



28411 Northwestern Hwy. Suite 200
Southfield, MI 48034
(248) 556-2900
www.bernard-wealth.com

Third Quarter 2016

Enclosed are your Portfolio Statement, showing your portfolio's holdings and asset allocation, Performance Analysis, displaying investment returns for your portfolio, and Statement of Management Fees for the fourth quarter of 2016.



Fig. 1 – S&P 500



Fig. 2 – MSCI Emerging Markets

Stocks advanced broadly in the third quarter, as investors shook off Brexit fears. The large cap S&P 500 index (**Figure 1**) posted total returns of +3.9% for the quarter and is now up +7.8% year to date. In a clear sign of investor optimism, small cap stocks, which have generally lagged the last two years, posted strong gains. The Russell 2000 rose 9.1%, and is now +11.5% for 2016. Foreign markets bounced back after a weak second quarter. The developed world outside the U.S., including Europe and Japan gained +6.4% in the quarter, but is only +1.7% for the year. Emerging markets (**Figure 2**) registered a gain of +8.3% after losing -0.3% in the second quarter.

S&P 500 companies reported a combined earnings decline for the fifth consecutive quarter, matching the length of the contraction in the Great Recession. According to research firm Factset, Energy (-84%) and materials (-8.8%) had by far the largest declines again. Earnings were generally better than feared, with 70% of companies beating analysts' conservative expectations. The second quarter aggregate earnings drop for the S&P 500 was -3.2%. While still weak, this is somewhat better than the -5.5% that was expected for the quarter on June 30th. Current forecasts call for a smaller decline in earnings of -2.0% for the third quarter, as most non-energy sectors seem likely to continue or resume growth. Stocks should continue to benefit as U.S. corporations move out of this profit contraction.

The U.S. economy appeared to slow over the summer, but continued to grow. New housing construction was relatively steady, and existing home sales remained strong. Solid employment trends persisted, with unemployment hovering around 4.9%. In addition, new job creation bounced back after a soft spring with a very strong read in July, and announced corporate layoffs have been historically low. Wage growth, which has been stubbornly weak through most of this recovery, seems to have accelerated. In September, the Census Bureau reported that 2015 median household income rose 5.2% over the previous year, the largest annual increase since the reporting began in 1967. The combination of solid job trends and improving wages should support consumer spending, by far the largest sector in our economy. Purchasing manager surveys for August in both the manufacturing and services sectors reflected some weakness and raised fears of further slowing. However, early October data showed significant improvement in both manufacturing and service activity.

Bond yields have stayed historically low for most of this year (**Figure 3**). The Federal Reserve has been cautious about hiking short-term rates, out of fear of crimping credit growth. Domestic inflation has stayed below the Fed's stated target of 2%. In addition, bond purchases by the European and Japanese central banks have pushed rates negative overseas, making our bonds relatively attractive. However, bond yields have risen gradually since briefly logging record lows in July. Further increases in long-term yields may be supported by wage growth, a slight uptick in inflation, and overall economic improvement. Also, overseas central banks may be backing away from their bond buying policies, out of recognition that negative rates have failed to stimulate growth and inflation, and may be hurting bank profitability, particularly in Europe.



Fig. 3 – U.S. 10 Year Treasury Yield



Fig. 4 – Dow Jones U.S. Financials Index

The potential for rising rates, supported by improving economic fundamentals and corporate earnings, has important investment implications. Utilities and real estate investment trusts (REITs), among the strongest performers this year, may see lower relative returns, as their dividends are compared to better bond yields. Economically sensitive sectors, including industrials, technology companies and financials (**Figure 4**), may benefit from the improving profit outlook as well as the potential for slightly higher inflation. Government bonds may see small price declines. Fixed income investors may be better served with investment grade corporates, which offer a yield cushion over Treasuries. Some caution may be warranted with high yield (junk) bonds, which have seen very strong inflows after lagging badly in the energy scare of late 2015.

Relative calm prevailed in the third quarter, and stock investors benefited. In contrast to the second quarter, with the surprising U.K. vote to exit the European Union, there was very little headline-induced volatility. Many of the same global worries persist, including China's burgeoning loan balances, Brexit-related weakness in the U.K., and questionable European bank capitalization. However, these issues are generally well known. It is often said that equity markets hate uncertainty. As of this writing, there were no events in the quarter large enough to derail investor confidence. At the same time, the U.S. presidential election has sidelined some investors, and it is possible that some businesses are delaying projects, waiting for the outcome November 8th. We caution against trying to time this. Those who sold before the 2012 election may have missed participation in the equity market of 2013, a very strong year. At some point, the election will be history, and the economy will likely continue growing, regardless of the winner.

We look forward to speaking with you about your investments and financial picture soon, and encourage you to contact us at any time.

Sincerely,

Kenneth M. Bernard, CFA