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MARKET AND ECONOMIC OUTLOOK

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Autumn Begins With No Recession Imminent, a Bull Market, and Strong Auto Sales

As the days grow shorter we may begin to feel the ache of nostalgia for the summer of 2016. Not only did we enjoy the seasonal pleasures of family vacations and our favorite outdoor activities, but we experienced it all without the capital markets imposing any serious stress. The widely watched S&P 500, for example, is up nearly 8 percent this year (as of September 30) without much volatility. Bonds are up nicely, too. In fact, you have to search far and wide to find an area of the capital markets that has produced negative returns this year.

With that as background, this issue of *Market and Economic Outlook* reviews the relatively placid third quarter and examines our lengthy bull market. We also contemplate how the action (or inaction) of the Federal Reserve has influenced our current economic conditions, while examining leading economic indicators for clues on trend changes. Finally, we talk to the leader of CLA's dealership industry team to get a picture of the auto industry, one of the brightest spots in the current economy. While that industry has rebounded in tandem with broader indicators, analysts are uncertain where it is headed.

We would be remiss if we didn't also mention the upcoming presidential election. As we discussed in the July 2016 *Market and Economic Outlook*, we would not think it wise to make investment decisions based on the election's outcome. Historical data support this viewpoint. But regardless of which candidate wins, there are bound to be policy changes in taxes, regulations, immigration, foreign trade agreements, and more, some of which could create short-term volatility in the capital markets. We can only speculate what (if anything) it will all mean for business and investing, so for the time being, the best attitude is wait and see.

Positives	Negatives
Employment is strong	Future expected returns are below historical averages; U.S. stocks, specifically, are no longer cheap
Housing prices continue to firm	Brexit-related uncertainty over U.K. and Eurozone area economies and markets
Auto sales remain strong	Geopolitical concerns; specifically, terrorism
Energy costs, gasoline, natural gas prices low	Fear of slowing Chinese economy and impact on global economy
Low financing costs	Distress in European banks
Benign inflation	

Third quarter saw the storm before the calm

The third quarter began turbulently for U.S. stocks. This was mainly due to the shock of the Brexit vote in the United Kingdom, a topic which we wrote about at some length in the second quarter *Market and Economic Outlook*. Although the long-term ramifications of this vote and what it may mean for the future of the European Union are significant, the markets fairly quickly shrugged off the short-term concerns with Brexit, and July ended with gains in most asset classes. August was a notable month for what didn't happen. The S&P 500 did not close 1 percent higher or lower on any day in August, a rare stretch of muted volatility. In addition, trading volume was relatively light and the Volatility Index (VIX) remained at very low levels. September ushered in a return to volatility, but U.S. stock investors enjoyed sizable returns for the quarter. Small cap stocks, as measured by the Russell 2000 index, were up more than 9 percent for the quarter. Large company stocks were also up nicely, with the S&P 500 finishing with nearly a 4 percent gain.

The U.S. bond market experienced volatility as well. The yield on the bellwether 10-year U.S. Treasury note bottomed at 1.37 percent in July before peaking at 1.73 percent in mid-September. The broad U.S. bond market, as measured by the Barclays U.S. Aggregate Index, notched a small gain for the quarter. High yield credit continues to be the hottest sector of the bond market, with junk bond indices up around 15 percent year-to-date.

Third Quarter and Year-to-Date Index Returns

Index Name	Capital Market Segment	3Q16 (%)	YTD (%)
Barclays U.S. Aggregate	U.S. Broad Market Bonds	0.46	5.80
S&P 500	U.S. Large Cap	3.85	7.84
Russell 2000	U.S. Small Cap	9.05	11.46
MSCI EAFE	Non-U.S. Developed Markets	6.43	1.73
MSCI EM	Emerging Markets	9.03	16.02
Hypothetical 60/40 Portfolio[1]	Diversified Mix of Indices	3.53	6.71

[1] 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM
An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

U.S. Treasury Market

Maturity	Yield 9/30/16	Yield 12/31/15
2-year	0.78	1.05
10-year	1.60	2.27
30-year	2.32	3.02

