Market Review & Outlook: A Case of the Slows

TRUXTON TRUST
A PRIVATE BANK

Miles T. Kirkland, CFA
Senior Vice President &
Portfolio Manager
Wealth Management Services

Connect With Us

615-515-1700

TruxtonTrust.com

Subscribe

Follow Us

Executive Summary

- *Although global equity markets had a good third quarter, some combination of events, rhetoric, and circumstances seems to have obscured the facts.*
- *While recessions will inevitably come, we think the U.S. economy will likely continue to muddle through with growth rates below historical averages for the next several quarters; however, we expect any near-term recession to be shallow and short-lived.*
- *We still believe a globally diversified portfolio of stocks will offer potential for long-term returns above the rate of inflation and an intermediate duration portfolio of investment grade bonds offers the most time-tested and economical means of managing portfolio risk.*

Negative Headlines Muddle Markets

Global equity markets had a good third quarter. Typically, this is not something we have to point out to people, but some combination of events, rhetoric, and circumstances seems to have obscured the facts. It all starts with the election, where the populist rhetoric begins with dire circumstances created by an identifiable bad guy. As if on cue, some corporate dirty laundry has been dragged into the streets with revelations of bad incentives and resulting bad behavior at Wells Fargo and more absurd pricing for critical drugs by Mylan pharmaceutical company. The bad behavior was followed by bad public relations in each case, amounting to little more than finger pointing to try to deflect. Rather than identifying bad guys with a laser pointer, politicians, pundits, and the media in general have elected to pursue something that looks more like a carpet bombing campaign, attacking corporations, fellow citizens, trading partners, various public and private institutions and (of course) Federal Reserve Chair Janet Yellen. Time will tell if these arguments are constructive or not, but the seemingly constant barrage of negative headlines and soundbites does not make the investment environment easy for investors to interpret. During the quarter, it appears the markets viewed the hot topics of the day as transitory and continued to climb the wall of worry as they often do.

Equity Market Index Returns

As of September 30, 2016

Asset Class	Index	3Q 2016 (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	3.85	7.84	15.43	11.16	16.38	7.24
	Russell 1000 Large Growth Index	4.58	6.01	13.76	11.83	16.60	8.85
	Russell 1000 Large Value Index	3.47	9.97	16.17	9.70	16.15	5.85
	DJ US Select Dividend	1.37	17.12	22.23	12.96	16.46	7.07
Mid Cap U.S.	S&P 400 Mid Cap Index	4.14	12.40	15.32	9.36	16.50	9.12
Small Cap U.S.	S&P 600 Small Cap Index	7.20	13.88	18.12	9.05	17.86	8.70
Developed International	MSCI EAFE Index	6.44	1.74	6.52	0.48	7.39	1.82
Emerging Markets	MSCI Emerging Market Index	9.03	16.02	16.79	-0.56	3.03	1.82
Commodities	Bloomberg Commodity Total Return Index	12.78	13.25	-13.32	-10.55	-10.82	3.94
Real Estate	NAREIT Equity Index	-1.21	12.48	21.12	13.88	15.99	6.39
Global Market Cap Weighted	MSCI World Index*	4.86	5.55	11.35	5.84	11.63	4.47

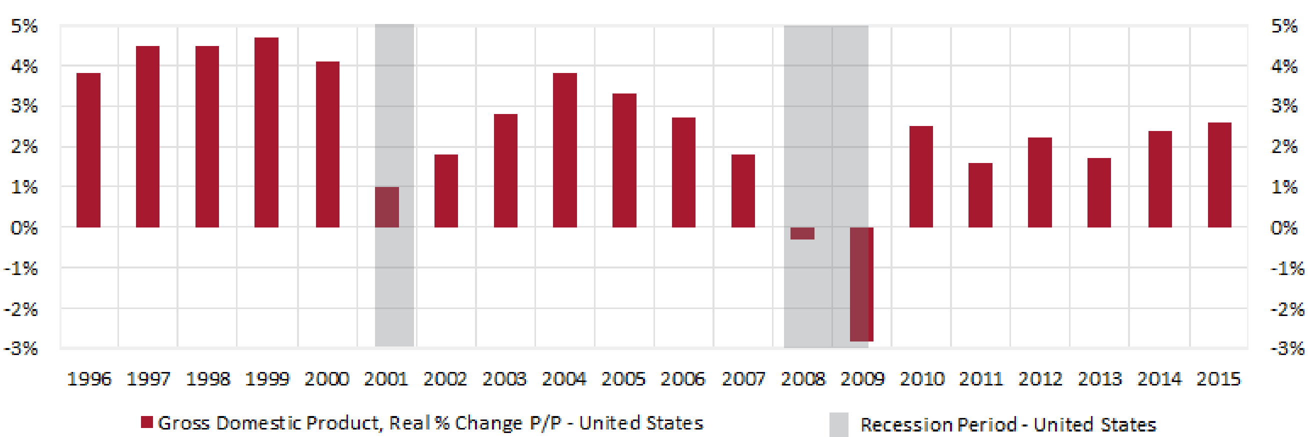
**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of September 30, 2016

