SIGNATUREFD

Fall 2016

MARKET SENSE:
Quarter Surprises on the Upside

The third quarter began with the uncertainty over the Brexit referendum vote in the United Kingdom on the minds of investors. Markets suffered a short, but meaningful, tailspin in late June, but they had already partially reversed this move at the beginning of the quarter. The markets continued their recovery in the early part of the quarter and held onto most of their gains through the end of September. For the U.S. market, the highest levels of the quarter—and, in fact, new record highs—were achieved in mid-August. The markets were slightly lower by September 30 but still within 1% of record levels.

Outside the core U.S. equity markets, returns were generally even stronger. The Nasdaq, small cap U.S. and international markets all outperformed. These returns ranged from 5% to 10%, with the emerging market countries and small cap U.S. providing the strongest returns. Fixed income markets confirmed the “risk-on” environment: Lower-rated, high-yield bonds rose more than 5%, while investment-grade core fixed income in the U.S. was generally flat. The yield on 10-year Treasuries ticked higher to 1.61% from 1.49% on June 30.

For a review of major market indexes over the recent period and the past year, please see the table below.

	3rd Quarter	52 Weeks
S&P 500	3.85	15.43
Dow Jones Industrial Average	2.78	15.46
MSCI EAFE (International)	6.43	6.52
MSCI EM (Emerging Markets)	9.03	16.78
Bloomberg Commodity Index	-3.86	-2.58
Barclays Global Aggregate Bond Index (Global Bonds)	0.82	8.83
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	0.46	5.19
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	-0.02	2.98
HFRI Fund of Funds Composite Index	2.54	0.61

IN SPITE OF THE BREXIT OUTCOME, WE CAME INTO THE QUARTER MODESTLY OVERWEIGHT GROWTH INVESTMENTS FOR MOST CLIENT PORTFOLIOS.

WE REMAIN BULLISH FOR NOW …

In spite of the Brexit outcome, we came into the quarter modestly overweight growth investments for most client portfolios. This positioning was rewarded as the quarter progressed and markets advanced. Early in the year, we wrote that the two primary risks to markets in 2016 centered on policy mistake potential by either the Federal Reserve or China. At their December 2015 meeting, when implementing the first rate hike of this cycle, the Fed communicated to markets that they expected an additional four rate hikes in 2016. If they had implemented these hikes, it would have certainly triggered market declines and very possibly a recession. To date, zero increases have occurred this year, though in our opinion one is probable in December. The risk of recession is lower now, we believe, given the market's expectation for a slower pace in hikes. As for China, policy action in late 2015 and early 2016 gave rise to a growing view that a substantial devaluation of the yuan was being considered. Since the February market lows, data in China has mostly stabilized and the yuan is down a negligible 1% against the dollar.

As these risks subsided over the quarter, equity and other risk markets trended higher. Broad global equity markets are up nearly 20% since early February, while small cap U.S. and emerging markets have surged more than 32%. The Brexit vote also ignited expectations that policymakers would push back against the populist movement by unleashing new rounds of fiscal stimulus—infrastructure and other spending programs. Japan has already acted, and both major U.S. presidential candidates are talking about it. Finally, politically injured leaders in Europe need to boost their economies ahead of elections in 2017, and they will likely expand spending.

Can markets continue to move higher? Our answer is yes, with caveats. The primary reason for our outlook? We believe that investors remain too cautious and underinvested. Here are a few key observations to make our point:

- **Global valuations reasonable:** While valuations across many pockets of the U.S. equity market are at, or in some cases above, fair market value, valuations in many global regions remain relatively favorable. Stock markets in Europe, Japan and emerging markets all trade below 15x earnings and 1.2x sales. These are levels around their historical averages. We actually believe valuations could overshoot fair value higher due to the "relative value" versus fixed income. In short, fewer opportunities may push more capital toward equities and drive up valuations.

- **Technical dynamics favorable:** Remember supply and demand lines from Econ 101? This basic equation matters for the stock market as well. One can assess the volume of buyers versus sellers in the market and compare them to determine which is creating the marginal pressure. In recent weeks, buyers have been overwhelming sellers, and this pressure is currently at the strongest level since September 2014. This indicator correlates well with rising markets and tends to persist once trending.