Source: Bloomberg

Foreign markets hold to earlier trends

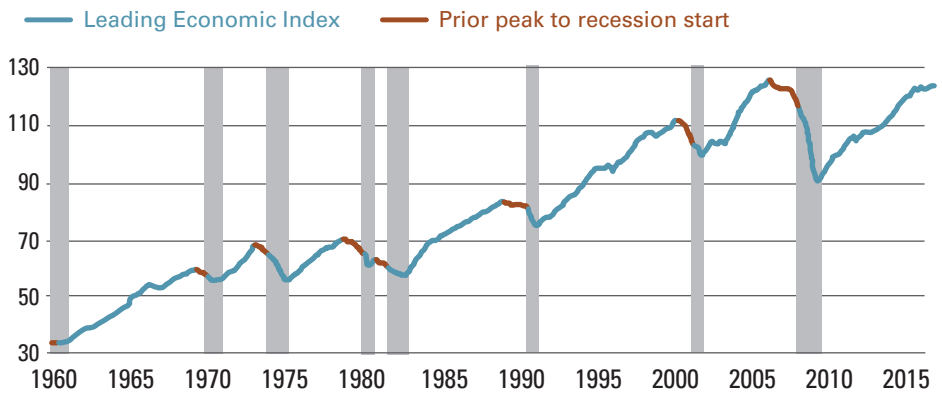
Foreign markets mostly continued trends that have been in place since the beginning of 2016. Emerging markets are surging, with the key MSCI EM index finishing with a 9 percent gain for the quarter. Brazil, despite enormous economic difficulties and massive corruption scandals, has led this space, with the MSCI Brazil index up an eye-popping 62 percent for the year in U.S. dollar terms. Another large and troubled emerging market, Russia, is posting big gains this year, with the MSCI Russia index up more than 31 percent year-to-date in U.S. dollar terms. China, the largest emerging market and the world's second largest economy, saw large gains during the third quarter, but has posted more modest gains of about 6 percent on a year-to-date basis (MSCI China).

Developed markets have struggled relative to emerging markets and U.S. markets this year. The MSCI EAFE's 6.5 percent gain for the quarter, though, brought the index into positive territory for the year. Europe remains a trouble spot for the developed markets. The Euro Stoxx 50 index is down more than 5 percent on a year-to-date basis in U.S. dollar terms, with the troubled financial sector being a main culprit. The stocks of Credit Suisse and Deutsche Bank, for example, have been hit especially hard and were featured in many fear-inducing headlines in September. Japan's stock market always has a large impact on MSCI EAFE's results, as the country comprises nearly a 25 percent weight in the index. Notably, there is a large difference in the currency-adjusted returns of Japanese stocks this year. In their local currency, the MSCI Japan index is off more than 14 percent. However, with the yen rising sharply against the U.S. dollar this year, the return in dollar terms is about 3 percent. Changes in currency markets have generally been beneficial for U.S. investors holding international stock funds in 2016 — a reversal of the trend seen in recent years.

Leading economic indicators tell us a recession is not imminent

The U.S. economy is a vast, complex, and dynamic machine that frustrates attempts to perfectly analyze it or make accurate predictions about significant changes. It can be insightful, though, to examine the levels and trends of leading economic indicators, i.e., items that purport to show the direction of economic trends. The Conference Board publishes the Index of Leading Economic Indicators (LEI), which incorporates 10 sub-indices measuring key economic variables.

Leading Economic Indicators and Recession



Source: FactSet, The Conference Board, as of August 31, 2016

In examining a long-term chart, it is somewhat easy to note the tendency for the LEI to foretell a recession (represented by the periods shaded in gray); that is, recessions have always been preceded by the LEI peaking and then going into a months-long downtrend. Although the August 2016 LEI was weaker, we are not in a sustained downtrend. Recession is not imminent according to our reading of the LEI. We should note that the LEI's excellent track record in predicting recessions does not guarantee future results.

Charles Schwab & Co. has created a dashboard of the 10 individual underlying indicators that comprise the LEI.