Economic Growth Expectations

Most of the discontent comes back to one thing. Our economy is not growing at the pace at which we are historically accustomed to. The chart below shows that since the 2008 recession, the United States has not seen an annual real GDP growth rate of even 3%, which we previously considered average. The statistics, specifically the change in per capita GDP (officially known as "economic growth") translates to Main Street as a lack of improvement in the standard of living for many. Increases in per capita GDP allow employers to pay employees more, consumers to consume more, and the Government to provide more services all with reinvestment to continue the virtuous cycle. While U.S. economic performance has been good relative to most of the rest of the world, a repeat history of abundance seems to be fading for many.

The general mood of discontent is made worse by a

United States Real GDP Growth



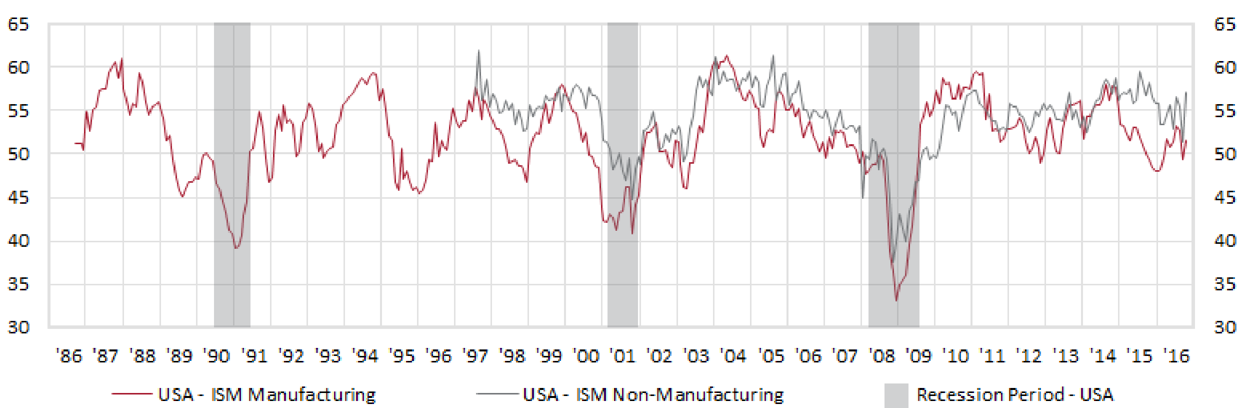
Source: FactSet as of September 30, 2016 pervasive belief that things are about to get worse, not better. Much of this pessimistic moodiness is very general starting with the political platform of the candidate an individual opposes. The expansion is over seven years in age, longer than the average economic expansion observed since World War II. We cannot argue with that, but most cycles end with some form of overheating, not because the clock runs out. The two most common forms of overheating are inflation and asset price bubbles. The Fed has to react to the first by charter while the Fed's responsibility toward asset prices has seen a variety of interpretations over the years. At this point, we do not think the evidence supports either. Core inflation is running slightly above the Federal Reserve's 2% target. We believe this warrants a steady, gradual increase in rates rather than more aggressive tightening. Asset prices are somewhat expensive relative to historical averages as investors have been pushed to pursue an acceptable return on investment in the low yield environment. However, we do not see extremes in the capital markets that require painful downward adjustments.

December Rate Hike Probable

Whether the Fed has done anything to help with its accommodative monetary policy and the amount of damage the Fed can do to already disappointing rates of growth is subject of continuous debate. We believe the Federal Reserve will increase the federal funds rate 25 basis points (0.25%) before the end of the year, probably in December. September non-farm payrolls increased 156,000, below expectations for 172,000 but probably healthy enough to keep the Fed on track for a measured series of increases. The unemployment rate actually increased from 4.9% to 5% due to an increase in the labor force participation rate, which is a positive for the trend. Average hourly earnings seem to be a focal point for Fed governors. For September, average hourly earnings increased 2.6% year over year, a small acceleration from 2.4% in August. We believe that the Fed's strategy of gradually raising rates can continue without hurting demand or pushing inflation. The delay probably had more to do with what is going on in Europe than here in the United States.

