CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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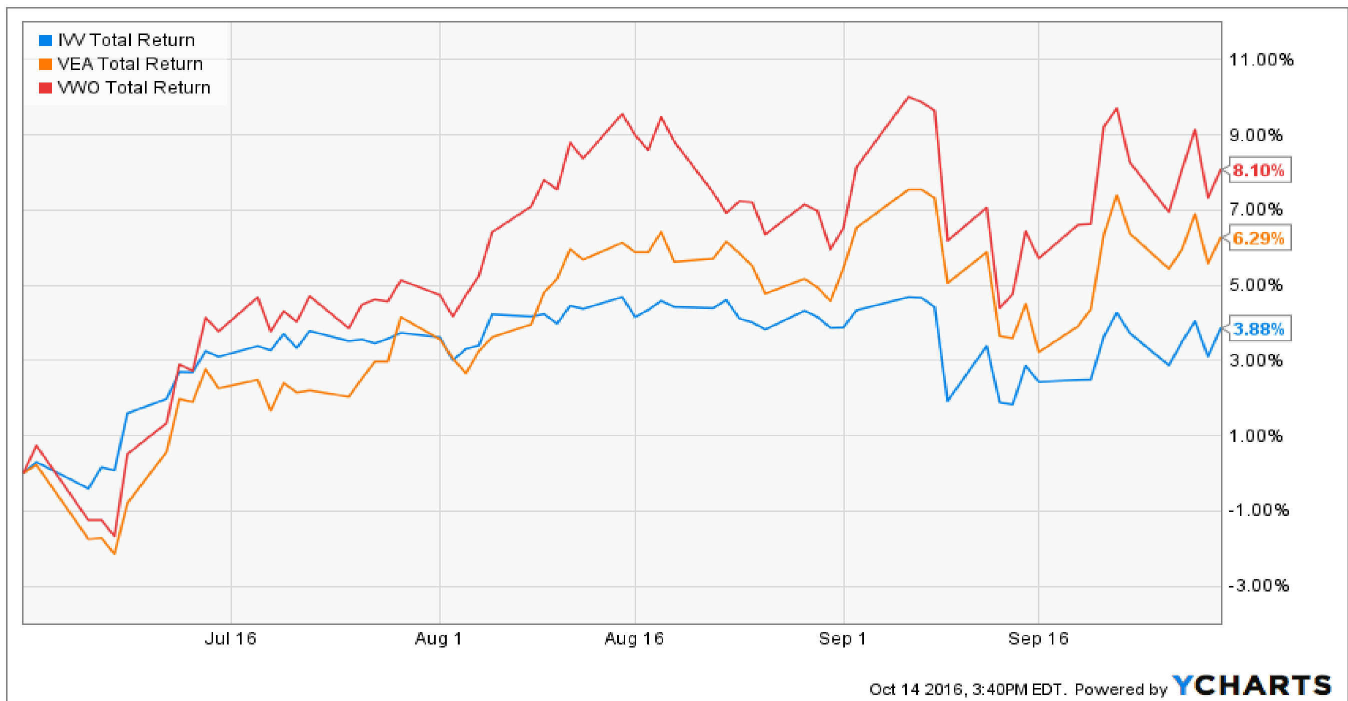
Financial Markets Commentary 3rd Quarter 2016

Summary

Stocks performed well in the third quarter, for the most part. The S&P 500 gained 3.88% with dividends included, its best quarter since the final quarter of 2015. [1] As always, the gains were not evenly distributed. This time, defensive and high dividend stocks lagged while more economically sensitive stocks shined – a complete reversal from the previous six months. Technology was by far the best sector last quarter with a 12.9% increase. Transportation was a distant second at 8.3%, and no other sector topped 5%. By contrast, utilities were down by -5.9%, telecom stocks -5.6%, consumer staples -2.6%, and real estate -2.1%.[2] That is one of the highest performance dispersions we have seen in quite a while. An investor could easily have been very right last quarter or very wrong.

Last quarter was also very good for international stocks, as both developed and emerging markets outperformed U.S. stocks. Happily, the sector caveats we noted above largely did not apply to foreign stocks. All regions gained; in fact every single region outperformed the U.S. Emerging markets led with gains of 8.1% and developed markets gained 6.29%.[3] Brazil continues to turn things around; it has been the best broadly investable market in the world this year. See Chart 1.



[1] As measured by iShares Core S&P 500 ETF (IVV)
[2] Sector performance via JP Morgan's "3Q Guide to the Markets", p. 10
[3] As measured by Vanguard FTSE Emerging Market ETF (VWO) and Vanguard Developed Markets ETF (VEA).

