We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Third Quarter 2016 and a summary of historical performance for the major asset style passive indices for the period ending September 30, 2016. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

Principals
Charles E. "Ted" Herget, Jr.
John F. Meehan, CFA, CPA
Alfred J. Morrison
410-528-8282
www.assetstrategyconsultants.com

ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing over $7.5 billion under advisement. Headquartered in Baltimore, ASC has offices throughout the East Coast.

CELEBRATING 25 YEARS 1991-2016

Third Quarter 2016

Market Review

MACROECONOMIC ENVIRONMENT

What Brexit?

Investor angst over the unexpected vote on Brexit was short-lived with a "risk-on" theme returning to the markets in July and leading to stock market highs for the Dow, NASDAQ and S&P 500 in August. Highly unusual election antics and continued geopolitical concerns on a number of fronts did not dampen investors' risk appetite or their quest for yield. Emerging markets equities posted their best quarterly return since 2012, outperforming developed markets, and high yield bonds were also top performers. Volatility was exceptionally low throughout the quarter as investors appeared to be somewhat complacent about continued accommodative policies from central banks and steady, albeit slow, economic growth.

The Fed continued to stay the course, leaving the fed funds rate unchanged at a target range of 0.25% - 0.50%, but the number of dissenting votes at the September meeting marked a shift in sentiment for the Board. Three of the Federal Reserve officials voted to hike rates; the most since December 2014. As of quarter-end, the markets were pricing in a roughly 50% likelihood of a rate hike before year-end. Fed policymakers now expect growth for all of 2016 to be 1.8%, down from the June expectation of 2.0%. Longer term, the Fed expects the Fed Funds rate to be close to 2% in 2018 while markets are far more dovish. Markets are pricing in a Fed Funds rate of less than 1% in 2018.

Volatility was exceptionally low throughout the quarter as investors appeared to be somewhat complacent about continued accommodative policies from central banks and steady, albeit slow, economic growth.

Real GDP was revised modestly higher to +1.4% for the 2nd quarter in a continuation of the slow but steady pace over the past three quarters. Consumer spending, which represents two-thirds of GDP, remained robust at a growth rate of 4.3%. Residential investment slowed but remains up 6% over the past twelve months. The average price of a single family home ($274,000) is now just shy of the high hit in October of 2005. Unemployment remained unchanged at 4.9% but wages showed signs of improvement, rising 2.4% over the last twelve months; down slightly from July's 2.7% which had been the highest in seven years. CPI remained muted, +1.1% for the trailing one year period, but Core CPI was up 2.3% year-over-year. Prices of services (less energy) climbed 3.2% with medical care (+5.1%), shelter (+3.4%) and transportation (+3.1%)

showing the largest gains. Prices of goods were down modestly and energy prices remain down 9.2% year-over-year. The Fed's favored measure, the core Personal Consumption Expenditures Index, rose 1.7% over the past year, short of the Fed's 2% target but the highest in 6 months. Consumer confidence jumped to its highest level since August 2007, according to the Conference Board's Consumer Confidence Index.

In the euro area, fears around Brexit faded though economic growth remained weak. Second quarter GDP came in at 0.3%, down slightly from the 0.5% rate in Q1. Unemployment remained stubbornly high at just over 10% but down from the high of 12% in July 2013. The range is highly divergent among countries, with Spain's unemployment nearly 20% and Germany anchoring the low end at 4.2%. Inflation remained well short of the 2% goal but has stopped falling; the latest print for eurozone core inflation was +0.8% (headline +0.4%). The European Central Bank left interest rates unchanged and as the quarter ended, there was speculation that it may taper its bond buying program sooner than the markets expected. While it committed to the €80 billion monthly program through March, 2017, the markets were expecting an extension through September. Also late in the quarter, the Bank of Japan announced a shift in policy and while it is maintaining asset purchases, it has added a new tool to its quantitative easing kit – "yield curve control." The Bank intends to adjust its purchases to target a yield of 0% for the 10-year JGB while maintaining negative short rates with a goal to steepen the yield curve and thus help increase profitability for banks. ■