There is always the chance that the economy could slow down on its own without the Fed's assistance or with the onset of an unforeseen systemic crisis. Some forward looking economic statistics are flashing warning signals. Most notably, the ISM Manufacturing Purchasing Managers Index (PMI) is flirting with the 50% dividing line between growth and contraction after several months of recovery through July 2016. As shown in the chart below, the problem with the

ISM PMI Predicts More Recessions Than Actually Occur



Source: FactSet as of September 30, 2016

PMI is that it predicts more recessions than actually occur. The September survey rose to 51.5 after the sharp drop in August to 49.4, so it is difficult to identify a trend right now. On the other hand, the ISM Non-Manufacturing PMI rose to 57.1 from 51.4 in August, the best report since October 2015. The Index of Consumer Sentiment, a leading indicator rose to 91.2 in September from 89.8 in August, breaking a negative trend. Construction fundamentals are somewhat volatile, but there has not been a breakdown and home values remain strong. While recessions will inevitably come and high frequency economic data will give us many head fakes to ponder, we think the U.S. economy will likely continue to muddle through with growth rates below historical averages for the next several quarters. Given that the more cyclical areas of the economy are not in danger of overheating, we expect any near-term recession to be shallow and short-lived.

The economic data is a little murky and we are looking at a continuation of interest hikes from 0.25% to 0.50% today to a normalized level, which the Fed now sees at 1.88% by year-end 2018 and 2.88% longer-term. As of October 7, 2016, the 10-year Treasury yield is 1.72%. "Lower for longer" (historically low interest rates for an extended period) appears to be a reality we will live with for the foreseeable future. We believe the best return expectation for medium duration investment grade bonds is the yield to maturity at the time of purchase. Like everyone else, we are not sure what to make of negative interest rate lending in parts of the world, but we are not buying.

What about Stocks?

Domestic equity valuations are still at the high end of the normal historical range, but we would not characterize the environment as anything approaching a bubble. We believe the prudent course is to assume a lower than historical expected return in planning. While valuations appear to be somewhat extended, S&P earnings should see renewed growth after a second flat year as the headwinds of low oil prices and the strong dollar are less impactful. The current forecast is for 13% growth in 2017 and 11% growth in 2018 with 5% and 8% growth in dividends for each year, respectively. The actual earnings could differ materially from the forecast and the recent trend has been optimistic initial forecasts with progressive downward revisions over the course of the year, but growth is the normal state for S&P 500 earnings. Pricing power, innovation, and the ability to adjust are powerful things. We believe the higher multiples reflect low rates rather than euphoric expectations for future earnings growth or dismissiveness about risk.

We still believe Europe and developing markets offer good value after years of poor performance. Ironically, the decision by the British to leave the European Union served to "clear the air," leading to outperformance relative to U.S. stocks after an initial sharp decline on the news. Bad debt remains a concern for Europe's "zombie banks" but we believe that Europe will muddle through with strong return potential on any improvement. The European Central Bank (ECB) is likely to spring into action, further supporting banks should they come under pressure. Emerging markets could continue to see economic turmoil around currency fluctuations, debt, and Chinese growth concerns. Compelling valuations, political change in several key markets, and young and growing populations (in many markets) offer potential for long-term returns more commensurate with the risk than we have seen over the last four or five years.

Fixed Income Market Index Returns

As of September 30, 2016

Asset Class	Index	3Q 2016 (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	0.46	5.80	5.19	4.03	3.08	4.79
	BC Intermediate Government Credit	0.16	4.24	3.52	2.80	2.45	4.17
	BC US Intermediate Credit	0.77	5.69	5.21	3.80	3.92	5.08
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	-0.02	2.30	2.98	2.93	2.63	4.08
International Bonds	Citigroup Non-US Government Bond	0.60	14.18	12.61	1.21	0.24	3.94

All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of September 30, 2016

Conclusion

Bare-fisted elections, public disenchantment, and periods of economic adjustment are not new things. They do not always feel good, but it is how we do things. At least the election will be over in a month clearing one source of uncertainty. Comprehensive wealth management requires a deep understanding of clients' unique needs, circumstances, and goals, along with a realistic assessment of long-term return and risk potential. We still believe a globally diversified portfolio of stocks will offer potential for long-term returns above the rate of inflation. An intermediate duration portfolio of investment grade bonds offers the most time-tested and economical means of managing portfolio risk. A high quality orientation towards both stocks and bonds gives us comfort our portfolios will be durable under various market conditions and cycles. Tax-efficiency is always important and might become more so after the November election. ■