RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

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STATE OF THE MARKETS

After recovering from the “Brexit” shock early in the third quarter, equity markets traded within a narrow range in August and September. The S&P 500 ended the quarter up approximately 3% at 2,168, the same level it hit in mid-July. The Federal Reserve’s continued interest rate accommodation, the relative calmness of oil prices, and an improving labor market put a floor under the market, but at the same time the uncertainty of the upcoming presidential election put a lid on gains after the post-“Brexit” bounce. The S&P 500 is now only about 2% below our 2016 year-end market prediction of 2,221.

The RDM Capital composite of large-cap value equity-oriented accounts rose almost 3% in the third quarter, continuing its strong performance for the year. In fact, as we informed our clients back in August, RDM Capital was again named in Lipper’s “Best Money Managers” rankings for the performance of its Large Cap Value Equity composite in the second quarter of 2016, ranking in the top 13% of 228 composites surveyed. Despite significant market pullbacks in January and June, the RDM Capital composite is now up about 6% for the year.

With fiscal policy virtually nonexistent, much of the markets’ attention during the third quarter again was focused on the Federal Reserve and the timing of interest rate increases. The Fed did not raise rates in September, as expected, but hinted it would raise the Fed Funds rate by 0.25% in December, barring any sudden and dramatic changes in financial markets. As we expressed in the past, the Fed is very reluctant to derail the weak economic recovery by raising rates too quickly, which would spook investors and chill investment in the economy. Given the slowly improving labor market and likelihood of inflation picking up in the coming years, we expect the Fed to continue cautiously raising rates over time on a very slow path. Ultimately, a return to “normal” interest rates is a positive for equity markets, as long as the Fed does not raise rates too fast or too early.

Equities remain somewhat expensive technically from a historic perspective at the current level of earnings, yet are attractive for investment when compared to other asset classes, most notably fixed income. In this sense, valuation needs not only to be compared to historic averages, but relative to other asset classes available for investment at the current time. This can be seen statistically today in the context of the equity earnings yield relative to treasury yields, which reflect a much more attractive level of corporate earnings available through equities than interest from fixed income.

Within equities, developments in the energy and financial sectors were in focus again during the third quarter. The price of crude oil remained volatile, particularly towards the end of the quarter as OPEC held informal meetings in Algeria in late September. For the first time in years, OPEC reached a tentative agreement to cap production, albeit at a near record high level. While this agreement surprised the market and sent oil prices sharply higher, it is doubtful the agreement will have a lasting impact on oil prices. Among other things, the agreement will not go into effect until the end of November; OPEC producers still have to agree on the individual caps applicable to each country; and the agreement won’t apply to non-OPEC members, including Russia and the U.S. Ultimately, OPEC is unable to control oil prices as in the past, leaving market forces of supply and demand as primary drivers of oil prices. If oil exceeds $50 for any extended period of time, U.S. shale producers in particular are likely to ramp up production and increase supply, putting a lid on further price increases. We thus believe supply and demand will reach equilibrium in the low $50 range by early 2017, barring any unexpected changes in the world economy that impact demand.

In the financial sector, banks around the world await a return to normalized interest rate policy, which will bolster bank profits due to higher interest rate spreads. U.S. banks continue to weather low interest rates by cutting costs and maintaining strong capital structures, but low interest rates are beginning to take their toll on many European banks. In particular, the combination of low interest rates, regulatory fines (and the threat of a large fine from the U.S.), and high leverage led to concerns that Germany's Deutsche Bank would need a bail-out or additional capital to avoid a Lehman-like liquidation that could ripple through the banking system. Unlike Lehman, though, Deutsche Bank still has many additional levers to pull before a liquidation, and the banking system as a whole is in far stronger shape than in 2007-2008.

Wells Fargo also was under pressure in the third quarter. Wells Fargo historically has been one of the best run of all the big banks, but this reputation was tarnished when news came out that some bank employees had a practice of opening unauthorized accounts in an effort to earn incentive-based pay. While this scandal became a hot button political issue, complete with congressional hearings and related grandstanding, the ultimate financial impact to Wells Fargo customers was extremely limited. All told, the accounts generated no more than $2.5 million in fees over 1.5 million erroneous accounts out of the more than 70 million total Wells Fargo customers and nearly $2 trillion in assets. Despite this lapse of corporate conscience, we still favor Wells Fargo as one of the top banks in the sector.

Of course, the presidential elections became increasingly important to markets as the quarter progressed. We explore the possible impact of the election in more detail below.

The Presidential Election Takes Center Stage For Investors

Major Candidate Proposals Impacting Client Accounts

Trump

- Federal income tax brackets lowered and condensed to 12%, 25% and 33%
- Business income tax capped at 15%
- Elimination of the alternative minimum, gift, and estate taxes
- Capital gains held until death will be taxed, but the first $10 million is exempt
- Current capital gains tax rates remain, but the 3.8% Obamacare tax on investment income will be repealed and carried income will be taxed as ordinary income

Clinton

- 4% "fair share" surtax on income above $5 million, raising the top marginal rate to 43.6%
- Minimum effective tax rate of 30% for those making more than $1 million per year
- Long term capital gains rate of 20% for investments held at least six years and a sliding scale tax rate for shorter-term investments
- Estate tax raised to 45%-65%, depending on the size of the estate, and estate tax exemption lowered to $3.5 million
- Lifetime gift tax exemption lowered to $1 million
- Limits on the amount of funds that may be held in retirement accounts.

