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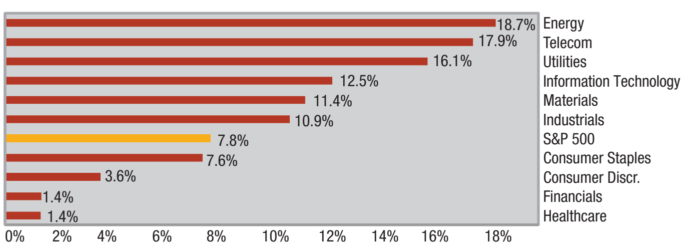
During the quarter, equity markets recovered from the volatility driven by the United Kingdom's unexpected vote to leave the European Union (Brexit), and the S&P 500 ended the period with a positive return. This rebound, along with stable economic data points, puts a Federal Reserve rate increase back on the table for later this year. Despite having bounced off of record-low levels, negative rates in Europe and Japan continue to be a major factor. Global investors' focus on yield has driven a good portion of the returns this year, and some pockets of excess are developing. The U.S. economy continues to expand at a slower pace than expected, and the rebound in the industrial segment of the economy has been bumpy. Housing remains a bright spot. Low borrowing costs and healthy employment statistics should support further improvement and, by extension, greater consumer spending. Consumer confidence has reached levels not seen since 2007. The results of Election Day will be critical for various investment and financial planning considerations. In general, the first year of a presidential term has not been positive for the stock market or the economy. For now, we position portfolios for modest economic growth, although volatility may increase as November 8th nears.

The S&P 500 Index gained 3.8% on a total return basis for the quarter. The Technology sector led, up 12.9%. The Financials and Industrials sectors also performed well. The higher-dividend-yielding and defensive Telecom and Utilities sectors underperformed but remain up double digits for the year.

Figure 1: 2016 Performance by Sector



Source: Bloomberg. Data as of 09/30/2016.

Slow Growth Keeps the Fed on Hold

The U.S. economy, as defined by Gross Domestic Product (GDP), continues to expand modestly. The first-half of the year saw a lackluster 1.4% increase in GDP; the second-half performance is expected to be marginally better. If this slight improvement occurs, full-year growth will be 1.5%, the lowest level since this expansion started. Residential investment and consumer spending remain key drivers.

With a combination of low mortgage rates and rising incomes, housing fundamentals remain favorable. Strength is expected to continue in the construction of single-family homes, which is still depressed compared to long-term averages. The National Association of Home Builders/Wells Fargo Housing Market Index, a monthly survey of builder confidence, jumped an impressive six points in September to the highest level in nearly a year. Builders remain confident that these positive trends will continue.

The unemployment rate was 4.9% in August—the same level as in January, when the economy was running near "full employment." Retail sales, a closely watched measure of consumer spending, showed strong gains this spring before easing in recent months. The Conference Board Consumer Confidence Index spiked to 104 in September. This is the highest level in nine years and well above economists' forecasts. Consumers reported that jobs were "plentiful" and had a positive outlook on the labor market. Perhaps the upcoming election is holding back spending. If income tax rates increase in the future, there will be less to spend on discretionary items.

Last quarter we noted that we were seeing signs of stabilization in the industrial economy, after a prolonged period of weakness. The ISM Manufacturing Index – which monitors employment, production inventories, new orders, and supply deliveries – was above 50, signaling growth, for five months in a row. In August, ISM came in surprisingly low at 49.4, with disappointing new order figures driving the majority of the weakness. This indicator rebounded in September to 51.5. Upcoming reports need to be watched closely. In many of the previous recessions, ISM was a harbinger of the coming slowdown.

Slow global economic growth, a timid consumer and a weak industrial economy have made it difficult for companies to increase revenue and earnings. Last December, the Fed indicated they would increase rates four times in 2016. Since then, the March, June and now September meetings have come and gone with no increases. It is unlikely that rates will be raised before the election, but traders assign more than a 50% chance of an increase this December. The Fed really wants to raise rates, but if growth remains slow their plan may need to be adjusted.

In the September meeting, Fed officials lowered the long-term U.S. growth rate to 1.8%—down from 2% in June and 2.5% earlier. If this forecast becomes reality, it will be very difficult for the U.S. to grow its way out of its debt problem. Federal debt held by the public (which excludes the Social Security Trust Fund) has nearly quadrupled over the past 15 years, to $13.1 trillion in 2015. Yet net interest expense has remained roughly the same. Deficits may balloon if rates move back towards historical levels.

Election Day Considerations

In general, the start of a new presidential term has not been a positive for the stock market or the economy. Eight of the last 11 recessions have coincided with the inaugural year of a presidential term (see Figure 2). According to Ned Davis Research, the S&P 500 has posted its weakest returns in the first year of the four-year election cycle. Since 1900, stocks have gained just 3.4% on average during this period, although this average is pulled down by some outsized down years during recessions. The presidential race will be key, but the makeup of Congress is also critical.

