October 2016

Our global benchmark was down 2% in October. U.S. stocks underperformed, suffering their worst month since January, while the S&P 500 was down for the 3rd consecutive month. According to the WSJ's James Mackintosh today, "The two big market moves in October were a vicious bond selloff and the dollar's rise back to where it started the year ...." Since the S&P 500's August 15th high, the 2 worst performing Sectors have been Telecom (-11.4%) and Real Estate (-9.4%), both interest rate sensitive.

Friday's 3rd Quarter economic growth rate was above consensus, but as Morningstar's Robert Johnson, CFA pointed out on Saturday, "While headline GDP growth of 2.9% sounded pretty darn good, 1.2% of that growth was due to export growth, primarily agricultural-related products. And after five quarters of inventory shrinkage, inventories managed to tack 0.6% onto the GDP calculation. Without those two items, GDP growth would have been a more problematic 1.1%."

Inflation is rising. The following article from the front page of yesterday's WSJ has been edited and the accompanying **Consumer price indexes** chart added:

Inflation, Long Quiescent, Begins to Stir

Fed's preferred measure reached a two-year high in the third quarter

By **GREG IP** Updated Oct. 30, 2016

After being given up for dead, inflation is gradually coming back to life.

It's not roaring back. Indeed, it's still below the 2% level the Federal Reserve targets, one reason the Fed is almost certain to leave interest rates unchanged when it meets this week.

But economic circumstances and attitudes of policy makers have shifted in the past year in ways that suggest the likeliest path of inflation is up, not down. Data released Friday showed that core inflation, which excludes food and energy, reached a two-year high of 1.7% in the third quarter, according to the Fed's preferred measure. Other data found stirrings of wage acceleration.

The intellectual case for low inflation is also showing cracks. Central banks now openly entertain, and even welcome, inflation bubbling over 2%.

This isn't bad news. To the contrary, markets and central bankers alike will be relieved that the world is no longer skirting a deflationary abyss. Normal inflation is a necessary (though not sufficient) condition for savers to once again enjoy normal interest rates.

Nonetheless, it could portend a significant repricing in financial markets, which had come to assume inflation would be too low forever. Since early July the U.S. 10-year Treasury yield (which moves in the opposite direction to price) has climbed half a percentage point to 1.85%. Yields in other countries have risen somewhat less.

Most of this increase reflects a reappraisal of the inflation outlook. The behavior of inflation-protected bonds suggests that in early July, investors expected U.S. inflation to average 1.4% over the coming decade. As of Friday, that had risen to 1.7%.

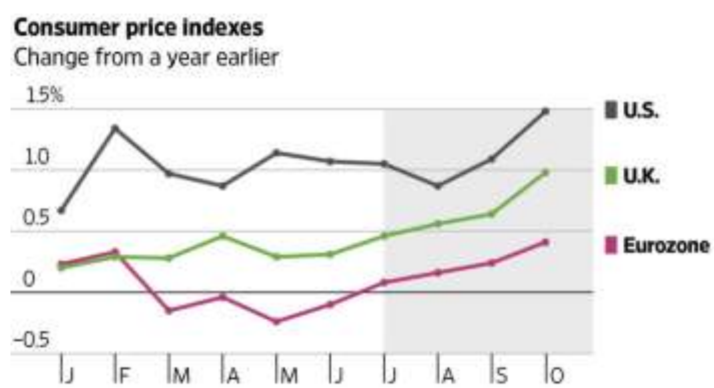
That is still below the Fed's 2% target, evidence that investors remain unconvinced the Fed has licked the low-inflation problem. Yet many of the assumptions that underpin their skepticism are no longer warranted: that excess capacity and low oil prices will last indefinitely, that elected governments are fixated on austerity, and that central banks will clamp down if they see inflation about to top 2%.

The best gauge of spare economic capacity is the unemployment rate. In the U.S., it has fallen to 5% from 10% seven years ago. Across the seven largest advanced economies, it has fallen from 8.4% in 2009 to 5.4% in July, back to where it stood in 2007, just before the global financial crisis, according to economists at Goldman Sachs.

Typically, high unemployment nudges inflation down and low unemployment nudges it up. That inflation stayed low as unemployment declined led some economists to worry the relationship had broken down.

Goldman economists say the relationship was muddied by commodity prices. First, oil climbed above $100 a barrel in 2011, then crashed below $50 in 2015. This year, for the first time since the crisis, labor markets and commodity prices are pushing prices in the same direction.

Job growth remains robust across the developed world, and prices of oil and other commodities are up solidly since February. This is making itself felt in inflation, which overall is positive and rising in most countries. Core inflation across the Group of Seven developed economies is roughly back to where it was before the crisis, according to Goldman.



The main exception is the eurozone. Jan Hatzius, Goldman's chief economist, said that isn't surprising because Europe is the one part of the developed world still struggling with high unemployment.

The country where inflation is furthest along the road to normality is the U.S. Core inflation, according to the Consumer Price Index, is already above 2%. ...

Wage growth is still weak, but less weak than it was. The employment cost index released by the Labor Department Friday showed that excluding jobs paid via incentives, such as sales commissions, wages were up 2.4% in the third quarter from a year earlier, the fastest since 2009. Though well below the 3% to 3.5% that prevailed before the crisis, current wage growth is roughly in line with the sluggish pace of productivity growth.

Another potential worry is inflation expectations. On Friday, the University of Michigan said consumers' long-term expectations had slipped to 2.4%, the lowest on record. However, this measure has been sliding for a while and this is because a minority of people who had expected runaway inflation have thrown in the towel. A growing share now expect inflation of exactly 2%. That leads Goldman to believe the public's views on inflation really haven't changed much in the past decade, a view top Fed officials share.

