Market Commentary

Third Quarter 2016

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The third quarter was another positive one for US equity markets, although all the gains were achieved in the first half of the quarter before backing and filling for the remainder. The benchmark S&P 500 Index had a total return of 3.86% during the third quarter which brought the nine-month total return to 7.84%. After opening the year with a 10% sell-off, US equities have rallied faster and farther than most had projected. These quick short-term movements further substantiate our disdain for market-timing strategies. Looking at fixed income, yields continued to hover near multi-decade lows in much of the developed world. The relative attractiveness of US bond markets relative to those globally caused the yield on the benchmark 10-year US Treasury Note to stay near record low yields during much of the quarter. The 10-year note yielded 1.60% on September 30, 2016, slightly above the 1.49% yield at the end of June. Returns for fixed income holdings were positive again during the quarter, with better returns registered by lesser credit qualities.

Economic and Market Outlook

With all eyes on central banks around the world, investors are losing confidence that the banks can be as effective as they were historically in pulling the correct levers to move inflation and/or employment in the direction they would like. Many have opined that central bankers are making it up as they go along. We believe part of the issue is that during the financial crisis in 2008/2009, bankers believed their extraordinary measures would only be needed short-term. However, with no appetite for fiscal policy changes in the developed world, these extraordinary actions have lasted for most of the past decade and have become entrenched in the global mindset. The markets have become conditioned to believe the Federal Reserve is short-term data dependent, although nobody has an idea as to what data the Fed is looking at. It is very difficult to stimulate an economy that is facing structural headwinds. Additionally, the Fed seems to be trying to compensate for the lack of desire by the legislative and executive branches to enact structural reforms on fiscal policy. This, along with vastly increased regulatory encumbrances is keeping a lid on potential economic growth in our opinion. The last several years have seen a growth-stifling wave of regulatory controls. In sectors as diverse as banking, telecommunications, and healthcare, regulatory burdens have reduced productivity and dampened the "animal spirits" of corporate management teams to expand and invest.

Markets have been marking time for most of the past six months caught between the cross-currents of stagnant earnings growth, a Presidential election, and a Fed that seems to change its mind on interest rates almost daily. Earnings growth for the S&P 500 as a whole is expected to resume in the fourth quarter of 2016 and continue throughout 2017. In fact, when taking out the energy sector which has seen its earnings decimated from the sharp decline in crude oil prices, earnings growth has remained positive for the remaining 92% of the S&P 500 for each of the past two years.

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With less than three months remaining in 2016, the Presidential election is the largest uncertainty facing investors. As we head towards the most hotly contested US Presidential election in decades, we continue to believe that investors view a Clinton victory as status quo for markets. Presidents actually have far less direct control of the economy than most believe and get far too much credit or blame. Congress holds the purse strings and thus can do more to effect economic events. Tandem believes Republicans will keep control of the House and possibly the Senate. This means a split government (Republican House, Democratic President, and uncertain Senate) is a likely result so no “major” reforms would be expected regardless of which candidate wins the election. We believe the major differences between a Clinton presidency and a Trump presidency would be mostly on the regulatory front. Markets abhor uncertainty, so the conclusion of the election season will most likely result in less volatility in the capital markets. As the election draws closer, if Clinton maintains her lead, we believe markets will accept this and volatility will remain subdued.

An agreement by OPEC to reduce oil production was discussed during the final week of the quarter, helped energy prices continue to rebound from the multi-year lows reach earlier this year with WTI crude closing the quarter at $48.06 per barrel. We do not see the supply/demand factors that would lead to a continued substantial increase in oil prices from these levels. 2017 prices should be in a range of $40-60 barring any unforeseen geopolitical events. There are far more beneficiaries from low oil prices than those that are negatively affected so we believe this continues to be a tailwind for the consumer and economic activity both in the US and abroad.

Portfolio Positioning

The two areas we receive the most questions about are stagnant earnings growth and current valuations. Earnings growth has been better than reported when excluding the volatile Energy sector. In fact, although the S&P 500 companies have reported six consecutive quarters of declining earnings, all but one of those quarters would have seen positive earnings comparisons when excluding Energy. With the strength in the US dollar subsiding and energy prices stabilizing, we expect earnings growth to resume in 2017, providing support for higher equity prices. Valuation is a bit more complicated, but essentially revolves around our belief that we have endured a rolling bear market through many industries and sectors over the past 12-18 months. Most recently, we have observed high-yielding stocks sell off during September as concerns of an imminent rate hike caused investors to review their holdings in these names. Through these periods of cross currents, we believe a portfolio of companies with strong balance sheets, the ability to increase dividends, and well-run management teams will best serve investors over the long run. Based on this, we have made minimal changes to portfolios during the past few months.

Conclusion

We believe investors are in a wait and see approach regarding the election, interest rates, and earnings. Stocks have moved in a narrow range for the past few months. Once the election is behind us, we anticipate more clarity on both the Fed’s next move as well as corporate earnings. As always, we welcome feedback from our clients. Please call or email us if you have any comments or questions about your investment portfolio.

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