Both parties seem to agree on the need to spend money on infrastructure. It also seems likely that a plan would be funded by revenue generated from the repatriation of foreign profits, which are estimated to be $2 trillion or more. This "deemed repatriation" tax is likely to be part of a new international tax system that addresses the double taxation issue U.S.

Figure 2: Recessions During Inaugural Years

Party	President	Inauguration Date	Recession Periods	First Year Recession Overlap?
D	Truman	Apr 1945	Nov 1948 - Oct 1949	No
R	Eisenhower	Jan 1953	Jul 1953 - May 1954 Aug 1957 - Apr 1958	Yes
D D	Kennedy Johnson	Jan 1961 Nov 1963	Apr 1960 - Feb 1961	No
R R	Nixon Ford	Jan 1969 Aug 1974	Dec 1969 - Nov 1970 Nov 1973 - Mar 1975	Yes Yes
D	Carter	Jan 1977	Jan 1980 - Jul 1980	Yes
R R	Reagan GHW Bush	Jan 1981 Jan 1989	Jul 1981 - Nov 1982 Jul 1990 - Mar 1991	Yes Yes
D	Clinton	Jan 1993		No
R	GW Bush	Jan 2001	Mar 2001 - Nov 2001 Dec 2007 -	Yes
D	Obama	Jan 2009	- Jun 2009	Yes

Sources: Citibank, Inverness Counsel.

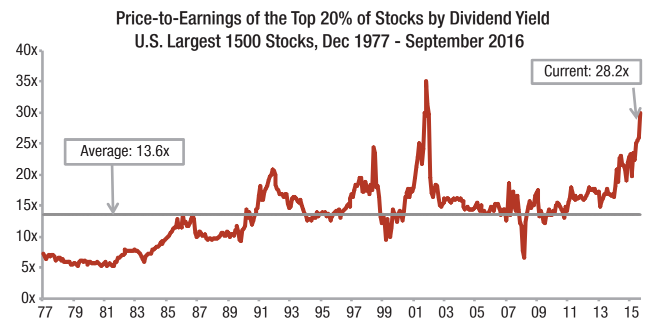
companies currently face. The sectors with the largest amount of cash held overseas are Technology and Healthcare. We have summarized some other election proposals (see Figure 3). The two parties have very different plans.

The Hunt for Yield

The World Trade Organization cut its forecast for global trade growth to 1.7% in September. This marks the first time in 15 years that international commerce is expected to expand more slowly than the world economy. In response to this and other deflationary forces, the European Central Bank and the Bank of Japan continue to use negative interest rates, which means they are actually charging depositors to hold their money.

In the current environment, many traditional bond investors have invested in stocks with higher-than-average dividend yields instead of bonds. The 300 stocks with the highest dividend yields in the S&P 1500 are trading at record valuations (see Figure 4). This has driven significant performance this year in the Utility, Telecommunications, Real Estate, and Consumer Staples sectors. These sectors make up roughly 20% of the S&P 1500 but represent over 40% of the top 20% of stocks ranked by yield. In addition, many of these names are paying more in dividends than they make in profits. We see significant risk developing in this group of stocks.

Figure 4: Valuation of Highest Yielding Stocks



Sources: Bloomberg, Bernstein Research. Data as of 09/30/2016.

Course of Action

Our focus remains on top-line revenue growth as a driver of cash flow and earnings. We continue to have significant exposure in the Technology and Consumer Discretionary sectors, which offer attractive relative earnings growth. The Healthcare sector also offers attractive growth, but the political risks are significant, and we have reduced exposure. We have also reduced exposure in Financials due to concerns about low interest rates and increased regulation. We continue to be underweight Utilities, Telecom, and Real Estate, and we have been selective with our Consumer Staples exposure. Election Day results and their implications are the wild card, and volatility may increase as the date nears.

Figure 3: Election Outcomes and Proposed Tax Implications

Issue	Clinton	Trump
Top Tax Rate on Ordinary Income	47.4%	33%
	Includes 4% surtax for income > $5M and 3.8% on "net investment Income"	Married - joint filers earning > $225,000
Top Tax Rate on Capital Gains	Short Term 47.4%, Long Term 23.8%	Short Term 33%, Long Term 20%
	A taxpayer earning more than $415,000, would have to hold an asset for six years to use LT rate	Retains existing capital gains structure except removes Obamacare 3.8% surtax
Alternative Minimum Tax	Adds "Buffet Rule" to existing AMT	Repeals AMT
	Buffet Rule states all taxpayers with income > $1M pay a minimum effective tax rate of 30%	
Top Estate Tax Rate	65%	0%
	45% on estates between $3.5M and $10M, 50% on $10M-$50M, 55% on $50M to $500M, 65% > $500M	The estate tax currently resides at 40% on estates above $5.45M for a single person
Corporate Tax Rate	?	15%
	The top corporate rate is currently 35%	

Sources: Fortune, Inverness Counsel. Data as of 09/30/2016.

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