630 Business Center Drive, Third Floor, King of Prussia, PA 19406 • www.tp-advisory.com
Phone: 610-254-0451 Fax: 484-580-8482 email: thomaspadilla@comcast.net

It's Been an Eventful Year and there is More to Come

Global Markets and Regions

	3rd QTR	2016 YTD
US	4.10%	7.80%
Developed Europe	5.40%	0.60%
Asia	9.60%	8.00%
Emerging Markets	9.20%	16.40%

US Markets

	3rd QTR	2016 YTD
Dow 30	2.80%	7.20%
Large Cap Cos.	5.56%	7.20%
Mid. Cap Cos.	0.55%	12.40%
Small Cap Cos.	7.14%	13.96%
Bonds	2.30%	5.48%

The third quarter of 2016 has come to a close with markets closing a bit higher and showing some semblance of sustained strength. After what we experienced in the first half of the year, any positive movement is welcome. New highs have been greeted with mostly relief rather than euphoria. The truth is, broad stock indices have barely scratched out positive price returns since the end of 2014. International indices have yet to exceed their highs from mid-2014. If you take into consideration sub-sectors of the market such as energy or mining, where new highs are a long ways away, it's not surprising returns have been so muted. Volatility has increased, with market declines in excess of 5% more frequent. Headline and Event risk are back and buffeting prices like they haven't since the early years after the Great Recession.

This year we've had to deal with the US Federal Reserve raising interest rates and suggesting more increases, the continued persistence of stagnant growth both in the US and globally and the British vote to exit the European Union (Brexit). Such events would be significant even in "normal" market circumstances. They have assumed a seemingly outsized significance recently. Investors seem to become fixated on upcoming events and their potential effect on prices. The concern is that the next event will be the game changer, but more along the lines of the "last straw" rather than the "new dawn". Prices have reacted significantly only to recover as soon as the event fades into the background. The market seems to lurch from one event to the next.

Part of the problem is that stocks are priced at the higher end of historical valuation ranges and earnings and sales growth have been tepid to non-existent. Earnings growth has been in recession for going on six consecutive quarters. Companies are not losing money, but earnings are shrinking and the concern is a general recession could push earnings into the red. Any event that threatens to exacerbate that trend is not received very well by the markets and the environment becomes “risk-off” and the sellers have the upper hand for a while. The event of the moment doesn’t result in the perceived catastrophe and the environment becomes “risk-on” and the buyers have the upper hand for a while. If stocks were at the lower end of their historical valuations, this pattern might be playing out differently as was the case in the 1980’s when markets generally shrugged off events and markets quickly resumed an upward bias. It was helpful that interest rates at the time were experiencing a long gradual decline.

Now, all of this is playing out in an era of extraordinarily low interest rates with apparently little room to lower rates further. The persistent global policy response to the 2008-09 Financial Crisis and the Great Recession, was to slash interest rates and then force money into the financial system first by bailing out banks and secondly by supporting bond and other asset prices. The intent of this Great Experiment was to avoid a global financial meltdown and then to stimulate the economy and foster a return to growth. The Financial Crisis has passed and the Great Recession is behind us but a return to growth has not been achieved. We seem to have reached the end of the line for interest rate policy.

Other trends, some of which are the result of policy and some of which are just natural, are starting to converge. Debt levels globally have soared to levels not seen before. They are becoming a drag on the economy. Aging demographics are straining budgets and constraining economic activity. Sixty five year olds don’t spend like 30 year olds, especially when a significant percentage of those 65 year olds haven’t saved enough for retirement and a similar percentage of the 30 year olds are saddled with college or other debt constraining their ability to spend. Public employee pensions are testing the sustainability of taxpayer funding.

It isn’t surprising that events playing out against this backdrop result in significant investor unease and market volatility. The upcoming US election could have a larger impact than recent events because of its potential game changing nature. We’re the largest economy on the planet by a factor of five. What happens in the US has a consequently large global impact.

There appears to be a clear difference in policy preferences between the candidates. Donald seems to be the candidate of lower taxes, reduced regulations and renegotiated trade deals. Hillary seems to be the candidate of higher taxes, increased regulation, increased infrastructure and social spending and continued commitment to globalization. The markets appear to slightly favor Hillary. Markets rallied after the first debate which Hillary appeared to win. Investor polls, which are different from public polls, give Donald only a 30-35% chance of winning.

It may be the markets believe Hillary to represent the status quo; not great but livable. Donald, on the other hand, is seen as a total wild card. Everybody knows everything about Donald except how he will actually affect government policy. He has no governing track record. Hillary has a 25 year government track record. Is this election just another Event? I haven’t discussed that Italy will be holding their “exit” deciding election at around the time of our elections, or that a number of other European countries will be having elections late December through the middle of next year addressing some of the same issues. The Events just keep on coming.