Investment Update

BNY MELLON
WEALTH MANAGEMENT

September 2016

Back to School

With temperatures cooling here on the East Coast, the back to school season is upon us. The Mortimer family is leaving behind the relative tranquility of summer and returning to a household once again filled with backpacks, football gear and textbooks. My two boys are entering grades 8 and 12, and I'm encouraging them to start the year fresh. But I will also impress upon them that a new school year also means taking stock of what they already know, so they can be in the best possible position to be successful.

At BNY Mellon Wealth Management, we approach investing in a similar fashion. By understanding and assessing events that have recently transpired, we can be better prepared for what may lie ahead.

Summer Holdover

As we enter the fall season, understanding the impact of a few summer holdovers will help us discern the direction of this late-stage bull market. Following an unexpected vote by the United Kingdom (U.K.) to exit the European Union (also known as Brexit), markets rallied in the aftermath of the initial pullback. Stocks remained resilient through the summer as several central banks around the world continued to put downward pressure on short-term interest rates, pushing some into negative territory to spur growth. The European Central Bank first cut rates to below zero back in 2014, but it wasn't until this year that other central banks began to follow suit, first with the Bank of Japan and later by other smaller European banks. One of the most recent moves to lower rates was made by the Bank of England, which lowered interest rates by 25 basis points in early August. The cut was largely anticipated by markets and was seen as an attempt to avoid recession in the U.K. after the uncertainty created by Brexit in late June. The economic effects of Brexit have, so far, been primarily contained to the U.K. itself, and this recent rate cut has provided a bit of a silver lining for the region.

The Federal Reserve (Fed) is also playing a role in supporting growth. After hiking rates 0.25% in December 2015, the Fed has remained on the sidelines throughout 2016 as it weighs improvements in the labor market against below-target inflation and global risks. Chances of a hike in 2016 have crept higher from low levels, but we anticipate only one hike later this year following the election. The Fed should remain accommodative in 2017, tightening gradually with only one to two increases.

Though summer headlines emphasized the uncertainty surrounding the upcoming U.S. presidential election, markets remained unfazed. Though this election cycle has been a bit more unusual than normal, investors must be careful to not overreact to what each candidate is saying on the campaign trail. The winning candidate's agenda must be thought of as a process, not an event, because what is said on the stump is usually very different from what actually becomes U.S. policy. The process of getting policy proposals through Congress has a tendency to pull ideas toward the center and make them watered-down versions of the candidate's wishes. This process may be giving the markets some comfort, as they have had little reaction to either candidate's campaigns so far. Investors would be well served, in my opinion, to treat the election with the same sort of wait-and-see attitude.

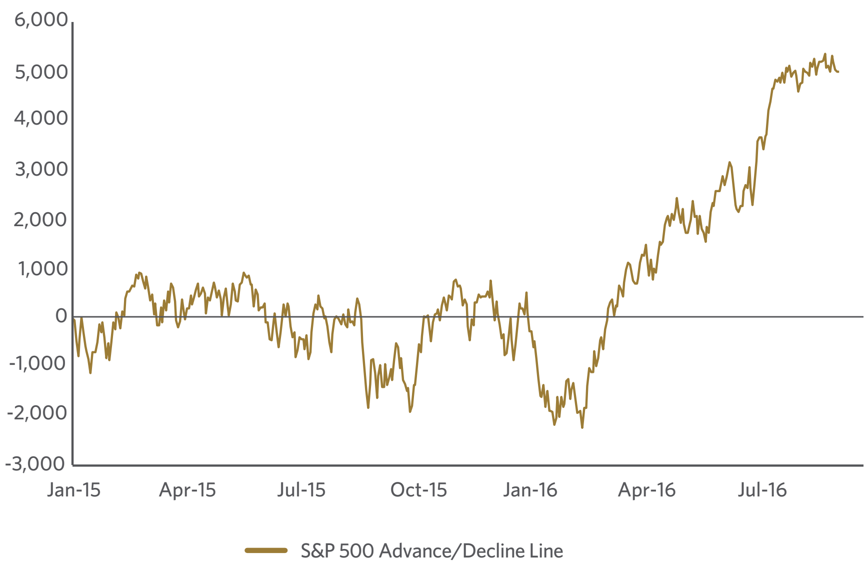
Cliff Notes

Amid these uncertainties, we cannot ignore the fact that U.S. equity markets are at or near all-time highs. Many people fear this backdrop because they believe there is nowhere to go to but down, but I disagree. Markets at all-time highs are typically sending a signal that better economic times may lay ahead. The stock market itself is in the index of Leading Economic Indicators because of its ability to serve as an important indicator of future economic direction. Of course, markets must always be monitored for severe overvaluation and froth, but these traits are notably absent in the current market environment.

Other variables demand varying levels of importance throughout an economic and market cycle. As such, our focus is on market breadth, inflation and Fed policy, as these variables have shown a propensity to foreshadow economic and market moves at this point in the cycle.

Overall breadth, a measure of how many stocks are participating in the move higher, has historically indicated more gains to come at this stage in the economic cycle. One way to measure market breadth is through advance/decline lines, which show trends in the net number of stocks advancing or declining within an index. As Figure 1 illustrates, market breadth has been trending higher and is exhibiting strength. Although it remains a bit too weak to declare that better times are ahead, we are confident that market breadth should continue to strengthen as uncertainty subsides.

Figure 1—What is Market Breadth Signaling?



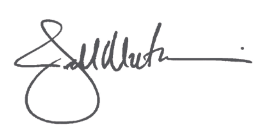
Source: FactSet. As of 8/31/16

During mid- to late-stage bull markets, inflation must be monitored closely because of its historical tendency to flare. Rising inflation puts pressure on the Fed to tighten monetary policy in order to combat overall higher prices, the combination of which puts downward pressure on equity markets, usually leading to a correction or bear market. With inflation currently below target, the data-driven Fed should remain accommodative. However, inflation's main drivers of oil and wages need to be watched closely.

Crude oil prices plunged earlier this calendar year, bottoming in early February and rising almost 80% since. If prices merely stay where they are from here, the year-over-year change in the price of crude oil would begin to have a significant impact on inflation calculations. So far in this economic expansion, wage gains have grudgingly moved higher. As this expansion ages and unemployment levels continue to drop, it may be more difficult for companies to find quality workers which may put upward pressure on wages.

Continuous Learning

We will be watching crude oil, wages and market breadth in the months and quarters ahead. These variables remain the most important in today's environment for determining the future path of both equity and fixed income markets. As my sons head back to school and begin to get homework, I hope I've been able to show you what my study plan looks like for the remainder of the year. Applying what we know about mid- to late-stage bull markets and studying the drivers most important in this market phase will help us best position portfolios for what lies ahead.



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