// BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

Stocks finished the third quarter on a positive trend. On the last day of trading in September, stocks rallied up 1%. Overall, the U.S. stock market averages were up 2% to 4% during the third quarter, depending upon which index is selected for comparison.

Overall, U.S. stocks have posted a reasonable return since the beginning of this year – up about 7% when dividends are included and just over 5% excluding dividends. International stocks posted similar performance during the third quarter, but the year-to-date performance is less than 3% while the emerging market category (small international companies) was up the most – 9% during the third quarter and 17% year-to-date. Once again, emerging market stocks typically provide a higher return during periods when overall stock prices are up and larger losses during declining market periods. Hong Kong equities were up nearly 12% during the third quarter, China up about 5% and Europe was down about 1%.

For the first time this year, both value stocks (companies that are mature, have stable sales, and pay dividends) and growth stocks had similar performance. Value stocks of all sizes outperformed growth stocks by a margin of 5% or more during the first six months of 2016.

Energy companies and energy mutual funds were up about15% during the third quarter as the price of oil climbed to over $48 per barrel after breaking below $30 per barrel last year.

Real estate (REIT's) prices were down by a modest 1.5% during the third quarter after rising about 14% during the first 6 months of this year. A very small increase in interest rates during the third quarter kept real estate performance relatively flat. Likewise, another interest rate sensitive category, fixed income or bonds, also suffered small declines as well – with intermediate-term bonds declining about ½% in value.

The best performing asset categories during the third quarter was energy and telecommunications stocks with both categories advancing 15%. Gold prices suffered the biggest reversal – down less than 1% during the third quarter but still up nearly 24% since January 1st.

The following chart displays sample returns of various asset categories during the third quarter of 2016:

Yr-To-Date 2016	**3rd Qtr. 2016**	**Index Return (*includes dividends reinvested*)**
+ 4.75%	+ 1.80%	**Dow Jones Industrial Average (^DJI)**
+ 7.79%	+ 3.79%	**Standard & Poor's 500 Index (^GSPC)**
+ 8.29%	+ 4.42%	**DJ U.S. Total Stock Market (VTI)**
+ 5.86%	+ 4.54%	**Large-company stock-Growth (IWF)**
+ 9.89%	+ 3.46%	**Large-company stock-Value (IWD)**
+ 6.79%	+ 4.54%	**Mid-Size Stocks – Growth (IWP)**
+13.67%	+ 4.35%	**Mid-Size Stocks – Value (IWS)**
+ 7.66%	+ 9.11%	**Small-company stock- Growth (IWO)**
+15.62%	+ 8.72%	**Small-company stock- Value (IWN)**
+ 2.75%	+ 5.93%	**International (EFA)**
+17.32%	+ 8.99%	**Emerging Markets (EEM)**
+11.99%	- 1.51%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 1.27%	- 0.15%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 7.26%	- 0.53%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
+ 23.83%	- 0.66%	**Gold (GLD)**

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FINANCIAL MARKET OUTLOOK

Not much has changed during the third quarter or year-to-date. Expect continued short-term price volatility in the financial markets. The future is simply very uncertain. Stock market performance has been rallying and declining by 5% or so since the beginning of the year. Until the significant uncertainties are removed, the financial markets will likely repeat the up and down pattern.

The best explanation given (but not a good reason to go along with it) for the U.S. stock market holding steady and up slightly this year is *there is not a better alternative*. International stocks are suffering with the same issue – slow economic growth. Fixed income (bonds and certificates of deposits) are paying very little interest income as interest rates are currently at a 65-year low. Gold and metals are now falling as well after a strong first quarter. In summary, the consensus explanation is to buy U.S. stocks because nothing else is better. That's not an acceptable reason in our view.

These are the primary uncertainties. Who will win the November election? When will the Federal Reserve raise interest rates, how much will the future interest rate increases be and will there be a series of increases thereafter. Most importantly, the U.S. and global stock markets will not deliver permanent stock market gains (without falling back again) until economic growth increases from less than 2% to a normal 3%-4% range. That's it in a nutshell. What remains unknown is: how long will we have to wait for answers before a sustainable trend will emerge. The Presidential election results will come very soon and interest rate changes (if any) will follow over the next six months. Improved economic growth hasn't occurred over the past several years and no one knows when or if improvement will occur.

The best insight into the future direction of the U.S. and global stock markets remains the same. Future economic growth and the timing of when the Federal Reserve will raise interest rates are the two key variables that will influence the direction of future stock price performance and whether any potential price gains are *sustainable*. In our previous newsletters, we discussed how economic growth in the U.S. and around the world remains very weak. The U.S. GDP growth rate (adjusted for inflation) has averaged below 2% over the past 7 years ranging from -0.24% to 2.73% and the current expansion's pace is the weakest of any since 1949.

