



**FROM THE DESK OF BOB CENTRELLA, CFA**

**October 2016**

**THIRD QUARTER SUMMARY AND OUTLOOK**

Well the summer has passed on by and we now head into football season, the World Series and the Presidential Election in Q4. I'm looking forward to the first two but certainly not looking forward to either of the two presidential candidates taking over our country. Take your pick, the robot criminal politician or the egotistical time-bomb. And since I'm not a fan of the current administration either I'm personally stuck in Presidential limbo. At the very least the current Presidential debates have been entertaining. I call it "cringe watching" - where you want to see what they say but cringe when they open their mouths and listen to them.

Stocks wrapped up their best quarter of the year as financial stocks finally rallied after the Fed meeting in late September. The S&P 500 returned 3.66% in the 3rd quarter following its 2.46% gain in Q2 and 1.35% gain in Q1. YTD the market has returned about 7.6% including reinvested dividends. But there are still many issues and possible rough spots ahead including

- when will the Fed will raise interest rates?
- Deutsche Bank's thin capital (and possible monetary penalty payment to the US Justice Dept) and whether this bank's troubles deepen and spread thru Europe,
- additional fallout from Wells Fargo sales tactics,
- an uncertain corporate earnings season,
- OPEC's decision to cut oil output and whether members will fall in line - where does oil price go?
- improving economic growth but a still anemic expansion
- UK exit from the EU (Brexit) and whether it will be a hard or soft Brexit
- the Presidential Election.

Below is a table with Q3 & YTD returns for various assets:

INDEX/ASSET	Q2 Price Change	YTD Change	
S&P 500 (Tot Rtn)	3.6%	7.6%	
Dow Jones Ind (TR)	2.6%	7.0%	
Nasdaq Comp	9.7%	6.1%	
Midcap 400 (TR)	3.7%	11.9%	
Russell 2000	8.7%	10.2%	
Euro Stoxx 600	4.0%	-6.3%	
Japan Nikkei	5.6%	-13.6%	
China Shanghai	2.6%	-15.1%	
Gold	-.3%	15.5%	
WTI Oil	-.2%	30.24%	
Barclays Bond Agg (TR)	.46%	5.79%	



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### STOCKS

Stocks had a strong quarter as the awaited pullback on seasonal weakness never really occurred. Large Cap stocks overtook Bonds YTD while Small Caps and the Nasdaq rallied sharply in Q3 and are outpacing large caps for the year. Commodities stumbled in the quarter although Oil is climbing early in October. Around the world there were a lot more winners than losers as investors saw stocks as a better alternative to low bond yields. Small caps outperformed large with the Russell 2000 rising 8.7% and Mid-Caps are the best performing group YTD returning about 11.9%. For the quarter, risk assets thrived as technology and financial stocks led the rally while investors cooled on dividend paying stocks as Utilities, Telecoms, Industrials and Consumer Staples which underperformed. Healthcare stocks were slightly positive overall but continue to lag over concerns about price controls and regulation. The rotation out of higher dividend-paying stocks has been intense lately on signs that the Fed may raise rates by year-end. Many investors bought these stocks to gain some yield to offset low bond yields. As a result many of these stocks were selling at higher valuations than in the past as investors and were vulnerable to a correction. This week we will start getting Q3 earnings releases as companies release earnings and provide their Q4 outlooks. Third quarter earnings are forecasted to decline 2.1% which if it occurs would mark the 6th consecutive quarter of earnings declines, the longest since FactSet began tracking the data in 2008. Stocks are trading at a forward P/E ratio of 16.7x compared to the historical average of 14.9x. So stocks are a bit overvalued but nothing crazy.

So the question is, will companies actually report a decline in Q3 overall? Historically, companies tend to report earnings above the forecasted rate, so it is possible that we can see some growth in EPS finally. Last quarter we saw earnings decline 3.5% compared to an initial forecast of -6.2%. Worst case, this should be the last quarter of declines as they've improved sequentially. As I've said many times before, we need earnings to rise to carry the market higher. We can't depend on the P/E multiple to grow much more, especially with interest rates likely to rise in the future. On the positive side, revenue growth is expected to be +2.6% in the quarter, the first rise since Q4 in 2014. Energy continues to be the largest detractor in earnings and revenues for the quarter. Excluding energy, EPS are forecasted to rise 1.3% and revenues 4.1%.

International stocks rose after a tepid Q2 with easy monetary policies continuing and Brexit fears subsiding a bit. The MSCI World Index (ex-US) rose 6.47% in the quarter with Brazil (+13.3%), Hong Kong (+12.0%), Germany (+8.6%) and the UK (+6.1%) leading the way. Economic growth remains challenged in Europe, soft in China and weak in Japan. And as details of Brexit unfold there may be some volatility. Internationally as well as domestically, the world needs fiscal stimulus to offset the over-reliance on monetary stimulus. Also, the Deutsche Bank fiasco bears watching as there are some similarities to the Lehman Brothers failure in 2008 including its large derivatives book. The fear is that DB issues spread to other banks who have inter-dealings with them such as what happened in 2008.

