WILSON CAPITAL
INVESTMENT ADVISORY

We feel investors should have an information outlet for the financial markets that is thorough, but does not require a prerequisite degree in economics. We hope this makes our commentary informative and educational for all levels of investors. We have also included a glossary at the end of this commentary that defines terms marked with an asterisk (*).

Quarter in Review

Off the heels of the market-rocking U.K. Brexit vote at the end of June and an approaching U.S. presidential election, the third quarter started under a cloud of uncertainty. However, despite these lingering issues and the almost robotic nature of volatile markets in recent quarters, the 3rd quarter was one of the most placid in history. After the initial shock of the Brexit vote, stock markets across the globe rose steadily. With only two trading days where the S&P 500 fell more than 1% (lowest number since 3Q 2013), it seems as though many investors took their late summer vacations.

Asset Class†	3rd Quarter 2016 Return
U.S. Small Cap Stocks	9.1%
International Stocks	6.9%
U.S. Large Cap Stocks	3.9%
U.S. Bonds	0.5%
Commodities	-3.9%

The quarter featured little movement in the key data that drives Federal Reserve policy, as the latest September unemployment number remains steady around 5.0% and inflation is hovering around the 1% mark. With the unemployment rate near the lowest levels since before the 2008 financial crisis and steady positive inflation, expectations of an interest rate hike have been on the rise. However, six consecutive quarters of decline in S&P 500 company earnings and issues of global economic growth have reduced the probability of any significant moves in the coming quarters.

In the Headlines: Wells Fargo

Among the more newsworthy events of the quarter was the announcement from Wells Fargo that the bank had opened over 2.1 million unauthorized accounts for their customers. The culprit was a sales culture that incentivized employees to cross-sell a wide swath of services to their clients regardless of their needs, or in these cases even their knowledge. The unauthorized account openings did little to add to the company's financial coffers, but the motivation by executives was not to directly increase the revenue or profitability of the firm, but rather to show appearances that their sales culture was superior to other banks which might result in riches down the road. Non-financial metrics such as "daily active users" or "mobile engagement" have become the norm when discussing social media companies, so perhaps it comes as no surprise that other companies would attempt to create their own new metrics to impress Wall Street stock analysts.

Commentary: Decline in CAPEX Spending

With a quarter of steady returns across the board, one could easily assume it was dominated by positive news and optimism about future prospects. However, as has been noted in this space in earlier quarters, the market tends to perform best under steady conditions, not necessarily with good news.

A troubling trend has been the reluctance of companies to spend earnings on capital expenditures. Capital expenditures, or CAPEX, are monies outlaid by companies to purchase physical assets like machinery or buildings, with an eye towards investing in the long-term profitability of the company. Such expenses usually have little or no immediate impact on profits and often require debt financing. With interest rates at record low levels, companies should be encouraged to increase debt loads in order to finance CAPEX projects. While debt levels have increased, the cash raised has had virtually no affect on companies' capital spending. Instead, more companies are choosing to repurchase shares as a way of increasing earnings per share*. The ubiquitous use of these buy-backs, often labeled "financial engineering", has been well chronicled by the finance media and was discussed in this column (April 2015).

The table below highlights the declines in both CAPEX and the number of shares outstanding for the non-financial companies in the Dow Jones Industrial Average (A list of companies is included in the glossary).

Average Year-over-year changes as of 2Q:

	2013-2016	2005-2013
CAPEX	-0.6%	11.1%
Shares Outstanding	-2.2%	-1.4%

Normally, capital expenditures have a significant positive affect on the economy. Dollars spent on CAPEX flow down through the economy to the construction, manufacturing, and building industries and eventually to the pockets of workers who are more likely to spend an extra dollar, sparking further consumer demand. On the other hand, money spent repurchasing shares has few direct beneficiaries other than shareholders, who tend to be wealthier and more wiling to save, rather than spend an extra dollar.

There is no telling how long a reduction in capital spending can continue, but along with the historic trends across the globe towards service oriented economies, a significant change in course appears unlikely. The question is whether this combination can persist without having lasting affects on wealth disparity, growth, and employment across world economies.

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Glossary

Brexit - Formally the United Kingdom European Union referendum, was a vote in June 2016 by U.K. voters to leave the European Union which affects trade and banking agreements between in U.K. and 27 other European countries.

Earnings-Per-Share – The amount of earnings or profit that a company makes allocated for each share that is outstanding in the market for that period.

Down Jones Industrial Average - One of the earliest stock market indexes, which tracks a small basket of stocks in order to measure performance of a broader stock market. Though the word "industrial" is in the name, the index tracks companies from all economic sectors.

Non-Financial Dow Jones Industrial Companies
3M, Apple, Boeing, Caterpillar, Chevron, Cisco, Coca-Cola, DuPont, ExxonMobil, GE, Home Depot, IBM, Intel, Johnson & Johnson, McDonalds, Merck, Nike, Pfizer, Procter & Gamble, UnitedHealthCare, United Technologies, Verizon, Wal-Mart, Walt Disney

† Indices used to represent asset classes:
U.S. Large Cap Stocks – S&P 500
U.S. Small Cap Stocks – Russell 2000
International Stocks – MSCI ACWI ex-U.S.
U.S. Bonds – Barclays Aggregate
Commodities – Bloomberg Commodity

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