What a difference a quarter can make! Continuing the bullish trend we’ve seen post-financial crisis, the U.S. stock market reached record highs during the 3rd quarter of 2016. The S&P 500 index posted a solid 3.8% gain. Both the S&P 500 and the Dow Jones Industrial Average recorded a series of record high closes during the quarter. The Nasdaq Index reached heights last seen in March 2000.

International markets also experienced solid returns during the 3rd quarter. The MSCI Europe Australia Far East Index (EAFE) had a 6.5% gain, while the Emerging Markets also enjoyed a strong quarter (reversing the downward trend of the last two years). The MSCI Emerging Market Index rose 9.1% for the quarter with all BRIC (Brazil, Russia, India and China) countries posting strong returns.

The fixed income sector (bonds) moderated during the 3rd quarter. The yield on the 10-year U.S. Treasury note rose to 1.6% at quarter’s end (up from 1.49%) while the Barclay’s U.S. Aggregate Bond Index rose 0.46%.

While investors have recovered from the Brexit vote shock this summer, risk in fixed-income markets remains as the U.S. presidential election nears, an Italian referendum approaches, and the likelihood of a December U.S. federal funds rate hike increases.

Federal Reserve
The Federal Reserve left interest rates unchanged at its last meeting, but strongly signaled it may tighten monetary policy by the end of this year. The target range for the benchmark federal funds rate remains at 0.25% to 0.5% (where it’s been since the last quarter-point increase in December 2015). The central bank policymakers appear increasingly divided over the urgency of raising rates and have been careful not to shock the markets before the upcoming U.S. presidential elections.

The U.S. Economy
U.S. economic data has been mixed. Measures of manufacturing, trade inventories and capital goods orders all showed signs of weakness. In a similar vein, the numbers of new housing sales, while rising, remain notably below the twenty-year average.
At the same time, initial jobless claims (a key leading economic indicator) have continued to decline, the unemployment rate remains low, and both wages and consumer confidence have been rising—albeit modestly. All of this suggests that the U.S. economy will continue to modestly muddle through into 2017.

The International Monetary Fund did lower the U.S. economic growth outlook to 1.6% for 2016. Main concerns noted were a continued decline in capital spending in the energy sector and the impact of dollar strength on investment in export-oriented industries.

**GDP Forecast**

According to the Commerce Department, the U.S. Gross Domestic Product (GDP—the value of all goods and services produced), increased at a 1.4% annual rate. Economic growth has remained below a 1.5% pace for three straight quarters.

Rising personal consumption and household spending have supported GDP growth this year. Consumers are still spending at a healthy clip and the housing market continues to get stronger. In contrast, manufacturing, business inventory investment, state and local government spending, residential and non-residential fixed investment all slowed in the second quarter.

As noted, U.S. manufacturing growth slowed in the 2nd quarter overall. While this suggests the economy may have struck a soft patch, in September, the Institute for Supply Management reported its index of manufacturing activity rose to 51.5% after dipping into negative territory in August. (A reading above 50 indicates that factory activity is expanding while a reading below 50 signals contraction.)

Employers continued to add to payrolls in September as record job openings drew more Americans into the workforce. The jobless rate stood at 5% in September. The continued improvement in the U.S. employment picture suggests that the U.S. labor market is stabilizing at a level that will support continued economic growth without, it is hoped, igniting high inflation.

**U.S. Unemployment Rate**

One downside to the otherwise favorable employment picture is that many of the new jobs being created are those in lower-paying service sector businesses (restaurants, personal services, etc.). The silver lining may be that these jobs are typically less exposed to economic headwinds (such as the stronger dollar) that affect manufacturers.

Consumer confidence is important when consumer spending accounts for two thirds of the total U.S. economic activity. According to the most recent Thomson-Reuters/University of Michigan Survey, consumer confidence reached a quite positive score of 89.8 in September. As a group, American consumers today are in a better financial shape than they have been for years. The combination of rising employment, low inflation and declining consumer debt are contributing to American consumers feeling more optimistic.

