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Economic & Market Summary
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Stocks and bonds posted positive returns through the third quarter as the U.S. economy continues to slowly expand, monetary policies remain extraordinarily accommodative, and the world is awash in liquidity searching for yield. Recall, it hasn't been a straight line upward. After several bouts of downward pressure in January, February, and June, stocks and bonds have soared to record highs. Capital markets are wide open, fueling a surge in large merger and acquisition transactions. Valuations have achieved cycle highs, but still seem only to reflect a "normalized" interest rate environment. U.S. GDP growth over the past 12 months was 1.3%, below the current expansion's already weak trendline, due to inventory realignment, weak business investment, and export challenges. Although burdensome regulation and taxation are reducing growth, we don't see an imminent recession.

Outside the U.S. we are observing conditions which were not thought to be possible, namely negative interest rates. The monetary policies driving these low rates are intended to spur faster economic growth, however, they appear to be causing individuals to save rather than consume more. If future returns are expected to be lower (i.e. lower interest rates), it is rational for individuals to save more money for retirement than if expected returns were higher. While this puts individuals in a more conservative financial position, it dampens economic growth prospects. The European Central Bank is considering extending its quantitative easing program which expires next March. Reports are suggesting the ECB will widen the spectrum of assets available to be purchased because inflation and growth have remained below target for several years. Meanwhile, the Bank of Japan announced it would purchase 10-year government bonds with the goal of forcing the yield to zero.

Based on improving economic conditions, we have long argued for elimination of emergency type monetary policy in the U.S. The latest unemployment reading was 4.9% and core inflation was 2.3%, continuing to suggest interest rates are inconsistent with economic realities. Periodic market sell-offs occurring at even the slightest hint of rising interest rates seem to keep the Federal Reserve on hold. At its recent meeting the Fed opted to leave rates unchanged, but suggested there would be one rate increase yet this year. Absent a dramatic decline in economic activity, we believe short-term rates will be increased in December.

After several quarters of declining earnings due primarily to currency-related pressures and losses stemming from commodity price declines for oil/gas related companies, S&P 500 earnings are expected to resume growth in the second half of the year. The forward P/E multiple on the market of 18x is within the historical range of fair value. We remain confounded by equity fund flows which have been predominantly negative in this recovery, including 2016. Flows to bond and money market funds, however, remain astonishingly robust. This fund flow data suggests market sentiment is far from ebullient and that many investors haven't captured the significantly higher returns earned in equity investments. As contrarian investors, we view this as bullish for the market going forward.

Thomas H. Rippl, CFA

To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.