StraightTalk
StraightLine
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3rd Quarter 2016 | Steven F. Mosshart AIF® — Chief Investment Strategist
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2016 Market Performance*

S&P 500
7.84%

Dow Jones
7.21%

NASDAQ
7.09%

MSCI EAFE
1.73%

Barclays US Aggregate Bond
5.80%

Morningstar Large Cap Core
9.33%

Morningstar Mid Cap Core
9.49%

Morningstar Small Cap Core
13.92%

**Market data is from Morningstar and is through 9/30/16. All returns are with dividends reinvested.*

The most notable thing about the third quarter was just how unusually quiet it was in terms of news and market movements. There was a noticeable lack of volatility in equity markets, even as domestic stocks pushed to new all-time highs. Meanwhile, there was a significant bounce in international stocks, where both developed and emerging market equities outperformed. Fixed income markets continued to chug along, with modest gains for the quarter. While the lack of drama in markets was a nice summer surprise, we don't expect that it will last. Although we remain somewhat optimistic in our view of the economy and stock markets, we believe that there are short-term risks in parts of the fixed income market.

Global equity markets had a great third quarter, with unusually low volatility and steady gains throughout. Beyond the broad based gains, there were a couple of noteworthy trends that we noticed in the quarter. We saw some nice outperformance by small cap stocks versus their large cap counterparts. The Russell 2000 was up 9.05% versus 3.85% for the S&P 500, and has outperformed on the year overall. This is important because in an ongoing bull market we expect to see small caps outperform; something that hasn't happened in the previous two years.

During the quarter we also witnessed the start of what might be a broader sector rotation. In the first half of the year higher yielding, defensive sectors led the way; however over the course of Q3 we saw rebounds in financials, industrials, and technology. We believe that this is a positive development, indicating greater confidence in stocks and the potential for a pickup in economic activity.

For the first time in a few years it looks like emerging market stocks will enjoy some sustained success. Throughout the year the MSCI EM Index has managed to lead both domestic and international developed markets, and after a 9.03% return in Q3 the index is up 16.02% through the end of the most recent quarter. Assuming that the index can hold on to its gains, it will be the first time since 2012 that it both posts a positive return and outperforms the S&P 500. In all these trends bode well for continued gains in stocks, and in our view have set us up nicely for the fourth quarter.

Turning our attention to fixed income markets, we've seen bonds do better this year than most were expecting, but we are somewhat cautious going forward. The reason for our caution is tied to central banks and the slow shift in monetary policy we see taking place. Global bond yields have been suppressed by the combination of asset purchases and negative rates in Europe and Japan. However, recently it appears that central bankers are realizing that these policies have limits and aren't necessarily achieving their desired objectives. There is a growing belief that quantitative easing is in its final stages and central banks will instead take more targeted measures to keep policy accommodative. Collectively this shift in policy should allow for the Fed to potentially raise rates at a slightly faster pace, which includes a rate hike before the end of this year. We could very well see global bond yields gradually move higher, as we've seen in recent weeks. As this happens we should see government bonds selloff, while corporate and mortgage backed bonds are somewhat less at risk. We certainly wouldn't advocate abandoning fixed income, but we see limited upside the next quarter or two.

For all the craziness that we've seen this year, it's turned out to be a pretty good one for diversified investors who have been willing and able to weather the storm. We see the potential for further gains in the fourth quarter and this year could prove to be much better than the previous two. As always, some caution is warranted, and while it wouldn't be surprising to see a pullback sometime before the elections, we would expect markets to quickly rebound. We aren't anticipating the need to make any major changes to our allocations in the coming months. While watching the election turmoil can be fascinating and engrossing we view it and the subsequent market reactions as just one more factor to consider as we continue to formulate our strategies. Please contact us at (866) 401-5238 or info@straightline.com if you have any questions.