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THE FUTURE AIN'T WHAT IT USED TO BE

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It's a familiar feeling: driving down the road when out of the corner of your eye you spot that bright little warning light indicating your gas tank is close to empty. Although, if you drive a newer car, that little light is now a full screen, high definition message letting you know how far you can push it before you fill up. If you are like me, that alert sets off a mental game of chicken…how far is the next exit, maybe I can get to the one after that, or even get home and deal with it tomorrow. Anxiety rises as mental calculation ensues as you decide whether to be cautious or roll the dice and risk stalling out.

In December 2015, the Federal Reserve switched on the warning light. A quarter-point increase in the Fed Funds rate was a long anticipated move toward 'normalizing' monetary policy. It was a real-time indicator that the high-octane, zero-interest rate policy that fueled the post Great Recession recovery was in danger of running out. Unfortunately, the Fed's communication is not an HD screen indicating precisely how long they will go before raising rates again. They prefer to play their own mental game of chicken and keep the markets guessing which exit they will choose.

Most economists concede that low interest rates have sparked the economic engine that kept the recovery moving forward. Unemployment has fallen steadily, housing prices have recovered, and most economic indicators have improved and stabilized. Both stock and bond markets have climbed higher and shown remarkable resilience in the face of adversity. The challenge facing the Fed is this: the engine driving the U.S. economy is lacking horsepower. The economy is growing, but slower than they would like. If they cut back the supply of that low interest rate fuel and the forward momentum isn't strong enough, there is potential for the economy to stall. On the other hand, if the Fed keeps its foot on the pedal, i.e., keeps rates exceptionally low, the economy could overheat, resulting in inflation.

At present, the Fed appears less worried about the economy overheating. Even more anemic economic growth levels around the world have kept inflation fears in check. Also, there hasn't been significant upward pressure on wages, a typical harbinger of inflation. That said, the Fed doesn't appear to be overly concerned about the economy stalling either. An increasing number of the Fed officials hold the opinion that the data supports a move toward a 'normal' level of interest rates, albeit at a gradual and measured pace. While consensus opinion among investors has coalesced around the belief that interest rates will remain 'lower for longer' – the question that continues to raise anxiety in the markets is "how much longer?"

With futures prices indicating over a 50% probability of a rate hike at the December Fed meeting, the market appears to be ready to navigate with relative ease. But as Yogi Berra keenly observed, "The future ain't what it used to be." History doesn't provide the markets with a road map when it comes to unwinding a zero-interest rate policy. As always, investors need to chart their own course, which starts with recognizing where we are currently.

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Despite a temporary scare from the Brexit vote at the end of the second quarter, we saw signs of stabilization during the third quarter. Currency and commodity markets steadied after significant volatility in prior quarters. Credit markets also showed signs of stabilizing, particularly among lower rated corporate credit. U.S. employment trends remain robust, despite a hiccup in the May jobs report. We are also seeing indications that the recovery is in the late innings. Corporate earnings continue to struggle, but have shown improvement over the previous two quarters. Companies have increased borrowing levels and mergers and acquisition activity is escalating. This makes the Fed conundrum that much more challenging.

In the face of mixed economic indicators and lackluster earnings, stock markets moved higher in the third quarter. We saw what may be the beginnings of a reversal of several trends that had been in place for over a year – higher yielding sectors lost value while other sectors gained, small cap stocks outperformed large cap stocks, and international developed and emerging market indices outperformed U.S. stocks. In each case, there was a move toward closing the valuation gap that had been exacerbated by macro factors. In the case of the high-dividend stocks, it is clear that the global thirst for yield had propelled these stocks well above their historical trading multiples. Similarly, large-cap U.S. stocks have been the beneficiary of a global bias for safe havens, particularly dollar-denominated assets. We expect that the relative valuation gap in these areas of the market will continue to close in the fourth quarter.

The bond market remains very challenging. Valuations are stubbornly high as central banks around the world employ their own stimulus. We continue to be defensively positioned and will look for tactical openings to employ cash. With election uncertainty, another rate increase looming in December, and the recent increase in the cost of currency hedging impeding foreign investors, patience will continue to be our mantra in the fixed income arena.

As we enter the final quarter of 2016 all eyes will be on the election and the Fed decision. But before either of these marquee events, the opening act will be a flurry of earnings that will provide greater insight into the health of the economy and corporate profits. Ultimately, the road forward in the markets will be paved by corporate earnings results, brick by brick. We are hopeful the road will be smooth, but we are prepared for the inevitable pothole.

2016 MARKET DIARY

U.S. Equities		Last 3 Months	Last 12 Months *
	S&P 500	3.85%	15.42%
	Dow Jones Industrials	2.78%	15.46%
	Russell 2000	9.05%	15.46%
	Russell 3000	4.40%	14.95%
International Equities			
	MSCI World Index ex-US	6.37%	7.73%
	MSCI Emerging Markets	9.16%	17.20%
Fixed Income			
	Barclay's U.S. Int. Gov't/Corporate	0.16%	3.52%
	Barclay's U.S. High Yield	5.55%	12.73%

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices