July 2016

PENNIALL PERSPECTIVE

"The four most dangerous words in investing are, It's different this time." - John Templeton

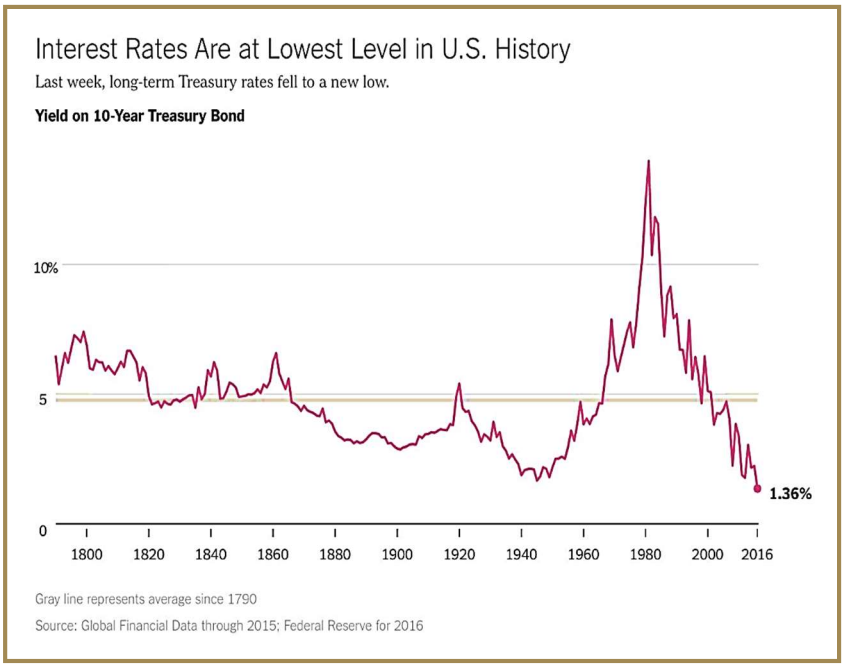
Economic Watch

Global economic growth remains suppressed, despite unprecedented efforts by top central banks to stimulate economic activity. While more robust than most of the developed world, U.S. Gross Domestic Product (GDP) muddles along, staying stubbornly below the 3% level indicating weak economic growth. After dismal May reports, domestic unemployment data for June came in undeniably strong. Despite this improvement in the labor market, corporate earnings and profit margins have not strengthened. When applying the GAAP (generally accepted accounting principles) method of accounting, both earnings and profit margins were actually down year-over-year.

In a historic decision, UK voters decided to leave the European Union (EU) ending 43 years of membership. June's "leave" vote shocked markets as investors had all but ruled out the possibility of the referendum passing. Despite overwhelming skepticism, more than 72% of Brits turned out to polls resulting in a 51.8% majority in favor of leaving behind their EU affiliation. Markets reacted swiftly and violently, selling stocks and European currencies, namely the British pound, and flooding into safe-haven assets. It only took a few days, however, for global markets to stabilize and many risk assets to recover and grind higher. Economic stability in both the UK and broad Eurozone must be carefully monitored in the coming months and years as they unwind their integral relationship and as European leaders fight to keep the rest of the European Union intact. China continues to be a source of global concern, as exports are slowing, local currency is on the decline, and loan growth is softening. Japan's growth prospects are even less inspiring, with past 4 quarters of GDP growth barely making it into positive territory.

Outlook:

We are witnessing an odd dichotomy in global markets today. Even as stocks rebounded in the wake of Brexit, global sovereign debt yields (specifically government bonds of Germany, Japan, and Switzerland) dropped to new historic lows (bond prices hit new highs) with over $13 trillion bonds or 1/3 of developed government global bonds now trading with negative yields. US interest rates, though positive, have followed downward with historic lows reached in both the 10yr (see chart 1) and 30yr bond yields. In a healthy market where the Fed is beginning to raise interest rates, stock and bond prices are typically inversely correlated. That is bond prices generally decline while stock prices increase due to the strengthening economy. However, today with both stock and bond prices increasing simultaneously, the markets and the underlying economy are not functioning properly. It seems likely that Fed intervention has created unintended disinflationary and/or deflationary consequences as zero and negative interest rates appear to actually impede



spending and consumption as consumers hoard cash. Our interpretation is that these global, deflationary pressures are stamping out economic growth, making it virtually impossible for global economies to gain momentum. And as our quote states, we believe it will not be different this time as equities reflect economic realities.