EQUITY MARKET RESULTS

Reduced fears of slowing global growth, particularly in China, optimism about the U.S. economy, and further delays in rate hike contributed to a rebound in domestic equity in the 3rd quarter. The S&P 500 climbed to its all-time high of 2,193 on August 15 and closed up 3.9% for the quarter. Small capitalization stocks outperformed by a large margin for the quarter as the Russell 2000 rose 9.1% and the Russell Mid Cap posted a 4.5% result. Growth outperformed Value modestly across market capitalizations with the largest difference seen in large caps. The Russell 1000 Growth outperformed its Value counterpart by 1.1% (4.6% vs 3.5%). Year-to-date, investors have shown a strong preference for income. The top performing sector based upon MSCI's factor indices was High Dividend Yield, with a 13.2% return y-t-d. At the bottom of the pack, Quality is up 6% for the year. The largest growth sector, Technology (+12.9%) posted the strongest return among all sectors and contributed to the excess return of growth over value. Utilities (-5.9%) and Telecom (-5.6%) were the worst performing sectors, hurt by the prospect of rising short-term rates.

Reduced fears of slowing global growth, particularly in China, optimism about the U.S. economy, and further delays in rate hike contributed to a rebound in domestic equity in the 3rd quarter.

In a new development, REITs and other listed real estate companies were extracted from the Financials Sector and elevated to a new Real Estate sector in the Global Industry Classification Standard (GICS). The new Real Estate sector, representing 3.1% of the S&P 500, finished the quarter with a -2.1% return.

Foreign developed market indices outperformed the S&P 500 and, consistent with the quarter's risk-on theme, emerging markets were the top performers. The MSCI ACWI ex-US posted a 6.9% return, modestly above the MSCI EAFE's 6.4% result. Currency fluctuations were modest and thus had a relatively muted impact on results. In developed markets, Germany (+10%) and Austria (+17%) were top performers while Denmark (-6%) was the laggard. The MSCI EM Index surged 9.0% for the quarter. Among emerging markets, Brazil continued to post lofty results (+11%) and the country is up nearly 63% year-to-date. Russia (+8%) and China (+14%) were also top performers while Turkey (-5%) and Mexico (-2%) were laggards. ■

FIXED INCOME MARKET RESULTS

Yields in the US moved modestly higher during the 3rd quarter with the 10-year US Treasury yield rising 11 bps to close at 1.60%. However, the Treasury note did hit a record low of 1.37% on July 8th at the height of the Brexit-induced worries before trending higher through the remainder of the quarter. July was the only positive return month during the quarter for the broad investment grade market. The curve continued its flattening trend in anticipation of eventual Fed rate hikes. The spread between the 2-year US Treasury note and the 30-year US Treasury bond shrank from 171 bps to 154 bps. Spread sectors outperformed US Treasuries with corporates, and especially high yield, being the strongest.

The Bloomberg Barclays US Aggregate returned +0.5% for the quarter and is up 5.8% year-to-date. The Credit sector rose 1.2% even with record issuance in the month of August. (Note that Bloomberg acquired the Barclays indices and rebranded the names in August). Lower quality bonds outperformed, consistent with the resurgence in risk appetite, and high yield performed the best. The BB Barclays High Yield Index gained 5.6% and is up over 15% year-to-date. At the same time, the default rate for the trailing twelve months ticked up to 4.9%, according to Fitch Ratings; with defaults in the energy sector approaching 16% thus far this year (58 companies through September 13th).

Currency fluctuations were relatively muted over the course of the quarter; the yen and euro both gained just over 1% versus the dollar while the pound lost nearly 3%.

Robust supply overwhelmed demand for municipal bonds, and the sector lagged Treasuries for the quarter. The Bloomberg Barclays 1-10 Year Municipal Bond Index returned -0.1% in the 3rd quarter.

