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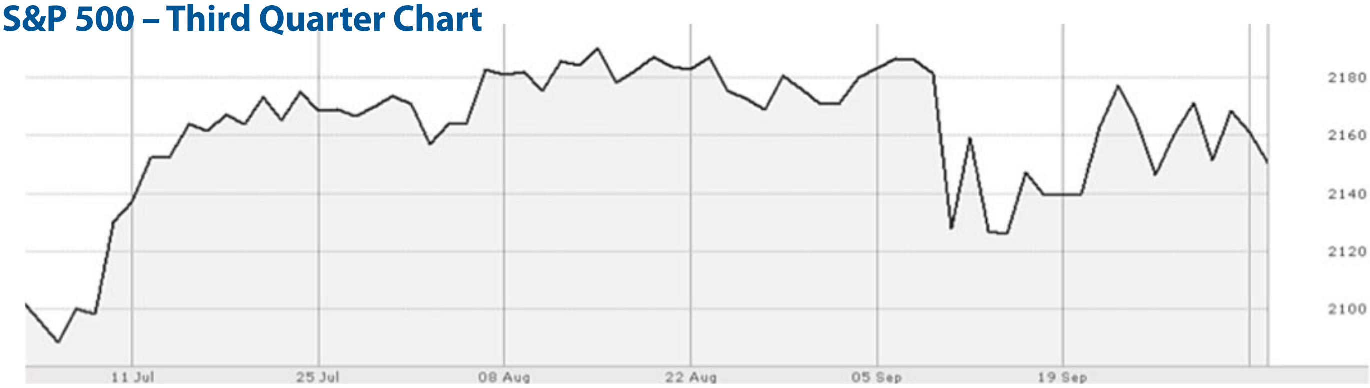
Third Quarter 2016 Review

The S&P 500 finished up 3.31% for the quarter. All of the quarter's positive performance was found in July, with the S&P 500 remarkably posting -0.12% in both August and September. After the initial move in early July, the S&P 500 experienced 43 consecutive days (mid-July through early September) without a 1% move in either direction, one of the least volatile periods over the past 20 years.

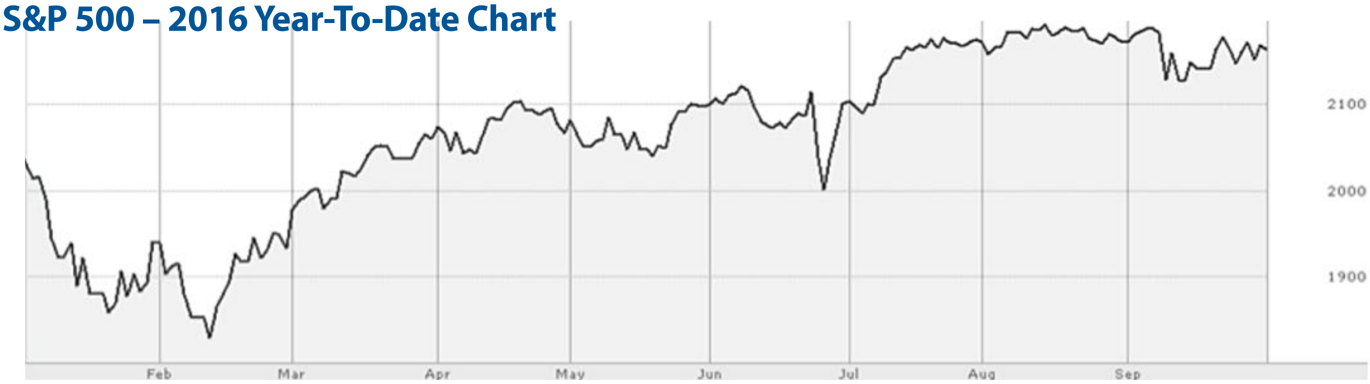
S&P 500 – Third Quarter Chart



Source: TD Ameritrade

Third quarter pushed the S&P 500's performance up to 6.08% for the year, led this quarter by the technology, financial, and industrial sectors. Energy has had the largest year-to-date influence on the market's performance as oil prices have finally stabilized after OPEC agreed to set production limits for the first time in over two years. The markets continued any fears of the consequences or effects that Brexit may have on the British and greater European markets.

