MARKET COMMENTARY

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To Every Season ... Turn, Turn, Turn

"We cling to our own point of view, as though everything depended on it. Yet our opinions have no permanence; like autumn and winter, they gradually pass away." — the Chinese philosopher Zhuangzi

The end of the third quarter marked eight years since Lehman Brothers' fall helped plunge the global economy into the Great Recession. While there have been fleeting moments of economic optimism during the subsequent slog toward recovery, in general it's been economic pessimism that has defined this time period. Concerns have been amplified over the past few years as the plummeting price of crude oil has clouded the economic outlook. The resulting low inflation and growth have conspired to solidify post-recession concerns into commonly uttered, absolute long-term truths. In other words, catch phrases such as "secular stagnation," "deflationary spiral" and "economic malaise" have wrongly morphed from shorter-term concerns into accepted wisdom. Pardon us if our innate sense of skepticism for consensus forces us to investigate the facts and examine how the future may, in fact, be different, rather than merely regurgitating these consensus phrases. After all, market prices are, in essence, a collection of commonly held beliefs, and additional value can best be delivered by making sense of other interpretations and possible outcomes.

A Change of Season and Economic Trends

The end of the third quarter not only marked the transition from summer to fall, but also a potential shift in economic variables. The aforementioned oil rout is finally loosening its grip on the United States and world economies.

Indeed, for the first time since June 30, 2014, the year-over-year change in the price of a barrel of oil has a positive sign before it. This will serve to dampen deflationary concerns and increase inflationary pressures. Importantly, the past quarter witnessed core Consumer Price Index inflation rising to its highest level of the recovery, while core Price Consumer Expenditures inflation accelerated to its fastest pace since the third quarter of 2014, when the slide in the price of oil was just beginning.

While these changes are significant, the largest change has not received sufficient press. It is not much of a secret that, prior to the Great Recession, the U.S. consumer was highly over-indebted. And while the ad was launched many years before the 2008 collapse, it's hard to forget the Lending Tree spot with the fictitious Stanley Johnson bragging about his four-bedroom home, new car and golf club membership. The answer to his self-posed question on how he affords it? "I am in debt up to my eyeballs."

One consistent trend during the recovery has been the American consumer's desire to avoid becoming Stanley Johnson and to better manage his or her financial circumstances. While the debt accumulation leading up to 2008 was unprecedented, the resulting debt drawdown has also been historically significant.

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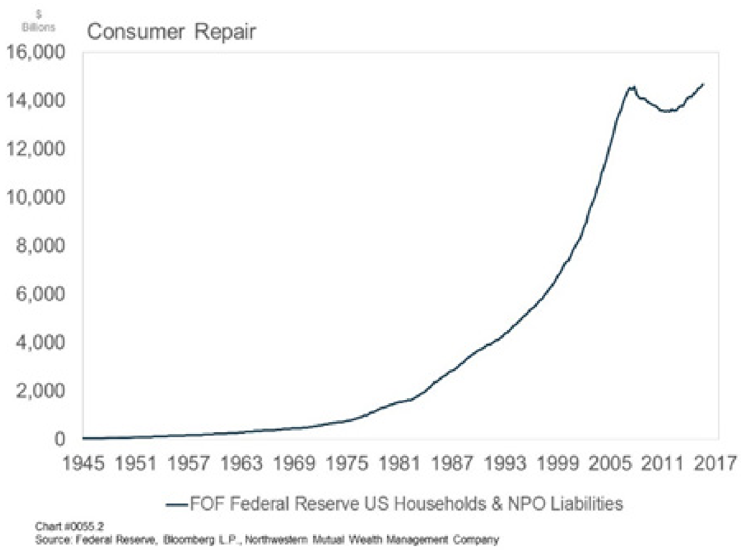
A review of Federal Reserve data reveals that U.S. consumer debt hit a peak of $14.334 trillion on Sept. 30, 2008. Data released this past quarter shows that after nearly eight years of restraint, overall consumer debt has finally eclipsed that level. For some historical context, from Dec. 31, 1945 until Sept. 30, 2008 there has been only one negative quarter, the first quarter of 1968, when overall household debt levels actually declined from their prior level. That's right – only one such quarter in nearly 63 years of data.



