

Third Quarter Review: New Highs, Old Corridor

The transition between the second and third quarters this year was interesting, in the manner of that old Chinese curse (may you live in interesting times). The political world was still reeling from the shocking outcome of the Brexit vote in the UK, yet asset markets were already in full-on relief rally mode as Q3 dawned. Anyone, who still held onto the quaint old notion that something could truly surprise or rattle a stock market singularly focused on central bank policy, was summarily disabused of said notion. Riskier asset classes, like small caps and emerging markets, joined U.S. large caps in registering high single digit / low double-digit gains from the post-Brexit low to the end of July. After more than one year since the last record S&P 500 high, July saw a succession of new all-time highs.

August settled into a lazy summer languor, with volatility at multi-year lows and the S&P 500 meandering along a new corridor level that looked every bit like the old corridor level. Investors, though, had their eyesight trained on the often unpredictable month of September. As always, seemingly, the red-letter days marked on people's calendars were those relating to central bank decisions. In particular, the European Central Bank was to meet on September 8, followed by Policy Wednesday (September 21) when announcements from both the Fed and the Bank of Japan were due. None of these meetings shed much new light on the direction of monetary policy. Observers seem less clear about the trajectory of the BoJ and ECB stimulus programs than they were earlier in the year, while the "will-they-won't-they" parlor game for the Fed's next rate hike is now pushed back to December.

For all the confusion, though, risk asset markets largely took everything in stride. The S&P 500 started September at a price level of 2170 and finished the month at 2168. Meanwhile a bullish sentiment swept through commodity markets, with crude oil rallying strongly to test recent resistance levels on the back of the latest apparent attempt by OPEC to implement a production freeze. Skeptics correctly point to the handful of past failures in recent months to successfully execute policy among OPEC's contentious member states. But falling inventory levels and moderately positive demand should also work in favor of continued price stabilization for crude oil, perhaps within an expanded trading range of \$45 - \$60. That stability may in turn provide a tailwind to other asset classes.

Fourth Quarter Outlook: Calm Today, Turbulent Tomorrow?

Our fourth quarter outlook would not be complete without mention of the upcoming U.S. presidential election. We believe the election, not just at the top of the ticket but also down-ballot, will have a muted impact on risk assets in the immediate term. The problems of a gridlocked government and a sharply divided citizenry will not be solved no matter who is swept into office on November 8, and that view is likely already priced into the market. The only policies that truly matter to share prices are those implemented by central banks, and that is where the focus is likely to remain for the foreseeable future. At some point, the myopic reliance on central banks as the sole dispenser of effective economic policy will have to change; it is not indefinitely sustainable. We do not see the time of reckoning as a high probability outcome for 2016. But central bank credibility is, in our opinion, a top-level concern to monitor over the course of 2017.

There appears to be little change to the ongoing macroeconomic story: low but positive growth, improving employment conditions and a gradual appreciation of wages and consumer prices. We will have 3rd quarter GDP to digest later this month, and in particular we will be interested to see whether the recent trend of slumping capital formation by private businesses reverses. Business investment has been a drag on GDP, and also helps explain the weakness in productivity over the past several years. In the absence of population growth or a higher percentage of the existing population joining the labor force, productivity is the only path to renewed economic growth. We will not see a return to pre-recession growth tendencies until and unless the productivity slump manages to reverse.

Quarterly Newsletter

The other likely key influencing factor in asset price trends this quarter will be the Q3 earnings season that is just getting underway. Analysts expect average S&P 500 earnings per share to decline for the sixth straight quarter, though by a smaller magnitude than the high single digit declines of Q1 and Q2. Weak earnings are a drag on upside for share prices, given that common valuation measures such as price to earnings (P/E) ratios are at decade-plus highs. Now, an expensive stock market does not necessarily preclude an old-fashioned “Santa Claus rally” if markets get through the next six weeks or so with minimal setbacks. Going forward, though, evidence of a return to double-digit earnings growth will likely be a necessary driver of improved confidence in the bull’s ability to keep running.