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FOURTH QUARTER 2016

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Q3 Market Update

(values as of 9/30/2016; % changes for Q3, not YTD)

U.S. Stock Indices

S&P 500	2,168 (+3.31%)
Dow Jones	18,308 (+2.11%)
Nasdaq	5,312 (+9.69%)
Russell 2000	1,252 (+8.66%)

Global Stock Indices

FTSE (London)	6,899 (+6.07%)
DAX (Germany)	10,511 (+8.58%)
CAC (France)	4,448 (+4.97%)
Nikkei (Japan)	16,450 (+5.61%)
Emerging Mkts	903.46 (+8.32%)

Bond Indices (Bloomberg)

U.S. Gov't.	129.09 (-0.28%)
U.S. Corporate	148.04 (+1.43%)
U.S. Hi-Yield	167.19 (+5.50%)
Eurozone	144.58 (+0.93%)
Emerging Mkts	165.54 (+3.31%)

Commodities

Gold (per oz)	1,316 (-0.47%)
Silver (per oz)	19.15 (+2.36%)
Oil (WTI, barrel)	47.72 (-1.14%)

Fixed Income Yields

U.S. 2-Year Treasury	0.77%
U.S. 10-Year Treasury	1.60%
U.S. 30-Year Treasury	2.32%
U.S. High-Yield Index	6.24%

Currency Exchange Rates

Euro/Dollar	1.12
Pound/Dollar	1.30
Dollar/Yen	101.34

The Election and Your Portfolio

Since the financial crisis and ensuing Great Recession, we've all become accustomed to the increasingly active role that politicians (and central banks) have taken in managing economic and market outcomes. For today's investors, political risk has become a near-constant phenomenon, an integral part of the market's ongoing background noise. And yet, even against that backdrop, this year's U.S. presidential election stands out as a particularly nerve-racking event.

Not surprisingly, breathless headlines abound. On one side, the uncertainty associated with a potentially volatile Donald Trump presidency has yielded predictions of steep stock market losses of 20% or more. Not to be outdone, Trump's supporters have gone so far as to predict that "Hillary Clinton will destroy the whole world" if she is elected (credit investor and newsletter publisher Marc Faber for that one).

Market-related predictions have become a quadrennial tradition, but that doesn't mean that they're worth the ink that's spilled on them. In terms of broader trends, politics in general—and elections in particular—have minimal predictive value with respect to subsequent market (and economic) activity. Nonetheless, we'll take some time to consider what both the historical—and the more recent—data might be telling us about this year's election.

The historical data

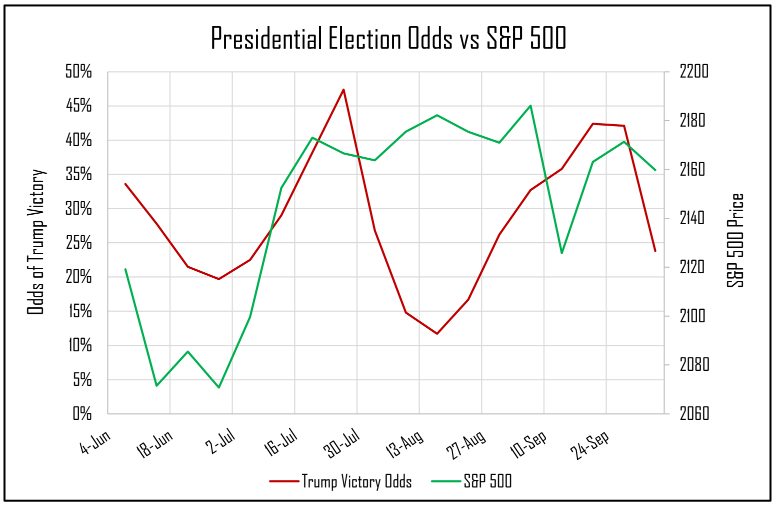
As a general rule, the impact of presidential elections on market outcomes is statistically weak and unreliable. In large part, the issue is one of small sample sizes—since there is only one election every four years, we only have a couple dozen useful data points to draw from, many of which are so old as to make extrapolation to the current environment problematic. Small sample sets are also famously vulnerable to one or two outlier events (the plunge leading into the 2008 election, for example).

