

MARKET COMMENTARY: Q3 2016

“Since I’ve become a central banker, I’ve learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said.” - Alan Greenspan, former Federal Reserve President

Some of you may have heard of the “Greenspan Effect” – a phrase used in reference to former Federal Reserve President Alan Greenspan’s usually opaque references to monetary policy and, more generally, his input on “whatever”. More specifically, the phrase could be linked to the beginning of an era when markets had become much more fixated on the Federal Reserve (Fed), an effect that still exists today. The reality is that much of the focus on the Fed stems from advances and deployment of Monetary Policy tools and their impact on the overall economy. But in our context, consider the fixation with the Fed by individual retail investors that is largely exaggerated. I would propose that economics and Fed policy in general lead to confusion – the more you know, the more questions you have, hence the greater the fixation. Or, for others, it may be somewhat of a mystery matter since they were never exposed to the subject or they suffered through a 101 class in college to happily never revisit the matter. Consider the term “Quantitative Easing” and there is a steady lull (but still begs the question, *what does that mean?*). Flip to the news, open the Journal, anything to find the answer. After all, we are heading into the holiday season and it could come up at a cocktail party.

Fast forward to current Fed President Janet Yellen and all eyes are still locked, waiting, debating and forecasting the next move based on every word. So we wonder, very diligently, does forecasting and some element of “guess work” around the next rate-hike lead to better portfolio results? Markets are pretty confident the Fed will hike in December.

Recall not too long ago markets were also pretty confident the U.K. wouldn’t vote to leave the European Union (enter the element of guess-work).

The idea is to be weary of fixation on anything in investments that distorts broader reality, which brings to mind the old adage “can’t see the forest for the trees”. While a rate-hike is likely looming for December and will carry economic impacts, consider the broader theme that the very notion of the hike itself means that the economy is on better footing; despite a global low-growth environment, there are quite a few positives domestically. September’s manufacturing PMI data was up 2.1% from the August read and, most notably, new orders and production are growing. GDP in Q2 2016 was revised upward again for the third time, from the previous read of 1.1% to now 1.4%. The Fed’s minutes from their September FOMC meeting note the labor market has continued to strengthen. Consumer sentiment is up, as measured by Michigan’s Consumer Sentiment Index, from 89.8 in August to 91.2 in September. The September read for inflation based on the Core Personal Consumption Expenditures (PCE) came in 0.18% higher than August and 1.69% year-over-year. Other inflation measures are ticking even higher. The Fed has continued to maintain they will assess realized and expected conditions relative to their inflation target (2%) and maximum employment target (a long-run range spanning from 4.5-5%, with a median of 4.8%). Things may not be moving along as quickly as one might hope, but they are moving nonetheless.

Despite positive reporting on key economic factors there are and will continue to be rumblings of “correction” and “recession”. As it relates to a correction – defined as a 10% equity sell-off – it is interesting to look back at the frequency of these events over time; Since June of 1950, on average,

corrections have lasted 135 days and we see 443 days between corrections. The longest time-frame between corrections was nearly 7 years, from July of 1990 to October of 1997. The shortest time-frame between corrections was 35 days back in 1974. Furthermore, the average severity of corrections in the S&P 500 since 1950 has been -14.2%. So to be clear, on average, we aren't "overdue" for a correction since we had one less than a year ago in Q1 2016. However, consider we are heading into a quarter with both a divisive Presidential election and a perceived rate hike.

The Wall Street Journal's Economic Forecasting Survey places a 20% chance of a recession over the next 12 months. That is up from January's survey of 17% but down from June's survey of 21%. While we very clearly do not rely on this read for portfolio decisions, it is a broad-based survey of more than 60 economists and arguably has as much merit as any single individual or institution. We do not see the underpinnings of a recession near-term but we should also consider the age of the current business cycle. More specifically with that in mind we did extensive research last spring and made key changes for Signature Choice advisory clients in our fixed income portfolio – a move to higher quality corporate debt and less exposure to high-yield credit and global debt. Since July we have steadily taken opportunities to raise cash for clients in a distribution phase as markets have posted resilient gains since the rocky first quarter.

We still feel strongly International Developed markets are an important part of a well-diversified and thoughtful portfolio but understand this is an area of unease for some investors. For example, the severity of post-Brexit uncertainty (particularly for banks) has added a theme of caution in Europe. Additionally, the Bank of Japan is nearing its limits with monetary policy. In an effort to battle a soft

Japanese economy, however, we are favorable on their supportive fiscal policy measures. Across the broader landscape there is still a theme of loose monetary policy, additional fiscal easing, and cheaper valuations that all add to the relative attractiveness long-term. Emerging markets through the end of Q3 2016 have been the best performing asset class this year of the nine we track, up 17.28% on the year as measured by the MSCI Emerging Markets Index. Needless to say we are happy to have exposure here for our advisory clients but are watching this space closely to see where the market heads.

Looking ahead it is important to keep an eye on fundamentals and judge them in the context of the overall global economy. Consider our Fed is pursuing a somewhat-agitated tightening cycle against a global backdrop of less-than-stellar growth and monetary/fiscal easing. Regardless of which Presidential candidate is elected, fiscal stimulus (i.e. through infrastructure spending, something both candidates support) could encourage consumer and corporate spending well before implementation. This, in turn, could fuel equity markets further and remind investors that there is more than just the Fed that matters. As we move towards the New Year, keep in mind market volatility wouldn't be unusual – valuations are generally fuller and even small pinch points could have larger impacts. The key is to continue to focus our success on long-term goals and objectives and to look at the bigger picture.

Please do not hesitate to reach out to me or my team to discuss your specific situation.

Warm regards,

Jeff

Disclosure:

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Michigan's Consumer Sentiment Index: A survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

GDP: Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. Though GDP is usually calculated on an annual basis, it can be calculated on a quarterly basis as well. GDP includes all private and public consumption, government outlays, investments and exports minus imports that occur within a defined territory. Put simply, GDP is a broad measurement of a nation's overall economy.

Manufacturer's Purchase Managers Index (PMI): The Purchasing Manager's Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

Core Personal Consumption Expenditures: The "core" Personal Consumption Expenditures (PCE) index is defined as personal consumption expenditures prices excluding food and energy prices. The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

S&P 500® Index: Capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The total return version of the index is used, which reflects the effects of dividend reinvestment.

MSCI Emerging Markets Index: The Emerging Markets Index is a float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.