FINANCIAL MANAGEMENT STRATEGIES
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Brexit does not end the World…Yet?
October 2016

My Dear Client:

A summary for the third quarter of 2016 would be the recovery of global financial markets from the shock that was created by the United Kingdom's (U.K.) referendum vote to leave the European Union in late June. After market disruptions continued into early July, we experienced a period of nearly unprecedented calm. As an example, for almost the entire summer the S&P 500® Index did not have a daily price change over 1%. While we did see more typical price changes towards the end of September, we must ponder the question of was the summer a pause before the storm or before the market continues higher? Additionally, two of the globes largest banks Deutsche Bank of Germany and Wells Fargo headquartered in California each received penalties and major negative fallout for practices that harmed markets and customers. There will be much more to say about this next quarter as the stories unfold.

U.S. investors returned from Labor Day in a fearful mood. Perhaps investors finally began to face the inescapable reality that one of the two most unpopular party nominees in recent U.S. history will be elected to govern the nation. Control of the U.S. Senate and House and Supreme Court nominations will also play a role in shaping the market expectations about future policy decisions from the legislative and judicial branches of government, as well as the executive branch. The rancor of the political discussion within the U.S has clearly shifted eyes and opinions around the globe to the United States. The upcoming U.S. national election will inject a sizable amount of uncertainty into investor expectations. However, the U.S. election is the second in a series of five major political contests in the world's largest developed economies over 2016-2017. This started with the U.K's Brexit referendum vote to leave the European Union on June 23, 2016, Italian constitutional reform scheduled for December 4, 2016, the 2017 presidential elections in France (April and May)~~;~~ and lastly Germany's 2017 probably late September, but sometime before October 22 national election. Like a TV-miniseries each of these events and the political discourse surrounding them can increasingly add anxiety to investors and citizens alike.

U.S. Equity Market

In the second quarter, the broad U.S. equity market as measured by the Russell 3000® Index rose 4.4%, and the large-cap focused S&P 500 Index increased by 3.9 %. Small-capitalization stocks fared better than mid-cap and large-cap stocks. Style-wise, growth-oriented stocks outpaced their value-oriented counterparts across all market capitalizations. Of the 11 economic sectors within the S&P 500 Index, which are most often viewed as a proxy for the equity market, one sector posted a double-digit gain: Information Technology.

In contrast, we saw Utilities and Telecommunication Services, two sectors known to investors for providing higher dividends, posted the biggest losses. Many would assert that the poor performance of high dividend sectors is a foreshadowing that the Federal Reserve Board will indeed finally make good on its promise to continue to raise interest rates. Additionally, that theory would also lend some credence to the reason growth stocks generally outpace~~d~~ value stocks in the third quarter.

International Stocks

International stocks rebounded strongly during the third quarter, as near-term investor fears about the looming negative impact of U.K's vote to leave the European Union subsided. Non-U.S. developed equity markets, as measured by the MSCI EAFE Index (net of taxes), rose sharply at 6.4% for the period. Emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), grew at an even better clip of 9.0%. This despite that the end of the third quarter saw investors' concerns intensified about the health of several large German and Italian banks in the core of the Eurozone. Of particular concern near the end of the quarter was the announcement of the German mega bank, Deutsche Bank facing a potential $14 Billion fine from the U.S Department of Justice and regulators for the bank's role in improper selling of U.S mortgages. Rumors spread that the German government who was the staunchest proponent of not bailing out Greece would also not come to the rescue of the bank if needed. This caused some to invoke Deutsche Bank as the "Lehman Bros" that would lead European financial markets into crisis. Apparently, we shall watch this play out in the coming weeks. However, challenges surrounding capitalization levels in the major European banks are not likely to be resolved easily and may inject additional volatility into markets for the coming quarters.

U.S. Bonds

U.S. bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, rose 0.5% during the third quarter, despite the increase in yields in the long end of the U.S. Treasury curve. The yield on the bellwether 10-year Treasury note rates rose from 1.49% at the end of the second quarter to 1.60% by the end of the third quarter. Many bond managers point to July as the new low mark for the bond market and are preparing for U.S rates to continue to move upward from this point. We should note that while the U.S. rates slid upward and the dollar remains strong, globally *there are estimated $14 trillion of negative-yielding bonds, representing a third of global GDP.* Even though the U.S. labor market is largely at full employment and there have been early signs of inflationary pressure, the Federal Reserve (Fed) declined to raise interest rates in late September. Employers remain reluctant to lay off workers as the pool of potential job candidates dries up and openings remain near record highs. Filings for jobless claims have been below 300,000 for 83 straight weeks the longest such streak since 1970 and a level typical for a healthy labor market.

Additionally, a growing trend in the workforce is the increase of those working two or three jobs, now standing at about 7.8 million workers or 5.2% of the total workforce. With a two-prong focus of employment and inflation, barring any dramatic negatives in macroeconomic data over the next few months, the Fed seem to signal it may tighten short-term interest rates an additional 25 basis points at its December meeting.

A Look Ahead

I have made few changes to my long~~er~~-term outlook, while expecting uncertainty around the policy outlook to jostle markets from time to time. The U.S. presidential election will take center stage during October and the other four political events in U.K. Italy, France and Germany are left to unfold my long-term outlook is little changed. The discipline of developing and ongoing implementation of sound asset allocation remains at the top of mind. While assets can be overpriced and in favor, or undervalued and out of favor, for extended periods of time the strategy of rotating from more expensive to less expensive is a tried and true practice. We cannot know yet if last quarter will mark where international, emerging and small-mid size international stocks, as well as growth stocks, separate themselves from the pack. Markets and investors will probably get back to evaluating monetary policy, macro data and corporate data (especially earnings and fundamentals) soon after we get an election result. Also, energy prices, especially crude oil prices, will continue to be a main area of focus for investors. Late in the third quarter, Organization of Petroleum Exporting Countries (OPEC) preliminarily agreed to a minor negotiated supply cut, which is designed to increase the price of crude oil. Perhaps, most importantly this deal will affirm a current floor price for oil. While significant increases in prices (i.e., inflation) at this time is not expected, I believe that even a steady, minor shift will force investors to consider adjusting their portfolios.

Finally, I expect all of the above to induce short-term market volatility, that much of which in hindsight will be deemed white-noise. We should keep the focus on long-term investment goals and objectives for your portfolio and utilize our discipline to look pass the white-noise and implement well-thought asset allocation decisions, which historically have rewarded patient investors.

The year is passing quickly and the fall season is upon us. I welcome any questions about your investments, long-term strategy, or a discussion the specific opportunities and challenges that the current market may present for your particular situation. As always, I look forward to continuing to work with you toward achieving your investment goals.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board