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To Our Clients, Partners, and Friends –

As we enter the final quarter of 2016, the year has been and will likely continue to be one of uncertainty and caution. Geopolitical strife, interest rate issues, and stagnant economic growth have persisted. Added to the news cycle was the surprise of Brexit and a contentious, at best, U.S. presidential election.

These concerns have led to what is perhaps the least optimistic bull market in history. Investor sentiment in May was the lowest it's been since March 2009[1]. Instead of chasing profits and growth, investors are buying into safety. The only two sectors which have reached new highs this year are utilities and consumer staples[2]—not exactly the definition of exuberance.

This is not surprising, as it is human nature to doubt the resiliency of the economy. Market booms tend to occur as gradual, long-term trends while emotional responses propagate much sharper market declines. Rational decision-making is typically abandoned in anxious situations.

Our perspective is that the secular bull market which began in 2009 is ongoing, albeit in a mature stage. We are expecting more discomforting bumps along the way. Timing these pullbacks correctly is extremely speculative, and we will continue to focus on long-term asset allocation. Along the way, our focus will be on the good, the bad, and the ugly of the current economic environment.

The Good

The S&P 500 is up four straight quarters and 13 of the past 15. The last time that we have seen a streak like this was in the mid-1990s. To boot, the best quarter of the year is upon us—historically speaking. Going back to 1950, the final three months of the year boast higher returns than any other three month period 79% of the time[3].

After five consecutive quarters of declining corporate earnings, a bright spot is emerging. Valuations have been modestly elevated and earnings need to start to carry the weight if the bull market is to advance. Analysts are expecting a 10% earnings growth in the fourth quarter and a 16% growth rate in 2017[4]. These projections seem overly optimistic and could lead to volatility should they be downgraded. Either way, this would be a welcomed change from what has been a period of stagnant earnings.

The collapse of the oil market is also in the rear-view mirror. There was a verbal commitment from OPEC members to cut production in an effort to support price. The outcome is yet to be seen, as the official deal will occur at the November meeting. The odds favor an agreement being reached, potentially pushing prices higher in the intermediate term. This would be a boon for earnings growth in the energy and basic materials sectors.

[1] American Association of Individual Investors Survey, May 26 2016
[2] The Most Pessimistic Bull Market in History, Wall Street Journal, June 13 2016
[3] LPL Research, FactSet, September 30 2016
[4] Bloomberg Earnings Forecast, September 30 2016

The Bad

However, true to its current form, the presidential election may help to derail any sense of optimism. Wall Street generally hates uncertainty—the S&P 500 has fell an average of 3.3% in years following second-term presidencies[5]. As former Federal Reserve Chair Alan Greenspan put it, "fear is a far more potent force than euphoria, and you can see it in markets and the economy."

The comments of current Federal Reserve Chair Janet Yellen are more than anecdotal, however. Expectations were boosted for a rate hike before the end of the year at the most recent Federal Open Market Committee meeting. The final decision will be contingent on economic data remaining decent in the coming months. Several indicators, such as GDP growth, jobs numbers, and home sales, will need to show a positive outlook. This ongoing strategy of "running out the clock" is likely to stoke the fires of market volatility.

Along with The U.S. Federal Reserve, The Bank of Japan, European Central Bank, and The Bank of England will hold meetings in November and December. One bad policy decision abroad could influence on the Fed's position, which is already divided. Three of the 12 members dissented on the vote to hold interest rates steady during the September meeting[6]. This is a relatively high number of dissents, suggesting a growing discordance among the committee.

The Ugly

Often brought up in economic discussions is the business cycle. This typically takes 5 to 10 years to run its course and can also be called the short-term debt cycle. What may be the most important factor today is the long-term debt cycle. This is not well understood because it only comes along once in a lifetime, taking 50 to 75 years to fully mature[7].

The important difference at this stage of the long-term cycle is that debt will not be able to rise as fast. This may sound good, but debt is the transmission mechanism of capital markets. Interest rates can't be lowered and risk premiums of other investments are low and shrinking. If appropriate risk premiums don't exist, capital flows become stagnant and the economy will grind to a halt. Central banks call this "pushing on a string".

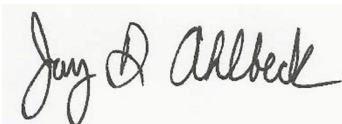
While no period is entirely analogous to today, the most similar would be the early to mid-1930s. In the late 1920s, a debt-financed bubble led to a market dive, followed by easy monetary policy leading to near-zero interest rates eight years later—sound familiar? What followed was a 10-year period (1937-1947) where the average annual growth of the S&P 500 was just under 6%[8].

Thank you for your continued confidence in Planning Capital Management. If you have any questions or comments, please do not hesitate to contact us. We welcome the opportunity to discuss our thoughts in greater detail.

Sincerely,

Richard W. Bell, Jr.

President, Senior Advisor



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[5] S&P Dow Jones Indexology Magazine, Fall 2016
[6] Schwab Market Perspective, September 30 2016
[7] Ray Dalio, Federal Reserve Bank of New York Central Banking Seminar, October 5 2016
[8] Federal Reserve Bank of St. Louis, FRED Database