Looking ahead to the fourth quarter, the presidential election in November and the economic impact of the winner's policies will dominate the markets. Currently, the polls are very close, however it is apparent from market trading activity and statements from Wall Street economists and traders that many market participants are expecting a Hillary Clinton victory and are somewhat apprehensive about the potential for a Donald Trump win. This is an unusual dynamic where the Republican candidate, normally seen as a stronger candidate for big business profitability, does not have the traditionally strong support from Wall Street and big business in general. We discuss below the potential impact of a Trump and Clinton victory.

Impact of a Trump Victory

We expect the markets to trade lower in the weeks leading up to the election due to the possibility of a Trump win, should the polls continue to skew in his favor. If Trump wins the election, we could see an immediate negative knee-jerk market reaction and an uptick in volatility through the end of the year. The primary reason for the expected Trump-related market reaction is the uncertainty that would be caused by his presidency. Trump has defined his candidacy as a political change agent that will reshape American life to recover a lost greatness, but the market has little guidance on how he would change the economy and financial markets. The main source of information is his business career, which has been characterized in part by a willingness to take on a tremendous amount of debt to finance risky projects that have led to several bankruptcies. Markets thus are concerned about how Trump's prior business practices will translate to his management of the U.S. economy.

Further, some of Trump's economic positions have the potential for negative consequences should he actually pursue them in office, most notably with respect to his positions on free trade. While many economists agree with Trump that China has been a currency manipulator and has artificially devalued its currency to support exports in the past, currently the Yuan is artificially *overvalued* and probably would fall further if it was a freely floating currency. China is manipulating its currency higher not for trade reasons but due to decelerating economic growth that has led to periodic market panics in the trading of Chinese equities and currency. It is taking any step possible to support confidence in the Chinese economy and a rapidly depreciating currency does not help that cause. Regardless, starting a trade war with China (or any other U.S. trading partner) would likely lead to more expensive foreign goods for American consumers and would not meaningfully spur manufacturers to relocate to the U.S. Due to technological advancements that allow for much freer trade across borders globally, and strong labor supply and demand forces that will continue to push manufacturing work to low labor cost nations, manufacturing in the U.S. will not quickly recover.

On the positive side, Trump's platform includes pro-business policies that could be beneficial for equities over time. First, he supports significant tax cuts for individuals and businesses. A business tax cut that would reduce the business income tax rate to a cap of 15% is long overdue to make the U.S. tax code competitive for businesses when compared to other nations. Additionally, his support of reducing taxes on the repatriation of cash held by U.S. companies overseas would induce business investment in the U.S. that has been lacking recently. Similar to his tax cut proposals, he supports reducing regulation on American businesses, including most notably the energy sector. These proposals are important because the expansion of tax and regulatory policy has been a major hindrance to the economic recovery during the Obama administration. Any relief from this expansion would be supportive of economic growth by shifting business capital away from taxes and regulatory compliance costs towards hiring, operational expansion, research and development and the like.

With respect to the impact on individual sectors, a Republican administration would seem to favor the financial and healthcare sectors, since reduced regulation on both sectors could lead to profit growth. Further, Trump appears to be more hawkish with respect to interest rates, although it is unclear how much impact he would have as president on the Federal Reserve's independent decision making process.

Impact of a Clinton Victory

Clinton, meanwhile, has a lengthy political career for the markets to digest, and, as a result, we expect the immediate market reaction from a Clinton win to be far more muted than a Trump victory. Markets hate uncertainty and Clinton is far more of a "known quantity" for better or worse. After eight years of a Clinton administration and her subsequent service as a U.S. senator and Secretary of State in the current administration, the markets more or less know what Clinton brings to the table.

Nevertheless we do not view a Clinton victory as being a catalyst for a break from the current low growth environment. At their core, Clinton's economic policies contemplate a continued role for government in redistributing wealth from the top income earners and private markets to government welfare expenditures and programs. We believe these policies are a net-negative for the economy and have contributed to today's anemic economic growth. However, given the likelihood of at least a split Congress with Republicans maintaining control of the House of Representatives, it is likely that much of the current political stalemate would persist in a Clinton presidency. We thus view a Clinton victory as a recipe for a continuation of sluggish, but positive, economic growth, low interest rates and low business investment.

A Clinton administration would appear to benefit real estate, materials and gold investments, as the current dovish monetary policy favors a weaker dollar and higher asset prices. The Democrats in particular appear to have the pharmaceutical industry in their crosshairs over drug pricing practices, which could hurt biotech and pharmaceutical manufacturers in the healthcare sector.

Conclusion

While it is difficult to predict the ultimate economic impact from this presidential election, especially considering the unorthodox nature of Trump's candidacy, the winner is unlikely to have a significant impact on long-term fiscal policy. As the past eight years have made clear, the president cannot have a significant effect on economic policy without a Congress that cooperates with the president's agenda. Whoever is voted into office will face a Congress that is likely to be controlling (in the case of Trump) or hostile (in the case of Clinton).

In the current political environment, we do not recommend making major asset or sector allocation changes in an attempt to predict the election. During volatile or uncertain times, we recommend that clients stay the course and stick with their long-term investment plans. We continue to favor equities over fixed income due to the likelihood of rising interest rates over the medium and long term, and U.S. equities over foreign equities due to a stronger overall economic picture domestically along with greater political risk associated with the European Union. Within U.S. equities, we view long-term opportunities for capital gains to be most prevalent for stocks with positive exposure to rising interest rates, rising inflation, commodity prices and continued economic expansion. Therefore, we recommend overweight allocations to the energy sector with underweight allocations to over-priced sectors that are viewed as proxies for fixed income, such as consumer defensive, utilities and telecom stocks.