, and into cheaper sectors, such as healthcare, technology and financials. Higher rates and a steepening yield curve should be a tailwind to financials as well. At the beginning of the year, there was a rush into equity income-proxies like telecom and utilities. As the return of capital to shareholders becomes an important part of total return in slower growth periods, we still like dividend-paying equities but, as valuations become increasingly stretched in some areas, we favor exposure through an active manager.

Despite the Fed hiking cycle, we still see interest rates as "lower for longer." However, given sub-1.75 percent rates in the short-term, the greater risk is to the upside so some caution is warranted regarding interest rate sensitivity. While interest rates remain low, there is a risk of building inflation pressures, which may present opportunities in commodities and/or inflation-protected securities. Also, given potential volatility in equities, we see good risk/reward opportunities in high yield and floating-rate bonds, given potential credit spread contraction.

Globally, central bank stimulus should not only provide a floor for markets to protect against significant downside, but it may also contribute to volatility as unconventional policies are deployed. The stabilization of energy prices and of the US Dollar should provide opportunities in Emerging Markets, which may be poised to rebound following a lengthy period of underperformance.

Central bank efficacy is increasingly being questioned. As many reach practical limits on what they can buy within their current mandates, interest rates have risen and become less negative overseas. Over the past five years, domestic equities have outperformed international equities by the widest margin since the period from 1996-2000. Given more accommodative central bank policies in Europe and Japan, coupled with better valuation and earlier stages of economic recovery, we would expect some mean reversion with more opportunity in international markets for the long-term.

Lastly, the third quarter of 2016 was characterized by historically low levels of volatility. With the U.S. election and many important central bank decisions ahead, we believe volatility will increase in the fourth quarter. Implementation of new regulations may also contribute to increased uncertainty. Any increase in volatility, however, should provide opportunities for active managers to add value and outperform.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

Glossary

MSCI EAFE Index *(Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.*

MSCI Emerging Markets Index *is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.*

The ***MSCI World Index*** *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.*

Russell 2000 Index *measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

The ***S&P 500*** *is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

The Conference Board ***Leading Economic Index*** *is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables.*

The ***ISM Manufacturing Index*** *is an index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.*

Federal Reserve Bank of Philadelphia Partisan Conflict Index *tracks the degree of political disagreement among U.S. politicians at the federal level by measuring the frequency of newspaper articles reporting disagreement in a given month. Higher index values indicate greater conflict among political parties, Congress, and the President.*