KLS Professional Advisors Group, LLC

Complete Financial Management

The Season for Debates

With the election season upon us, investor uncertainty has been heightened by the potential outcomes and economic policies that would be pursued by alternative administrations. The political theater of the campaigns has also captured the attention of capital markets analysts. While the presidential debates could have been more focused on substantive economic issues, the analysts continue to debate and crystalize the issues providing much food for thought. It is this perspective and these debates that inform investor risk-reward analysis and ultimately find their way into portfolio construction. Herein we will recap some of the most important issues that merit consideration.

Outlook for economic growth

The current outlook for domestic growth may be best described as anemic. There is little agreement, however, as to how this should be addressed by government policy. Some have posited that this low level of growth is a normal baseline level absent artificial monetary, fiscal or other external stimulus. Others disagree and attribute the low growth scenario to policy mistakes. There is disagreement as to whether the protracted low interest rate environment has stemmed a severe decline or whether it has merely created a yield driven multiple expansion in stocks (and real estate). Even those who believe that the extraordinarily accommodative Federal Reserve policy has prevented a depression are questioning the continued efficacy of such policy going forward. Economists and analysts continue to struggle with the potential for unintended consequences. Does the low interest rate environment encourage spending as intended, or rather does it incentivize investors to save more for the future to compensate for the low interest-based returns that they expect on their savings going forward? Will they defer retirement to add further to savings and thus not make room for younger entrants to the workforce? Will pension funds, insurance companies, and banks (all dependent upon a higher level of interest-based returns for their profitability and funding of future obligations) be able to withstand a prolonged period of low returns or will they turn to higher risk strategies and investments?

Central bankers continue to struggle with these issues, keenly aware that asset values supported by low yields are vulnerable to valuation decline as interest rates rise. The alternative thinking is that future economic growth will validate current valuation levels. The fundamental question nevertheless remains – what is the level of baseline normal economic growth?

Historically, the drivers of growth have been innovation, productivity gains, and globalization. As domestic and worldwide GDP have grown, it has become increasingly difficult to maintain a high growth rate relative to an increasingly larger base (i.e., the law of large numbers). In addition to the enhancements and detractors attributable to monetary and fiscal policy, the sea change experienced as a result of technology-based disruptors to the status quo have had profound economic implications. As unskilled labor has lost ground domestically to lower-cost workers in other countries, technology-based industries have not provided sufficient available and viable alternative employment. The shifting demographics of an aging workforce has also provided headwinds to economic growth as the baby boomer generation enters retirement years with lesser resources and spending ability, and a reduced outlook for returns on their investments.

Geopolitics, globalization, protectionism and immigration

The lightning rod issue in the presidential contest in both the primaries and the upcoming election has been international trade and the impact of globalization. Although globalization has driven down the cost of consumer products and has enhanced the earnings of multinational corporations, it has also caused significant dislocation of American workers replaced by lower-cost workers overseas. So the long simmering debate has intensified. Is globalization a net positive or negative? Is there any alternative?

The U.S. economy continues to be the most resilient of developed economies. Europe continues to be greatly challenged with respect to its banking sector and broad economic growth. China's housing sector and related banking sector present risks as to housing prices and loan quality while the Chinese economy (still export dependent) continues to be restrained by lower growth in Europe and the United States.

The protectionist sentiment has been elevated and is part and parcel of the debate on immigration. Will U.S. workers continue to be replaced by immigrants working for lower wages? And, must the government step in to raise wages and regulate matters such as job security? Alternatively, should a free market resolution to these issues be allowed to play out?

The role of government vs. the free market

Although the recent financial crisis provided a bracing reminder that the free market does not always succeed in regulating risk resulting in the rational allocation of capital, the domestic debate continues as to how much regulation is appropriate and necessary. Policymakers and economists continue to argue the respective roles of government and the free market in allocating capital and delivering services such as healthcare. Should tax policy be further engineered to provide the government with greater resources to deliver services or should the burden be lessened so as to encourage investment and economic expansion? Similar to the doubts regarding the efficacy of monetary policy, there is also doubt as to the efficacy of fiscal policy. Even if there is postelection fiscal stimulus (whether it be tax reduction or spending on infrastructure) it is uncertain as to whether such will it provide an enduring economic benefit or merely a transitory lift.

