CAPITAL ASSET MANAGEMENT

# Quarterly Commentary 2016 | Q3

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***I'm optimistic about the country; I'm optimistic about the American people. --Howard Schultz-***

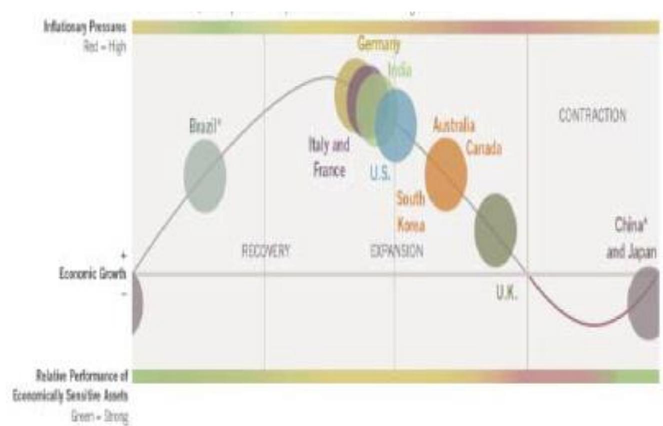
Despite an unusually antagonistic and polarizing General Election campaign, equity markets remained relatively calm through much of the Third Quarter 2016, despite underlying concern over the possibility of a rate hike.

As the quarter began, lingering anxiety over the June 24th Brexit vote was soon replaced with intense scrutiny of the Federal Reserve. Investors analyzed virtually every word spoken by Federal Reserve Chair Janet Yellen and other members of the Open Market Committee, who have become increasingly vocal in recent years. All Fed watchers shared a common goal—to uncover some inkling of whether the Fed would move to raise rates at their September meeting. When the meeting ended once again with no increase, investors breathed a sigh of relief and equity valuations continued to rise. Even so, investors remain hesitant.

While the effect of extended, ultra-low rates on the economy is an on-going debate, the effect on equity markets is very clear. By keeping rates low, the Fed has significantly reduced the return expectations companies traditionally have had to meet to attract and retain investment. With reduced competition for investment dollars, equities have remained attractive, with little or no growth in revenue.

Traditionally, revenues reflect demand. Muted revenues become the norm when demand is limited. Despite unprecedented monetary accommodation, the Fed has not been able to stoke demand. With more than two-thirds of our economy consumer driven, economic growth rests heavily on households' willingness and desire to spend. Although some economists feel that stronger growth may be in our future, past quarters have been relatively anemic.

The lackluster growth, coupled with an aging business cycle, has given rise to some talk of recession. For those of us who have lived and worked through the relatively recent Great Recession, even the mention of the term sparks panic. In reality, recessions are quite common and should be considered when developing an appropriate investment strategy. Recessions occur normally after a peak in the business cycle. Fidelity Investments produced the graph below, illustrating where certain sovereign economies are believed to be in the current cycle.




Although we and most analysts and advisers see the risk of a serious recession as relatively low, all economies go through four relatively well-defined phases, the last being recession. Most economists agree that we are closer to the end of the cycle than the beginning.

**Going forward….**

If uncertainty continues to persist, it may once again give rise to volatility. In coming months, political uncertainty may by the catalyst for market instability. Although equity markets have remained relatively steady, an unexpected outcome in the November 8th election may prompt a brief sell-off.

While we are in no way insinuating how you should vote, it does appear that markets have priced in a Clinton victory.  It is important to remember that markets do not like uncertainty. Unlike some of her hopeful supporters, equity markets do not perceive that Clinton will be an agent for change, but simply a steady force for maintaining the status quo.  If other down-ballot Democrats were also able to make significant gains or possibly reach a majority in either the House or Senate, the markets may begin to worry.  While a divided government that accomplishes little may not benefit the nation, it may—at least for now--stabilize the markets.

As equity markets continue to become more fully valued, the upside for returns may be somewhat more limited than investors have enjoyed over the last several years.  Without significant improvement in corporate earnings and cash flows, it will likely be difficult for investors to justify significant advances in valuations.  With the economy most likely in a mid-to-late business cycle, substantial revenue growth is difficult to envision in the near term.

Finally, as noted above, one of the key supports for the equity markets over the last several years has been the Fed's unprecedented, accommodative monetary policy.  Eventually, this policy will change.  Unfortunately, no one knows when.  In the interim, investors are left trying to read the tea leaves, comparing notes and meticulously attempting to analyze every word uttered by a member of the Fed's decision-making board.

Many analysts and money managers are coalescing around the idea of a December hike. Even though the market is beginning to anticipate and thus price-in such an increase, there will likely be some volatility when the next increase actually occurs.  Hopefully, the reaction will be less dramatic than what we experienced this past January, following the first rate hike in December 2015.

In addition to raising the bar for equities, an increase in the Federal Funds rate will also have an impact on existing bond positions. Investors, who would have an opportunity to purchase newly issued bonds at higher rates, will have less interest in owning existing inventories.  Current bonds will need to be discounted—think devalued—to produce a yield equivalent to those newly issued, offering a higher rate.

While we believe that bonds can and will continue to be an important ballast in client portfolios, we have continued to shorten the duration on these fixed income holdings.  The duration of a bond is an important measure of how sensitive the valuation will be to changes in interest rates.  Although the shorter durations have necessitated sacrificing some gains in the short run, we feel this measure has been an important step towards preserving our clients' capital.

When we view our current situation favorably, we seldom welcome change.  But change remains a constant both in investing and in life. The most prudent approach is to control the variables we can and to accept—albeit reluctantly—those we can not.

In the existing market environment, asset allocation remains challenging.  Uncertainty persists and the business cycle is aging.  In addition, upside potential is becoming limited. Periodically assessing your risk tolerance is critical, as it is the foundation of your investment strategy.  A properly determined risk score should account for market fluctuations and mitigate concerns.  It should culminate in a well-diversified portfolio and promote a disciplined investment approach.  The best news—these are all variables any investors can control.

If you have questions or feel that your portfolio may not accurately reflect your risk tolerance, we would welcome a call. As always, we remain committed to your financial success.

Sincerely,
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