Fed policymakers project the economy will grow at 1.8% pace for all of 2016. The long-term U.S. average GDP growth rate is above 3%. The world's sluggish economic growth is now a prolonged problem. And, this problem is still here even after countries around the world have reduced interest rates to the lowest level in 65 years.

Economic growth (or lack of it) isn't the only problem – corporate earnings are declining as well. Earnings haven't been just lackluster; they've been negative.

For third quarter 2016, the estimated earnings decline for the S&P 500 is -2.1%. If the corporate earnings index reports a decline in earnings for the third quarter, it will mark the first time the index has recorded six consecutive quarters of year-over- year declines in earnings since 2008.

In summary: Stock prices are near record highs despite months of declining corporate earnings, which has stretched valuations to worrisome levels. Meanwhile, almost all analysts argue the market needs robust earnings growth for the rally to continue. But some analysts warn that the consensus estimate for corporate earnings growth is far too optimistic. And so, you can begin to see why the stock market is in a precarious position.

How can we expect the U.S. stock market to maintain its current level or move higher when both economic growth and corporate earnings are well-below average and declining?

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Here's the problem. The two primary policy tools that our government has to influence economic change over the near-term are **interest rate changes** and the **income tax code.** Lowering interest rates reduces borrowing costs for businesses and encourages expansion, starting new business and generally reduces the cost of failure. For individuals, lower interest rates reduce borrowing costs for homes, credit, autos, student loans etc. and basically allow families to buy and consume more goods and services. The end result is increased economic activity. Raising interest rates has the opposite effect.

The problem here is multiple interest rate reductions (to a 65-year low) have already been implemented over a very long time period and while it is a fair argument to make that the rate reductions may have significantly helped our economy avoid a multi-year recession back in 2008, seven years later the resulting economic growth is anemic and well-below what would be expected. Further, interest rates are so low today, any further reductions would have very limited, if any, impact on better economic growth. So, this policy tool is already completely exhausted.

Changes to the U.S. income tax code can also offer a positive or negative impact on economic growth, but recently this policy tool has been hijacked by political posturing. In general, the lower the income tax cost, the more funds individuals, families and businesses have to spend/invest/expand in a manner they choose. The opposing view believes the U.S. government should collect more by raising taxes on those individuals who earn more and then redistribute the funds to reduce/improve inequality.

We will not advance the discussion on <u>individual income tax rates</u> in this newsletter, but instead focus on <u>corporate income tax rates.</u> Very simply stated; U.S. corporations pay the highest income tax rate (35%) in the world. Not only does this put American companies at a disadvantage, but it also encourages large global corporations to move their headquarters and jobs outside of the U.S. And of course at this point of the discussion, it gets political and misinformation spins out of control.

The point being made is this: lower interest rates and lower income tax rates stimulate consumption, spending and the economy. Very simple. So, when you consider what **could happen** that would stimulate the economy, standard of living and the financial markets, these are the two most powerful tools available to get results. So, investors must assess the likelihood of lower interest rate and/or lower income tax rate changes being implemented if they are interested in determining the *probability* (not possibility) of <u>better economic growth</u> and <u>better financial market performance</u> in the future. Economic improvement just doesn't happen on its own nor can anyone simply talk-it-up without some meaningful changes.

Interest rates are already at a 65-year low and even if further fractional interest rate reductions were to come, the impact would be negligible. No help here.

Corporate income tax rate reduction is the only significant change that would have a quick and meaningful impact on economic growth – and that jolt to improve growth is what we need worldwide. Will it happen? Sorry folks – we place a low probability on this one as well. Too many people are receiving and fewer are paying into the system for this policy change to become popular.

Another possible tool that would have a meaningful impact on economic growth is trade agreements with other countries. But, we have to admit ignorance here. If any of our readers can give provide a brief and meaningful summary of NAFTA and TPP (Trans-Pacific Partnership) and specifically how it would benefit the U.S. economy and financial markets, we would be grateful to receive it.

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INVESTMENT OUTLOOK AND RECOMMENDATIONS

The immediate outlook for the financial markets is simply unclear and it appears to us that downside risk is higher than upside reward. From a fair or reasonable valuation perspective, both the stock and bond markets are overvalued and have been so for the past 18 months. Yet, the stock market continues to rise at a slow pace. There are many explanations offered in the financial press. Some explanations are laughable, others are certainly possible, but not probable, and some are useful.

The two most common explanations for a continued advance in stock prices are: Stock prices have continued to rise, so don't fight the market – get in. This approach to buying and selling is often referred to as momentum investing. Stay with the momentum (direction) of the financial markets and don't bother considering any of the explanations or rational evaluations. This approach can certainly keep an investor in the market even when rational or emotional thoughts say "this market doesn't make sense". The downside is an investor can experience buying in and selling out multiple times each year when the financial markets move 5% or more during short periods of time, but the overall trend remains positive year-over-year.