Bonds, on the other hand, didn't fare so well. The brief scare that "Brexit" was going to negatively impact global growth sent many bond yields to record low levels in early July, but over the next several week those concerns faded and with them bond prices. By quarter's end the Barclay's Aggregate Bond index was up only 0.38%. Fortunately, most sectors of the bond market performed better. High yield corporate bonds returned 4.50% last quarter, investment grade bonds earned 1.16% and emerging market debt rose 4.80%. Unfortunately, to be safe was to be sorry. Municipal bonds fell -0.48% in the quarter while short term, high quality bonds gained just 0.07%. As inflation expectations finally began to tick upward, inflation-protected bonds started to catch a bid. They were up 1.05% last quarter.[4] See Chart 2

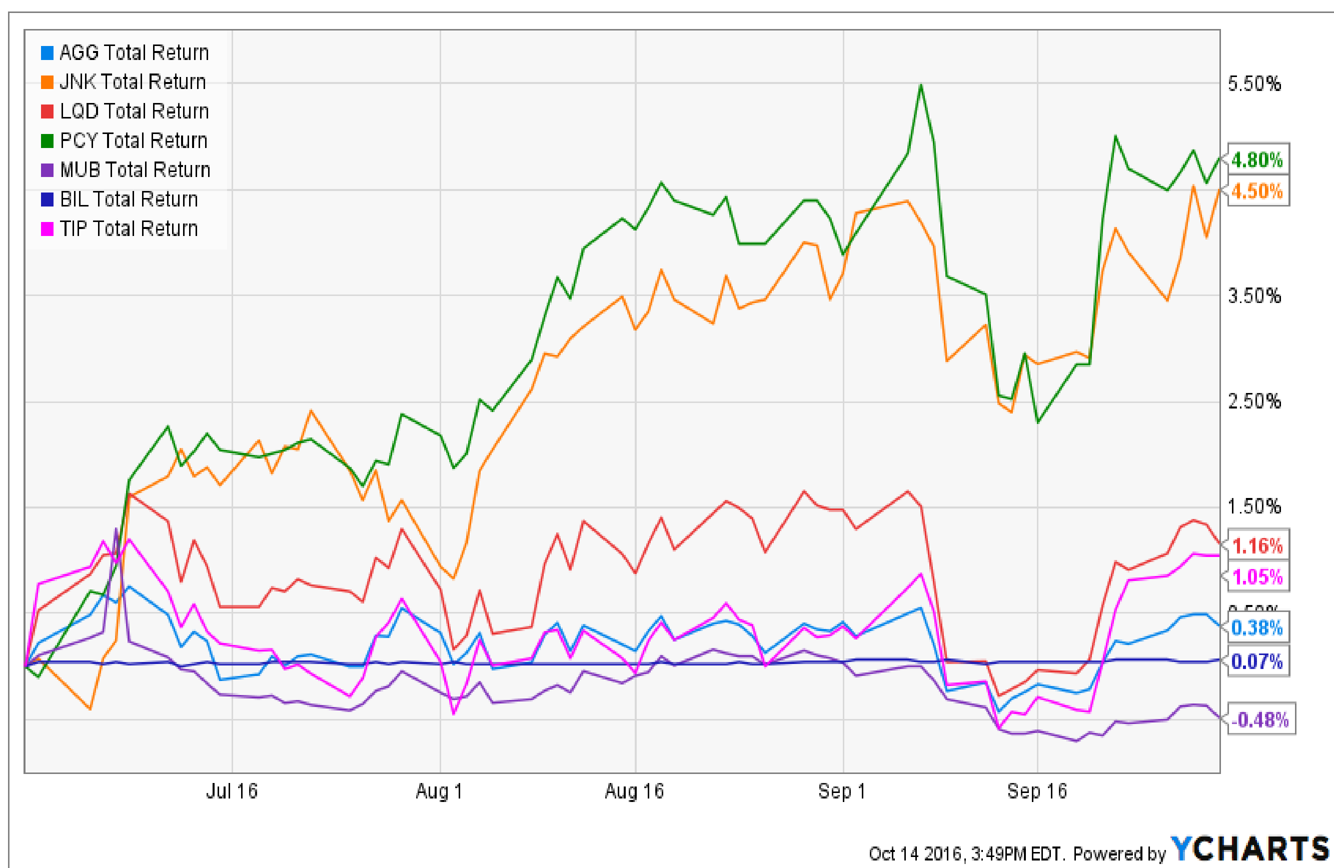


Chart 2

Activity

We were not particularly active last quarter. We added to our emerging market exposure in July, which has worked out well so far. Around the same time we took a small position in gold as weakness in the dollar and the belief that deflation was a real risk created a strong tailwind. In mid-August, however, the dollar began to firm and recently the deflation scenario has begun to look less compelling. Because the gold position tends to be small – less than 2% – our inclination is to hold on pending confirmation that the longer term trends really have reversed.

