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Don't Worry, Be Happy!

A lot of black ink in Figure 1. Except commodities. Perhaps that's because global economic growth has been slowing steadily throughout 2015-16. Slower growth = lower demand growth for natural resources. And, supply has adjusted very slowly downward from its "supercycle" of a few years ago, which has sharply constrained price indices.

The 3rd quarter rather emphatically reflected a "risk-on" market environment. Emerging markets and small-cap stocks led equity markets upward. High yield and emerging bonds did the same for fixed income. High quality bonds, especially sovereign (Treasury) debt, lagged because their yields entering Q3 were temporarily depressed in the wake of the late June Brexit vote outcome. When yields reversed themselves, returns for the quarter were flattened.

Overall, the past twelve months have been highly favorable to nearly all bonds except short maturities. Investors have been paid handsomely for taking credit, maturity (duration), and even currency risk, as the Global Aggregate's 8.8% one-year return attests.

Only not as handsomely as those taking equity risk. Who among us really believed last October that EM stocks would be up 17% one year later? Especially in the middle of what became a very cold January (oh yeah, didn't we endure a correction in the 1st quarter? How quaint). The best many were able to muster last year was staying the course with EM stocks, by not cashing out prematurely.

Not much risk of cashing out US stocks. It's been sweetness and light on the domestic front except for January's drive-by correction. After three year's of such gains, you have trouble finding any institutional portfolios that aren't oveweight US stocks in general, and large-caps in particular. This worries us, in the sense that the market segment is becoming something of a crowded trade. Then again, the segment is the world's largest capital market.

Don't worry, be happy!

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	3Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	3.9	15.4	11.2	16.4	7.2
U.S. Top-cap Stocks	3.8	15.2	11.3	16.3	7.1
U.S. Mid-cap Stocks	4.5	14.3	9.7	16.7	8.3
U.S. Small-cap Stocks	9.1	15.5	6.7	15.8	7.1
Non-US Stocks (**EAFE**)	6.5	7.1	0.9	7.9	2.3
Non-US Stocks (**Emerg**)	9.2	17.2	(0.2)	3.4	4.3
3 mo. T-Bills	0.1	0.2	0.1	0.1	0.8
U.S. Aggregate Bonds	0.5	5.2	4.0	3.1	4.8
High Yield Bonds	5.5	12.8	5.3	8.2	7.6
Global Aggregate Bonds	0.8	8.8	2.1	1.7	4.3
Consumer Prices	*0.2*	*1.6*	*1.0*	*1.3*	*1.7*
Bloomberg Commodity	(3.9)	(2.6)	(12.3)	(9.4)	(5.3)
MSCI Wrld/Eq REIT's	(1.0)	17.5	10.8	12.9	3.2
Global 65/35	*4.3*	*12.8*	*6.0*	*9.5*	*6.2*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	3Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	4.5	12.3	9.1	15.0	6.9
U.S. Mid-cap	5.0	11.0	7.3	14.8	7.5
U.S. Small-cap	7.8	13.2	5.9	15.1	7.2
International Lg. Cap	6.4	7.3	0.9	7.7	2.3
International Sm. Cap	7.3	10.3	4.3	11.1	5.3
Emerg. Mkt. Equity	7.5	16.0	(0.2)	3.9	3.8
Balanced/Hybrid	3.0	8.9	5.2	8.8	5.4
General Bond	0.9	5.5	3.9	3.6	5.1
High Yield Bond	4.7	9.2	3.9	7.0	6.4
Equity Hedge Index	4.7	6.0	3.2	5.6	3.3

*Annualized trailing returns for periods ending 9/30/16

Chartwell Consulting (USA), LLC
34 Park Street, Montclair, NJ 07042
info@chartwellusa.com
www.chartwellusa.com
Phone (973) 783-2900
Fax (973) 783-2998

Economies, Economics, Prices, and Policy

	9/2016	9/2015
CPI - headline, y-o-y	1.6%	(0.2)%
CPI - core, y-o-y	2.2%	1.9%
Real GDP Growth, 1-year *	1.3%	3.0%
Employment (000's)	151,968	148,942
Employment / Population %	59.8%	59.3%

** 2Q vs. 2Q, y-o-y*

The American economy continues to expand at a sluggish rate. Including initial estimates of a good third quarter, real growth has been only 1.5% during the past year, compared to 3.0% one year ago.