At the same time that debt accumulation has subsided, the consumer savings rate has ticked higher. This has helped to return the overall debt/asset percentage ratio to where it was in the early 1990s. Emboldened by this reality, consumer confidence during the third quarter spiked to the highest levels of the recovery. With oil loosening its grip on the manufacturing sector, as noted, and U.S. consumers feeling more confident about their financial condition – and, as a result, spending more – it is reasonable to believe that U.S. economic growth may firm in the coming quarters.

Lastly, we'd be remiss to not comment on the U.S. election. While the candidates are dramatically different, the one thing they have in common (besides their historically negative ratings) is their pledge to increase government spending. This will end one other trend that has been in place over the past few years: fiscal austerity. How many are aware that the U.S. government's contribution to economic growth in this recovery shrunk by the largest amount on a three-year rolling basis since the mid-1950s?

Are Investment Trends Changing?

It should also be noted that, despite all the economic concerns and points of views mentioned above, U.S. equities have provided compelling returns and relative outperformance versus their global counterparts since the recession began. Quite simply, while overall U.S. economic growth has been substandard, global growth concerns have been more substantial. Global risks still exist, however, we believe many of these markets already reflect these concerns. If our forecast of stabilizing global growth is correct, the attractiveness of these markets may soon be enhanced.

In fact, during the third quarter, both international developed and emerging market equities outperformed their U.S. Large Cap counterparts. Indeed, for the first time since the fourth quarter of 2012, emerging-market equities bested U.S. equities on a year-over-year basis. Remarkably, investors who have reviewed their year-over-year performance at the end of each quarter since March 30, 2011, have seen 20 of the last 22 readings favor U.S. equities. This is in stark contrast to the previous trend: From the beginning of 2002 through March 30, 2011, the year-over-year performance of emerging-market equities beat U.S. equities in 34 out of 38 measured quarters, including a streak of 27 straight quarters from 2002 through June 30, 2008.

The Bottom Line

Many have clung to the negative point of view about the U.S. and global economies and the risks that arose after the Great Recession. Many have used this outlook to justify little to no equity exposure. While their belief that economic growth would be substandard was largely correct, the reality, as articulated by the Chinese philosopher Zhuangzi, is that equity market returns weren't, in fact, dependent on fast growth.

Even so, the overall sentiment toward equities and the economy remains sour, while fixed income investors remain complacent. Those who have been courageous enough to venture into the equity markets over the past few years should be careful not to extrapolate the aforementioned recent U.S. equity performance dominance into a longer-term investment certainty and abandon foreign markets.

Economic pundits often look back and wonder how investors made such obvious mistakes, such as concentrating their portfolio in technology stocks in the late 1990s or in emerging markets (as in Chinese stocks) in the mid-2000s. We believe the lack of foresight often occurs when economic and market trends remain in place for extended periods, and as a result, complacency clouds the judgment of investors.

Our central philosophy of portfolio diversification is designed to keep us centered and out of this fray. Additionally, while our investment process is grounded in the intermediate to long term, our economic and market "opinions have no permanence and gradually pass away." In fact, our contrarian antennae quiver when market consensus morphs into conventional wisdom.

Many trends have remained in place in the aftermath of the Great Recession and have now become oft uttered, absolute, long-term truisms. My 20+ years of experience have taught me that when truisms abound, it is fertile ground for change. For the reasons noted above, we believe the third quarter of 2016 may indeed mark the beginning of an economic and investment trend change.

Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Core Consumer Price Indexes (CPI) is a method for measuring core inflation. It is the Consumer Price Index (CPI) excluding energy and food prices. There are many other methods for calculating core inflation, but this is the most popular measurement. This method has become the most widely used because food and energy prices can be very volatile, and this wide amount of movement would unfairly bias the measure of inflation.

The core Price Consumer Expenditures is defined as personal consumption expenditures (PCE) prices excluding food and energy prices. The core PCE Price Index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying infla tion trends. Food prices consist of those included in the PCE category of "food and beverages purchased for off premises consumption." Prices included in the PCE category "food services and accommodations" are not included in the "food" price index because these services prices tend to be far less volatile than those for food commodities such as meats, fresh vegetables and fruits.

The U.S. Large Cap asset class is measured by the S&P 500 Index, which is a capitalization-weighted index of 500 stocks.

The International Emerging Markets asset class is measured by the MSCI Emerging Markets Index, which is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

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