TECHNOLOGY STOCKS DRIVE STRONG QUARTER FOR EQUITIES

In the third quarter of 2016, investors reduced their holdings of defensive yield-substitute stocks such as telecom, utilities, and consumer staples and bought stocks of technology, financial, and industrial companies. The Standard & Poor’s 500 Index delivered a solid total return of 3.9 percent for the quarter, led by technology stocks and their strong 12.9 percent return. Shares of Apple rose 18 percent for the quarter following the release of the new iPhone. Sectors such as consumer staples, telecom, and utilities, which had delivered strong returns during the first half of the year as bond yields fell, had negative returns. Verizon shares were down 6.9 percent for the quarter while Coca Cola was down 6.6 percent. The Russell 2000 Index of small-capitalization stocks was up 9.0 percent and also significantly outperformed stocks of larger companies.

International markets also had a strong quarter and outperformed the U.S. The MSCI All-Country World Index-ex US was up 7.1 percent led by Germany (up 10 percent) and Japan (up 8.6 percent). Emerging markets continued their hot streak for the year, ending the quarter up 9 percent. All BRIC countries – Brazil, Russia, India, and China –had strong returns. Strength in emerging markets was due to rising oil and commodity prices and a stimulus to the Chinese economy.

BONDS: LIKE STOCKS, RISKIER CREDIT SECTORS DID BETTER

The bond market took its lead from the stock market with riskier bonds of companies rated below investment-grade outperforming other sectors. The Barclays U.S. Corporate High Yield Index returned 5.6 percent for the quarter. Option-adjusted spreads started the quarter at +594 and tightened to +480 at the end. Emerging market bonds also did well and the JPMorgan Emerging Market Global Diversified Bond Index returned 4.1 percent for the quarter. High yield and emerging market debt benefited from the recovery of oil prices.

The Barclays U.S. Aggregate bond index returned a muted 0.5 percent in the third quarter. Within the broader index, the government-backed mortgages sector was up 0.6 percent. Credit spreads tightened modestly from +158 to +141 and investment grade corporate bonds returned 1.2 percent. Yields in most bond sectors ended the quarter rising 10 to 15 basis points. Bond yields, which had fallen earlier in the year in anticipation of “Brexit,” rose as the global economy recovered and as central bankers in Europe and Japan began discussing not increasing stimulus and even reducing it. This hurt returns for Treasuries and municipal bonds. Both Treasury and municipal indices fell 0.3 percent for the quarter.
OUTLOOK FOURTH QUARTER 2016: EXPECT VOLATILITY
We expect sub-par global growth to continue in the fourth quarter. However, U.S. growth is expected to bounce back from below 2 percent in the first half of 2016, to above 2 percent in the second half. Inflation remains muted and global monetary policy is supportive of growth. The Federal Reserve is expected to raise interest rates in December. Perhaps more importantly the Fed expects a shallower path to rate hikes than previously indicated. The market now expects the Fed to raise rates twice in 2017, not four times as was projected earlier. Also, the long-run neutral fed funds rate is seen reaching 2.75 percent versus a prior prediction of 3 percent.

This environment, along with negative yields in Europe and Japan and robust demand for fixed-income due to demographic factors, suggests that bond yields will remain low and range-bound. We expect bond returns in the low- to mid-single-digits and for corporate bonds to outperform government securities. We believe it would be difficult for yields to rise sustainably higher until global growth and inflation turn higher.

This environment of low growth, low inflation, and accommodative monetary policy is also good for the stock market. However, the equity bull market is entering its seventh year and we expect muted results for U.S. stocks. High valuations, peak margins, and six consecutive quarters of earnings declines for the S&P 500 all pose challenges. The healthcare sector should benefit from an aging population and secular trends from the Affordable Care Act. Telecom and utility stocks should continue to do well as long as interest rates remain low. However, low rates and increased regulations continue to be headwinds for bank and financial services companies. Valuations are cheaper outside the U.S., particularly in Europe, where the European Central Bank remains accommodative. But as “Brexit” has shown, there are significant political risks and the European banking sector remains undercapitalized. Emerging market stocks, currencies, and local bonds have done well in 2016 but the credit quality of many government and corporate borrowers is deteriorating, suggesting possible trouble ahead. We are bullish on select countries and stocks.

With the U.S. heading into a presidential election and the bond markets expecting a rate hike in December, we expect financial markets to be volatile through the end of the year. In addition the constitutional referendum in Italy and the presidential elections in Austria, both slated for December, are expected to increase market volatility as “Brexit” did earlier in the year.

Key risks:
China — a hard landing in China poses one of the biggest risks to stocks and other risk assets.

Federal Reserve — if forced to tighten at a rate that is faster than what the market expects.

U.S. Presidential Elections — the uncertainty of the outcome is often a cause of volatility and puts a lid on market gains.

Europe – Constitutional referendum in Italy, re-run of presidential election in Austria.