- **Lack of "investor exuberance" typically associated with market tops:** There have been significant outflows from equity funds in recent months. So far in 2016, total U.S. equity outflows have totaled more than $50 billion. Perhaps counterintuitively, this has historically been a favorable dynamic for future equity returns. Most markets don't peak without retail investor participation, and the market has historically been most at risk following periods of significant retail investor participation. Moreover, it is not a secret that active managers have been lagging recently. By some estimates, as much as 85% of equity strategies have failed to beat their indexes in the recent past. This creates tremendous pressure to chase the market in an up move.

- **Coordinated economic stability:** For some time we have viewed the economic glass as half-full. It sometimes feels that this stance is a mistake, but we continue to think this way. In fact, we believe that there is a decent chance of a synchronized global growth period for at least the next several quarters. Data in Europe, even after Brexit, is surprisingly good. Japan is implementing plans to give Abenomics another boost. China has stabilized and is even showing hints at growth, as are other emerging economies. Several leading indicator indexes in the U.S. have recently hit levels not seen since 2013. A word of caution, though: The headwinds that have been buffering long-term growth remain, and we aren't predicting a 1990s-style growth occurrence. However, even a short period of synchronized growth that exceeds expectations would be a surprise to most and could be the trigger for another leg up in growth assets.

- **Favorable credit market dynamics:** The credit markets remain healthy. We watch credit closely, as it often gives leading warning about problems. There were pullbacks late last year and into the first quarter, but since then markets have improved notably—in fact, possibly too much. One noted high-yield investor we recently met with believes that junk bonds are yielding 2.5% less than they should at this point in the cycle. But it is not just high yield. A wide swath of bonds (including mortgages, high-quality corporates and emerging markets) is trading at yields below historical norms (and prices higher than normal). Economies don't typically retreat when credit is widely available at below-average prices, which is where we are today.

- **Historically positive presidential cycle:** Finally, the presidential cycle remains in our favor. While we would never invest solely based on historical patterns, we are encouraged that the cycle is lining up with a period of fundamental strength. The first year of a new presidential cycle is typically higher through summer. After that, the weakest period of the cycle runs from the middle of the first year through the mid-term elections (which will be November 2018 in this cycle).

... BUT CHALLENGES REMAIN FOR LONG-TERM RETURNS

Even though the base case is positive, we are aware of higher-than-normal risks. As we discussed, equity asset valuations are fairly valued (i.e., not significantly undervalued), interest rates are at historic (possibly all-time) lows, debt levels are high, European banks are struggling, a Chinese hard landing remains possible and geopolitical risks abound. In their September outlook piece, the investment team at PIMCO characterized things as "Stable But Not Secure." Of course, no one can predict the catalyst or the timing of moving to unstable, but we can be prepared for when change occurs.

We discussed above the reduced risks from China and the Federal Reserve. As for other risks, markets don't usually succumb to elevated valuations or high debt without a trigger. That leaves an interest rate shift, European banks and geopolitical issues as our primary concerns. We will touch on these three now.

EQUITY ASSET VALUATIONS ARE FAIRLY VALUED, INTEREST RATES ARE AT HISTORIC LOWS, DEBT LEVELS ARE HIGH, EUROPEAN BANKS ARE STRUGGLING, A CHINESE HARD LANDING REMAINS POSSIBLE AND GEOPOLITICAL RISKS ABOUND.

