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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

In New England, the weather is getting cooler, the leaves are beginning to change color, and the stock market has fallen like a rock. It must be October. Although the pundits eagerly try to explain the markets' every move, the news stories have not changed much. The Fed is still waffling on whether to raise short-term interest rates. The stock market players continue to obsess about the Fed's waffling. Yet something different is happening that is not explained by the headlines. While we cannot see the invisible hand of financial forces, made up of the aggregate effect of millions of independent decisions by people (and computers), that moves the markets, we can be aware of the visible results and infer whether the degree of risk has changed.

The Economy

The reported unemployment rate continues to drop and employment continues to expand at a steady 2% rate. Home construction is up. Home sales prices are increasing, especially in the south and west. Home mortgage rates continue to remain relatively low. GDP for the first and second quarters have been revised upward. The most recent reading is a 3.9% annual growth rate. The value of the dollar continues to climb, making gasoline and other commodities cheap and holding inflation at bay. The consumer price index has increased by only .2% over the past year. Even wages have picked up, growing at a rate of 3.1%. What could better?

Corporate profits, for one thing. Profits are actually ½% below the level of a year ago, and a year ago they were only 1.2% above the year before that. International economies for another. Europe is growing at about 2%, a rate similar to the US. China's slow down is in the news, but they still have a growth rate of 7.3%, which leaves the US in the dust.

There can be a difference between the health of the real economy and the financial system. In 2007 financial risks built up unseen by most. The cascading effect of the collapse of a daisy chain of financial contracts almost brought the financial system to a halt, which subsequently had a significant effect on the real economy: real people with real jobs. The financial system leads the economy, so a low unemployment rate, while an immediate comfort to millions of workers, may be a false comfort to investors.

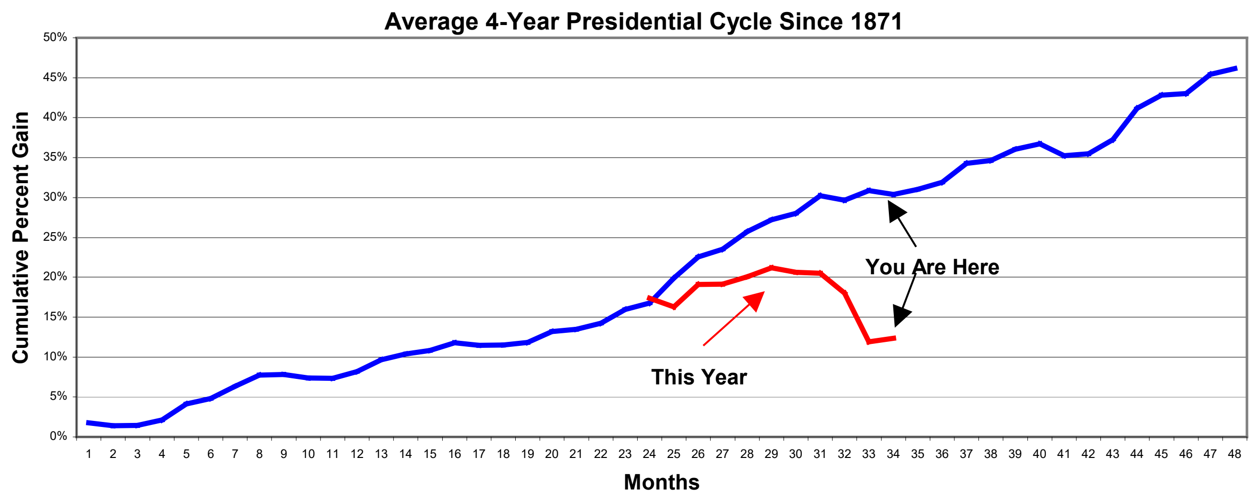
For years, the Fed has played a role in the management of the money supply. Since business investment can be more profitable when interest rates are low, the economy tends to expand under these conditions. With high rates, fewer planned capital investment projects will achieve their profitability requirements, so new investment drops off, along with all the business activity required to implement the project. As a result, recessions usually start after the Fed raises interest rates, and end after interest rates are lowered.

This time has been different. Rather than increasing rates when the economy regained its footing, the Fed has waited for close to six years, providing much more money than companies could use, hoping to stimulate more investment. While not really having the desired effect on the economy, the policy has had an effect on the financial markets. Very low interest rates on bank deposits and other low risk options caused both speculators and retirees to search for greater returns. That search led to taking on more risk, so the stock market and the high-yield "junk" bond markets rose almost non-stop for the six years. Investors decided that the extra risk and valuations, which are more extreme than any time except 1999-2000, were acceptable, since the Fed "had their back" with the easy-money quantitative easing policies.

The Fed ended their Quantitative Easing (a.k.a. money printing) policy in late 2014. Perhaps not coincidentally, the stock market started slowing down shortly thereafter. With interest rates at zero, and their liabilities and assets having grown to $4.5 trillion, the Fed is now in a position where providing additional support can be difficult. They would like to normalize their position. But if they do, they will need to raise interest rates, suggesting that the free lunch is over. What happens when all the people who ignored risk based on a supportive Fed policy no longer feel comfortable, or find themselves over-extended on borrowed money? What happens when there are fewer risk-seeking investors willing to push valuations to ever-higher levels?

The Stock Market

The graph shows the cumulative average return in each month of the four-year Presidential terms since 1871. If results had been random, the blue line would be a smooth increase from start to finish. The average is bumpy though, because the market tends to outperform, or to lag, at different times in each cycle. At this point, we would typically expect, on average, to have a small positive tendency for the next several months. If conditions were normal, we would have also expected this year so far to be the strongest span of all four years.



The red line shows the actual return so far this year. It clearly diverges from the long-term average. Additionally, the divergence has grown since the beginning of the year. Is this an aberration? Or is it the visible sign of investors being less willing to take risk after the Fed stopped their QE policy. We will let you be the judge for now. The market will eventually tell us which was the correct interpretation.

In the interim, as an investor or a 401(K) participant, it would not hurt to reassess your capacity to bear risk and make sure you have thought out the actions you can use to protect your principle if need be. If it turns out not to be necessary now, you will be ready for the next time that it is.

If you are not comfortable addressing this question yourself, it could be worthwhile to enlist the aid of an advisor that has developed and follows a strategy that is comfortable for you. If you would like help managing your investments, looking into your financial future, or planning to manage your income effectively, please call or e-mail. We invite you to visit our website www.linnardfinancial.com.

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