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Q3 2016 Market Commentary

Low returns rule the markets. Governments are warming up to fiscal support. An unusually divisive U.S. presidential election looms large. What should investors expect in the last quarter of the year?

The "sell in May and go away" crowd was out in full force to begin the summer as many market uncertainties came to light. Yet as the summer months wore on, we witnessed a stable U.S. dollar, comforting Federal Reserve language and an ease around Brexit. From Memorial Day to Labor Day most of the major asset classes rallied outside of oil and pound sterling.

In our base case scenario we see upside to global economic growth prospects but also greater market volatility ahead. Central bank asset purchases have changed market volatility and pushed investors to take greater risks, but we could see short bursts of heightened volatility as the limits of monetary policy become clearer.

In the face of significant policy uncertainty, businesses are likely to defer investment, hiring, and pretty much every major decision until after the election. This makes sense, given the wide policy differences between the candidates. Meanwhile, consumers, though confident, are not acting on that confidence in any significant way, as spending growth has dropped. Price momentum is slightly positive in the U.S. and emerging markets, while flat elsewhere.

We can therefore expect growth to remain at low levels, possibly above recent quarters but still not great, through the end of the year.

Based on the most recent communications from the Federal Reserve, its members seem largely confident that economic growth and employment have reached a tipping point that justifies higher rates. Federal Reserve officials decided only after considerable disagreement to hold interest rates steady at their September meeting but expected to raise them "relatively soon" thereafter. Several officials viewed the decision as a "close call," with some wanting to move then and others preferring to wait a bit longer in hopes of seeing more improvement in the labor market, according to minutes of the Sept. 20-21 meeting. So far, at least, that message has not pulled markets down, but as we saw last month, a combination of potentially higher rates and slower growth can lead to volatility. If growth does remain slow as the December meeting approaches, we may be poised for a repeat of early September. We expect the U.S. Federal Reserve to press on with its low for longer approach with slow interest rate increases while other major central banks start to approach limits of their easy policies. It is generally expected that the November meeting is off the table for a rate increase due to the election. Expect monetary policy to continue as a support for financial markets through October.

We will see the second economic factor, corporate earnings, increasingly come to the forefront over the next few months. Once again, expectations that earnings would finally start to increase look likely to be dashed. Since June 30, the expected growth rate for the third quarter has dropped from 0.3% to -2.1%, with all 10 sectors revised down, according to FactSet. Although companies are likely to beat expectations, both prospective and actual earnings are unlikely to match earlier growth expectations.

Beyond the U.S., there are other issues to watch, of course. A potential crisis in the European banking system has been brewing as concerns about Deutsche Bank, one of the largest in the world, increase. This has potential to become a market-moving situation in as early as October.

Over the course of the next month we should see more of the same, with the economy taking two steps forward and one back while markets oscillate between hope for economic growth and fear of a rate hike. This comes after a summer lull, record highs for U.S. equities and a rebound in emerging market assets. Expect continued slow growth and range-bound markets.

The battle between policy and fundamentals should really heat up in November and December, after the election. Once we see who wins and what the new president means to do and is able to do, we will have a better understanding of the potential impacts on the economy and financial markets.

The mix of slow but positive growth and extended valuations presents a challenge for investors. We should accept the fact that equity multiples are quite full and are sensitive to the higher policy rates, which may accompany stronger growth. While we do adopt a slight pro-growth tilt, we are under no illusion that returns will be anything but meager. This reinforces the idea that the diversified portfolio's we maintain, help to reduce overall volatility with the ultimate goal of providing a strong risk adjusted return for our clients. Based on this forecast, we maintain our strategy within our current allocations but will be reviewing them ahead of the presidential election.

To discuss this commentary further, please contact us at 914-825-8630.

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