Trends of Individual Economic Indicators

Indicator	Curent Level	Trend
Leading Economic Index (LEI)	Fair	Stable
Average workweek	Fair	Stable
Unemployment claims	Strong	Improving
New orders: consumer goods and materials	Fair	Improving
Institute of Supply Management (ISM) New Orders Index	Strong	Worsening
New orders: nondefense capital goods excluding aircraft	Fair	Stable
Building permits	Fair	Worsening
S&P 500	Strong	Improving
Leading Credit Index	Strong	Improving
Interest rate spread	Fair	Improving
Average consumer expectations for business and economic conditions	Fair	Worsening

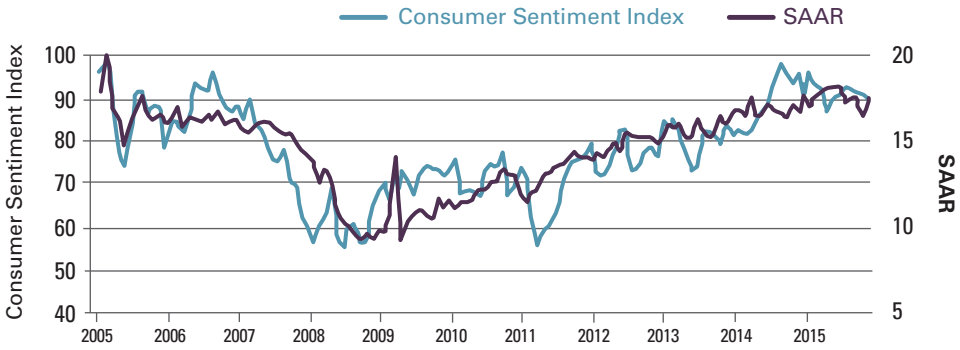
Sources: Charles Schwab, The Conference Board, as of August 31, 2016

As stated earlier, there was some weakening in August, as manufacturing (the Institute of Supply Management or ISM index), building permits, and average consumer expectations worsened. Liz Ann Sonders, chief investment strategist for Charles Schwab, states that she "[does not] view this as particularly alarming," and we would tend to agree with this assessment. Indeed, five of the indicators show improvement. In summary, recession is not likely near-term according to leading economic indicators, but we will continue to monitor the trend.

Auto sales are strong, but they may have peaked

The auto industry accounts for a significant portion of the overall manufacturing sector, which has experienced incredible growth since 2009. From a macroeconomic and consumer standpoint, it appears to be on solid footing. Unsurprisingly, there is a strong correlation between consumer confidence and auto sales. The chart below overlays the University of Michigan's consumer sentiment poll on the seasonally adjusted annualized rate (SAAR) of auto sales. Low unemployment, increasing household incomes, low gas prices, and attractive financing rates are just a few factors contributing to consumers feeling confident enough to buy a new car.

Consumer Sentiment Versus SAAR (Seasonally Adjusted Annualized Rate)



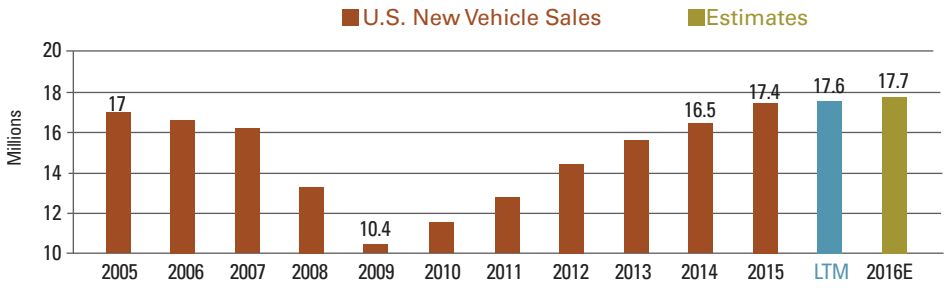
Sources: Thompson Reuters/University of Michigan; Automotive News

After sputtering to alarmingly low levels in the wake of the financial crisis, auto sales have come roaring back. The 2016 sales estimate stands at 17.7 million vehicles. That's just 1 percent growth over 2015 — the slowest growth pace since the Great Recession — leading to debate among analysts about the sales outlook. Some believe that sales have reached a plateau in the 17-18 million vehicle range, while others feel the boom could continue up to 20 million units.