It's not just the inflation data that have shifted; so have the attitudes of policy makers. Investors long suspected central banks treated 2% as a ceiling and would tighten as soon as inflation approached that level. This year, central bankers have gone out of their way to dispel that suspicion.

In Britain, inflation is likely to top 2% soon because of the pound's drop after the vote to leave the European Union. Bank of England Governor Mark Carney recently said an overshoot was better than "another 400,000 or 500,000 people unemployed."

That same week, Fed Chairwoman Janet Yellen spoke approvingly of allowing unemployment to fall to levels typically associated with accelerating inflation. to undo some of the damage that years of joblessness have done. And in September, the Bank of Japan committed to not just meeting but exceeding its 2% target.

Of course, aiming for higher inflation is one thing; achieving it another. The Bank of Japan and the European Central Bank both pushed short-term interest rates below zero and bought large quantities of bonds in an effort to spur lending, growth and prices, but the costs of those policies are rising.

Zero to negative rates are crushing banks' lending margins, which could undermine their ability to lend. One reason bond yields now are rising is a belief that the ECB and BOJ want to protect their banks from further pressure.

Even as central banks lose their appetite for stimulus, elected governments are rediscovering theirs. Governments in Britain and Japan have relaxed their budgets, and many think the U.S. is likely to as well, regardless of who wins the presidential election. Morgan Stanley predicts fiscal policy will add to growth in the developed economies next year, for the first time since 2010.

While higher inflation and more fiscal stimulus portend more upward pressure on interest rates, there still seems little chance they will get to the 4% or above that investors once took for granted.

The U.S. grew just 1.5% in the year through the third quarter, the Commerce Department reported Friday, which may be the new trend given the drag from an aging population and lackluster productivity. Sluggish growth saps investment and borrowing and limits how high interest rates can go. ...

Despite Friday's latest Clinton email uproar, she will win next Tuesday. As of today, PredictWise ("The backbone of predictions on this site are market-based, generated from real-money markets that trade contracts on upcoming events.") has Democrats' chances of keeping the Presidency at 85%, down from a recent 91%, taking control of the Senate at 67%, down from 79%, and only 8% of gaining control of the House, down from 25%. A Clinton victory with at least the House remaining Republican is Wall Street's preferred outcome.

What all of the above does is set the stage for a December interest rate increase from the Fed. According to BCA Research's Global Investment Strategy on Friday, "We expect the FOMC to raise rates twice next year, in addition to the 25 basis-point hike we are penciling in for December. This pales in comparison to the mere 54 basis points in hikes the market is pricing in through to end-2018." If their non-consensus prediction is correct, stocks will likely remain under pressure. "Turning to equities, the need for the market to price in a more aggressive path for Fed tightening poses near-term downside risks to global stocks. We remain tactically cautious. Once the dust has settled, however, higher beta equity markets are likely to outperform. ... European and Japanese stocks generally do well in a rising yield environment." Remaining Internationally diversified is important.

A New Client

With the proliferation of Smart Beta Funds over the last several years, the roster of Funds we are currently using has changed. Last month we shared an example of the Initial and Goal portfolios for a client seeking Capital Appreciation, but wanting to keep Maximum Drawdown, our preferred measure of risk, in line with that of the S&P 500. Our newest client is seeking Capital Appreciation with a Risk Profile that obviates the Maximum

%	Symbol	Type	Description	Factors (1)	Yield	(2)	Risk (3)	(4)
			Initial					
10	GFMRX/IGR (5)	OEF	Global Real Estate		2.3%	Q	1.1	C
20	KNOW	ETF	Domestic Mid Blend	I, E, V	1.4%	Q	1.0	T
10	QVAL	ETF	Domestic Mid Value	V, Q	1.4%	Q	1.5	T
10	MTUM	ETF	Domestic Lg Growth	M	1.0%	Q	1.0	T
10	QMOM	ETF	Domestic Mid Growth	M, Q	0.6%	Q	1.6	C
10	IVAL	ETF	Foreign Lg Value	V, Q	2.2%	Q	1.3	C
10	IMOM	ETF	Foreign Lg Blend	M, Q	0.7%	S	1.2	C
20	OBIOX	OEF	Foreign Small/Mid Growth	S, M, Q	0.2%	A	1.3	C
			Weighted Average:				**1.2**	
			Goal					
10	GFMRX/IGR (5)	OEF	Global Real Estate		2.3%	Q	1.1	C
40	IVE System & IBT (6)		Domestic	I, V, E			1.4	
10	QMOM	ETF	Domestic Mid Growth	M, Q	0.6%	Q	1.6	C
10	IVAL	ETF	Foreign Lg Value	V, Q	2.2%	Q	1.3	C
10	IMOM	ETF	Foreign Lg Blend	M, Q	0.7%	S	1.2	C
20	OBIOX	OEF	Foreign Small/Mid Growth	S, M, Q	0.2%	A	1.3	C
			Weighted Average:				**1.3**	
			Notes					
1	V=Value, M=Momentum, Q=Quality, I=Insiders, E=Earnings, S=Size							
2	Distribution Frequency: A=Annual, S=Semi-Annual, Q=Quarterly, M=Monthly							
3	Ratio of average historical Max. Drawdowns to S&P 500 declines greater than 10%							
4	Holdings: C=Core, T=Transitional							
5	IGR (CEF; Risk 1.5) when trading at a significant discount to NAV							
6	IBT=Insider Buying Themes							

Drawdown concern.