

QUARTERLY ECONOMIC UPDATE

A review of 3Q 2016

QUOTE OF THE QUARTER

“Self-confidence is the first requisite to great undertakings.”

- Samuel Johnson

QUARTERLY TIP

Winterizing your home (caulking in the right places, checking the efficiency of your furnace, installing new insulation) could cost you a little more this fall, but the payoff could be many years of savings on your heating bills.

THE QUARTER IN BRIEF

The economy seemed to hit a soft patch this summer, but stocks carried onward and upward – the S&P 500 advanced for a fourth straight quarter in Q3, rising 3.31%. Markets were notably placid for much of the quarter, even with two major banking scandals, multiple terror attacks, and the latest dispatches from an especially contentious presidential race in the headlines. As Q3 went on, the Federal Reserve all but signaled to investors to expect a rate hike before the end of the year. Home sales, residential construction, factory activity, and consumer spending seemed to wane in the quarter, but consumers grew more confident.¹

DOMESTIC ECONOMIC HEALTH

As Wall Street mulled over the chances of a fall interest rate increase, some economic indicators pointed to a summer slowdown. In August, the Institute for Supply Management’s manufacturing purchasing managers index went under 50 (49.4), meaning the sector had contracted for the month. Both industrial and manufacturing production declined 0.4%. Durable goods orders, up 3.6% for July, were suddenly flat. Retail sales fell off by 0.3%, and personal spending was flat after an 0.4% gain in July (personal incomes did manage to rise another 0.2%).^{2,3}

The pace of hiring also moderated in August, though July’s number was revised upward in September. Employers added 275,000 new jobs in July, 151,000 for August. The headline jobless rate (4.9%), the U-6 rate counting the underemployed and the unemployed (9.7%), and the labor force participation rate (62.8%) were exactly the same in both months.⁴

Other indicators were less dismal. As September ended, the federal government said the economy grew at a 1.4% pace in Q2 – not very good, but better than the 1.1% growth previously estimated. Additionally, ISM’s service sector PMI remained above 50 in August at 51.4 (though that number was decidedly lower than the 55.5 mark from July).^{3,5}

Accentuating the positive, consumers grew more upbeat as the quarter went on. In July, the Conference Board announced a reading of 97.3 for its consumer confidence index; in August, the CB said the gauge was at 101.1, and in September it reached 104.1. Across the quarter, the University of Michigan’s monthly measure of household sentiment rose slightly from 90.0 in July to 91.2 for September (including a dip to 89.8 for August).^{6,7}

Consumer inflation picked up, but wholesale inflation did not. By August, the Consumer Price Index had advanced 1.1% in a year, as opposed to 0.8% in the 12 months ending in July. Core consumer prices were up 2.3% year-over-year by August. In annualized terms, the Producer Price Index showed no change from a year earlier in August; in monthly terms, the PPI fell 0.4% in July and was flat a month later. Core inflation, as measured by the Federal Reserve, increased 0.1% in July, 0.2% in August.^{2,3}

Speaking of the Federal Reserve, it left interest rates alone during Q3. It did, however, clue Wall Street in on the probability of a Q4 rate hike: its latest dot-plot forecast showed consensus for one, and the vote against raising the federal funds rate at its September policy meeting was close (7-3). After the vote was announced, Fed chair Janet Yellen remarked that FOMC members were “generally pleased with how the U.S. economy is doing” – a notably sunny viewpoint. On September 29, she made further headlines by commenting how useful it would be if the Fed could buy securities and corporate bonds to stimulate the economy in a recession (something it is currently prohibited from doing).^{8,9}

Wells Fargo certainly made headlines in Q3. In September, its CEO was brought before Congress after news broke that employees had opened as many as 2 million fake accounts in pursuit of sales goals. The bank was contending with \$190 million in fines and severe damage to its reputation when the quarter ended.¹⁰

GLOBAL ECONOMIC HEALTH

Trouble at another, even larger banking giant emerged during Q3. Deutsche Bank looked increasingly shaky after failing the U.S. government's bank stress test early this summer and barely passing the equivalent test in the European Union. S&P Global Ratings lowered its outlook for DB to negative. By the end of the quarter, CNBC and AFP were reporting that DB was trying to negotiate \$14 billion in fines it owed to the Department of Justice down to the \$5 billion level; indications were that the German government had no intention to bail the bank out should its situation worsen.¹¹

Economic indicators pointed at a less stagnant E.U. economy during the summer after the Brexit. Eurostat projected 0.4% consumer inflation in September, rising from 0.2% in August; the euro area jobless rate stayed at 10.1% in both July and August, the lowest level observed since July 2011.¹²

In September, OPEC nations agreed to reduce oil production for the first time since 2008. The agreement, to be finalized in fall, would essentially restore the production limits that were in place back in 2015. Previously, Saudi Arabia had held out on such an agreement, saying it would cut production only if all other OPEC and non-OPEC oil-producing nations vowed to do so.¹³