[4] As measured by iShares Core US Aggregate Bond ETF (AGG), SPDR Barclays high Yield Bond ETF (JNK) and iShares iBoxx Investment Grade Corporate ETF (LQD), iShares National Muni Bond ETF (MUB), SPDR Barclay's 1-3 Month T-Bill ETF (BIL) and iShares TIPS Bond ETF (TIP). Source: YCharts.com

In more conservative portfolios we reduced our over-weight to income-oriented sectors because that move appears to have been played out for the time being. We also added broad international exposure because we do not use a dedicated emerging market fund in more risk-averse portfolios.

Outlook

Bonds are behaving rather badly right now, and that is starting to have an impact on stocks. At first it seemed that bonds were merely pulling back from a ferocious rally that began early in the year, but since the beginning of October yields have broken out to the upside. This is not a big problem for the stock sectors that depend on economic growth, but it is hurting those stocks that happen to be priced off of bond yields, namely utilities, REITs, and consumer staples. This has caused a fairly abrupt rotation within the stock market away from so-called dividend stocks. If the current trend toward rising interest rates moderates, then small, mid-size, and foreign stocks might well continue to post superior performance to the major indices as they did last quarter. On the other hand, a prolonged surge in bond yields would probably have a negative impact across the board, since many stocks are priced for a very benign interest rate environment. The dollar has gained strength due to expected Federal Reserve rate hikes in coming months. That could create an economic headwind for large cap and international stocks. It is almost always more favorable for stocks to have interest rates fall, so our sense of caution has increased.

Commentary – "… It's What You Know that Just ain't So"

I have been in the investment business for more than thirty years. I hear one phrase from time to time that gives me pause. Whenever a sentence begins, "Everybody knows that …" I cringe. I suspect that more money has been lost trading on what everyone knows than anything else in the securities business. The fact is, every trade has two sides. It is useful to ask yourself, therefore, "what do I believe I know that the other party doesn't know?" Chances are that you have to pay a high price to get on the side of a trade that everybody expects to be right. And even when you pay extra to get on the popular side of a trade, you might still be wrong.

Another example; "everybody knows October is a bad month for stocks" and "everybody knows stocks go down before the election". As it happens, neither October nor election years or even Octobers in election years have been especially bad times in which to invest. Granted, there have been a very few really bad Octobers and one of which occurred in an election year (2008). Behavioral finance uses the term *hindsight bias* to describe the belief that past events were easily foreseeable before they occurred. A lot of investors have subjected their portfolios to losses at the hand of hindsight biases that "everybody knows" are true.

The truth is, the market is extremely efficient at pricing information. To outperform the market, you have to bet that you know something for certain that the market either doesn't know or is only pricing in as a probability. By definition then if you say "everybody knows" a particular thing, you are also admitting that it is fully factored into current prices and therefore provides no opportunity for extra profit. The only real opportunity to profit, therefore, is to bet against the consensus.

Actually, I believe that when people use the "everybody knows" line, they hope to capitalize on the subset of people (let's call them "rubes") that don't have this knowledge. Their belief is that rubes will, of course, be decimated due to their lack of knowledge. I cannot recall when this has ever happened. There have been three major events in my investment career – the market crash in October 1987; the dot-com crash in 2000-01; and the mortgage debacle in 2008. I don't know of anyone who has said prior to any of these events that we needed to get out of stocks because

"everybody knows a major event is coming". On the other hand, I have seen and read many market pundits over the years suggesting that investors sell stocks and/or bonds and move to cash or gold based on various political, economic or seasonal conditions. I truly believe that none of those "experts" ever avoided anything serious or lasting. And the poor rubes who were supposedly going to be decimated? They always came out ahead.

All of that being said, the investment world is full of risks. It always is. When the things that might go wrong don't, our hindsight bias kicks in and we minimize the risks that existed. I worry about a lot of things today – the destabilizing effects of extremely low interest rates on the financial system, the very slow rate of economic growth in developed countries relative to the debt they carry, an economic collapse in China, a collapse of the European Union, and more. It is quite possible that none of these things will ever precipitate a major market event. The hardest thing for any market strategist to do is to predict when any particular risk factor will suddenly blow up into a full blown panic.

Investing involves living in a perpetual state of uncertainty and dealing with it the best you can. This requires having both defined investment processes and emotional discipline to guide your behavior when the road seems especially unclear. It also requires humility and flexibility, because no strategy works in all environments, and nobody is smart enough or connected enough to be immune from loss. There is no "everybody", and investing with the consensus does not lead to superior returns. As Mark Twain said more than a century ago, *It ain't what you don't know that gets you into trouble, it's what you know for sure that just ain't so.* To put it more simply, the investment world is complicated. Certainty is rare, and very hard to profit from. Most of all, being sure you are right about how the markets are going to move often leads to the poorest investment decisions.

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