S&P 500 – 2016 Year-To-Date Chart



Source: TD Ameritrade

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Third Quarter Highlights:

- Stocks outperformed bonds. The S&P 500 was up 3.31% while the Bloomberg Barclays U.S. Aggregate bond index was up 0.50% for the quarter.
- The tech heavy Nasdaq composite index surged 9.7% during the third quarter, erasing its first half loses to finish up 6.08% for the year.
- The Morgan Stanley Capital International (MSCI) EAFE index tried to erase its losses for the year, too. The MSCI EAFE index was up 6.04% for the quarter, down 1.61% for the year.
- Even though gold lost 0.39% of its value, it is up 24.29% for the year.
- The U.S. dollar dropped 0.46% for the quarter, giving it a -3.36% return for the year.
- The S&P Goldman Sachs Commodities Index was down 2.56% for the quarter, giving up a small fraction of its 16.95% year-to-date return.
- Oil plunged 13% in July but quickly regained nearly all of the loss during the remainder of the quarter.
- Third quarter was all about mean reversion. In other words, what was losing money in the first half of the year came back and what was working in the first half lost money. The top performing sectors were information technology, financials, and industrials, up 12.44%, 6.51% and 3.56% respectively. Utilities, telecom, and consumer staples, the top performing sectors in the first half of the year, were down 6.72%, 6.60%, and 3.27% respectively.
- The MSCI All-Country World Index (ACWI) was up 4.55% (in local currency) for the third quarter, pulling the index into positive territory up 2.96% for the year.
- Emerging markets have been a strong international region, up 6.88% (in local currency) for the quarter and 9.14% for the year.

Fourth Quarter Outlook

Currency

Currency valuations have played an important role on corporate earnings over the past few years. Part of the reason why U.S. companies were in a six quarter earnings recession was because the dollar had strengthened against currencies like the euro, making U.S. products more expensive than their European competitors. The chart to the right shows the deep decline in the euro's value to the dollar in 2014 and into early 2015. As you can see, the dollar has stabilized and actually lost some of its value to the euro, mitigating one of the headwinds effecting U.S. corporate earnings.

Source: TD Ameritrade

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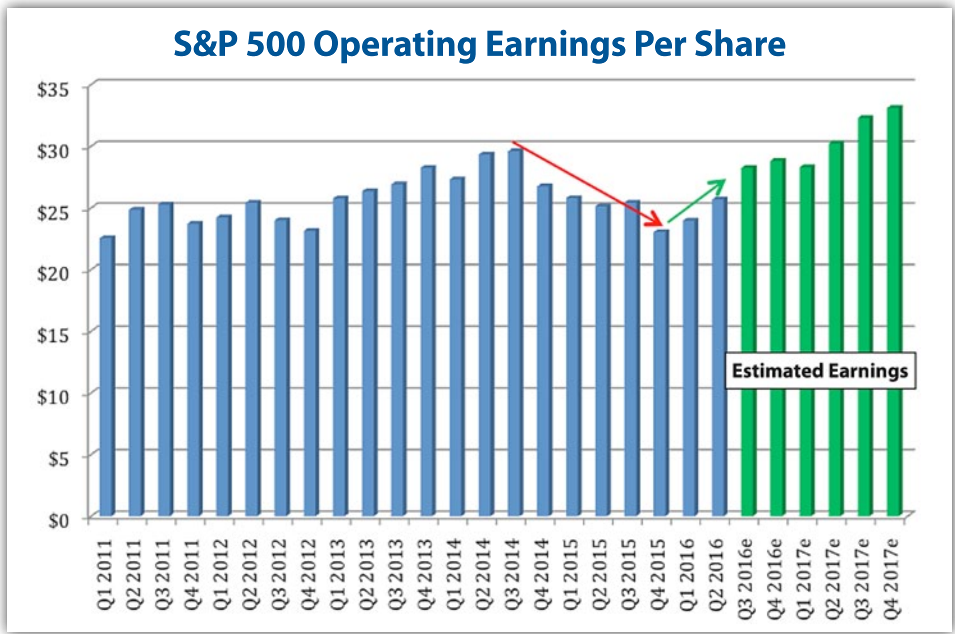
Earnings