Nevertheless, if you study a data set long enough, a few trends are bound to pop out. One of the most commonly cited effects is the "previous 3 months" phenomenon. Over the last 22 elections, the direction of the stock market in the 3 months leading up to the election has correctly "predicted" the winner 19 times—when the market is positive in the pre-election period, the incumbent party tends to hold on to the White House; when the market is negative, the incumbent party loses. The three exceptions occurred in 1956, 1968, and 1980—interestingly, all Republican wins.

Of course, that phenomenon says nothing about subsequent market returns—if anything, the effect suggests that the stock market impacts the election, and not the other way around. What happens, then, if we do attempt to study subsequent returns?

Since the 1952 presidential election (we're studying only the time period for which S&P 500 data is most reliable), 10 out of 16 elections have included a sitting president; of those 10, the incumbent president won reelection 7 times. In the 6 elections without a sitting president, the incumbent party only held onto the White House once. That last fact alone makes drawing historical conclusions about the election's impact on the stock market difficult, because one data point cannot be trusted to indicate a trend.

That said, in the 8 elections where the incumbent party kept the presidency (7 of which were reelections of sitting presidents), the 12 months following Election Day saw an average gain of 10.88%. But when the incumbent party lost, the market was essentially flat over the next 12 months, with an average return of -0.23%. That difference may or may not indicate a causal link, but it would lend credence to the theory that markets dislike uncertainty, and therefore perform best when there is a sense of continuity in the White House.



For what it's worth, the one election in which the incumbent party held on to the presidency despite the absence of a sitting president (1988, George H.W. Bush over Michael Dukakis) saw one of the strongest subsequent rallies in our data set, with a 22.9% gain. That fact might get Clinton supporters excited, but remember, the predictive power of a single data point is minimal.

This year's data

Amid a sea of semi-hysterical headlines, one recent piece has attracted extra attention. In the immediate aftermath of the first presidential debate, University of Michigan economist (and New York Times contributor) Justin Wolfers wrote that "Wall Street fears a Trump presidency," predicting market losses of 10-12% in the event of a Trump victory.

As evidence, Wolfers studied minute-by-minute data of overnight futures markets compared to similar real-time data of betting odds on Trump's election chances. As Trump's odds of victory steadily declined from 35% to 30% over the course of the evening, futures markets trended higher, by about two-thirds of a percent. Because there was no other meaningful news during the debate time period (and because futures markets are typically calm during the evening hours), Wolfers ascribed the entire market reaction to the debate, and extrapolated the market's broader feelings about the candidates from there.

Unfortunately for Wolfers, this effect is not supported by data over any other relevant time frame. As Trump's odds of victory steadily increased throughout July, the market also climbed. And rather than sparking a broader rally, Clinton's debate "victory" has been followed by mostly sideways trading, even as her election victory odds have spiked. Since June, Trump's election odds actually reveal a slight positive correlation with the S&P 500 (higher Trump odds equal higher stock prices), but the statistical link is incredibly weak. By any fair definition, there is no relationship between election odds and market activity, regardless of what two hours of data suggest.

The data notwithstanding, many voters remain convinced that the election outcome is pivotal—a recent CNBC poll found that 53% of those surveyed thought Clinton would be better for markets than Trump, while 26% thought Trump would yield higher returns (the remaining 21% were either neutral or had no opinion). Ultimately, we can slice and dice the data any number of ways and reach a variety of different (and likely contradictory) conclusions about how the election might impact markets. But recent experience suggests that the market has a tendency to overreact to political news, both in magnitude and velocity.

In the final analysis, we think it's always best to leave politics out of your investment approach. At Cypress, we help clients to build diversified portfolios that are designed to hold up well in a wide variety of environments, and that are nimble and flexible enough to take advantage of any potential opportunities. We don't know how this election will turn out, nor do we know with any certainty how the market will respond. What we do know is that having a coherent plan in place (and sticking to it) yields positive risk-adjusted returns over the long run.

