Market Matters

Market surveillance: Brexit gave Q3 a rough start, ended modestly higher

After a sharp post-Brexit jolt at the end of the second quarter, the U.S. stock market gained its footing and marched modestly higher through the third quarter. A mix of decent economic news, improving confidence, easy monetary policy and the prospect of emerging from the current profit recession by the end of 2016 all helped to buttress stocks.

Regarding the latter, after five consecutive quarters of declining aggregate corporate earnings, the coming quarters could prove to be vital to the near-term state of the bull market. With valuations modestly rich by most common measures, earnings need to start expanding if this bull market is to advance. If oil and the U.S. dollar continue to stabilize while the economy continues to expand at the current rate, a return to aggregate earnings growth is likely.

Employers added an average of approximately 192,000 jobs during each month in the quarter, but that wasn't enough to push the Federal Reserve to raise short-term interest rates at its September policy meeting. Instead, the Fed pushed the possibility of a rate hike into the final quarter of the year. Based on current economic data, our view is that a hike of 0.25 percent is likely at the Fed's Dec. 14 gathering.

One cannot discuss the economy and financial markets in 2016 without some mention of the impact of elections. Markets hate uncertainty, and this election has brought forth more than most. Additionally, the economy tends to slow a bit in election years due to uncertainty, especially when there is no incumbent running. It's not unusual to see spending and new investments slow while America's electorate chooses our next leader.

Despite this, for the foreseeable future we expect modest economic growth to continue powered by growth in new jobs, rising wages, improved consumer spending and an upturn in housing. All of this is occurring in an environment of low interest rates and low inflation.

Looking beyond our shores, China continues its structural economic pivot from an export-driven economy to one based on consumption. We are neither exuberantly bullish nor overly bearish on China. In Japan, central bankers continue to tinker with new monetary programs in an effort to revive their moribund economy. Finally, Mario Draghi continues a supportive ECB policy in an attempt to keep Europe's economies above water. All told, we continue to anticipate growth in world output to march along at a modest pace over the balance of this year.

As for U.S. stocks, from our perch we reason that the secular bull market which began in 2009 is likely to persist. But it's also true that we're at a more mature phase. A bumpier ride is likely as the Fed begins to normalize monetary policy and profits revert to longer-run averages. Trying to time these bumps is, unfortunately, a fool's errand. Instead, we encourage our clients to stick with long-term asset allocations and view pullbacks as a natural part of the investment journey.

On valuation, the broad market presently sits at about 16.7 times 2017 earnings estimates. This level is not cheap; it is slightly above the 10-year average. But it is also not terribly expensive, especially in light of low inflation and low interest rates.

For nearly 35 years we have accepted that investment markets will be volatile with sectors and investment fads coming in and out of fashion. Yet our long-term investment approach has reinforced the time-tested concept that finding and owning a slice of first-rate American businesses with sound fundamentals will lead to good long-term investment results.

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