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Market Commentary **Fall 2016**

Following what was a very volatile market in the first half of the year, the third quarter provided a welcome respite allowing the major stock averages to resume a stretch to modest new highs. Much of this upward move was delivered on the back of the continued search for yield and corporate America's continuing affinity for stock buyback programs.

For the quarter, the S&P 500 rose by +3.4% to deliver +6.1% on the year through September while the tech heavy Nasdaq gained +9.7% to end September also at +6.1%. Neither index however was a match for small cap stocks which, as measured by the Russell 2000 index, rose by some +10.2%. Clearly, first half uncertainty drove equity investors to the most defensive high-yielding issues while the third quarter witnessed a marked rotation into the more economically sensitive, cyclical sectors - including the small cap space as risk-on trades resurfaced.

From a style perspective, growth investing - which had consistently outpaced value in 2015 - found itself lagging behind across all capitalizations as the year has progressed. Through September, value performance well outstripped growth. This makes sense as early year market volatility offered plenty of discovery opportunity for hearty investors who were attracted to the downtrodden energy and materials sectors, which subsequently recovered.

Internationally, developed market returns through the period were tepid at best with most developed indices registering 0-2% returns. Markedly different however, were the emerging markets which posted returns of over +15% through September. It goes without saying that persistent low growth combined with zero range-bound or negative interest rates across much of the developed world favored a resurgence of cash flows into emerging market debt and equity. And while it's too early to tell how things will play out in this very cyclical asset class, we know that dollar strength is again becoming a modest headwind as it has strengthened to reach a seven month high. While a strong dollar is itself a nominal headwind for US growth, if the Fed decides on a rate increase by year-end it is likely that emerging market gains would quickly weaken.

Meanwhile, the bond market continued to offer competitive risk adjusted returns. Municipal bonds, as measured by the Bloomberg Barclay's 10 year Muni Index, posted +4.4% through September while Barclays Aggregate Bond Index delivered +5.8% and higher yielding taxable bond portfolios surprisingly posted returns upwards of +7-10%.

So to a broader discussion: where are we now and how do we see the economy and financial markets playing out over the balance of this year? At the risk of stating the obvious and amid continuing mixed signals, the economy remains persistently sluggish with longer range forecast revisions suggesting growth will likely not change much either for the US or for the world at large for some time to come. We do know that the US consumer, on the back of low unemployment, a greater labor participation rate and improving wage growth, is largely behind what progress we have seen year to date. And while first half GDP growth averaged only +1.1%, thanks to increased consumption it is expected to exceed +2.5% in 3Q16. Consensus however suggests it could fall back under +1.7% in 4Q16. If so, this would result in another year of comparatively poor performance. So why would the Fed raise rates by year end? Apparently they believe there are enough positive data points to suggest that, on its own, the economy can absorb another quarter point rise though they are clear to emphasize they will remain alert to the potential for negative impacts from exogenous events. To that point, the hastening of Brexit - expected to be triggered this coming Spring - and its real impact on the UK and Eurozone growth or China's progress transitioning from an export to a consumer driven economy will surely be monitored closely. Meanwhile, from a financial markets perspective, there appears to be little on the near term horizon that could upset the apple cart, but for a December rate rise whose probability has risen to better than 75%. This will likely trigger an immediate, but modest - and we think very brief - reaction across both the stock and bond markets following which they will settle and simply move on.