The final estimate of **2nd quarter GDP growth** was only 1.4%. Household spending was the economy's bright spot, rising at an annualized rate of 4.3%. But the gain was overshadowed by considerable weakness in fixed private investments, especially residential (i.e., housing) and business inventories. The inventory adjustment held back 2Q GDP by nearly 1.2%.

Figure 3: Breaking Down Real U.S. GDP

	% Change from Preceding Period			
Factor	3Q '16	2Q '16	1Q '16	4Q '15
Real GDP Growth	2.9	1.4	0.8	0.9
Nominal GDP Growth	4.4	3.7	1.3	1.8
Final Sales	1.6	3.2	1.1	1.8
Personal Spending	2.1	4.3	1.6	2.3
Private Investment	3.1	(7.9)	(3.3)	(2.3)
- Fixed, Businesses	1.2	1.0	*(3.4)*	*(3.3)*
- Fixed, Residential	*(6.2)*	*(7.7)*	*7.8*	*11.5*
*- Chg. In Inventories **($bn)***	*$13*	*($10)*	*$41*	*$57*
Export growth	10.0	1.8	(0.7)	(2.7)
Import growth	2.3	0.2	(0.6)	0.7
Government Spending	0.5	(1.7)	1.6	1.0

Most economists forecast the GDP growth rate increased in Q3, as inventories were re-built. The government's advance estimate is that **3rd quarter GDP growth** was a solid 2.9%. Below the 3-3.5% "whisper number," but not by much. As expected, inventory re-building accounted for more than all of the 1.5% increase from Q2. Net export growth accounted for an additional 0.6% of the positive change. The trade deficit narrowed due to sharp increases in exports of both capital and consumer goods, and declines in capital goods imports.

Of some concern is the downside risk associated with a slowdown in domestic demand. The estimate of personal consumption growth in the 3rd quarter was well down from the earlier period because of observed weakness in retail sales. Lower imports may be a result of this weakness as companies react to falling demand by cutting back on imports.

Payroll job growth weakened as we moved through the quarter, but ultimately increased 575k jobs in Q3, comparing favorably to 442k in the second quarter. The household survey indicated a gain of 871k jobs in Q3.

Non-farm jobs have increased by 178k/month this year, following gains of 229k/month in 2015. As a result, the Employment/Population ratio has risen to 59.8%.

The strong jobs market has inevitably led to rising wages, but increases have been mediocre. Real average hourly earnings for all employees increased 1.0% from Sept. 2015 to Sept. 2016. Average workweek hours fell by 0.3%, resulting in weekly earnings gains of less than 1%.

After employment growth, stable prices (low inflation rates) are the Fed's second mandated responsibility -

- **"Headline" CPI** rose moderately in August and September, after falling in July. It advanced just 0.2% in the quarter (up 1.2% in Q2). This price index has risen 1.6% during the past year. That is a big change from last September when it had declined (0.2)%.
- **Core CPI** (ex-food & energy) rose 0.4% during the third quarter (+0.6% in Q2), and is up 2.2% during the past year. This index has been steadily rising.
- The **Producer Price Index** for final demand goods and services *declined* (0.1)% during the past quarter, due to a weak July. Producer prices have risen just 0.7% during the past year. PPI ex-food & energy, has risen by only 1.5% the past year.

In September, we learned that non-farm labor productivity declined (0.6)% in Q2, which was the third straight quarterly decline. From the 2Q 2015 through 2Q 2016, productivity decreased (0.4)%, the first four-quarter decline since 2013. Unit labor costs in the nonfarm business sector increased 4.3% in the second quarter, and costs have increased 2.6% over the last four quarters.

For the third quarter, industrial production rose at an annual rate of 1.8%, its first quarterly increase since the third quarter of 2015. Total industrial production in September was still 1.0% lower than a year-earlier.

