PATHSTONE
FEDERAL STREET

Economic & Market Commentary
Q3-2016

The third quarter of 2016 ended on a much more positive note than it started. Still reeling from the effects of Britain's decision to leave the European Union, global investors showed increased demand for the safe haven of U.S. Treasuries, resulting in the 10-year U.S. Treasury yield hitting a record low on July 6th. Bearish investor sentiment, however, quickly abated as positive U.S. economic data, combined with broader acceptance of a "lower for longer" interest rate environment, drove stock returns higher. The international equity markets (MSCI EAFE) gained 6.4%, U.S. small cap stocks (Russell 2000 Index) and emerging markets stocks (MSCI Emerging Markets Index) both gained 9%, far outpacing the 3.9% returns of the largest stocks in the U.S. (S&P 500). High yield bonds continued their run, returning over 15% year-to-date (Barclays Corporate High Yield Index), buoyed by both relatively low default rates and continued investor demand for higher yields. With interest rates rising from their early July lows, investment grade bonds were generally flat with shorter term bonds posting better results than longer term bonds.

Within the U.S. equity markets, leadership changes among sectors and styles were swift. For example, high dividend stocks, after posting impressive results in the first half of the year (despite valuations at 10-year highs), were sold off in favor of other areas trading at more attractive valuations. With previous recession fears becoming a distant memory, value-seeking investors dove into beaten-down cyclical stocks while large cap technology names led with a 12.9% return during the quarter after a flat first-half of the year. Amidst this backdrop, the average return achieved by hedge funds (HFRI Equity Hedge Index) outpaced that of the S&P 500, posting a 4.67% return for the July-September period.

The quarter also brought forth the broader recognition that we may be in an environment of "lower for longer" in terms of interest rates, economic growth, and market returns. While the seven plus year economic expansion has lasted almost double the length of time of the historical average, economic growth remains muted and inflation largely contained, contributing to the Federal Reserve's decision to keep rates at current levels. Broad market equity and corporate credit indices are trading at values that look neither concerning nor compelling, and bond yields globally remain low, with many yields abroad in negative territory.

Looking forward, the November elections are gathering their fair share of attention, with the strong views of the candidates contributing to volatility within the markets. The Federal Reserve will once again meet to weigh the risks of raising rates, against the risks of holding off. Needless to say, we expect market volatility, fueled by traders and speculators, to surface once again. While the broad equity markets look fairly valued, many pockets of opportunity remain, particularly in segments that have been ignored as investors have sought more stable dividend-payers, irrespective of price. Together with the third-party investment managers that work on your behalf, we continue to identify and exploit opportunities that present themselves in this environment.