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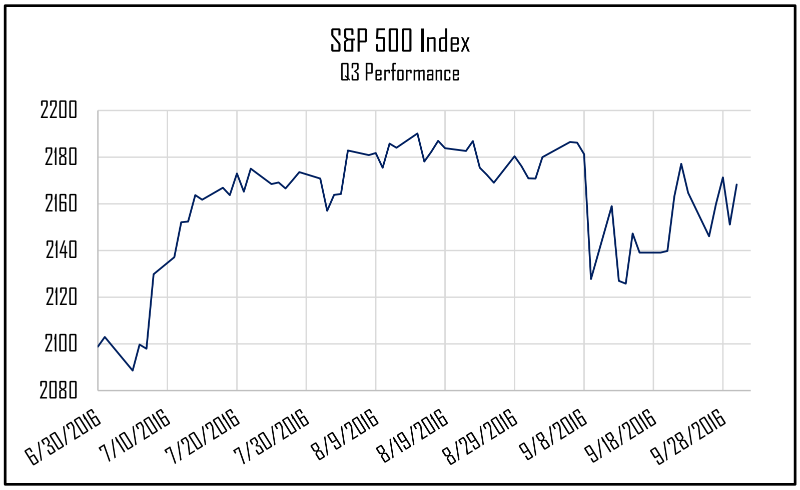
SHARES OF GERMAN LENDER DEUTSCHE BANK ARE DOWN 54% IN 2016

Equity Overview – Domestic Equity Markets

A strong finish to the second quarter (which started with a snapback rally in the wake of the Brexit vote) continued throughout July, as stock indices once again marked all-time highs in Q3. As the quarter wound to a close, however, sideways trading once again returned, as investors remain preoccupied with an uncertain Federal Reserve policy path and a testy presidential election campaign that is mercifully nearing completion.

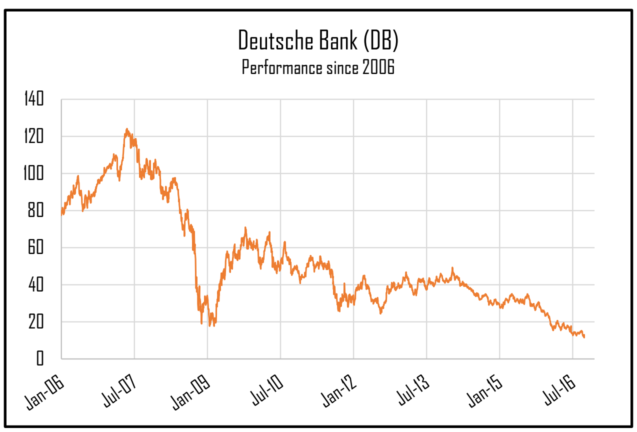
All told, the S&P 500 logged a solid 3.3% return for the quarter, closing at a level of 2,168, another record-high quarterly close. But some of the more important data was found in the divergences between market sectors. The most recent leg of the market rally was led by outsized gains in technology stocks and smaller-cap companies, both of which logged double-digit gains for the quarter. Utilities, telecom, and other defensive names, meanwhile, actually retreated despite the broader market's gains.



That the "riskier" names have led the recent rally might in fact be a very good sign for markets going forward. Rallies that are led by defensive stocks are rarely as robust or long-lasting as those that are led by high-fliers, and investors' apparent embrace of risk heading into the election may be a sign of further gains to come. But for now, eyes remain fixed on the political realm, as markets await November's news.

Deutsche Bank Leads European Banking Concerns – Fixed Income

Nearly a decade has passed since the worst of the financial crisis, and for the most part, U.S. banks have reclaimed the profitability that they enjoyed before the housing bubble collapsed. While the stock price recoveries have been a bit of a mixed bag—JP Morgan and Wells Fargo both trade above their pre-crisis levels, while Morgan Stanley, Citigroup, and Goldman Sachs are still in the red—the firms are generally much healthier now than a few years ago.



Unfortunately, the same cannot be said about most European banks, which are still feeling the strain from an ongoing fiscal crisis that has gripped the continent and compromised a decade's worth of European economic growth. The latest challenge faced by these beleaguered banks is the recent proliferation of negative interest rates, which essentially represent a tax on banks (and their cash reserves). Add in a still-unresolved Brexit vote that has cast a pall of uncertainty over all of Europe, and it's easy to see why the banks continue to struggle.

Frankfurt-based Deutsche Bank may be the poster child for Eurozone bank weakness, as its shares have been under constant pressure (down 54% in 2016, 27% since Brexit). A recent liquidity scare at the bank sent global markets tumbling, sparking memories of Lehman Brothers' failure in 2008. So far, such comparisons remain unwarranted, but investors' nervousness is palpable. This is an area that bears close watching over the coming months.

