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THIRD QUARTER 2016 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a tumultuous start to this year and a strong rebound this spring, the stock market was unusually calm during the summer months. In fact, market volatility was near historic lows and trading volume was down considerably. Even the early-summer stock market plunge that occurred after Great Britain decided to leave the European Union was short-lived and the benchmark S&P 500 Index did not see a daily 1% price move, up or down, during most of July and August.

Volatility increased in September due to uncertainty regarding the upcoming elections as well as the possibility that the Federal Reserve Board could potentially raise interest rates again soon. Fear of rising interest rates was also one of the primary reasons the stock market declined last fall and earlier this year. Investors also became concerned that central banks around the world may stop buying bonds with printed money as this monetary policy no longer seems to be stimulating economic growth. The volatility that occurs each time central banks discuss ending accommodative monetary policies is a reminder of the extent that stock and bond market gains are reliant upon support from central banks. Despite this short-term volatility, the S&P 500 Index ended the third quarter up 6.1% year-to-date, while the Dow Jones Industrial Average gained 5.1%. Bonds have also performed well so far this year, as the Barclays Intermediate U.S. Government/Credit Bond Index was up 4.2% year-to-date as of September 30, 2016. *

Although the upcoming Presidential and Congressional elections could give rise to additional market instability, the stock market may continue to appreciate as investors begin to look forward to better economic growth in 2017. The stock market is typically forward-looking and investors tend to forecast future economic growth (or recession) six to twelve months in advance. The reason that stocks often appreciate if the economy is expected to improve is that an expanding economy usually leads to better corporate earnings. This tends to be true over long periods of time even while interest rates are rising gradually or political uncertainty creates anxiety among investors. Therefore, even if the stock market declines due to worries about the outcome of the upcoming elections, it is possible that much of the election uncertainty is already priced into stocks, and politics could take a back seat to the anticipation of stronger future earnings growth.

One reason that economic growth is likely to accelerate next year is that oil prices continue to remain very low. Earlier this year, oil prices plunged as OPEC countries oversupplied the oil market in an attempt to drive U.S. oil-drilling companies out of business. Additionally, countries like Iran and Libya have been increasing their domestic oil production. While the supply of oil remains high, oil prices have remained depressed, and low oil prices have historically acted as a stimulus for the global economy in the following months and years. This is because low oil prices reduce energy costs for individuals, corporations, and importing countries. Money saved on energy costs should soon be spent on goods and services, which should lead to better economic growth.

In addition to low oil prices, relatively low interest rates for the foreseeable future should continue to provide support for the stock market. One of the main reasons the stock market recovered from the 2008 financial crisis was because the Fed lowered interest rates to near-zero immediately afterward and has only raised them once by 0.25% since then. Low interest rates may be good for borrowers, but they are not helpful for fixed-income investors who continue to earn very low yields on CDs, bonds, money market funds, and savings accounts. Over the past several years investors have been forced to allocate more money from bonds to stocks in search of higher rates of return. Although the Fed may raise interest rates nominally in the short-term, due to economic and geopolitical problems throughout the world, they are not likely to begin raising interest rates aggressively until they are forced to do so by rising inflation. The good news is that inflation is not expected to accelerate for many more months. Therefore, despite recent talk that the Fed could raise short-term interest rates gradually, interest rates are not likely going to rise significantly enough for fixed-income investments to provide competition for stocks for a long time.

Another reason for optimism over the long-term is that the stock market rallies that took place after the beginning-of-the-year plunge and after the decline caused by the "Brexit" were both broad-based. By contrast, over the past several years, only certain large company stocks appreciated while the broader stock market lagged. A sign of a healthy stock market is when the majority of stocks, including small- and mid-size companies, are advancing on a daily and weekly basis. A sign of a weak uptrend is when fewer and fewer stocks are rising, even while stocks of the largest companies continue to appreciate. The fact that small- and mid-size company stocks have performed well this year, rather than only a few large corporations, is a good sign of strong market breadth, which bodes well for the future.

To summarize, volatility caused by uncertainty regarding the upcoming elections and central bank policies could create additional market instability this fall. However, a significant bear market is not likely to begin until the Fed starts raising interest rates aggressively, oil prices start to rise significantly, the broad stock market becomes overvalued, or investors become overly optimistic. In the meantime, we currently favor U.S. stocks over foreign stocks, as the U.S. financial markets appear to be more stable and reliable than the financial markets of most foreign countries. While it is nice to see emerging markets stocks recover lately, it is too early to trust that the emerging markets stock rally is sustainable. We are hopeful that small- and mid-size companies will continue to perform well, along with the broader stock market, after underperforming over the last several years. Regarding fixed-income investments, we continue to favor short-term bonds over long-term bonds, as the yield curve remains relatively flat. This means that long-term bonds do not yield much more than short-term bonds and they carry additional interest rate and credit risk when rates do start to rise.

As always, please call us if you have any questions or concerns regarding your personal financial situation or the financial markets in general.

** Index returns were obtained from the Wall St. Journal and Barclays on October 1, 2016.*