A round of inventory re-building was expected in Q3, because inventories were reduced in Q2. But overall inventories are still up 0.7% during the past year, and overall sales have been flat. In retailing, inventories were up 4.8% through August, but sales just 1.6%. This leaves an overhang of concern for 4th quarter GDP.

Energy prices have dominated the US inflation outlook for the last few years but their dominance is fading. As the output gap closes and we near full employment, the combination of low productivity growth, accelerating wages and the pick up in core services prices is set to dictate the trajectory of inflation. Aggregate global inflation remains low, but many think the risk is growing of an upside surprise in US inflation.

Investors Continue their Search for Yield

Global policy rates generally continued down their "lower for longer" path during the third quarter. The major exceptions were the United States and Japan. Japan's reason for a shift is pretty evident – it is trying mightily to reflate the economy and weaken the Yen. With that as backdrop, a (0.09)% yield seems low enough.

Yields for the US 10-year Treasury popped up to 1.6% by quarter's end, having gapped down to 1.37% in early July following a Brexit induced global flight to quality. US rates have continued rising this quarter, and the 10-year yield is 1.85% as we go to print. That seems a long way above 1.37% until you look at year-end 2015 levels: US yields remain much lower than at the start of the year, with July probably representing a capitulation low for this cycle (which in bond terms means the peak in prices).

Most fixed income benchmarks increased their year-to-date gains during the quarter, with the exception of the middle of the US Treasury yield curve (2-10 years) and long Municipals. Limited market volatility over the summer months and decent economic data supported credit markets, as did a seemingly insatiable demand for current yield. US$ high yield, long-term investment grade, and emerging markets bonds led the fixed income markets up during the quarter. These market segments reflect low- to mid-teens returns during the past year.

Both the US Aggregate and Government/Credit indices earned more than 60 basis points of excess return versus like-duration Treasuries during the quarter, as spreads narrowed. US securitized benchmarks did the same. The Fed still owns $1.7 trillion of mortgages and remains a powerful and price-insensitive buyer in that market.

All credit sectors again benefited from noteworthy price appreciation and declining spreads in the quarter. Those with higher starting yields benefitted the most. Thus, the top performing credit sector was *defaulted* (D-rated) bonds (17% return in Q3, 63% y-t-d), followed neatly by CCC, B, BB, BBB, etc. BB-rated corporates returned 4.4%, and AA-rated corporates just 0.93%.

Sovereign interest rates were a mixed bag in developed countries for the quarter. Three bellwether developed countries, Germany, Japan, and Switzerland, saw little change in their negative 10-year bond yields. Not so for Britain and Spain where term rates plunged. The BoE cut its benchmark lending rate by 25bps to ease potential economic backlash from Brexit, precipitating the decline in local currency term rates. The ECB continues buying sovereign and investment grade corporate bonds, putting a high floor on prices. The yield-to-maturity of the Euro-Aggregate index has rallied to 0.66% this year. In comparison, the US Aggregate index yields 1.97%

Emerging market fixed income was again a bright spot in the global bond space for the quarter, and reflects outstanding 12-month total returns (as with EM stocks). US$ sovereign EM bonds led the way, up 3.7%.

Figure 4: Primary Bond Sector Returns (%)

Index	3Q '16	1 Year	3 Years	5 Years
US Aggregate Bond index	0.5	5.2	4.0	3.1
US Gov't/Credit: 1-3 Yrs.	0.0	1.3	1.1	1.1
US Treasury: Long	(0.3)	13.1	11.2	5.5
US Inflation-Linked	1.0	7.1	2.7	2.0
Mortgage-Backed (MBS)	0.6	3.6	3.6	2.6
CMBS	0.6	5.2	4.1	5.0
Asset-Backed (ABS)	0.2	2.2	2.1	1.9
Inv. Grade Credit, 1-10yr	1.0	5.7	4.0	4.2
Inv. Grade Credit, 10+yr	2.6	16.7	9.6	7.1
US High Yield Credit	5.5	12.8	5.3	8.2
Municipal Bonds	(0.3)	5.6	5.5	4.5
Global Aggregate, ($ hdgd)	0.5	6.5	5.1	4.3
Global Credit, ($ hdgd)	1.7	8.2	5.4	5.3
Emerg. Mkts Bonds (US$)	3.1	17.8	8.0	7.4