Scott Gorden, principal and leader of CLA's dealership industry, says that annual output of 20 million cars would not be possible without massive investment by the automakers and a major expansion of manufacturing capacity. He doesn't believe that will happen in the near term.

"The auto industry is running on all cylinders right now, but dealers know it is going to slow down eventually," Gorden said. "We know the industry is cyclical, we've had five or six years of solid growth, and we've exceeded the previous high in 2005. The question is, will sales plateau and then fall slowly over the next couple of years or will it drop quickly?"

U.S. New Vehicle Sales

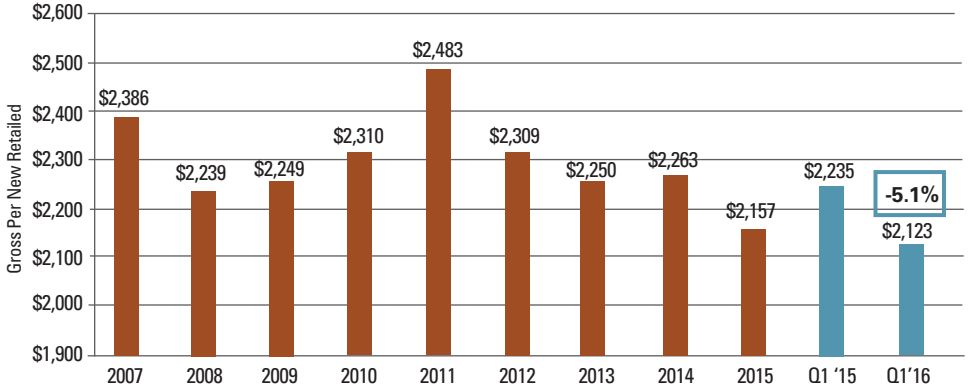


Sources: Historicals: Automotive News, *Estimates: National Automobile Dealers Association*

Gross profits on both new and used cars are solid, but off of recent highs.

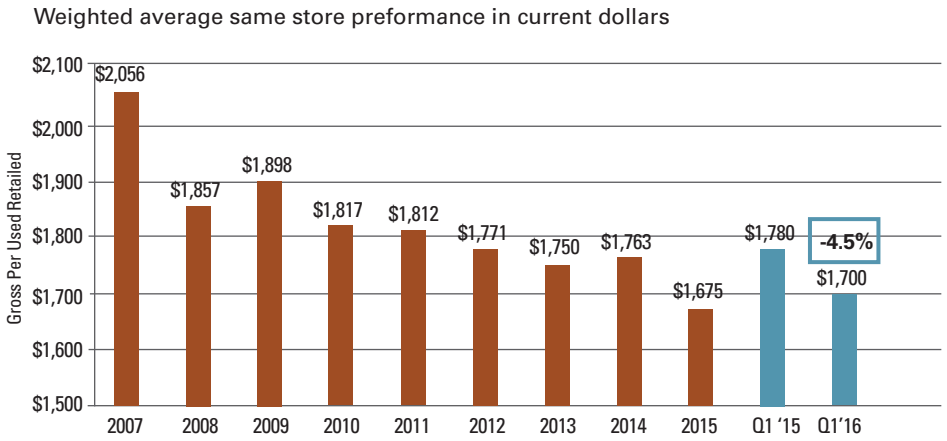
New Gross Profits Per Vehicle: Public Company Data