Overseas, yields were generally lower with Mexico and Japan being exceptions. There is now over $12 trillion of negative yielding debt globally with Japan accounting for nearly half of that amount and Western Europe the other half; namely France, Germany, and the Netherlands. Currency fluctuations were relatively muted over the course of the quarter; the yen and euro both gained just over 1% versus the dollar while the pound lost nearly 3%. The Bloomberg Barclays Global Aggregate ex-US Index returned 1.0% for the quarter; up 0.5% on a hedged basis. Emerging markets debt, like its equity counterpart, outperformed developed markets. The JP Morgan EMBI Global Diversified Index gained 4.0% for the quarter and the local currency GBI-EM Global Diversified was up 2.7%. ■

OTHER ASSET RESULTS

In a sharp turnaround from the top notch 2nd quarter results, commodities were the worst performing asset class in the 3rd quarter. In spite of a late quarter rally, the S&P GSCI Commodity Index sank 4.2% for the quarter. MLPs were fairly flat (Alerian MLP Index +1.1%) but the Index remains up nearly 16% year-to-date. ■

CLOSING THOUGHTS

The quarter ended with OPEC surprising markets with an announcement that it would curtail production and worries over the financial health of Deutsche Bank, (whose assets total one-half of Germany's GDP) which is facing a large fine for its mortgage-related dealings during the crisis. The focus in coming weeks will likely be on the US election as well as more speculation as to when the Fed decides to lift rates. Volatility, which has been subdued amidst investor complacency, is likely to pick up and we would further caution clients to temper expectations for returns from the robust gains we have seen thus far in 2016. As always, prudent asset allocation with appropriate levels of diversification and a long-term perspective remain Asset Strategy Consultants recommended course. ■