The capital markets

Cognizant of all of these uncertainties, equity markets have traded within a fairly tight range, seeking clarity on central bank outlook for interest rates, inflation and signs of economic growth and stability. The domestic economy continues to grow at a modest rate (2.9% in the 3rd quarter, although driven in large part by soybean exports resulting from a temporary dislocation in the Asian soybean market) and the Federal Reserve has signaled a slow and cautious approach to raising interest rates and a tolerance for some increase in the rate of inflation. Oil prices have firmed in part due to production cutbacks in higher cost U.S. energy fields, and in part due to the on-again/off-again rumors of OPEC agreements to limit production. Even in the short term, however, prices remain vulnerable to an increase in U.S. production which will re-emerge as prices rise and provide a ceiling absent an increase in demand. Thus far, oil prices have risen this year although demand has not risen significantly.

Equity market valuations should be earnings dependent even as the quality of earnings growth continues to be suspect. Composite analyst projections continue to indicate negative earnings growth (inclusive of the energy sector) through the third quarter although the rate of decline has slowed. As noted above, sector share price gains driven by the low interest rate environment are susceptible to correction as interest rates rise. Analysts estimate that the PE ratio of the S&P 500 is approximately 19X 2016 earnings.

Third quarter earnings have thus far been in line or better than analyst expectations and analysts continue to expect fourth quarter earnings growth that will result in positive (though lackluster) earnings growth for the calendar year. Thus far, artificially low interest rates continue to cause misallocation of capital and misalignment of risk. Share prices have benefitted from share buybacks financed by low cost corporate debt. Finally, if the U.S. dollar continues to strengthen on expectation of rising interest rates and capital flows from negative interest rate countries, corporate earnings may experience pressure from currency conversion losses and a less competitive export environment.

Equity Market Performance

For the quarter, the Dow Jones Industrial Average returned 2.78% (7.21% ytd); the S&P 500 and Russell 1000 Indices advanced 3.85% (7.84% ytd) and 4.03% (7.92% ytd), respectively. The Wilshire 5000 gained 4.29% (8.44% ytd), the Russell 2000 Small Cap Index 9.05% (11.45% ytd), and the S&P 400 Mid Cap Index 4.14% (12.4% ytd). The MSCI EAFE Index gained 6.43% (1.73% ytd) the MSCI All Country World Index 5.3% (6.6% ytd), and the MSCI European Equity Index 5.4% (0.0% ytd). The MSCI EM Index rose 9.03% (16.02% ytd).

Worldwide equity markets advanced throughout the year principally as a function of PE expansion and historically low central bank interest rate policies.

Portfolio Construction

The uncertainties discussed above have led us to conclude that we remain in a period of elevated risks both as to asset valuation and policy. We address these risks through diversification of asset classes and sectors and by maintaining a modest duration exposure in the fixed income portfolio. By investing a significant portion of the portfolio in high quality intermediate-term municipal bonds, cash, and high quality sovereign, corporate and U.S. government debt, overall portfolio risk is lessened, and as we have observed before we, endeavor to strike the appropriate balance given the artificially low rate of interest available in the fixed income markets as a result of central bank policy.

November 1, 2016

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

The material contained herein is intended as a general market commentary. The prices/quotes/statistics referenced herein have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness; any yield referenced is indicative and subject to change. The views and strategies described herein may not be suitable for all investors. Certain opinions, estimates, investment strategies and views expressed in this document constitute our judgment based on current market conditions and are subject to change without notice. The information contained herein should not be relied upon in isolation for the purpose of making an investment decision. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results.