FLAGSTONE

FINANCIAL ADVISORS, INC.

MARKET REVIEW
THIRD QUARTER 2016

What Happened:

The market continues to show remarkable resilience in the face of mixed economic signals. For every indicator that looks positive, you can find another that looks dismal. Despite the heightened uncertainty, stocks delivered positive returns in the third quarter of about 4%. Year-to-date, stocks gained almost 8%, especially impressive given the 15% correction in early 2016. We were also pleased to see a nice rebound in international stocks, which gained 6% in the 3rd quarter.

We have stated many times that corporate earnings drive stock prices. The recent stock rally seems to contradict that premise when you consider that earnings have been in decline for the past several quarters. However, it is important to remember that the market is forward-looking. Starting with the 4th quarter of 2016, corporate earnings are projected to grow by 10%, and many analysists expect 2017 earnings t grow by 15% or more—a direct result of a stabilizing dollar and an improvement in oil prices.

The upcoming presidential election presents an interesting quandary for investors. Each candidate has a different vision for our country and the economy. Regardless of your political leaning, you may be wondering how the markets may be impacted. History tells us that the election outcome will have little effect on future market returns. In fact, there is no statistical difference in investment performance under either Democratic or Republican administrations. The candidates are fond of telling us of all the changes they will make on "Day 1," but the reality is that no individual president has that kind of absolute authority—there are simply too many checks and balances in place. Our country has prospered under all kinds of presidents, conservative and liberal, smart and not-so-smart, popular and unpopular. The market tends to rise over time regardless of who occupies the White House. It will this time as well.

YTD Performance Through 9/30/16:

S&P 500 Index (large stocks)	7.8%
Russell 2000 Index (small stocks)	11.5%
MSCI EAFE Index (international stocks)	1.7%
Barclays U.S. Aggregate Bond Index (bonds)	5.8%

Prognosis:

Barron's recently wrote that Wall Street strategists (i.e., market prognosticators) have lowered their projections for stock returns for the remainder of 2016. The writer pointed out that this is great news for investors because, historically, when market strategists predict little or no gain, the markets advanced 95% of the time over the subsequent 12 months, with an average gain of 11%. Conversely, when they are bullish on the markets, there is about a 50% chance that the market will fall.

We are very aware of the many challenges facing our country and our economy, but we are encouraged by expectations for corporate earnings growth. Elevated volatility, especially in an election year, will be the norm, but we should remind ourselves that volatility is not all bad—it provides investment opportunities that are not available in calmer times.

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