Weighted average same store preformance in current dollars



Source: SEC filings

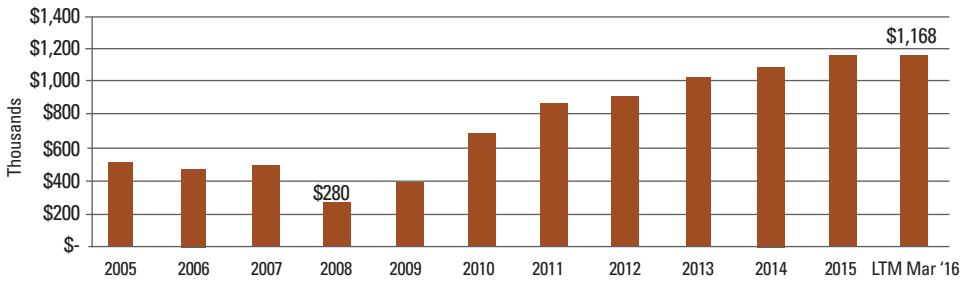
Used Gross Profits Per Vehicle: Public Company Data



Source: SEC filings

Like overall sales, net profits for private dealerships have levelled off.

NADA Average Private Dealership Earnings



Source: National Automobile Dealers Association (amounts prior to 2010 use NADA's historical earnings prior to 2014's reporting methodology change)

The fact that nearly 1 million Americans are employed in vehicle and parts manufacturing and another 1.3 million by auto dealers (U.S. Bureau of Labor Statistics) makes it easy to see why so much weight is placed on the health of the industry.

Waiting (and waiting and waiting) for the Fed to raise rates

U.S. monetary policy, as governed by the Federal Open Market Committee (the Fed), has had an especially outsized influence on capital markets in recent years and even going back decades. What the Fed does and says about what it may (or may not) do next, and what the market believes the Fed will do next, moves markets around the world. Bespoke Investment Group calculated the return of U.S. stocks (specifically the S&P 500) on "Fed days" going back to 1995, when the Fed began announcing policy decisions on the day of its meetings. The results are astonishing and quantify how Fed policies have served to boost stock prices. Stocks have gained an average of 0.34 percent on Fed days, which is 10 times higher than the average return of 0.03 percent of all trading since 1995. Remarkably, Fed days comprise just 3 percent of all trading days going back to 1995, but have accounted for approximately 35 percent of stock gains.

Going back decades, through Chairs Alan Greenspan, Ben Bernanke, and now Janet Yellen, the Fed appears to have sought to boost asset prices while seemingly having little regard for the potential market distortions these policies could create.

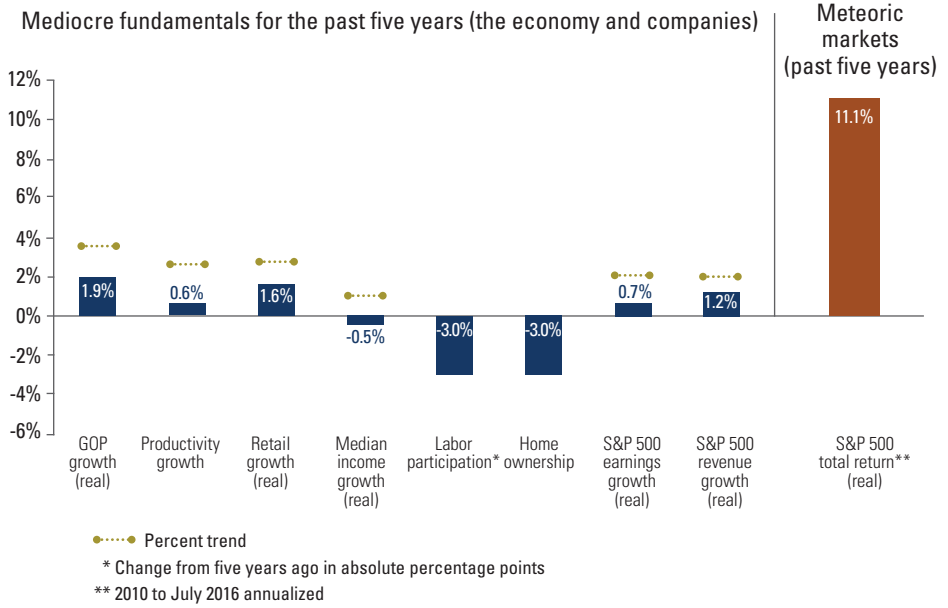
We are in agreement with many market analysts who are dismayed with the Fed's current unwillingness to raise rates. Let's go back to the end of 2015 to review why.

