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Central Banks Trump the Election

As the third quarter comes to a close, most investors are likely to turn their attention to what they perceive as the biggest factor to drive fourth quarter financial markets: the presidential election. While events in Washington definitely have an impact on returns, the bigger driver is likely to be global monetary policy.

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 keeping rates on hold 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.

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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 playing bull market by historical standards, we believe a moderate degree of caution remains advisable despite our generally optimistic near-term outlook.

For the fourth quarter, we believe that the markets may be range-bound, and there may still be upside left. As a result, we do not recommend drastic deviations from long-term stock/bond targets. Within stocks, we still favor domestic equities; however, opportunities in emerging markets have increased. Within fixed income, we continue to maintain a somewhat defensive position.

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