### BONDS

The 10-yr US Treasury rate rose from 1.49% to 1.6% in the quarter resulting in a drop in bond prices. This was the first quarterly rise in yield this year. The yield was depressed due to fears on Brexit as well as uncertainty over the Fed. In its most recent meeting the Fed has inched closer to a possible rate increase in December. The Barclays Bond



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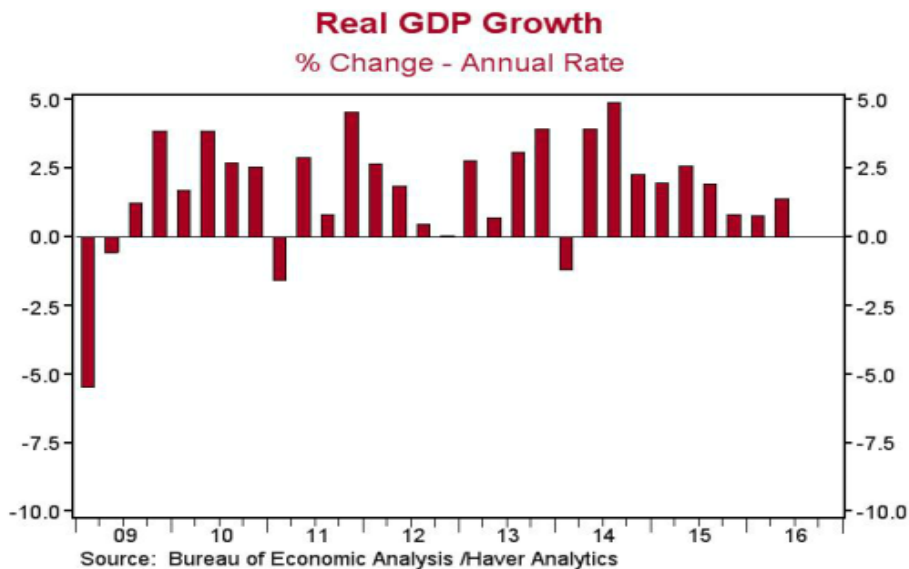
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Aggregate of US Treasury Bonds (the major bond index) now yields only 2.3% so it only takes a small move in prices down to generate a negative return in bonds. The bull market we've seen in bonds for the last 15+ years may be coming to an end as room for price appreciation is waning. Yet, the US treasury yield is likely to remain low due to subdued global growth, low levels of rates abroad, weak inflation and continuing strong demand for fixed income in portfolios. We still have Japan and Europe using negative rates to stimulate their economies so the US bond looks attractive on a relative basis. Look for the 10-yr UST to remain range bound in Q4 between 1.5% and 1.8%. A move to 2% isn't out of the cards but unlikely to hold if it happens until the Fed raises rates a second time.

### ECONOMY

Second quarter GDP growth was revised "up" to 1.4% compared to .8% in the first -- hardly impressive and actually quite anemic. Inflation remains low, a common reason cited why the Fed hasn't raised rates and employment is solid at 5.0% unemployment but jobs are being created at a lower paying level. Having said that, it is possible the economy is accelerating as we head into the fall and economists are looking at possible GDP growth around 2.5% in Q3 and slightly higher in Q4. We haven't had back to back quarters above 2.5% since the last 2 quarters of 2014.



Elsewhere, Housing continues to remain fairly strong as mortgage rates are low and employment gains do add to the potential homebuyer list. Manufacturing has been up and down the past few months but appears to signal a return to growth while the service sector is booming entering its 80th month of expansion. Overall we are plodding along, still one of the better houses on the world's block - but not a mansion by any means!

### INVESTMENT OUTLOOK

This might be a good time to talk a little about Oil and the Dollar. Oil prices have rebounded back above \$50 a barrel in October after OPEC came to an agreement to production cuts in coming months. Whether the countries actually



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stick to the cuts is debatable. Also, if we approach \$60 per barrel, Oil becomes more attractive to the frackers in the US and we could see more shale fracking here which would increase production and supply. And Vladimir Putin is chiming in that Russia is also ready to freeze or cut production. Higher oil prices overall is good for energy company earnings but not so good for consumers or companies that use oil as a source. But the net effect would be a positive for stocks. On the flip side, higher oil could lead to some inflation which in turn gives the Fed more reason to increase interest rates.

The US dollar has held about steady overall with the bias to being strong worldwide, especially the past 2 weeks. The year-over-year comparisons are getting easier and currency effects on corporate earnings should be lessening, but further dollar strength could have a negative effect on exports and corporate sales/earnings figures. It's still a good time to travel especially to England where the dollar has rallied sharply against the pound again. A rise in rates should be accompanied by a stronger dollar so this bears watching.

My wrap-up is going to be similar to what I said last quarter. So I start with the assumption that the Fed will not raise rates in November but are likely to raise them in December by .25%. I am still a bit cautious on stocks at this level but if earnings come in above consensus and companies show more optimism on their outlooks, we could see our typical Q4 rally. On the risk side of the equation, if earnings are weaker than expected and companies give cautious outlooks, then I believe we could see a 5-10% drop in equity prices. Most expect Hillary Clinton to win the Presidential election so any deviation from that would probably cause an initial shock to markets and a decline. But that would be a buying opportunity. Lower bond yields will still serve as a backstop for investors to continue to own equities as the risk/reward remains favorable to equities. I still prefer US to international markets but think there should still be a little international flavor in the portfolio. On the bond front, I prefer a mix of fixed income instruments including corporate bonds, preferred, high yield and Munis. I would stay in the intermediate range for maturities. So overall I still favor a balanced and diversified portfolio. For added diversification you can sprinkle in some gold or commodity exposure.

**That's it for now, have a great fall and start to winter. This is a great time for outdoors stuff including golfing, biking and camping among other things. Even a nice long walk among the colored leaves here on the east coast is a way to relax! Feel free to email or call me at 908-344-9790 with any questions or comments.**

**Bob**