# 3Q 2016 Market Review

## Third Quarter Market Recap

*Stocks wrap up their best quarter of the year…*

Stocks recovered losses from the Brexit-related selloff late in the second quarter and the S&P 500 index reached a record high in early July. The market then traded in a fairly tight range before the index sold off in September on fears of global monetary tightening measures, which were subsequently assuaged as the Bank of Japan and Federal Reserve continued easy money policies. The markets thus rebounded, yielding an S&P 500 index total return of 4.0% in the third quarter and 8.0% year-to-date. Growth stocks outperformed value in the quarter, reversing the trend seen in the first half of the year, as investors began to shift allocations to growth sectors, a sign of increasing confidence in the economy. Demonstrating this change, the Utilities sector, serving as a proxy for income-oriented securities, pared yearly gains by (6%) in the quarter as yield-oriented investments faltered after massively outperforming in the first half of the year. As the outlook for a rate increase rises, the relative appeal of such investments declines. Financial stocks rallied and could benefit further if the Fed does indeed raise rates before the year ends. On a year-to-date basis however, value indices have retained their lead.

The U.S. election is drawing nearer, and the market continues to attempt to handicap the odds for both candidates and the subsequent impact each would respectively have on the market and specific sectors. Moving into the fourth quarter, focus on political events both domestically and overseas could prompt additional bouts of volatility. Corporate earnings releases and management commentary will also help shape the remainder of the year. Current expectations for third quarter earnings have been lowered, with expectations for S&P earnings to fall (2.1%) from a year earlier, according to FactSet. Better than expected results could provide for a move higher in stocks.

## One Last Chance in 2016

*The Federal Reserve hesitates again*

Market trepidation surrounding a potential rate hike going into the Fed's September meeting proved yet again unfounded. The Fed left the policy interest rate unchanged at 0.25-0.50%, while simultaneously indicating their belief that the case for an increase in the federal funds rate has strengthened and is still likely by year-end. This represented the sixth straight hold in policy, and was met with dissent by three officials, the most since December 2014, who felt that a rate hike was already in order. Also released was the "dot plot" which provides insight to the Fed officials' expectations for the path of interest rates, revealing scaled back expectations for hikes in 2017 and beyond. A gradual pace of increases continues to be emphasized by Fed officials, with a reduction in the median long-term interest rate projection to 2.9%, down from 3.0% in June. The November Federal Open Market Committee meeting will take place within a week of the presidential election and is not viewed by the market as a likely meeting for an increase. Investor focus has now shifted to December, which presents the last opportunity for the Fed to raise interest rates this year.

## Opec Capitulates

*Oil prices find support in proposed plan*

In what represents the first attempt at coordinated action by the cartel to help support the oil market since its collapse in 2014, a preliminary agreement to cut production by OPEC nations recently has bolstered energy prices. The proposed plan would limit production at 32.5-33Mbpd from a current level of ~33.2Mbpd. This change in tone may have come after a boost in Iraqi exports and the reopening of terminals in Libya, along with additional supply from Iran have contributed to increasing output levels. The plan has also likewise been greeted with a degree of skepticism. Past agreements to curtail production have not always been adhered to, with accusations of certain member nations “cheating” and overproducing to take advantage of higher prices. Nevertheless, this shift is incrementally positive news, and fund flows should also serve as a catalyst for the sector given long only investors remain largely underweight the space. According to Morgan Stanley, of all 14 OPEC production cuts since 1998, oil has rallied 11x over the next 12-month period, with an average return of 32%. The formal meeting is scheduled to take place on November 30th.

## A New Normal Economy

*Slow and steady wins the race*

The current cycle has been prolonged and characterized by steady, slower growth than past recoveries, with U.S. nominal growth averaging 3.3% as compared to 5.3% in the prior cycle. This slower nominal growth with a muted inflationary backdrop portends for a persisting low interest rate environment. Valuations for growth companies are likely to remain elevated given the scarcity of rapidly growing investments. Market breadth will likely narrow moving into next year as companies delivering outsized growth begin to outperform the broader market.

This slower growth environment, while frustrating at times, has also precluded the types of excesses that led to the last major downturn. While we do not currently see signs of an imminent recession, when one inevitably does materialize, we believe it will be a mild event with positive implications longer term. An economic slowdown can help by allowing well managed companies to gain market share, re-setting the table for future returns, as well as providing investment opportunities.

