Looking Ahead to the Fourth Quarter

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September 2016

We're about to wrap up the third quarter of 2016 and head into the final months of the year.

The third quarter has a reputation of being a dicey period, but as of the writing of this update, markets avoided any large swings. Though the reverberations from the Brexit vote in late June could be felt in the early part of Q3, markets recovered fairly quickly. Ultimately, markets did what we hoped they would do, which was continue to slowly consolidate gains.

With 2017 on the horizon, we are looking at three key areas that have the potential to impact the markets and economy during the remainder of this year.

1. **The Election:** Unlike two or three years ago, market prices are no longer cheap.

Any time we have higher prices, by default there will be greater expectations. Investors want certainty, but the way the election cycle is playing out is not giving them what they crave. Markets will likely get more volatile as we get closer to the presidential election.

2. **The Federal Reserve:** Markets seem fixated on whether the Fed will raise interest rates and when.

   As we've stated before, it's important to recognize that while the Fed can control certain rates within the banking system and take action in open markets, it is the market that ultimately controls rates.

   Last December, when the Fed raised rates and stopped buying bonds, interest rates moved down instead of up — the opposite of what the Fed wanted. It almost certainly would have been better if the Fed had raised rates during stronger economic growth in 2013 and 2014, but we're not as concerned over what the Fed will do because we know that ultimately the market will make the call.

   Regardless of the Fed's decision, we anticipate rates will stay low and move higher very gradually. That's because low and negative rates worldwide are funneling buyers into U.S. bonds, keeping our rates lower. Additionally, there have been weak economic numbers in the U.S. The most recent jobs report did not meet expectations, and manufacturing levels leave something to be desired – as new orders are contracting, employment and the Purchasing Managers' Index (PMI) are also contracting.

   Again, while this timing is not ideal, if the Fed raises rates, we believe the market is strong enough to absorb a .25 percent rate hike. Additionally, we do want rates to rise long-term to better compensate investors for their lending.

3. **Profit growth:** This year has seen its share of ups and downs, but the most disappointing thing has been the decline in earnings. We've gone through several quarters where we saw earnings stall and in some cases, go backward.

Usually when we see earnings like that, it's indicative of a recession. That doesn't appear to be the case right now. Instead, the market realizes that energy companies are the cause behind the poor earnings numbers. These losses are shrinking, however, and will eventually return to gains.

Besides energy, industrials and basic materials have been dragging down profits, but it's very likely these sectors will also begin to normalize. The other sectors have held their own and will likely continue to grow.

In the fourth quarter, we will be closely watching third quarter earnings reports, particularly those coming from the energy sector. We don't have unrealistic expectations of massive growth though and will instead be watching for stabilization.

The common theme with all of these areas is that they could lead markets to become more volatile.

It won't take much to increase volatility because we have gone through an unusually quiet period in markets. In mid-September, when we saw 1 to 2 percent movements a few days in a row, investors were shocked because it hadn't happened in so long.

Even though we anticipate higher volatility, we don't expect it to spike dramatically. Historically, the S&P has a standard deviation of 18 or 19 (Source: DFA Returns). We're forecasting an increase from about 12 to about 14 or 15 (Source: DFA Returns). While we will likely have more days of 1 or 2 percent movements, price movements will also bring with them higher expected returns over time.

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