Financial Services Advisory
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Election Outlook and the Fed Push Markets Back and Forth

October Market Update—October 7, 2016

Stocks continued to languish in September, as markets got pushed to and fro by presidential poll numbers and uncertainty over when the Federal Reserve Board will raise interest rates again. Investors seem to believe that a Trump win will create angst in the stock and bond markets since he is such an unknown political figure and has made statements suggesting a more protectionist policy stance for the U.S. As his poll numbers have risen, market returns have become more choppy.

In addition, there was much hand-wringing in mid-September as the Federal Reserve met to decide if it should raise interest rates. An environment of generally rising interest rates will be seen as a negative for stocks (and bonds), which is why there is such anxiety around these Fed meetings. However, there has only been one increase in rates over the past eight years, so we find it difficult to get too worked up over the next 0.25% move in short-term interest rates by the Fed.

Now attention is shifting to the last Fed meeting of the year in December as the next opportunity for the Fed to raise rates. The Fed continually says it wants to raise rates and get overall interest rates in the U.S. to a more normal level, but economic reports released by the government show an economy that may not be strong enough to withstand too many interest rate increases, so the Fed keeps postponing. At the end of October, we should have a better clue as to whether or not the Fed will indeed raise rates at year-end because we will have another round of economic reports, as well as, a slew of corporate earnings reports that will tell us if corporations are doing better.

From a technical standpoint, after finally breaking to new highs in mid-July, large cap stocks have stalled. That has left the FSA portfolios with low money market levels, but little in the way of gains. During the quarter, we saw more defensive areas of the market, such as bonds, utilities, real estate, and consumer staples, dip in price, as the broad market rallied moderately. Leading areas of the market included technology, financials, foreign stocks, and small-cap stocks.

At the beginning of the quarter, we held mostly defensive sectors (including equity income funds). As the quarter wore on, we began adding more cyclical sectors (basic materials and industrial stock funds) to the portfolios. Presently, we have a mixture of both areas—defensive and cyclical. Market behavior in the coming weeks will either have us further reduce the more defensive areas and add more to the cyclical areas (such as technology and energy), or we will begin to lean back to the defensive areas.

<u>Perspective for Year-end</u>
Three things will be dominating the attention of investors in the coming weeks:

- The election
- Corporate earnings
- Federal Reserve meeting in December

Depending on the outcome of these events, stocks could mount a rally from these levels and carry stocks to all-time highs into the New Year. Or, we could have another correction (last mild correction was January; last serious correction 2011; last serious bear market 2008) that could threaten to pull stock returns back towards zero (or even negative) for the year.

Historically speaking, we are entering a seasonally strong period for the stock market, with the November to January period exhibiting the year's best three-month span. But clearly, we are in a period of transition—electing a new president, entering a period of rising interest rates (maybe), adjusting to a period where corporate earnings strengthen (maybe). This has created an uncertain environment for stocks—struggling for any further gains, while resilient to any sustained losses.

As a firm, we have money market levels pretty low across all our strategies, but are sensitive to the risks out there and we would be pretty quick on the trigger to defend the portfolios if the stock (and/or bond) markets turned down measurably from these levels.

<u>Portfolio Review</u>
Below we review the six broad strategies that FSA manages. Keep in mind that your specific portfolio may differ to some degree from the averages, as our portfolios are individually managed.

Income (Strategy 1)
Bonds continue their consistent march forward in the third quarter, so the Income Strategy remains a good place to capture returns above CD rates, with historically low drawdown potential. The strongest returns were generated by the high yield and floating rate funds, while the municipal bond funds were pretty flat. For the quarter, we made no changes to the portfolios and the money market allocation is roughly 5%.

Income & Growth (Strategy 2)
This conservative strategy fared relatively well for the quarter, even though its equity income funds struggled somewhat as more aggressive areas of the market fared the best. We made almost no changes to these portfolios during the quarter and the money market level is near 5%.

Conservative Growth (Strategy 3)
Over the quarter, these accounts managed to handle the various ebbs and flows of the markets pretty well, in spite of the defensive nature of the stock funds in the portfolios. The high yield and floating rate bond positions helped returns. We made few changes to these accounts, with most accounts only seeing the reduction of the consumer staples sector fund. Currently, these portfolios hold about 10% in money market funds.

Core Equity (Strategy 4)
As stocks broke out of their trading ranges in the third quarter, we brought the money market levels quite low in Core Equity. During the quarter we increased our allocation to diversified stock funds, along with adding to our industrials sector position, as well as initiating a position in a health care fund. The equity income funds and the consumer staples sector fund lagged during the quarter, while the MLP fund and the telecommunications fund provided the most lift. At this time, the money market allocation in these accounts is 15% to 20%, due to recent sales of the consumer staples fund and the telecommunications fund.

Tactical Growth (Strategy 5)
These accounts continue to hold an eclectic mix of stock funds (including technology and emerging markets), as well as bond funds (high yield corporate and high yield municipals), and in some cases even some commodities. During the quarter, we sold the energy stock fund and the utilities fund, while reducing the basic materials, real estate and the consumer staples funds. In addition, we added technology positions and increased the emerging markets positions. Finally, in those accounts that held a natural gas fund, we sold that position, as well as added an inverse utility position (should rise in value if utilities are falling in price). Overall, these accounts hold roughly 15% to 20% in money markets.

Sector Rotation (Strategy 6)
The environment for this sector rotation strategy continues to be choppy. It seems that the various sectors are rotating pretty quickly between being at the top and falling towards the bottom of the ranking. Nevertheless, for the month of September, the strategy performed quite well, thanks to a strong performance by the technology components, which more than offset lagging performance by real estate and consumer staples. For the current rotation, there is a decided overweight to technology, as that sector represents half of the portfolio (technology, internet, electronics).

Please remember to let us know about any changes taking place in your lives that could have an impact on your investment objective, or if you wish to talk before our next review.

Note: As a reminder, our quarterly billing statement will be available for viewing next week in the FSA Vault.

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