Dear Client,

The posture of the world’s major central banks ranges from those looking to start the normalization process (Federal Reserve and Bank of England) to those still providing significant monetary accommodation (European Central Bank and Bank of Japan). The previously moribund ECB has continued its three-year move toward greater activism with aggressive programs announced over the last four months.

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While it’s important that the ECB garners sufficient interest to help boost credit creation, the impact of the ECB’s intentions has helped weaken the euro by 7% in four months. This should provide some boost to European exports, and has clearly helped bolster inflation expectations.

Interest is building around the Fed’s communication policy regarding its intentions of keeping interest rates at their current extraordinarily low level once it completes the quantitative easing program (likely next month). We see little sign of pressure on the inflation front, and the recent weakness in commodity prices provides policy makers some extra breathing room. We continue to expect the Fed to favor growth over inflation in this environment, with its concern being that a premature rate hike may endanger the economic recovery.

In regards to economic growth, the United States has realized annualized growth of only 2.2% this cycle (which has also lasted five years), and we see little excess in the real economy and expect the expansion to continue for the foreseeable future. While the Fed is looking to start normalizing policy, we would expect any further deterioration in economic data in Europe, Japan or China to elicit further stimulus in their respective economies. Our greatest economic uncertainty surrounds the growth outlook for Europe, but we think market expectations have become sufficiently negative to minimize the risk of a material downside surprise.

Equities, as measured by the MSCI All Country World Index, showed slowing momentum during the 3rd quarter, and ultimately ended in negative territory (-2.2%), with growth concerns in Europe and the broader geopolitical picture ultimately weighing on shares. Year-to-date returns remain in positive territory at 4.2%. Implied volatility (as measured by the VIX) spiked, though realized daily volatility was in-line with the first half of the year.

Despite a pick-up in volatility corporate share repurchases are approaching record levels last seen in 2007. Does this mean buybacks are really what’s been driving earnings growth in the United States? Based on our calculations, this hasn’t been the case. As shown in the accompanying chart, we differentiated between aggregate earnings and earnings-per-share from the S&P 500 to analyze the historical contribution of share repurchases to earnings growth. Overall, it’s been a negligible effect. It’s likely that other corporate decisions, such as stock-based acquisitions and compensation, dilute the positive impact of share repurchases. Given the multiple expansion last year, further upside in the market will be driven largely by earnings growth which we expect to approximate 8% during the next year.
European Equity

The euro has fallen 7% relative to the U.S. dollar from its intraday high in early May. Fundamentally, the weaker currency should improve the economic outlook, but the effect on investor appetite is less predictable. An outlook on future euro moves, which are volatile and notoriously difficult to forecast, might affect hedging decisions but shouldn’t, by itself, dissuade investment in European equities. We continue to expect earnings growth from European companies to outpace domestic growth because of the significant exposure to faster-growing markets.

Emerging-Market Equity

Emerging markets struggled in the 3rd quarter with a -3.4% return. September’s -7.4% return weighed heavily on the asset class alongside the flight to safety. Historically, emerging-market assets have been pressured during periods of U.S. dollar strength, and the current relationship indicates a strong inverse relationship between the U.S. dollar and emerging-market equities. One cause of this is the increasing attractiveness of U.S. assets, reversing capital flows to the emerging markets. Additionally, the countries that tie their currencies to the U.S. dollar experience currency strength, reducing their competitiveness. Finally, commodity producing countries suffer from falling commodity prices. Foreign direct investment in China fell 14% in August, after a 17% decline in July, as foreign investors found Chinese investment less attractive. Chinese economic data remains uneven, as good retail sales figures were offset by disappointing industrial production levels. As China’s economy continues to mature, we expect more of this volatility as the government works to moderate the economy’s dependence on fiscal and monetary stimulus.