Figure 5: Primary US$ Bond Yields

	Sep-16	Jun-16	Dec-15	Sep-15	*1-Year Change*
US Treasuries	**(%)**	**(%)**	**(%)**	**(%)**	***(%)***
3-month	0.28	0.26	0.16	0.01	***0.27***
2-year	0.77	0.59	1.06	0.63	***0.14***
5-year	1.15	0.71	1.77	1.38	***(0.23)***
10-year	1.61	1.49	2.25	2.06	***(0.45)***
30-year	2.33	2.31	3.01	2.88	***(0.55)***
BarCap Aggregate	1.96	1.91	2.59	2.31	***(0.35)***
BBB Credit	3.27	3.42	4.34	4.14	***(0.87)***
AA Credit	2.07	2.01	2.63	2.37	***(0.30)***
Agency MBS	2.06	2.07	2.34	2.61	***(0.55)***
Emerging Mkts ($)	4.98	5.37	6.39	6.46	***(1.48)***
US High Yield	6.17	7.27	8.75	8.04	***(1.87)***
UST30yr - UST2yr	1.56	1.72	1.95	2.25	***(0.69)***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	**Sep-16**	**Jun-16**	**Dec-15**	**Sep-15**	***1-Year Change***
United States	1.61	1.49	2.25	2.06	***(0.45)***
Germany	(0.13)	**(0.12)**	0.64	0.59	***(0.72)***
Switzerland	(0.51)	**(0.50)**	**(0.07)**	**(0.10)**	***(0.41)***
Britain	0.78	1.13	1.99	1.81	***(1.03)***
Poland	2.87	2.93	2.92	2.85	***0.02***
Italy	1.18	1.30	1.63	1.73	***(0.55)***
Spain	0.98	1.33	1.85	1.90	***(0.92)***
Greece (new bonds)	8.30	8.19	8.34	8.46	***(0.16)***
China (5 year)	2.56	2.70	2.67	3.09	***(0.53)***
Japan	(0.08)	**(0.19)**	0.28	0.34	***(0.42)***
Australia	1.95	1.99	2.75	2.61	***(0.66)***
Russia	8.22	8.39	9.52	10.98	***(2.76)***
Brazil	11.49	12.15	16.41	15.47	***(3.98)***
India	6.92	7.44	7.76	7.54	***(0.62)***

US Stocks Advance

Uncertainty in Europe took the S&P down to the 2000 level just before the quarter began. This was immediately followed by a sharp upward move in risk assets, including US stocks, in what was a surprise to many investors after the UK's unprecedented decision. For the most part, these gains were maintained. July/August were both characterized by exceptionally low levels of volatility - investors spent most of the summer confident that growth would remain slow-but-steady and that monetary policy would remain accommodative.

The S&P rose steadily to an all-time peak of 2190 by mid-August, a 10% bounce off the late June low. That was the best of it. Some of these gains were given back in September, due largely to concerns about the trajectory of monetary policy. The S&P index ended the 3rd quarter at 2168, and has since dipped down to 2136. Nothing too dramatic, and well up from post-Brexit lows.

Figure 7: U.S. Equity Market - Size/Style Returns

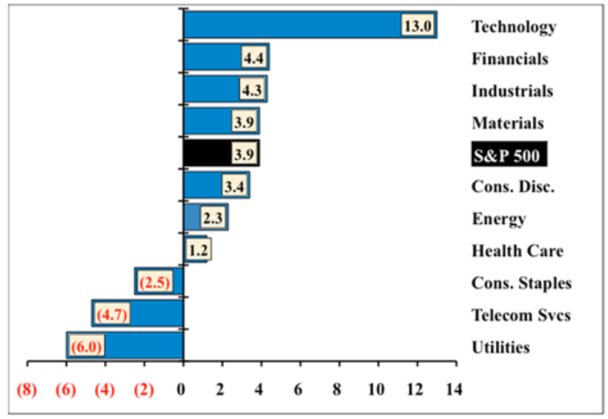
			Trailing	
	3Q '16	**1-yr**	**3-yrs**	**5-yrs**
Growth				
Large Cap	4.6	14.8	13.1	16.9
Mid Cap	4.6	11.2	8.9	15.9
Small Cap	9.2	12.1	6.6	16.2
Value				
Large Cap	3.1	15.7	9.4	15.6
Mid Cap	4.5	17.3	10.5	17.4
Small Cap	8.9	18.8	6.8	15.5