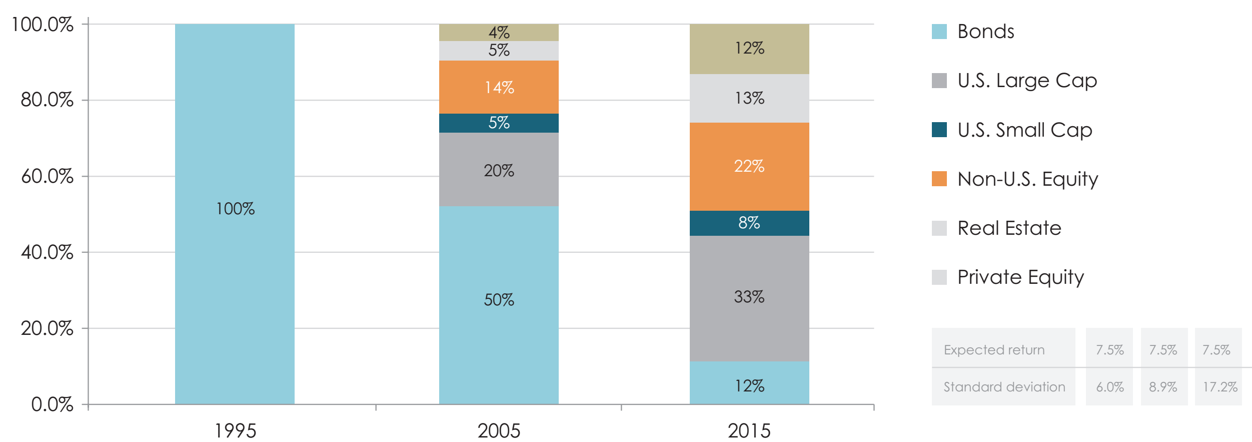
- **Low interest rates:** The current level of interest rates is likely the most significant risk today. Rates have been trending lower for decades but recently took a sharp drop, to zero and below. Several central banks have instituted negative-interest-rate policies, which have had limited positive impact and arguably have, on balance, been disruptive. The continuing use of nonconventional policies has raised many questions about the credibility and efficacy of central bank policy. Without credibility, an effective response to a future crisis could be difficult. The addition of fiscal policy to the current framework could create a rapid increase in growth and inflation expectations, investor risk attitudes and interest rates. By some analysts' calculations, a global rise in interest rates of as little as 0.5% could trigger a change in investor attitudes and bring down investment values on almost all assets. Of course, higher returns tend to be self-correcting, as they would themselves slow down growth and reduce inflation pressures, so we still don't see a major shock. However, markets are complex and investors don't always act rationally, so we need to be alert to this scenario.

- **European banks:** European banks remain a concern, but they don't appear to pose systemic risks at present. Though the International Monetary Fund ranks Deutsche Bank (the center of the current storm) as the most systemically important bank in the world, its problems don't appear similar to 2008's issues. That the bank will need to raise additional capital is assumed by most. But Deutsche Bank appears to have enough liquidity given changes to large bank funding models and the programs developed by the European Central Bank since the financial crisis. Further, the market doesn't currently suffer from the type of ill-fated investments that existed during the run-up to the mortgage crisis. And lastly, given the short distance from the collapse of Lehman, we find it hard to believe that governments would let a bank at least four times in size go without support. Certainly, the markets are thinking similarly, as stress levels in the bank financing sector and credit markets in general are not signaling investor panic.

- **Geopolitics:** Geopolitical risks are too numerous to detail, so we will focus on just two. First, the move toward populism is a global phenomenon and doesn't show signs of stopping. We will touch on the U.S. election below, but similar moves are happening elsewhere, especially in Europe. The Brexit vote took most by surprise, but it has elevated the importance of other upcoming votes in Europe. In December, Italians will vote on constitutional reforms that some see as a proxy for EU membership. Spain has had two failed elections and has yet to put together a coalition government. There are also leadership elections in France and Germany in 2017. The second risk is military conflict in East Asia. Tensions in the area have continued to rise, and some type of engagement, though unpredictable, would create global market fears given the size of the region's economies and the importance of these markets to global trade.

Of course, none of these concerns can be part of a base case for investors, so possibly the highest risk currently is altogether different: persistently low future rates of return. Slow growth and high valuations can place a lid on future returns, and these low returns can create a negative feedback loop requiring investors to save more to compensate, thereby slowing the economy further. This dynamic impacts the decisions of individual investors, pension plans, endowments and insurance companies. *The Wall Street Journal* did a great piece on this subject a few months ago. Their data—which can be seen in the table below—compares the risk and portfolio allocation needed to earn a 7.5% return (the baseline used by many pension plans) in 1995, 2005 and 2015. Twenty years ago, an investor could hold a portfolio of 100% bonds and be required to accept annual deviation of 6% to earn the 7.5% return. In 2005, an investor allocation to fixed income would have needed to drop to 52% with various equities making up the difference, resulting in deviation of 8.9%. By the end of 2015, an investor would need to reduce bonds to just 12% with the remaining 88% in riskier assets, including 25% in private investments, which would force deviation to 17.2% versus the 6% from 1995. To earn the same return in the current environment, an investor would need to take on 2.9 times more volatility compared with 20 years ago.

