KayneCast

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Episode 41

A Market Review of the Third Quarter of 2016, and an Outlook for the Rest of the Year

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Equities produced outstanding returns during the third quarter. The S&P 500 Index advanced almost 4 percent, bringing the year-to-date return up to 7.8 percent. Small-cap stocks, as measured by the Russell 2000 Index, were exceptionally strong, advancing 9 percent for the quarter, and up over 11 percent for the year. Global growth prospects seem to have stabilized during the quarter after a slow period in the first half of the year, which encouraged investors to embrace more risk-based assets.

The 10-year bond finally stopped declining, with yields rising slightly from the 1.47 percent at the beginning of the quarter, to 1.6 percent at the quarter end. The Bloomberg Barclays U.S. Aggregate Bond Index was essentially flat for the quarter, returning 0.46 percent, due to this modest yield increase in the 10-year bond. The chase for yield that occurred in the first half of the year took a breather in the third quarter, but credit-sensitive risk assets performed very well. High yield bonds returned over 5 percent for the quarter and are now up over 15 percent for the year, and emerging-market debt returned 3.7 percent for the quarter, and is up slightly over 15 percent for the year. Both of these credit-sensitive areas continued to do very well during the third quarter.

Global growth prospects stabilized during the quarter for a few reasons: number one, continued central bank easing at the Bank of Japan and the ECB; number two, there was no real negative impact of the U.K. Brexit vote as of yet; number three, there was continued stability in the oil markets. For U.S. equity investors, second quarter earnings reports were much better than feared overall, as most U.S. companies continued to perform extremely well, even in this slow-growth global environment. Over the last two years, two major factors have had a very negative impact on reported S&P 500 earnings: one has been the collapse in the price of oil and the second has been the strength in the U.S. dollar. Both of these have the potential to reverse going forward, or at least become much less of a negative for reported earnings for many large multinational companies. Businesses which have suffered from the decline in energy prices have yet to meaningfully recover, but they are showing signs of some stability in end demand. Cost structures, particularly for oil and oil-related companies, have been dramatically reduced over the last two years and will, therefore, show much better profits at much lower levels of crude-oil prices than they have in the past.

The interesting thing about this market is, despite the fact that the stock market has been hitting all-time new highs during the third quarter, there are very few traditional indicators that would indicate some sort of "blow-off top" in equity prices. Investor sentiment overall is still mixed, at best, with net outflows of $157 billion out of domestic equity funds and ETFs over the last year and nine months, and net inflows of $178 billion into bond funds and ETFs. Initial Public Offering activity, which is usually very frothy at market tops, is very quiet at best and only a few deals have gotten done over the summer. Inventories are usually high and climbing into a market top as businesses optimistically gear up for strong demand. However, $144 billion dollars worth of inventory has been liquidated over the last five quarters, making inventory levels more likely to be rebuilt rather than liquidated in the future. And, most importantly, corporate earnings prospects in the U.S. appear sound even in a 1.5 to 2.5 percent GDP growth environment.

As we enter the final quarter of the year, we continue to face the uncertain outcome of a presidential election and the prospect that the Fed will raise rates slightly in December. This will create some short-term uncertainty and headwinds for the market, but we recommend staying the course for the long term. Investors have had plenty of time to process the election possibilities, and the Fed's outlook for a rate increase, so we do not believe either will have a meaningful impact on equities over the long term. It is important to remember that even the President of the United States has limits to his or her power with checks and balances from the legislative and judicial branches of our government. Many campaign promises made are never actually accomplished once a politician is elected. Additionally, future rate increases by the Fed are intended to "normalize" interest rates and give the Fed some more room in the future. They are not intended to shut down an overheated economy, as is typically the case when you are going into a recession.

Our outlook continues to be that the United States will grow over the next year at 1.5 to 2.5 [percent] in gross domestic product, and corporate earnings growth will drive equity returns of 6 to 8 percent over the next 12 months.

We thank you for your continued trust and support, and we will continue to implement our high-quality investment approach on your behalf.

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