From a market cap perspective, Q3 was not the very best time for large-cap stocks. Small-cap stock indices outperformed by quite a wide margin, and mid-caps indices slotted in between. Size/style performance differentials ranged from a high of 9.2% for small-cap growth to a low of 3.1% for large value. Per Figure 7, longer-term returns still clearly favor large-growth stocks versus large value, but differentials among smaller stocks are mixed. Mid-cap value indices have produced the strongest returns during this long recovery.

The performance differential across sectors was a wide 19%, due to outperformance of information technology stocks. That sector returned 13% for the quarter, with small-cap info tech stocks up 16%. Of the Russell 3000's 4.4% third quarter return, the Tech sector accounted for 2.4%. We recall that info tech and consumer discretionary stocks were the only negative performers in Q2.

The laggard sectors in Q3 were telecom and ttilities, each of which had been market darlings for the first half of the year, but which collectively account for only 5.9% of the Russell 1000.

Figure 8: US Sector Returns –3rd Quarter 2016



Financial services, led up by i-banks and brokers, were the second largest positive contributor to Q3 market returns. This sector now excludes real estate companies (REIT's, etc.), which were anointed as a standalone sector during the quarter. On cue, large-cap real estate companies declined 2.9% for the period. Together, these sectors have been the worst performers during the past year, and have returned only 1.6% for the year-to-date.

Energy did not give up their first half gains during the 3rd quarter, despite quite a bit of natural resources price volatility. Led by E&P firms, this is the best performing sector in 2016 by a slight margin, up 18.1%.

The consumer discretionary sector has struggled in 2016. The sector has returned 3.7% (almost all of which came during the third quarter), but that is largely because the largest industry, internet retail stocks, were up 16% for the quarter and the y-t-d (led by Amazon).

Prices of large health care stocks have suffered from being in the cross-hairs of both presidential candidates. The sector has returned less than 1% this year, with biotech and pharmaceutical firms off 9.6% and 0.4%, respectively. Medical equipment stocks are up 16%,.

Figure 9: One-year Trailing P/E Ratios – Sept. 2016

	Value	**Blend**	**Growth**
US Large	16.8	19.7	23.3
US Mid	21.3	23.7	27.5
US Small	22.2	27.1	34.6
EAFE		17.4	
Emerg. Mkts		14.7	

International Markets - Rally Across the Globe

Signs of stability in the global economy, the Brexit bounce, strong corporate earnings and ongoing central bank stimulus set the stage for a "risk on" rally during the third quarter. In a shift from the first half of 2016, technology and materials stocks led global markets higher, while telecom and utilities retreated. Developed markets (MSCI World ex-US) rose 6.3% during the quarter, pulling y-t-d results into positive territory (+3.6%). Emerging markets easily outpaced these returns, gaining 9% in the quarter and 16.4% in 2016. The Canadian market slowed with the pullback in energy prices, but still rose 4.9% for the quarter and is up 20.6% year to date.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 9/30/16	3Q '16	1-Yr	3Q '16	1-Yr
World ex-USA	**6.3**	**7.2**	**6.0**	**5.2**
- MSCI Growth	*5.0*	*9.4*	*4.6*	*7.0*
- MSCI Value	*7.7*	*4.9*	*7.5*	*3.4*
- Europe ex-UK	6.0	2.9	5.1	2.3
- Pacific, ex-Japan	8.2	20.1	6.5	13.3
- Japan	8.6	12.1	7.2	(5.2)
- United Kingdom	4.0	1.5	7.0	18.4
Int'l Small Cap	**8.0**	**13.5**	**7.7**	**9.8**
Emerging Mkts	**9.0**	**16.8**	**7.6**	**13.0**
- EM Asia	*10.5*	*16.9*	*8.8*	*13.4*
- EM Europe	*4.5*	*8.8*	*3.8*	*6.4*
- EM Lat Amer	*5.4*	*28.7*	*7.5*	*20.2*
- EM BRIC	*11.6*	*18.1*	*11.4*	*14.3*