When the Fed raised a key short-term interest rate 0.25 percent in December 2015, it felt like a momentous occasion. At long last — nearly 10 years removed from the last rate hike and nearly seven years into the most accommodating monetary policy in U.S. history — the Fed had finally taken a small first step toward "normalizing" rates. The Fed even fueled hopes for further rate increases. At the press conference following that December 2015 meeting, Chair Yellen forecasted four rate hikes during 2016 resulting in an additional one full percentage point rate increase.

As of the time of this article's publishing, however, the total number of rate increases for this year is zero. Why? It is likely that the Fed, as it often proclaims, has remained data dependent, seemingly grasping at any data point that will justify standing pat. What's puzzling about this claim is that the data, for the most part, are very strong; namely, we are at or near full employment, inflation is benign, and there are no imminent global financial risks. So why not raise rates?

Even such financial industry heavyweights as Goldman Sachs and BlackRock have joined the chorus urging the Fed to move rates up. Laurence D. Fink, CEO of BlackRock, the world's largest asset manager, states that he believes the Fed's persistent low rates is "one of the reasons we have such anger in the world" (Bloomberg, September 22, 2016). Low rates punish savers, put pension plans under pressure, and weaken banks, while the resulting surge in asset prices mainly serves to help only those with capital, and not the real economy. The chart below (courtesy of GMO LLC) quantifies the seeming disconnect between the U.S. economy's fundamentals, which appear mediocre, and stock prices, which have rocketed upward the last five years.

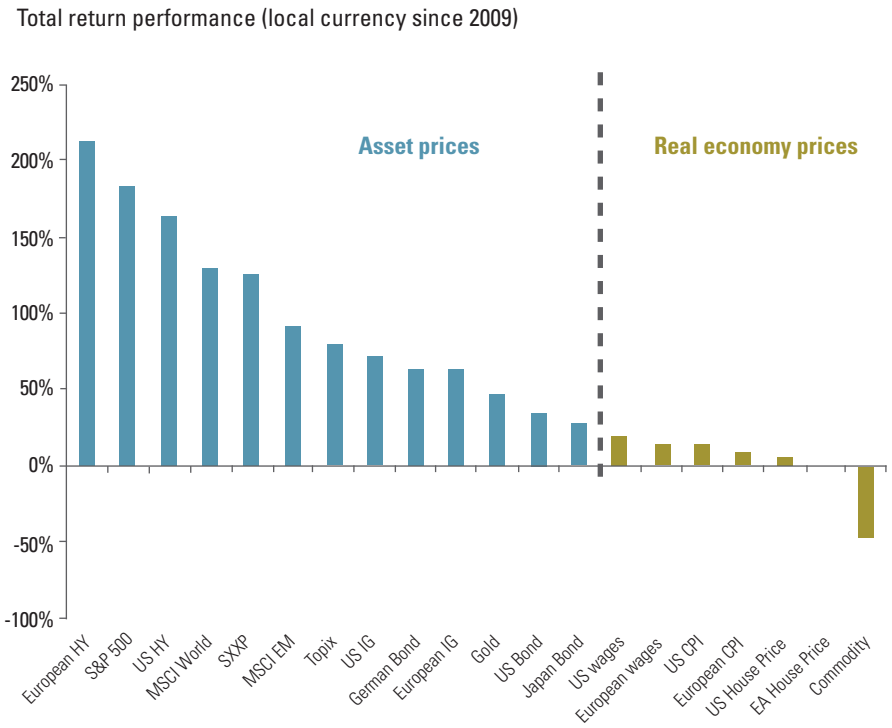
Economic Growth Versus Market Returns



Sources: Federal Reserve, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, U.S. Census Bureau, U.S. Commerce Department, Standard & Poor's, Robert Shiller, GMO

The apparent disconnect between asset prices and fundamentals can be seen as a global issue. The Fed is certainly not the only central bank engaging in extraordinarily accommodative monetary policies or direct asset purchases (such as quantitative easing or QE). The chart below illustrates the returns of various global stock and bond indices versus those of "real economy" prices.

