September 30, 2016

REVIEW OF THE THIRD QUARTER

The US Election

The big news is the US presidential election that has the US in a spin. This, along with the congressional election have garnered much speculation about what will happen to stock markets if either candidate gets elected. The only real consensus is that the market hates surprises and can sometimes react, creating some short-term effects in market prices. This does not mean the markets will move up or down. It just means that it will likely be harder for companies and investors to make allocation decisions depending on the future of the economy.

KeatsConnelly doesn't recommend that any clients adjust their portfolio in anticipation of election results. The first reason for this is that there is no historical correlation between election results and short-term stock market performance. [4] It is pure speculation to think that an election result will lead to stock markets moving in a given direction. The second reason is that any changes made in portfolios involve costs and may incur tens of thousands of dollars or more in taxes.

Stock Markets

The US stock market, as measured by the S&P 500, rose 3.9% during the third quarter of 2016. [2] The third quarter's strong performance came on the heels of the Brexit vote. At the end of the second quarter, the UK voted to leave the European Union. This sent stocks tumbling briefly but they quickly recovered and proceeded to rise through the third quarter. [3]

The Canadian stock market, as measured by the S&P TSX 60 index, rose 5.7% during the third quarter. Year to date it is up over 14%! [1] Valuations in Canadian stocks are perceived to be at a lower level after the poor performance in 2015. The 2016 growth also results from a slight rise in the price of oil which resets expectations and a slight increase in the CAD relative to USD which increases the outlook for Canadian companies.

International stocks fared very well in the third quarter from a US dollar investor's standpoint. International developed companies had a return of 6.3% and emerging market stocks saw a return of 9.0%. [2] The US dollar's recent pullback against other major world currencies was a contributing factor to the good showing of international stocks. In local currency terms, international developed markets are down 1.1% so far this year and emerging market stocks are up 11.6%. [2]

Canadian Dollar

The Canadian dollar has traded in a broad range this year in relation to the US dollar. In January it continued the decline that started two years ago and was down 5% within a couple of weeks. Then it strengthened and was up 10% in May. Since then it has pulled back a little and is still up 5% year-to-date. [1]

Oil

Oil dipped back down to the low $40s in August as it tested levels it hadn't seen since April. [2] For the rest of the quarter it climbed again and recently was testing the $50 barrier that it has struggled to break out of since the big drop in 2014. The Canadian dollar price has a lot to do with the price of oil and other commodities. While oil has been more volatile than the currency, there is a definite pattern where they both move in the same direction over time.

Bonds and Interest Rates

The bond market continued to trudge along with interest rates at the bottom. There was more talk of an interest rate hike by the US Federal Reserve, but as has been par for the course recently, no action was taken. The US Federal Reserve has only raised rates once in the past seven years, even though they have been making noise about doing so for the past three years. Low and declining bond yields have netted some positive returns for bonds because bond prices rise when yields fall, so it hasn't been all bad. However, as with anything in the markets, it is a set of trade-offs. We have some appreciation, but that has only come at the expense of low yields. As rates rise in the future, bond prices will fall.

Summary

So far this year, portfolio returns have generally been as good as or better than our long-term forecasts of returns for diversified portfolios. We updated our long-term expected returns recently and now expect a slightly lower return for stocks and bonds than we did in the past. Last year, our long-term expected return for a portfolio that is roughly half growth assets and half income assets was 4.7%. This year, the return we expect to achieve in this type of portfolio is in the low 4 percent range. Please note that this forecast is not a short-term forecast, but rather a forecast of what we expect a well thought out, balanced portfolio with safety in mind to achieve on average over many years.

KEATSCONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

There are two reasons why expected returns are lower. The first is that bond yields have continued to move lower. The second reason is that earnings growth is expected to be lower in the future. Stock prices rise when earnings grow, and if earnings growth is muted, we should expect stock market performance to also be muted. Our forecast of earnings growth comes from a survey of leading economists that compiles their forecasts and provides a summary of averages. This earnings growth forecast makes up the backbone of our assumptions about stock market returns over the long-term.

[1] Morningstar, 2016, [2] JPMorgan, 2016, [3] Wall Street Journal, 2016, [4] Dimensional Fund Advisors, 2016

Sincerely yours,

KEATSCONNELLY

Robert F. Keats, CFP® (US and Canada), MSFP, RFP® (Canada)

John E Rice

John E. Rice, CFA®, CFP®
Chief Investment Officer

KeatsConnelly Offices
3336 North 32nd Street, Suite 100 | Phoenix, AZ 85018 | T: (602) 955-5007
1880 North Congress Avenue, Suite 302 | Boynton Beach, FL 33426 | T: (561) 659-7401
1400, 350-7th Avenue SW | Calgary, Alberta T2P 3N9 | T: (403) 290-0026
www.keatsconnelly.com