European markets rebounded from steep losses after the Brexit vote. Investor sentiment shifted as it became evident the consequences to UK and European economies would take 2-3 years to unfold. Europe ex-UK gained 6.0% in US$ terms, as the Euro rose modestly versus the US dollar. In the UK, Theresa May replaced David Cameron as Prime Minister and vowed to move expeditiously toward the EU withdrawal process. UK stocks returned 4% during the quarter in US$ terms, and 7% in local currency.

All European countries posted gains for the quarter, except for Denmark (-6.3%, because of a sharp drop in Novo Nordisk). Austria was the top performing country (16.7%), followed by Germany (10%). Strong returns by SAP, BASF and Bayer offset the weakness of Deutsche Bank shares.

The Pacific region outpaced Europe gaining 8.5% for the quarter. All countries in the region posted positive returns, except for Singapore (-0.2%). Japanese equities rebounded, rising 8.6%, after lagging most developed countries during the first half of the year.

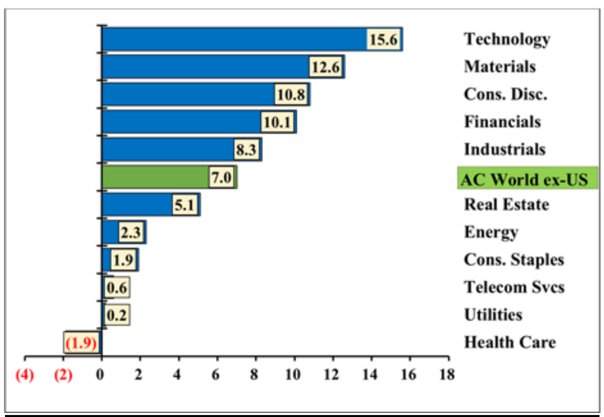
The yen rose only 1% versus the US dollar in the quarter, but has appreciated 19% year to date.

Australian equities rose 7.9%, led by materials companies and Australian megabanks. Hong Kong was the top performer in the region for the quarter, rising 11.9%, as all Macau-based casino operators rose by at least 15% amid signs the region's gaming revenues were stabilizing.

Emerging markets posted their strongest quarterly gain since 2012, benefitting from US interest rates remaining unchanged and global central banks continuing to provide stimulus. The index rose 9%, taking y-t-d returns up to 16%. China surged 13%, its best quarterly gain since 3Q13, led by strong gains in technology and financials. After steep declines earlier this year, Chinese stocks are back in positive territory year to date (8.6%). Technology stocks also lifted other Asian markets; Taiwan rose 11.7% and Korea gained 11%, led by Samsung despite its product recall woes. India's parliament approved a goods and service tax designed to make it easier to conduct business throughout the country, helping Indian equities rise 5.9%.

Latin American emerging markets rose 5.4% and are up 32.2% year to date. Brazil marched higher (+11%, taking year to date returns to +63%) on hopes of economic change under a new president. Megabanks and state-run oil giant Petrobras soared. Conversely, Mexican stocks slid -2.2% as the peso fell 5% against the US dollar. In Russia, equities climbed to their highest level in a year (8.4%, and +31% year to date) on optimism that the economy will start to grow again. Lukoil, Sberbank and Magnit all rose double-digits.

Figure 11: Ex-USA Sector Returns (3rd Qtr 2016)



In a reverse from the first half of 2016, defensive sectors pulled back (health care, utilities, telecom, consumer staples) and gave way to economically sensitive sectors technology, materials, consumer discretionary). The largest sector, financials, rebounded strongly as Brexit fears and its impact on UK and European banks subsided. Energy stocks pulled back with the price of oil during the quarter.

