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### Third Quarter 2016: Fighting Gravity

As anyone who has skipped a stone across a pond knows, sufficient force perpendicular to gravity's pull can keep even a non-buoyant object above water. This basic physical principle can be taken to remarkable extremes, as this man on his snowmobile illustrates:

#### Horizontal momentum, positive angle of attack



Image source: snowmobilefanatics.com

Maybe you can't walk on water, but with enough horsepower, you can sure as heck gun your way across the smooth patches.

For six straight quarters, US companies' earnings growth has flagged, yet stock prices have kept gunning along. This is due in no small part to low, low interest rates, which have helped ramp market momentum since the Great Financial Crisis. In the third quarter, however, rates may have hit their limit.

US Treasury yields bottomed in July, with prices then deteriorating into early autumn for a slight loss on the quarter. It is now our conviction that Treasury valuations have finally topped out (i.e. rates have seen their lows). While municipal bonds also finished in the red, the rest of the bond market rallied to varying degrees such that not a single investment grade sector ended the quarter trading cheap to its 10-

year average spread. With spreads narrowing as base rates climb, there is less and less margin of safety in bonds, the very asset class to which many investors look for protection.

Valuations as measured against fundamentals and expectations have been running high in the stock market as well. Only one of ten S&P 500 sectors – and one of the smallest sectors at that (telecom) – ended the quarter even slightly cheap relative to expected earnings. Meanwhile globally, all geographic sectors ended pricing high to their 10-year average forward P/Es. If a groundswell of growth were evident, this might not be a concern, but absent economic vigor worldwide, it's going to be hard to keep gaining against gravity's pull.

Does this mean markets are headed for a sudden stop and icy plunge? Not necessarily. You can run flat a long time, until you lose lift (interest rates turn unfriendly), you run out of fuel (earnings fail) or you hit water rough enough to knock you "off plane" (volatility surges). Whereupon you'll need buoyancy in a portfolio, something we aim to provide by packing cash and quality assets unencumbered by too much debt; otherwise, only cartoon physics can carry you. Herewith, an old friend:

#### The power of not looking down



Image source: cartoonbucket.com

Problem is, the market, like Wile E. Coyote, always looks down eventually.