"The Election"

Market Commentary – November 2016

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.9% in the third quarter of 2016. This is the highest reading since 2014 Q3 when GDP measured 5.0%. However, the quality of 2016 Q3 is suspect. The components of the 2016 Q3 GDP reading are as follows: consumer spending +1.47 percentage points, investment +0.52 percentage point, net exports +0.83 percentage point, and government spending +0.09 percentage point. The sum of these numbers equals 2.91%. The components of the investment value are disappointing in two ways. First, inventory accumulation generated +0.61 percentage point, accounting for more than 100% of overall investment. Second, 2016 Q3 was the second consecutive quarter of negative residential investment, suggesting that the housing market is cooling. Separately, net exports are notoriously volatile, so a reading of +0.83 is not sustainable (especially with the dollar strengthening in October). Where is economic growth?

Minutes from the Federal Open Market Committee (FOMC) meeting on September 20 and 21 revealed a growing divide among Fed officials about when to increase interest rates. According to the minutes, "Several members judged that it would be appropriate to increase the target range for the federal funds rate relatively soon if economic developments unfolded about as the Committee expected." There are two remaining FOMC announcements on monetary policy scheduled for 2016: November 2 and December 14. It is unlikely that the Fed will make any major decisions on November 2, right before the election on November 8. Indeed, federal funds futures have priced in the federal funds rate at 0.50% by December 2016, 0.75% by December 2017, and 1.00% by February 2019. The market is essentially expecting one 25 basis point hike per year, which is a very slow pace.

While global central bank monetary policy is more important to future economic growth than the 2016 U.S. election process, we do need to consider the potential effects of the election on financial markets. As general rules, Wall Street likes when Washington is constrained in gridlock and it also prefers the known to the unknown. If Hillary Clinton wins, the stock market would likely celebrate in the short run (spanning days to weeks) because it knows what to expect with her, but long run (over several years) may struggle because of the potential for higher taxes and more oppressive regulation. On the other hand, if Donald Trump wins, stocks could sell off in the short run as Wall Street is unsure of what will change. This would be a fantastic buying opportunity. The policies of a Trump administration, especially lowering corporate and personal tax rates, simplifying regulation, and repealing and replacing the "un"Affordable Care Act, could shake the economic malaise just like Ronald Reagan led us out of the 1966-1982 economic funk. If control of both houses of Congress goes to the party of the president, expect magnified moves with one exception: a Clinton presidency with Democrats controlling both houses would likely create a selloff. We believe a Trump upset is more possible than many may think.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $127.35, which implies a price-to-earnings (P/E) ratio of 16.7 with the S&P 500 at 2,126. The earnings yield (E/P) of 5.99% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.83%.

Large cap stocks have been range-bound in recent weeks, while small and mid-cap stocks have crept to mildly lower prices. The S&P 500 index (large cap) continues to trade between 2,120 and 2,190, where it has been stuck since the post-Brexit rally. Interestingly, in the small and mid-cap world, growth stocks are underperforming value stocks. Perhaps investors are taking on a more defensive stance. We stand by our balanced position between stocks and cash, as we can take advantage of weakness or strength following what is sure to be an amazing election.