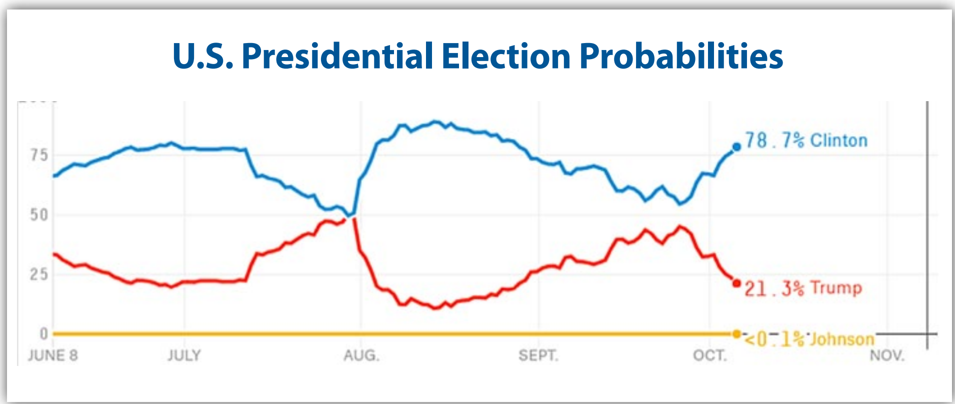
The S&P 500's second quarter earnings finally provided the first year-over-year improvement in earnings, breaking a six consecutive quarter decline in year-over-year earnings. While it was only a slight improvement over the second quarter of 2015, the second quarter's 2% earnings growth set the stage for what many analyst are expecting should be a strong third quarter earnings season. According to Standard and Poors, third quarter earnings are estimated to increase over 11% from where they were a year ago (see chart to the right).



Source: Standard & Poors Polaris Greystone

November's U.S. Elections

A lot has gone on over the past few weeks that has been shaping the probabilities of the presidential election. Fall out from multiple controversies and a sub-par presidential debate has Donald Trump trailing Hillary Clinton by 5 points, according to CNN polls. According to fivethirtyeight.com, the probability of Hillary Clinton becoming the first woman to be President of the United States sits at almost eighty percent. There is still a lot that could happen in the next month, but at the moment it appears that the Democrats will keep the presidency.



Source: www.fivethirtyeight.com

The question now is, "How will the election play out in the Senate and the House of Representatives?" Currently the Republican Party holds 54 of the 100 Senate seats. There are 34 Senate seats up for reelection, 24 held by Republicans and 10 held by Democrats. According to research conducted by the University of Virginia's Center for Politics, it appears that the Democrats will pick up at least one seat with five other seats being considered a "toss up." They also predict that the Democrats will pick up 10 to 15 House seats, far below the 30 seats necessary to take a majority.

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The Fed

It appears more and more likely that we will see some Fed action this year. It seems very unlikely that the Fed will raise fed fund rates in November since their meeting is on November 2nd and such a move could be construed as a political move. December is a different story. According to the CME Group's 30-day Fed Fund futures, there is a 65% chance that the Fed will move rates at least once before the end of the year. As I write this, gold prices have begun to plummet, down over 5% to start the fourth quarter.