Another common explanation that is true, but not a good reason to buy more stocks at current prices is: Cash (money market funds, savings and certificates of deposit) earns next to nothing, bonds pay very little interest (new 10-year and guaranteed U.S. Treasury bonds are paying only 1.6%), and these low returns are causing investors to increase their investment into common stocks. This explanation is true for a growing number of investors and is a good example of how the stock market can continue rising because of increasing demand for stocks, but the reason for the increased demand isn't because of increasing corporate profits, revenue growth or other variables that are characteristic of a multi-year stock market rally. The money is flowing into stocks because alternative investment choices are offering the lowest safe rate of return in 65 years.

The laughable explanations are varied, but the most common one today is the financial markets will go up or down depending upon which political party is elected.

Our approach to this quandary today is not to favor one scenario over another as we normally do. Most of time, we may have greater confidence and assign a higher probability to one expected outcome over another. Conversely, even when we don't have convincing probability expectations regarding the direction of the financial markets, if the stock market is relatively fairly valued, we remain fully invested with a buy-and-hold strategy.

Over the past 18 months, the stock market has reached a valuation level that we find difficult to justify and therefore stay fully invested in stocks according to each clients recommended asset allocation. We made the decision to reduce stocks by roughly 20% -30% about 13 months ago.

Presently, we have prepared investment recommendations for each client account(s) that cover all three general possibilities: 1) the stock and/or bond markets decline, 2) overall economic growth improves and the stock market continues to advance or 3) anemic economic growth continues and the financial markets deliver a slightly negative to slightly positive returns.

We have already created (unexecuted) block trade files to execute sell and purchase recommendations under all three scenarios above. Under Scenario #1 above, generally gold/precious metals and defensive stock purchases may be implemented. Under Scenario #2 above, stock purchases would be increased back to the recommended levels for each client's normal or recommended allocation. Purchase selections include international stocks, U.S. stocks and specific dividend-

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paying companies, technology/internet and energy companies. Under scenario #3, only limited purchases of dividend-paying common stocks would be considered because our recommended reduction in stocks or equities under scenario #3 above was already implemented in August 2015.

Because the recommended transactions are so varied according the three scenarios above, again **we will not include any purchase recommendations on the blue sheets you are accustomed to receiving at quarter-end.**

MEDICARE OPEN ENROLLMENT

Medicare Part A:	***Hospital coverage***
Medicare Part B:	***Medical insurance***
Medicare Part C:	***Insurance coverage for the gap not covered in A & B above***
Medicare Part D:	***Prescription Drugs***

Each year from October 15 to December 7th is Medicare open enrollment for Medicare Part D and Medicare Advantage (private insurance policies that pay for the "gap" or things not covered 100% in Medicare Part A, B or D) for coverage applying to the following year (2017). Medicare Part D is for prescription drug coverage. If you want to make changes to your current coverage choices, now is the time to do it. Why would you change?

Insurance companies often change their formularies (which drugs they cover or accept) and this open window period is the time to assess any changes to your prescriptions and whether your current provider or a different one covers more of the cost of your specific prescriptions. Every insurance provider for Medicare Part D must provide their *Annual Notice of Change*. Look for changes or any restrictions on coverage for the drugs you need, are they raising the co-payment, dropping coverage for certain drugs, or charging you more if you don't use their listed pharmacies.

In addition to the open enrollment period discussed above, instead of accepting Medicare Part D, you can instead choose a Medicare Advantage plan (private insurer) that costs about $37 per month compared to Medicare Part D premium of $34 per month. This type of private insurance also covers the "gap" or shared costs you are responsible for under Parts A & B. Either way, it is not the monthly cost of premiums (they about the same) that are important, it is the covered list of drugs and how much you share in the cost.

In addition, at age 65, taxpayers who sign up for or will receive Social Security benefits for the first time (new enrollees), you will be automatically covered by Medicare unless that person actively opts out. Why would you opt out? Because maybe you are already covered by your or your spouse's employer plan (still working or still have coverage) and you don't want the deductions for coverage taken out of your monthly Social Security benefit payments. Just be aware, if you opt out of Medicare coverage because you have coverage elsewhere, the cost of re-entering Medicare coverage later on will increase by 10% each year and stay 10% per year higher thereafter.

SCHWAB STATEMENT FREQUENCY

We have received a number of calls from clients who did not receive a monthly statement on one or more of their Schwab accounts. Beginning in April of this year, for accounts that do not have "qualifying activity", Schwab began mailing statements quarterly instead of monthly. Qualifying activity includes a deposit, withdrawal, trade or stock dividend. If you have any of these activities you will continue to receive your statements monthly. Interest on your cash is not considered a qualifying activity by Schwab. If interest income received is the only transaction, you will receive your statements quarterly

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COPIES OF 2015 INCOME TAX RETURNS

The extended and final due date for 2015 income tax returns October 15th. Please make a request to your income tax preparer to send paper or electronic (email) copies of your 2015 income tax returns to our office as soon as possible after completion. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

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Best Regards

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