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 3Q16

	Mo. Ending 9/30/16	Mo. Ending 8/31/16	Mo. Ending 7/31/16	Last Quarter	Last 2 Quarters	Last 3 Quarters	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
MSCI:ACWI	0.61	0.34	4.31	**5.30**	6.34	6.60	**11.96**	5.17	10.63	4.34	6.47
Russell:3000 Index	0.16	0.26	3.97	**4.40**	7.14	8.18	**14.96**	10.44	16.36	7.37	7.61
Russell:3000 Growth Index	0.45	(0.38)	4.86	**4.92**	5.76	6.12	**13.64**	11.40	16.56	8.80	7.46
Russell:3000 Value Index	(0.13)	0.90	3.09	**3.87**	8.62	10.40	**16.38**	9.46	16.09	5.84	7.59
MegaCap											
Russell:Top 50	(0.10)	0.15	3.33	**3.38**	5.70	6.75	**16.72**	11.51	15.68	6.69	--
Russell:Top 200	0.03	0.29	3.51	**3.84**	6.19	6.96	**15.23**	11.25	16.29	7.05	6.45
Russell:Top 200 Growth	0.52	(0.57)	4.64	**4.58**	4.83	5.67	**14.80**	13.12	16.94	9.06	6.82
Russell:Top 200 Value	(0.49)	1.22	2.31	**3.05**	7.69	8.39	**15.71**	9.36	15.61	5.03	6.08
LargeCap											
S&P:500	0.02	0.14	3.69	**3.85**	6.40	7.84	**15.43**	11.16	16.37	7.24	7.15
S&P:500 HQ	(1.19)	(0.08)	2.50	**1.20**	3.68	10.20	**16.66**	12.68	17.46	8.00	8.59
Russell:1000 Index	0.08	0.13	3.81	**4.03**	6.67	7.92	**14.93**	10.78	16.41	7.40	7.48
Russell:1000 Growth	0.37	(0.50)	4.72	**4.58**	5.22	6.00	**13.76**	11.83	16.60	8.85	7.35
Russell:1000 Value	(0.21)	0.77	2.90	**3.48**	8.22	10.00	**16.20**	9.70	16.15	5.85	7.46
MidCap											
S&P:400 Mid Cap	(0.64)	0.50	4.29	**4.14**	8.30	12.40	**15.33**	9.35	16.50	9.11	10.42
Russell:Midcap Index	0.20	(0.25)	4.57	**4.52**	7.84	10.26	**14.25**	9.70	16.67	8.32	10.44
Russell:Midcap Growth	(0.05)	(0.29)	4.95	**4.59**	6.23	6.84	**11.24**	8.90	15.85	8.51	9.66
Russell:Midcap Value	0.42	(0.21)	4.24	**4.45**	9.43	13.72	**17.26**	10.49	17.38	7.89	10.72
SmallCap											
S&P:600 Small Cap	0.64	1.36	5.09	**7.20**	10.93	13.88	**18.12**	9.04	17.86	8.71	10.78
Russell:2000 Index	1.11	1.77	5.97	**9.05**	13.18	11.46	**15.47**	6.71	15.82	7.07	9.26
Russell:2000 Growth	1.44	1.06	6.54	**9.22**	12.76	7.48	**12.12**	6.58	16.15	8.29	8.90
Russell:2000 Value	0.79	2.49	5.40	**8.87**	13.55	15.49	**18.81**	6.77	15.45	5.78	9.38
Russell:Microcap	2.94	2.70	5.23	**11.25**	15.66	9.38	**13.47**	5.84	16.37	5.50	8.85
Non-US Equity											
MSCI:ACWI ex US	1.23	0.63	4.95	**6.91**	6.22	5.82	**9.26**	0.18	6.04	2.16	6.56
MSCI:EAFE	1.23	0.07	5.07	**6.43**	4.88	1.73	**6.52**	0.48	7.39	1.82	5.81
MSCI:EAFE Growth	1.49	(1.41)	4.89	**4.96**	4.80	2.63	**9.47**	2.39	8.73	3.14	6.13
MSCI:EAFE Value	0.97	1.62	5.26	**7.99**	4.98	0.82	**3.52**	(1.49)	5.99	0.44	5.41
MSCI:EAFE Small Cap	2.97	(0.59)	6.13	**8.64**	5.82	5.19	**12.33**	5.08	11.07	4.39	10.20
MSCI:EM	1.29	2.49	5.03	**9.03**	9.75	16.02	**16.78**	(0.56)	3.03	3.94	11.55
Fixed Income											
BB Barclays:Aggregate Idx	(0.06)	(0.11)	0.63	**0.46**	2.68	5.79	**5.19**	4.03	3.08	4.79	4.80
BB Barclays:US TIPS Index	0.55	(0.45)	0.87	**0.97**	2.69	7.27	**6.58**	2.40	1.93	4.48	5.39
BB Barclays:Long Gov/Cr	(1.26)	(0.03)	2.55	**1.24**	7.87	15.74	**14.65**	10.08	6.32	7.84	7.61
BB Barclays:Long Credit A	(1.21)	0.13	2.89	**1.78**	7.92	15.00	**14.79**	9.90	7.09	7.19	7.27
BB Barclays:High Yield CP	0.67	2.09	2.71	**5.56**	11.39	15.12	**12.73**	5.28	8.33	7.71	8.62
BB Barclays:Mn 1-10(1-12)	(0.30)	(0.02)	0.22	**(0.11)**	1.33	2.59	**3.40**	3.34	2.95	4.04	4.02
BB Barclays:Gl Agg ex US	1.02	(0.81)	0.82	**1.03**	4.47	13.10	**11.67**	0.75	0.70	3.82	5.41
BB Barclays:Gl Agg x US H	0.02	(0.04)	0.55	**0.53**	3.26	6.89	**7.53**	5.78	5.04	4.68	4.65
JPM:Emer Mkt Bond +	0.46	1.76	0.86	**3.11**	9.29	15.78	**17.82**	7.99	7.35	7.62	9.75
Other Assets											
BLMBRG:TR Idx	3.13	(1.76)	(5.11)	**(3.86)**	8.42	8.87	**(2.58)**	(12.34)	(9.37)	(5.33)	0.57
GS Commodity Index	4.14	1.77	(9.57)	**(4.15)**	7.99	5.30	**(12.21)**	(22.16)	(12.61)	(9.04)	(2.19)
S&P:Gold Spot Price Ix	0.43	(3.40)	2.79	**(0.27)**	6.60	24.23	**18.10**	(0.25)	(4.08)	8.10	10.51
FTSE:NAREIT Equity Index	(1.76)	(3.67)	4.15	**(1.43)**	5.42	11.75	**19.86**	14.22	15.91	6.35	11.38
Alerian:MLP Index	1.85	(1.31)	0.56	**1.07**	20.98	15.94	**12.74**	(4.82)	4.96	9.01	11.16

DISCLAIMER AND SOURCES

The material contained in Asset Strategy Consultants quarterly Capital Markets Review is based upon information and data produced by Asset Strategy Consultants and Callan Associates.