Bonds

The 10-year Treasury yield hit an all-time low of 1.32% on July 5th. The 10-year Treasury yields then bounced off of these all-time lows and finished the quarter at 1.6%. As I write this market review on October 6th rates have continued to go up, finishing the day at 1.73%. As we discussed in our August education e-mail **"The Retiree Predicament"**, we expect bond yields to continue to climb as the bond market normalizes. As you might recall from our educational piece, when bond yields rise their price drops. If bond yields normalize, unaware bond investors could suffer significant loses.

Source: tradingeconomics.com

Brexit

Obviously Brexit was all the news at the end of second quarter and the beginning of the third quarter. While Brexit is no longer the lead story in the media, its impacts are definitely being felt in Europe.

As you can see from the chart to the right, the British pound plummeted in late June as a result of the Brexit vote. The pound has continued to deteriorate as British Prime Minister Theresa May announced that she would invoke article 50 of the Lisbon Treaty in the first quarter of 2017, starting the two year formal negotiations to exit the European Union (EU). May's announcement caused a flurry of responses from leaders of other EU countries, calling for a hard line against the British in these negotiations.

Source: tradingeconomics.com

As I wrote about in June and July, Brexit poses a significant impact on the British economy and could have much farther reaching consequences. Just the currency drop alone means that everything is costing the British people about 15% more now than it was prior to the vote. The Bank of England had to step in and inject significant stimulus into their economy to keep it from quickly going into a recession, further impacting the country's balance sheet. While it may no longer be headline news and the negotiations will go on for a few years, we are keeping a close eye on the ripple effect that Brexit may still have on the global markets.

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Summary

Fourth quarter of 2016 is set up to be a very interesting quarter for investors. Presidential election years can be a tricky time to invest. Yet our markets have been calm, with volatility well below historical norms. As we discussed in our **"Politics and the Markets"** piece in May, presidential election market years fair best when the incumbent party remains in power. Historically, the markets have performed better with a Democrat as President but are at their best when congress is either split or controlled by Republicans. In other words, the markets like to have check and balance systems so that no one party can "railroad" their agenda without being questioned.

It appears that the Federal Reserve will raise rates at least one time this quarter and possibly begin a more steady increase in rates in 2017. The Fed is taking action as the European Central Bank (ECB) and other central banks are being to taper their stimulus programs. Typically a rate hike would strengthen the dollar against other foreign currencies, but given the current global environment it should not be materially affected. Stability (or even weakening) of the U.S. dollar and the high probability of several Fed moves over the next year point towards a normalization of yields in the bond market. Bond investors should consider defensive actions, lowering their exposure to the bond market and shortening the duration of the holdings that remain.

In our opinion, U.S. stocks appear to be very well positioned to have further upside from where we stand today. Companies with low (or no) debt and those with low or negative correlation with interest rates will have a much better chance of successfully navigating a rising interest rate environment. Areas of the market that we will be keeping a close eye on will be the technology sector and the financial sector. Areas that could be negatively impacted are the utility and telecom sectors.

Please speak with your Polaris Greystone advisor to determine if you are investing in the correct PGFG strategy based upon your long-term financial goals, your risk tolerance, and the current market environment. If you are not a Polaris Greystone client or if you have assets away from us, please have us give you a second opinion.

Polaris Greystone Additional Service

We are proud to announce that we've launched a new podcast series. The purpose of our podcast series is twofold: we wanted to take advantage of another format and medium to keep you informed and engaged, and we wanted to provide you with an opportunity to hear from a variety of our team members. Most of you know at least two or three of our team members. The podcasts are a good chance to gain the insights of other members of our team about topics such as market and economic trends, retirement, and financial planning. Plus, the interviews are fun, and sometimes listening is easier or more convenient than reading. Please be sure to check out the PG podcast on our website, iTunes, or Soundcloud.

We always look forward to hearing from you.

Sincerely,

Jeffrey J. Powell
Managing Partner