**U.S. Housing**

Sales of new single-family homes fell 7.6% in August (to a seasonally adjusted annual rate of 609,000 units). Sales of existing homes also fell. According to the National Association of Realtors, sales of previously-owned homes fell 0.9% in August to an annual rate of 5.33 million.
Over the last few years, the residential housing market has been one of the strongest segments of the economy. Substantial property inventories, low mortgage rates and an improving affordability picture all contributed to strength in this segment of the economy. The recent slowing may reflect both declines in housing inventory and the steady rise in house prices.

Inflation

Inflation, which has persistently run below the Federal Reserve’s 2% target rate, remained muted this quarter. Still, stabilizing energy prices, the diminishing influence of a strong dollar and nascent wage gains are helping to gradually push inflation higher. August results showed core inflation to be up 2.3% over the prior year while “headline” inflation, which excludes food and energy, was up 1.1%. Continuing economic growth should encourage the Fed to resume its objective of raising the short-term federal funds interest rate.

The World Economy

The 3rd quarter saw the International Monetary Fund cut its global growth projections.

Weaker-than-expected growth in the United States is one of the reasons. Britain’s exit from the European Union is another. The uncertainty surrounding the U.K.’s planned exit from the European Union is an economic cloud over both the U.K. and its major trading partners within the European Union. A key concern centers on what Britain’s trading relationship with the remaining 27 E.U. countries will look like.

In addition to questions about U.S. economic growth and the Brexit, the global economy continues to be affected by the slowdown of the Chinese economy, terrorism and political upheaval in many parts of the world.

Euro Area

The Eurozone economy slowed in the second quarter of the year. The Eurozone’s gross domestic product (GDP) grew 0.3% in the second quarter, slowing to an annual growth rate of 1.6%. Of the Eurozone’s four largest countries, only France’s economy is showing signs of gaining momentum. Second quarter numbers indicate that growth is decelerating in Germany, Italy, and Spain.

Conditions in the European Union are slowly improving. Nonetheless, many issues remain. Potential deflation continues to be a concern with core inflation far below European Central Bank’s target of 2%. The unemployment rate throughout the E.U. remains high at 10.1%.

Earlier this month, in a bid to encourage lending and drive up inflation, the European Central Bank decided to maintain its record low interest rates. It also opted to leave intact the bank’s ultra-loose monetary policy, choosing to stay the course with a massive asset-buying program to the tune of 80 billion euros a month.

Japan

Japan’s economy grew at an annualized rate of 0.7% in the second quarter of 2016 (rising 0.2% in Q2). The government has initiated a number of measures in an attempt to boost growth. Still, Japan’s emergence from recession has been weaker than hoped for or expected.

The Bank of Japan (BOJ) announced a new policy framework in its attempt to battle deflation and generate economic growth. With the country’s current 10-year bond interest rate at -0.1% there is limited room for the BOJ to move in its efforts to drive growth. The country’s already massive asset purchase program continues as the BOJ seeks to achieve its goal of 2% annual inflation. Future governmental actions are unclear as there are reasonable fears of possible damage to Japan’s banking system.

China

China, the world’s second largest economy, has seen its growth rate stabilizing. Gross domestic product rose 6.7% in the 2nd quarter from a year earlier. A credit surge and housing recovery this year aided growth this year, but many questions remain as to the sustainability of the country’s debt-fueled expansion. China’s leadership has stated its objective of maintaining a minimum average economic growth rate of 6.5% through 2020. This would effectively double the size of the Chinese economy relative to its size in 2010.
To achieve its target, the Chinese government is looking to growth drivers, based on innovation and services, while seeking to reduce reliance on more traditional sectors, like coal and steel.

**Emerging Markets**

In contrast to the developed market economies, the emerging market economies are picking up momentum. All of the BRIC countries (Brazil, Russia, India and China) are showing signs of greater economic stability and, in some cases, moderate growth. Rising commodity prices have given a boost to commodity-oriented economies such as Russia and Brazil. Latin America broadly has seen notable improvement while the emerging resolution of Brazil’s political crisis seems to have calmed global investors to some degree.