Estimates of What Investors Need to Earn 7.5%



Source: Timothy W. Martin, "Pension Funds Pile on Risk Just to Get a Reasonable Return," *Wall Street Journal,* May 31, 2016, www.wsj.com/articles/pension-funds-pile-on-the-risk-just-to-get-a-reasonable-return-1464713013.

Essentially, falling interest rates are forcing investors to take more risk to maintain a level of expected returns. We are seeing investors stepping out the "risk spectrum"—from cash to bonds to junk bonds to stocks, etc., to try to find return. This can work for a while (while the tide is coming in) but could leave many investors overexposed to risk during the next correction.

Our approach is to resist the urge to add more risk than is prudent but continue to look for opportunistic investment opportunities to drive returns.

ELECTION AND BEYOND

Understandably, we get many questions on the U.S. presidential election and its potential impact on the markets. Given the timing of this letter, it makes sense to touch briefly on the subject. As we write this in early October, and just a week after the first presidential debate, the polls are skewed in favor of Hillary Clinton. Most prognosticators are showing odds of a Clinton win at about 70%. However, we know that much can change before you read this, and even between then and the election.

AS WE ENTER THE FOURTH QUARTER, WE ARE PLEASED THAT OUR PORTFOLIO POSITIONING HAS DRIVEN STRONG RECENT RETURNS AND REMAINS CLOSELY ALIGNED WITH OUR CURRENT OUTLOOK AND EXPECTATIONS.

A Clinton victory with at least the House staying Republican will not likely create much immediate change in investor behavior. A Trump win and a sweep of Republicans in Congress would likely create near-term volatility but could have some positive impact in 2017. Given Trump's relations with the congressional leadership, he will likely find negotiations difficult on many of his policy positions. But common ground may be possible on sweeping corporate tax reform and fiscal spending on infrastructure. These could both be positive over the next few years.

The reality is that our system of checks and balances means that the majority of what candidates campaign on is impossible to implement without major moderation. After elections, the markets usually revert quickly from political news flow back to economic fundamentals. As a result, we believe it is prudent for investors to focus more on the longer-term trajectory of these underlying trends rather than the media sound-bites.

PORTFOLIO POSITIONING

As we enter the fourth quarter, we are pleased that our portfolio positioning has driven strong recent returns and remains closely aligned with our current outlook and expectations. Our allocation to non-U.S. equities performed well over the quarter, and our higher-conviction, actively managed strategies performed well compared with their benchmarks as well. In addition, the investments we added to the portfolio over the past year have been largely helpful to returns, especially our additions to energy pipelines in the fourth quarter of 2015 and emerging market exposure in early 2016.

Below we outline our current portfolio positioning with the caveat that conditions change quickly and we are prepared to adjust the portfolios accordingly:

- We remain modestly overweight growth assets and underweight fixed income for balanced portfolios—in line with our view that, currently, near-term opportunities outweigh near-term risks.
- We maintain our focus on global diversification across our equity portfolio—split roughly 60% to U.S. stocks and 40% to non-U.S. stocks. While we maintain a majority allocation to the U.S., this level of global exposure is toward the top end of our threshold. This is in line with our view that that global stocks currently offer better long-term value.
- We maintain our exposure to global real estate and U.S. energy pipelines as inflation hedges.
- Within our fixed income allocations, we have a reduced allocation to investment-grade, core bonds that are susceptible to a move higher in rates. We have supplemented this with a diversified portfolio of shorter-term income investments, including a relatively new investment in mortgage- and asset-backed oriented fixed income investments.

We anticipate only modest changes to positioning during the fourth quarter. We are looking to reduce our holdings in high-yield bonds. This position has performed very well over the past six months and, as we mentioned earlier in the letter, is approaching or at fair value. We are also looking to potentially add fixed income inflation-protection bonds, as we believe inflation expectations are not accurately reflecting the risk of higher inflation. Finally, we retain a small amount of excess cash that we will look to invest on pullbacks.

We remain committed to growing your portfolio, helping you meet financial goals and managing risk in an investment landscape that is ever more complex. We welcome the opportunity to answer any questions, and we appreciate the continued trust you have in our team.