WORLD MARKETS

Benchmarks generally climbed higher in the third quarter, affirming that 2016 has turned into a good year for stocks. By the end of Q3, the U.K.'s FTSE 100 was up 13.82% year-over-year, and Germany's DAX had seen an 8.80% 12-month advance. Other impressive year-over-year gains: 20.39% for Russia's Micex, 11.76% for the Hang Seng in Hong Kong, 28.81% for Brazil's Bovespa, 14.07% for the MSCI Emerging Markets index, and 10.66% for the TSX Composite in Canada. The MSCI World index had risen 9.09% in 12 months; India's Sensex, 6.54%.^{14,15}

The past four quarters had not been so kind to some other indices. As the third quarter ended, Italy's FTSE All-Share had lost 21.06% in a year; Spain's IBEX 35, 8.16%; France's CAC-40, just 0.16%; China's Shanghai Composite, 1.55%; and Japan's Nikkei 225, 5.40%.¹⁴

COMMODITIES MARKETS

Precious metals remained on track to log an impressive 2016 comeback. Gold lost just 0.3% in the quarter, which still left it up 24.2% YTD. The yellow metal closed the quarter at \$1,317.10 on the COMEX. Silver wrapped up September at \$19.21, rising 3.2% in the quarter and gaining 39.2% through three-fourths of 2016. Platinum advanced 1.0% in Q3; palladium, 20.8%. That brought their respective YTD gains to 15.8% and 28.4%.¹⁶

Looking at the Bloomberg Commodity Index, the best Q3 performers were two base metals – zinc rose 12.6% in the quarter; nickel, 11.5%. Sugar advanced 9.8%; cotton, 5.3%; and soybean oil, 4.6%. The worst performers? Lean hogs lost 31.6%; soy meal, 25.1%; soybeans, 17.1%; and wheat, 14.0%. The U.S. Dollar Index retreated but 0.57% for the quarter, finishing Q3 at 95.42.^{17,18}

Like gold, WTI crude was nearly flat for the quarter. Futures lost just 0.2% in Q3, finishing September at a NYMEX price of \$48.24. Heating oil rose 2.9% in Q3, while unleaded gasoline retreated 0.9%.¹⁹

REAL ESTATE

Home sales and housing starts tapered off during the quarter. Existing home sales slipped 3.4% in July and another 0.9% in August as inventory slimmed; the National Association of Realtors also said pending home sales were up 1.2% in July, but down

2.4% a month later. In July, the Census Bureau announced that new home sales were up a whopping 13.8% and near an all-time peak, but then they fell 7.6% in August. Housing starts were up 1.4% for July; building permits, down 0.8%. In August, permits were down another 0.4%, with groundbreaking reduced by 5.8%. The year-over-year advance in the monthly editions of the 20-city Case-Shiller home price index kept shrinking – it was 5.1% in June, 5.0% in July.^{2,3}

Home loans, broadly speaking, grew slightly less expensive across Q3. The September 29 Freddie Mac Primary Mortgage Market Survey specified the following average interest on the three common mortgage types: 30-year FRM, 3.42%; 15-year FRM, 2.72%; 5/1-year ARM, 2.81%. Compare those numbers with these from the June 30 PMMS: 30-year FRM, 3.48%; 15-year FRM, 2.78%; 5/1-year ARM, 2.70%.²⁰

LOOKING BACK...LOOKING FORWARD

Tech shares and small caps set the pace in the third quarter – the Nasdaq Composite leapt 9.69%, while the Russell 2000 posted a 3-month gain of 8.20%.^{1,21}

The Dow ended the quarter at 18,308.15; the NASDAQ, at 5,312.00; the S&P 500, at 2,168.27; and the RUT, at 1,251.64. The RUT's YTD mark at the end of Q3 (+10.19%) surpassed the YTD performances of the big three.²²

Concluding the quarter at 13.29, the CBOE VIX retreated swiftly this summer. Its Q3 loss was 10.02%, leaving the “fear index” down 27.02% YTD.²³

% CHANGE	Y-T-D	Q3 CHG	1-YR CHG	10-YR AVG
DJIA	+5.07	+2.11	+12.43	+5.68
NASDAQ	+6.08	+9.69	+14.97	+13.52
S&P 500	+6.08	+3.31	+12.93	+6.23
REAL YIELD	9/30 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.00%	0.65%	0.17%	2.27%

Sources: wsj.com, cnbc.com, bigcharts.com, treasury.gov – 9/30/16^{1,22,24,25}
 Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
 These returns do not include dividends.

This is the time of year when bulls yearn for an extended rally. Will they get it? Will S&P 500 earnings surpass (low) expectations? Will the market confidently ride through the election, whatever the outcome? Will it simply and calmly price in a rate hike, assuming that happens? Will investors shrug off any unsettling headlines, whether from home or from overseas? If the market can answer “yes” to those last four questions, the quarter could see impressive gains for the major indices. According to S&P Global Market Intelligence research, the S&P 500 has risen an average of 5% in the fourth quarter since 1990, and advanced in the fourth quarter more than 70% of the time since 1945. The past has little or no influence upon future market behaviors, but even with continued slow economic growth, the overall market mood is still bullish – so perhaps investors will look at earnings first this quarter, then other factors. It is sure to be an eventful and possibly turbulent three months.²⁶

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