**Investments**

**U.S. Equities**

Stocks enjoyed stellar gains during the 3rd quarter of 2016, with both the S&P 500 and Dow Industrials achieving new all-time highs in August (they did fall back a bit afterward).

The S&P 500 Index ended the quarter up 3.8%. The Dow Jones Industrial Average also finished higher, gaining 2.8%, while the tech-heavy Nasdaq posted a very solid gain of 10% during the quarter.

Including this most recent quarter, the S&P 500 index has now risen 220% from its March 2009 lows (this excludes reinvested dividends—see chart below).

**U.S. Market Returns by Category**

![Chart showing U.S. Market Returns by Category](chart)

Both during the 3rd quarter and year-to-date, small U.S. stocks significantly outperformed larger stocks. The Russel 2000 small stock index was up 9% for the quarter and 11.5% year-to-date. This compares to returns for the S&P 500 Index of 3.9% and 7.8% for the same periods.

Irrespective of size, “growth” stocks maintained a slight advantage relative to “value” stocks in the 3rd quarter. But, as can be seen in the table above, across all size categories, year-to-date, value stocks have seen a significant performance edge relative to growth.
International Equities

Developed international markets recovered sharply in the 3rd quarter following the 2nd quarter’s broad sell off (attributable in large part to the Brexit vote). The MSCI Europe Australia Far East Index of developed international markets rose 6.5% for the quarter. Year-to-date, the index is up 2.2%.

The MSCI Emerging Markets Index (traditionally more volatile than developed market indices) experienced the highest returns in both the quarter and year-to-date. The index rose 9.1% for the quarter, while being up 16.4% year-to-date.

Fixed Income—Bonds

During the 3rd quarter, prices in nearly all major bond sectors rose. Although fixed income markets have rebounded from the Brexit vote shock this summer, “event risk” remains as the U.S. presidential election nears.

For the 3rd quarter, the Barclays Capital Aggregate Bond Index rose 0.46% and is up 5.8% year-to-date. The yield on 10-year Treasury Notes rose to 1.6% (from 1.49% in the 2nd quarter).

Somewhat surprisingly, given a benign inflationary environment, U.S. Treasury Inflation Protection Securities (TIPS) were up 0.96% for the quarter and are up 7.3% year-to-date.

As the dollar has stabilized relative to foreign currencies, emerging market debt posted strong returns for the quarter and year-to-date. Dollar-denominated emerging market bonds rose 3.1% in the quarter and have risen 15.8% year-to-date.

Alternatives

Other than Managed Futures, all alternative investment categories achieved solid returns in the 3rd quarter and year-to-date.

- The Algerian Master Limited Partnership Infrastructure Index, which tracks energy transportation and storage facilities, gained 1.9% for the quarter and is up 15.8% year-to-date.
- Global real estate, represented by the NAREIT Real Global Index, rose 2% over the quarter, and is up 11% since the beginning of the year.
- MultiAlternative— as measured by the Credit Suisse Hedge Fund Index, was up 1.51%, in the quarter and is flat so far in 2016.
- Managed Futures—as measured by the S&P Diversified Trends Indicator Index, which represents this category, declined 3.7% for the quarter and is down 3.3% year-to-date.

Summary

Looking ahead, there continue to be risks for investors. Domestically, the U.S. presidential election has created considerable uncertainty (given the very different policy positions and personal styles of the candidates). On the interest rate front, the Fed is expected to increase interest rates—if not in 2016, almost certainly in 2017. Globally, whether from terrorism, or extremist politics, threats to democracy continue as does militaristic posturing from a number of countries. Finally, the current economic recovery is getting “long in the tooth.” While we believe the recovery is likely to continue for a while longer, there remains a degree of uncertainty as to the future progress of the economy. Despite these many risks and concerns, our fundamental optimism about the long-term state of our economy and the world remains.

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