MARKET COMMENTARY **October, 2016**

U.S. stocks advanced modestly in the third quarter, with the S&P 500 up 3.3% in the quarter and roughly 7% year to date. Markets have been tightly focused on interest rates in 2016, and the ten-year Treasury appears to have bottomed in July at approximately 1.36%. It is currently yielding a little over 1.7%. A year ago, ten-year Treasury rates were around 2.5% but have declined along with expectations for future economic growth.

Currently interest rates in many parts of the world are negative, including Japan, Germany and much of the Euro Zone. As noted, in the U.S. rates remain positive but at historically low levels. The Fed has been signaling higher rates but has yet to raise rates in 2016. We expect the Fed will finally act in December after the election, once politics is removed from the debate. The market has already priced in an increase, so a December rate hike will not be a surprise.

Economic Outlook: A Slower Growth World

The focus has already shifted to 2017. We continue to believe that relatively low rates are here to stay. Despite continued improvement in our domestic economy and employment, interest rates remain only modestly above where they were in the depth of the financial crisis eight years ago. The market assumes that rates will move higher, but longer term rate expectations have actually been coming down. Fed Chair Janet Yellen has communicated that the "neutral rate" for the U.S. economy is much lower than previously thought. She has clearly signaled that the Fed will be cautious and gradualist in raising rates.

Noted economists Carmen Reinhart and Kenneth Rogoff have written that after a major financial crisis, it takes a decade to get back to normal. So, with the Financial Crises ending in 2009, more normal conditions might not return until 2019 or later. This is before taking into account the structural demographic headwinds to global growth. The world's major economies (U.S., China, Europe and Japan) are all being impacted by an aging population and declining birth rates.

All of this may help to explain that while the U.S. recovery continues to slowly progress, it remains halting and uneven. As we have written in prior letters, however, the slow and steady nature of the ongoing economic expansion means that the next recession could still be years away.

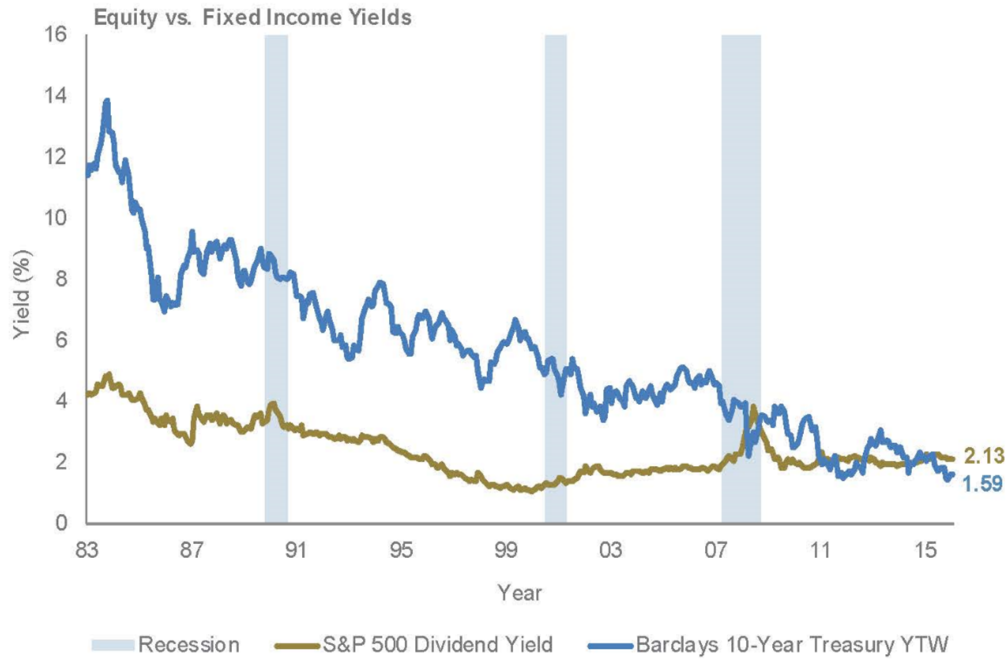
Market Outlook

In a low growth, low rate global environment we continue to find quality equities to be relatively attractive. In terms of valuation, stocks remain at the higher end of the range of reasonable valuation. Assuming continued modest growth and avoidance of recession, equities will need some combination of the following in order to perform over the next twelve months.

1) Some pick up in the global growth rate and in corporate profits, which have both been stagnant over the past two years.
2) Continued low rates (e.g. a December rate hike followed by only two additional hikes in 2017 rather than 3 or 4 hikes) and accommodative monetary policy.
3) A more stimulative Fiscal Policy in terms of government spending (e.g. increased infrastructure investment) and pro-growth measures (e.g. tax reform).

S&P 500 Yields vs. Treasury Yield (1983-2016)

Bonds have offered substantially higher yields than equities up until the last seven years. This surprising phenomenon has now become the norm, at least for the near term.



Source: Bloomberg as of 09/30/16

<u>The Presidential Election and the Markets</u>

As we write this commentary, we are a few weeks away from a presidential election which will not only install a new President, but decide control of both houses of Congress. Markets do not like uncertainty, and the election portends potential change in domestic and international expectations, domestic tax and industrial policy, and regulatory policy.

The market typically prefers political “gridlock”. It is expected, at this moment, that the Democrats maintain control of the White House, and that the Republicans will hold on to the House, while control of the Senate remains very much in doubt. Barring a clean sweep by either party, we do not anticipate a dramatic shift in current policy and market outlook. Certain industries, in particular banking and the drug industry, have experienced a higher level of scrutiny during the past year and this trend toward more activist government is likely to continue for at least the near term.