Asset Price Inflation and Real Economy Inflation



Sources: Haver, Datastream

There is legitimate concern that the longer the Fed and other central banks maintain these policies, the more extreme the disconnect will be between asset prices and fundamentals, which could lead to severe market volatility.

The Fed's actions may be defensible both during and in the immediate aftermath of the financial crisis. Our financial system was apparently on the brink of collapse and extraordinary measures seemed warranted. But in our view, the need for such extraordinary interventions has passed. Indeed, the risks associated with these policies may outweigh the benefits. Although raising rates may create some short-term pain in capital markets, it would appear to be the prudent thing to do.

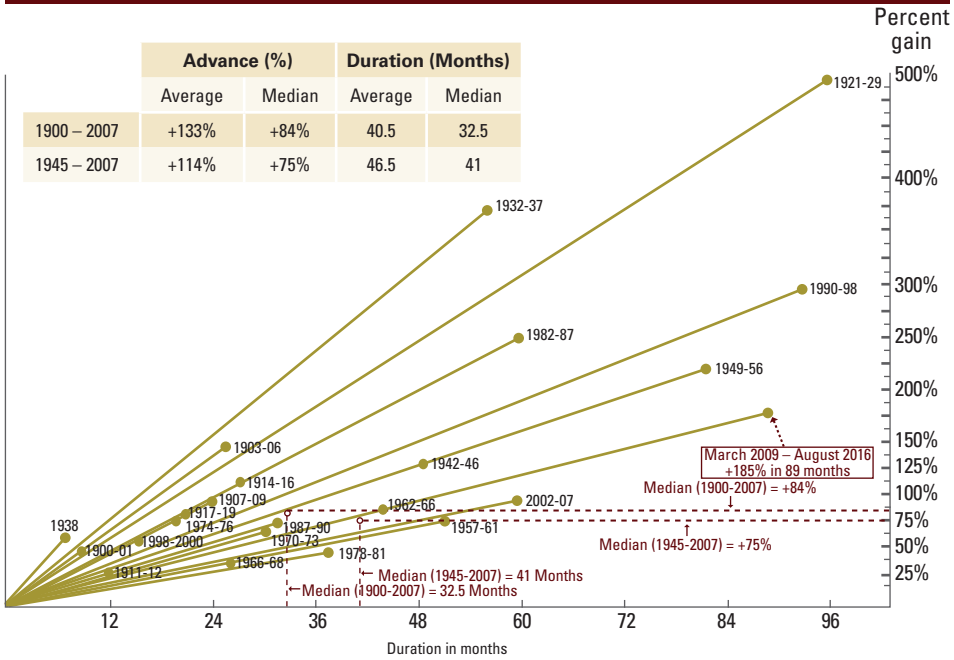
Bull markets don't die of old age

The length of the current bull market, (i.e., an advance without a 20 percent decline) is approaching 90 months at the time of this writing. This is the third longest bull market in history, and if it continues until December, it will become the second longest (see chart below, which uses the Dow Jones Industrials, an index with more than 100 years of history). The unusual length of this run-up has caused some to say that we are overdue for a correction. In a previous *Market and Economic Outlook* we noted how investment professionals are often fond of adages. One that may apply here is, "Bull markets don't die of old age." The point being, bull markets don't have a natural life span; they may continue, even far longer than one would suspect.

So what might cause the demise of this bull market? Just two of the possibilities include:

1. Extremely stretched valuations (of which there is scant current evidence)
2. A massive shock of some kind, such as extreme geopolitical events (which are, of course, unpredictable)

Bull Markets in the Dow Jones Industrials, 1900 – Present



	Advance (%)		Duration (Months)	
	Average	Median	Average	Median
1900 – 2007	+133%	+84%	40.5	32.5
1945 – 2007	+114%	+75%	46.5	41

Source: The Louthold Group

In the financial world, the summer of 2016 will mostly be remembered as being calm. But as surely as autumn will eventually give way to winter, so too will volatility eventually return. This is to be expected and, perhaps, even welcomed, as it may usher in some balance and more attractive valuations to our capital markets.

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