

**Market Comments**  
**October 10, 2016**

S&P 500	2137
10 year Treasury	1.77%

At the end of the third quarter, we provide a quick update on recent capital markets action and our outlook for the fourth quarter and 2017:

1. **Fixed Income** -- Bond returns were strongly positive during the first nine months of 2016, driven by continued declines in interest rates. We continue to maintain a defensive posture with respect to bonds, and will do so until such time as higher interest rates create more attractive forward returns and provide us with an opportunity to extend bond portfolio durations. We are generally under-weighted in bonds in client portfolios relative to long-term target allocations for cash and fixed income, given our desire to mitigate interest risk and given unattractive prospective returns for bonds at present due to very low nominal bond yields. We continue to prefer accepting credit risk over interest risk in bond portfolios.
2. **Stocks** -- Equity returns have been positive on balance to date in 2016, after a very difficult start to the year. The S&P 500 posted a modest new all-time high on August 15 at 2193, and has since traded in a fairly narrow range. We remain generally over-weighted in equities in client portfolios relative to target asset allocation levels as equity valuations (which we believe imply long-term average annual total returns of 6-9%) remain far more attractive than fixed income valuations (long-term implied average annual returns of 1-2%).
3. **Valuation** -- We believe fair value for the S&P 500 for year-end 2016 is approximately 2150-2200 (P/E of 17.5x on estimated S&P 500 earnings of about \$120-125), and roughly 2275-2350 for year-end 2017 (17.5x P/E on estimated earnings of \$130-135). Our fair value estimates imply total returns for equities from current levels (S&P 500 at 2137) that are flattish to slightly positive through year-end 2016, and 7-10% through year-end 2017.
4. **Strategy and tactics** -- Based on our assessment current investing environment, risks, opportunities, and asset class valuations, we continue to overweight stocks and underweight bonds. Within equities, we are neutral between “growth” and “value” in general; we believe dividend yield is overvalued, and we are underweighting utilities, telecommunications, real estate, and consumer staples, all of which carry very high valuations. Technology, business services, health care (particularly biotechnology), and consumer discretion appear to be more attractively valued. We are increasing exposure to international stocks, and we remain constructive on small and midcap equities.

5. **Risks** -- We expect elevated levels of capital markets volatility to persist through 2016 and into 2017. Our working assumption remains that the S&P 500 could trade in a range of 1700-2400 during 2016-2017, with equity market volatility being driven by ongoing volatility in commodity prices, periodic concerns about global economic softness, an eventual tighter Fed monetary stance, persistent dollar strength, and uncertainty surrounding the outcome and longer term implications of the 2016 U.S. elections in November.
6. **What's most important** -- The level, trajectory, and quality of corporate earnings growth remains the most important variable for investors over the next 4 to 6 quarters, in our view. While corporate earnings in the U.S. have been slowed in 2015-16 by commodity price weakness, a strong dollar, and extremely low interest rates, we believe that in general, U.S. companies have delivered solid financial performance against a backdrop of generally soft domestic and global economic conditions. Second quarter corporate earnings and cash flows were, in our view, generally solid, and supportive of our thesis that U.S. corporate profitability, while uneven across sectors, remains adequate in the aggregate to support the current level of equity valuations.
7. **What is the upside** -- Equity valuations remain reasonable in view of the current level of interest rates, which are at historically low levels. If/when some of the risk factors outlined above begin to moderate, it is possible that corporate earnings could surprise on the upside in 2017, and provide a lift to stocks, against the current backdrop of neutral to negative investor sentiment. Alternatively, if very low interest rates persist going forward, equity valuations could drift higher as investors are forced to seek higher return assets in order to meet required investment return goals.

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