THE END IS NEAR

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Please be assured that the ominous title of this newsletter does not refer to any expected economic apocalypse but rather to the great sense of relief that the rancorous Presidential campaign will soon come to an end. Historians can point to many examples of past campaigns full of as much vitriol and bluster but living through it in the age of 24 hour news, instant tweets, blogs and spin is tiresome indeed. The barrage of ads for all the races from President down the tickets to local elections seem to focus only on the incompetence, insensitivity and total lack of moral character of the opponent rather than any noticeable virtues of the chosen candidate.

It is difficult to assess how all of this negative noise impacts investors. The stock market seemed to weather the campaign and the turmoil of the June Brexit vote well as the third quarter produced a gain of 3.3% for the S&P 500. Year to date the S&P 500 has gained 6.1% while the Dow Jones Industrial Average (DJIA) has gained 5.1%. September saw a very slight decline in the S%P 500 of 0.12% but whether that can be attributed to the election is questionable as September is often a bad month for the stock market. According to Ned Davis Research Group, since 1900, September has been a positive month for the DJIA only 43% of the time. The only other month that is positive less than 50% of the time is June at 49%. Even October with its notorious crashes is historically positive 57% of the time. Indeed, the three months of the final quarter of the year are historically quite good with November positive 62% of the time and December being the best month of the year since 1900 with positive returns 71% of the time. We caution that while these historical numbers are interesting we would not make any short term investment decisions based on these very long term averages.

One reason Ned Davis Research Group cites as a possible explanation for the weakness in September is that by Labor Day analysts may be coming to the realization that their annual earnings estimates, and those projections by the companies they follow, may be too optimistic. This may explain the September malaise but it doesn’t really explain the subsequent historical rebound in the three months of the fourth quarter. However, the theory may be relevant this year as the earnings recovery expected by many in the third and fourth quarter of 2016 may not be as strong as projected. Argus Research is looking for about $120 in earnings for the S&P in 2016 which is where their estimate had been for most of the year. Some analysts expected a stronger economy with higher earnings in the third and fourth quarter of 2016 but that seems somewhat unlikely as weakness in sectors such as Energy and Financial Services continues.

Any rebound in Energy sector earnings this year will be modest as oil prices still haven’t recovered enough. According to Argus, crude oil prices have averaged $41 per barrel for the first nine month of 2016 versus $49 per barrel for 2015. By comparison, oil prices averaged $93 per barrel in 2014 and $98 in 2013. Any average price in 2017 in the $50-$60 range should have a positive effect on energy sector earnings and that of the S&P 500 earnings as a whole.

Another sector awaiting improvement is Financial Services. Many expected at least two increases in interest rates by the Federal Reserve in 2016 but a number of factors, including Brexit and perhaps the election, held the Fed back. Current consensus expectations are that the Fed will raise rates by a quarter-point in December. This would likely result in higher net interest margins and earnings per share for many banks. In the Materials sector some commodity prices are improving after years of significant declines. Due to these improvements amidst a slowly growing economy, Argus expects the S&P 500 to earn roughly $134 in 2017 versus $120 this year, an increase of 12%. While we do not project earnings per share for the S&P 500 the Argus estimate seems reasonable if not somewhat optimistic.

With the S&P 500 at 2168 at the end of the quarter, the price/ earnings (P/E) ratio on $120 worth of earnings is 18x. If earnings were to reach $134 next year the forward (anticipated) P/E is about 16x. Earnings of $134 with the current P/E multiple of 18x would result in a gain of over 10% next year in the S&P 500 to 2412. This may be optimistic but at current levels with a dividend yield of roughly 2.0% versus a ten year U. S. Treasury Note yield of 1.60%, the S&P 500, while not cheap historically, does not seem excessively overvalued.

We want to be careful about placing too much emphasis on the generally positive performance of the stock market in the fourth quarter historically, particularly in an election year. According to Credit Suisse, market volatility has increased in October during the last six Presidential elections. This volatility is not necessarily

a negative but it may rattle some nerves. Depending on your stance in the election, there may be more nerve rattling moments in early November as well.

Our focus has always been on periods far longer than one quarter but the monthly data is interesting in that it points to the generally positive long term returns from stocks. Hence most U.S. Presidents, regardless of party, have enjoyed positive stock returns during their tenures. In looking back at a similar piece we wrote 20 years ago when another Clinton was running, the long term market data from 1926 through 1996 compiled by Ibbotson Associates indicated that over 70% of one year periods, 89% of five year periods and 97% of ten year periods were positive for the stock market. The numbers may have changed slightly over the last 20 years and positive returns do not necessarily mean great returns, but it seems to bode well for the stock market under our next President, whoever he or she may be. We are more than ready to have the issue decided and the campaign behind us.

We thank you for your confidence in Knox & Downing Advisors and we wish you all the best for the Holiday Season.

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