U.S. Fixed Income

Improving U.S. economic data, along with the Fed signaling it intends to raise its benchmark Fed Funds rate next year, has left many investors scratching their heads as to why long-term interest rates have stayed stubbornly low in the United States. The 10-year U.S. Treasury yield took a bit of a ride during the quarter – reaching as high as 2.62% - but ultimately ending the quarter slightly lower at 2.49%. In addition, Investment grade fixed income gained 0.2% for the quarter as income offset a slightly negative price return due to a modest increase in yields. High yield fixed income lost 1.9% for the quarter; spreads widened due to record outflows, but fundamentals remain constructive. Municipal bonds
Emerging-market stocks have increasingly found dollar strength a headwind.

Left Axis: Relative emerging-market equity return 12-month rolling correlation to the U.S. dollar.

Note: Emerging-market equity return relative to developed-market equity return. Sources: Northern Trust, Bloomberg

increased 1.5% in the 3rd quarter; yields continue to converge back towards U.S. Treasury yield levels on longer-dated issues.

We believe the fixed-income market is a global one, with large investors having many options for investing in high-quality assets that offer good liquidity. While interest rates in Europe have fallen on a lower growth outlook, rates are being driven lower in countries such as the United States, the United Kingdom and Australia, as investors seek out higher relative yield. We believe the global nature of the fixed-income market will serve as a natural ceiling on how far, and how fast, U.S. rates may rise.
The negative market sentiment of early August set the stage for the ensuing rally in risk assets during the last month. Action from the ECB has put a floor, at least for now, under European inflation expectations. This has led to a modest rise in global interest rates, along with some technical correction from the low liquidity environment of the summer. With the global economy still generating growth below historic trend levels, inflation pressures remain reasonably distant. We believe this gives the major central banks leeway to manage monetary policy at a pace of their choosing, supporting their efforts to improve both growth and employment. Fixed-income markets have priced in considerable action from the Fed during the next three years, with an expectation that the two-year Treasury note will rise in yield from its current level of 0.53% to nearly 3%. We believe this gives some cushion to fixed-income investments, as we don’t expect rates to increase this rapidly.

Risk taking has been rewarded in the markets this year, and we expect a reasonably constructive investing environment to continue over our tactical time horizon. We made no changes to our global tactical asset allocation recommendations this month, which remain significantly overweight stocks at the expense of investment-grade bonds. The key driver for equity returns going forward remains earnings growth, which is expected to range from 7% to 9% across Japanese, U.S. and European companies this year. Investors have begun analyzing the performance of various asset classes during a Fed rate hike cycle, as the market is currently expecting the first rate hike next summer. Our analysis of prior cycles shows that, as long as the market isn’t negatively surprised, volatility may increase but stocks should follow profits higher.

There’s been some evolution in our risk case scenarios during the last month. Our first risk case relates to the sufficiency of growth from the G-2 (United States and China). While we have reasonable confidence in the U.S. growth outlook, Chinese growth has become more uncertain. We expect the Chinese authorities to respond with measured stimulus actions should growth risks increase. Our second risk scenario surrounds geopolitical risks in Eastern Europe and the Middle East. While energy prices have actually been falling, the risk of an interruption of energy supplies in Eastern Europe is one example of the potential difficulties in that region. Finally, we are focusing on the efficacy of the ECB’s actions to support growth across the European Monetary Union. They positively surprised the market with further action in September, but we now need to see evidence of the effects on the real economy. These are the developments most likely to prompt a potential change in our constructive outlook on the markets.
Meet a Member of the Enterprise Investment Advisors Team

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Salina currently serves as the Investment Operations Specialist with Enterprise Investment Advisors. She began her career at Enterprise as a Deposit Servicing Representative in 2001, and was promoted to the department’s Group Leader in 2005. Prior to joining Enterprise, Salina gained banking experience while working at MassBank Savings.

Salina earned a Bachelor of Science degree in Business Administration with a concentration in Management from the University of Massachusetts/Lowell in 2007. She holds the Registered Paraplanner (RP) professional designation.

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