Market Watch

As international equity markets floundered, U.S. stocks returned small, but positive gains during the second quarter led primarily by the continued rebound within the hard assets space (including precious metals/mining stocks, oil/energy companies, and commodities). Fixed income investments across the globe also had positive returns, most significantly by bonds with longer-dated maturities. While developed international stocks were mostly flat or negative for the quarter, emerging market equities rose modestly.

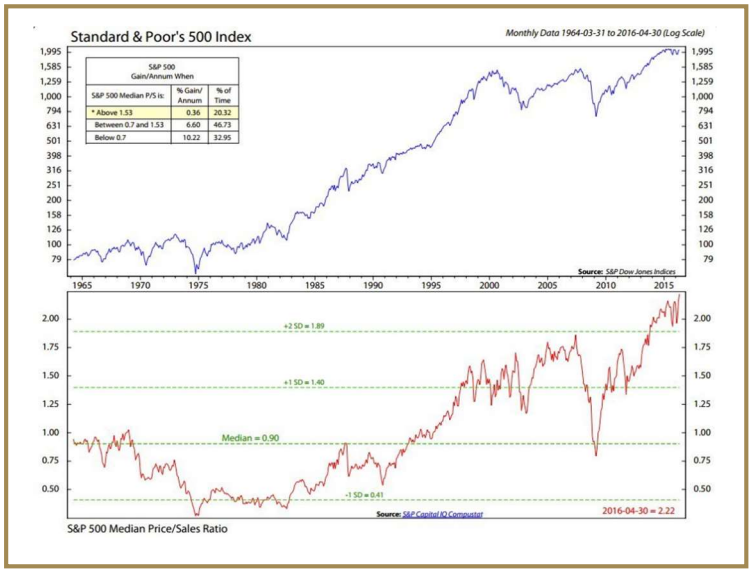
Here are some additional market data points from Q2:

- Barclays U.S. Aggregate Bond Index Q2 return: 2.21%
- 10-year U.S. Treasury yield ended Q2 at an all-time low of 1.49%, down from 1.78% at the beginning of Q2
- 30-year U.S. Treasury yield ended Q2 at 2.30%, down from 2.61% at the beginning of Q2
- S&P 500 Q2 return: 2.46%
- Dow Jones Industrial Average Q2 return: 2.07%
- MSCI EAFE Index Q2 return: -1.46%

Outlook:

At the risk of sounding like a broken record, we believe broad stock prices are too expensive considering underlying fundamentals. Just one example is reflected in chart 2 (bottom chart), where the median price-to-sales ratio on the S & P 500 is at historic highs. This doesn't mean, however, that we aren't finding attractive and highly opportunistic investments that are trading at more reasonable valuations and that have substantial upside potential. Below are a few of our highest conviction holdings that we own in most portfolios:

- **Wasatch-Hoisington US Treasury**: This government bond fund is invested in longer-dated US treasuries; those that have appreciated the most year-to-date (fund is up almost 18% through the end of Q2 compared the Barclays U.S. Aggregate Bond Index up just over 5%). Since 1/1/2000, the fund has annualized returns of over double the S&P 500 Index. Until data suggests lower interest rates will no longer persist, we will remain committed to this highly successful strategy.
- **American Century Equity Income**: Focusing on superior downside protection, this fund invests in high dividend paying domestic stocks and some convertible securities. The investment in convertibles of high-quality, undervalued companies essentially puts a floor value in place should a company's stock price fall, but still enables the fund to receive some of the upside if the stock appreciates. Fund management believes in the same principle that we do:



limiting large losses improves long-term performance. The focus on downside protection doesn't mean fund management ignores upside opportunity; the fund has returned almost 13% year-to-date compared to 3.84% by the S&P 500. We continue to believe increased volatility and macroeconomic uncertainty creates an environment where this time-tested strategy will continue to thrive.

- **Van Eck International Investors Gold**: Diversification, including allocations to traditional stocks, bonds, and hard assets, is a fundamental pillar of our investment philosophy. After a couple of underperforming years for gold and gold mining stocks, the sector bounced sharply year-to-date. With a 6-month return of 100%, this fund focuses on not only the bigger players in the mining space, but also on the further suppressed junior mining stocks. Healthy balance sheets, inexpensive valuations, and economic tailwinds are just a few of the reasons we continue to believe gold miners have more room to run.

Portfolio Allocations

During the second quarter, portfolios benefitted from exposure to long-dated government bonds, intermediate corporate bonds, high dividend paying stocks, and precious metals/gold. Total portfolio performance, in most accounts, significantly outperformed major indexes as a result of favoring these asset classes. As our thesis came to fruition throughout the quarter, most portfolios did not receive any changes and our conviction in these areas of the market remains high. We continue monitoring markets for reallocation and rebalancing opportunities.

PENNIALL & ASSOCIATES, INC.