## Deflation Woes

*How could lower prices be a bad thing?*

The prospect of deflation is universally feared by economists. When prices are declining, consumers tend to postpone purchases with the knowledge that they may acquire the same goods for less if they wait. Deflation also can spur irrational behavior on the part of competitors as they fight for consumer market share to help offset fixed cost burdens in the face of nominal growth declines. A missing element in this recovery has been inflation – inflation helps ease debt burdens, as well as boosts nominal GDP growth, which is what powers top line growth for businesses. The risk of deflation has remained in frame since 2008 and most recently exacerbated by the decline in crude oil prices in 2014. If the stabilization of energy pricing holds, it should at least help to bolster headline inflation numbers moving forward as the declines are lapped. The Fed continues to anticipate inflation, which is currently running at 1.6% excluding food and energy, to reach their 2% target over the medium term.

## Staying the Course

*The backdrop for equities remains favorable*

As we enter the final quarter of the year, we expect more of the same. Market levels have been supported by a persisting low rate environment aided by accommodative central banks. Policymakers remain ready and willing to act to support growth. The Bank of Japan remains committed to achieving inflation, recently announcing a shift in policy geared toward controlling the yield curve, to ensure the spread between short and long-term rates enables banks to make a profit from lending, in hopes that this will spur the economy. This unyielding support from global central banks could also lead to fiscal policies that may help drive the economy. An area we continue to closely monitor is global trade, as fears of a slowdown in cross-border trade has risen due to the recent Brexit vote as well as protectionist political rhetoric at home surrounding trade.

Domestically, we expect the recent business inventory reduction that has pressured GDP the past few quarters to stabilize and lead to a pick-up in business investment, especially given a stronger consumer. Steady job and income gains, coupled with weak inflation support a positive outlook for the Consumer Discretionary sector. Sentiment is strong as the US Consumer Confidence index rose to a cycle high of 104.1 in September. The National Retail Federation has announced that it expects November and December sales (excluding autos, gas and restaurant sales) to increase +3.6% to $655.8 billion, higher than the +3% growth in 2015 Holiday sales, and handily exceeding the 10-year average of 2.5%, boding well for spending this holiday season.

Adding further support to market levels is the record amount of cash that still remains on the sidelines. According to BlackRock president Rob Kapito at a recent financial services conference, as much as $70 trillion dollars of cash remains sidelined by investors, some $10 trillion of which is likely earning a negative yield. This cash may serve to provide a floor for market levels, as any significant selloff is likely met with demand from buyers who have felt priced out of the market, and are motivated to earn better returns on their capital, especially as interest rates remain low for the foreseeable future. If and when this cash flows into the market, it could be a boon for stocks. In recent years, high levels of stock repurchases by companies along with mergers and acquisitions have effectively removed more stock out of the market than has been replaced by new share issuance, providing further upward pressure on stock prices as money flows into the market. Given the likely continued low interest rate environment, equity markets should continue to rise.

## GRANITE LONG-TERM CATALYSTS FOR CHANGE

### TECHNOLOGY & PRODUCTIVITY

- Global demand for energy efficiency and lower emissions
- The proliferation of "Big Data" opens up a new world of analytical software tools
- Increasing risks around cyber crime necessitates advanced security solutions
- Cloud computing enables worldwide access to information from any device
- Software as a Service migration is accelerating
- Internet of things

### HEALTHCARE TRANSFORMATION

- Higher utilization and strong operating leverage as healthcare becomes universal
- Evolution of ACA and private healthcare exchanges
- Baby boomers demand more healthcare
- Genetic testing innovation and FDA regulatory pathways help accelerate personalized medicine
- On the cusp of revolutionary breakthroughs in the area of oncology

### EVOLVING CONSUMER TRENDS

- Changing consumption behavior
- Focus turns to individual health
- Rise of the middle class in emerging markets
- Evolving demographic trends
- Mobile computing

### DOMESTIC MANUFACTURING COMPETITIVENESS

- Less dependence on labor costs, more on technology
- Lower cost of energy and transportation
- Productivity of regional logistics
- Leveraging efficient U.S. distribution infrastructure

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Granite's only business is providing investment management services. Granite specializes in the management of equity and balanced portfolios for private and institutional clients including defined benefit and defined contribution retirement plans, endowments, foundations, public, Taft-Hartley and corporate funds.

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