Back Page Perspectives

At the start of the year, FOMC projections indicated four hikes of the fed funds overnight rate during 2016. As of the third quarter's end, there had been none. The FOMC may hike the federal funds overnight rate by 25 basis points in December. Thereafter, consensus is that the economic environment is not robust enough to expect more than two hikes per year. A low and slow fed funds rate path should prevent the long end of the yield curve from rising rapidly over the course of the upcoming tightening cycle. This will give bond portfolios time to adjust to lower prices with higher coupons.

Since much of the institutional investor community is allocated around this concept, a sharp rise in term rates would be very hurtful to portfolio returns. One potential driver of this could be an unaccounted rise in current inflation rates. Especially one that shifts expected term inflation upward. Higher long-term inflation expectations most often find their way directly into term bond yields, in a manner that is often neither low nor slow.

Thus, inflation is our biggest concern for high quality bond portfolios, not if/when the Fed re-starts its gradual and dovish normalization of the fed funds rate. Once inflation is evident, the Fed will surely follow.

For both US and non-US stock index returns, reversal was the major 3rd quarter theme. Worst performing sectors through Q2 became the best performing in Q3. The dividend yield darlings, telecom and utilities, took a big hit in relative performance. We're also seeing a rotation toward the "growth" stocks of select sectors. Thus, energy stocks in the S&P 500 Growth index rose 14% in Q3, while energy stocks in the S&P500 Value index were up just 1%. The same phenomenon was observable in the financial services and health care sectors.

Among the risk factors that are prime determinants of US equity returns, the following stood out -

- Historical and projected earnings growth (higher is better) was an additive factor in the quarter, but negative over the past year; (go figure)
- Quality (high operating margins and high ROE) was once again a large negative performance factor in the quarter, and a major reversal from the past year. Low quality is now a cumulative positive risk factor over the past 12 months; (go figure)
- In a significant shift, risk (high beta and volatility) was a very large positive factor during the quarter. As noted, it was a risk-on period. The previously positive contribution of low beta and low volatility to returns is now not observable over the past year;
- Positive price momentum subtracted nearly -4% from 3rd quarter returns. Only low beta and volatility subtracted more (-4.5%, each).

With two-thirds of the S&P 500 stocks having reported, there is a very good chance 3Q operating earnings of the S&P will be a bit over $29/share. That will compare unfavorably with the estimate one year ago, but very favorably with actual third quarter results in 2015 ($25.44). If so, the trend of negative y-o-y quarterly earnings comparisons will be stopped at five.

Should that prove to be the case, the S&P's trailing 1-year operating earnings will be $102.44/share, and as reported ("GAAP") earnings will be $90.29. Three years ago (3Q13), these figures were $102.20 and $94.27. Earnings have been flat-to-down for three years.

On 9/30/13, the S&P 500 index closed at 1681. On 9/30/16, it closed at 2168. Large-cap US stocks are as profitable as they were three years ago, but are priced nearly 30% higher. The domestic stock market has been in risk-on mode for some time, during which trailing PE's have expanded as much as 30% (see Figure 9 for current levels). The US equity market is "ahead of itself", and we're now hoping that future earnings will grow into current valuations during the next three years. Until then, overweighting non-US markets may be the better idea.

Despite the recent drop in bond prices, real yields are still in the (0.30)% range. The average over the past 58 years is +2.4%. Long-term highest quality bonds remain as risky as stocks. If nominal interest rates rise/fall by 1%, the estimated price impact would be -

- 10-year Treasury bond: *-8.8%* / *+9.7%*
- 30-year Treasury bond: *-19.3%* /*+25.5%*
- median high yield bond: *-4.1%* / *+4.0%*
- investment grade corporate sector: *-7.0%* / *+8.1%*

We continue to believe overweighting stocks, real assets, and liquidity is the logical strategic reaction to the lowest global policy interest rates ever. Although high yield bonds still offer relatively high yields and low durations.

Some very general thoughts on the upcoming elections –

- Since 1958, the S&P 500 has performed better with a D-party president and an R-party or split party Congress;
- R-party administrations with a D-party or split party Congress have underperformed other make-ups;
- It seems sad that so many voters will be unhappy with who is elected President, even if they voted for them !

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA