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High-Yield and Investment-Grade Bond Yields Often Diverge

Keep An Eye On Bond Yield Spreads – Fixed Income

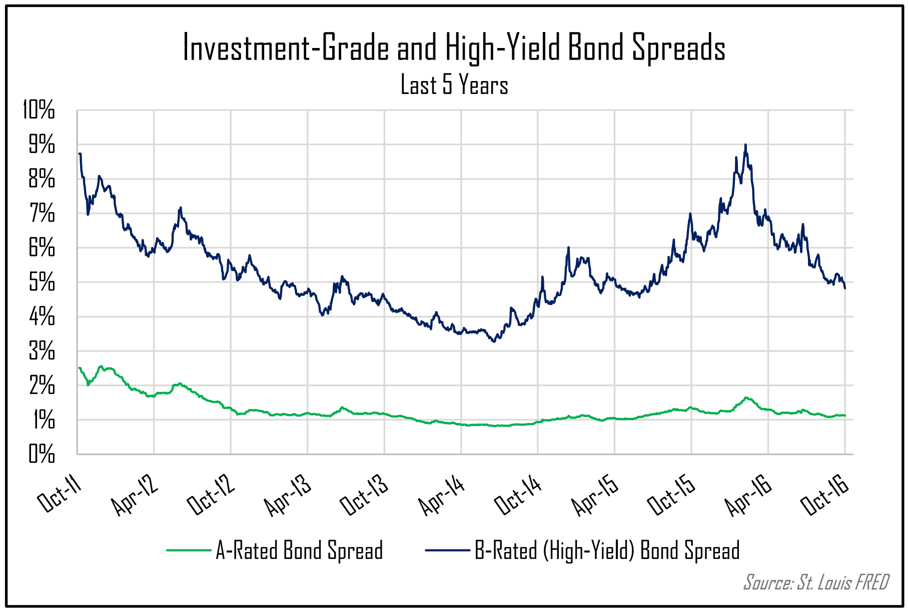
As the Federal Reserve Board continues to consider whether (or when) to resume increasing the target for its benchmark Fed Funds Rate—which has now stood below 1% for a record 96 straight months—investors everywhere are taking a second look at their fixed income holdings, lest they find themselves improperly positioned for an eventual end to what is now a 35-year bull market in bonds.

It has become taken almost for granted that interest rates must some day rise, but that statement (or belief) alone is insufficient to prescribe action. What happens with one group of interest rates may or may not also happen with a different group—in other words, it's not just "if" you own bonds that matters, it's what types of bonds you own that will determine your portfolio's performance.

A closer look at the behavior of a variety of bond yield spreads can better illustrate both the difference between various types of bonds and the likely market response to any "rise in rates". Helpfully, BofA/Merrill Lynch regularly tracks a wide variety of bond yields, from Treasury notes to A-rated corporate bonds to high-yield "junk" bonds and beyond. Calculating the yield spreads—the gap between the yields on the bonds in question and prevailing "risk-free" Treasury rates—can isolate the performance of a specific group of bonds from the broader fixed income environment.

As any high-yield bond investor is likely already aware, spreads for high-yield bonds spiked dramatically in 2015, as a plunge in the price of oil sparked widespread concerns about the liquidity and solvency of a wide variety of energy companies (who have been among the heaviest issuers of high-yield debt in recent years). Their higher-rated corporate bond cousins also saw a small increase in their yield spreads, but nowhere near as extreme an increase as was seen in the high-yield space. This year, as oil prices have stabilized, high-yield bond spreads have consistently declined as well, now nearing levels that were last seen before the oil price crash.

It's telling to note that while high-yield bond spreads have continued to compress in recent weeks, spreads for higher-rated corporate bonds have been stable, if not widening slightly. That divergence can be credited almost entirely to expectations of future Fed rate hikes. If and when the Fed does resume raising rates, it's likely that the highest-quality bonds will be the ones most heavily impacted in the near term. One of the central goals of the Fed's zero-interest-rate policy was, after all, to force investors into riskier assets, and high-quality corporate bonds quickly became something of a portfolio surrogate for Treasury bonds, which suddenly had yields too low to be worth owning in many portfolios.



Source: St. Louis FRED

As rates on Treasury bonds gradually return to more normal levels, it stands to reason that their surrogates would be the first things sold as investors move back into Treasuries and other "risk-free" instruments. High-yield bonds can be expected to feel the pinch as well, but their higher yields should insulate them somewhat, while industry-specific factors continue to play a role. Maintaining exposure to a variety of fixed income instruments remains the prudent move.