



Quarter of Historic Firsts July 2016

My Dear Client:

The second quarter of this year was and will be historic as it was a quarter of monumental firsts. While today's headlines rightly point to Britain's vote to leave the European Union (EU) "Brexit"—the first time a country voted to leave the EU in its current form—in time the second quarter may well be equally remembered as the first time the yields on government debt from several sovereign stalwarts, particularly Germany and Japan, dropped into negative territory. Thus in the world's third and fourth largest economies, respectively, as well as some notable others, investors were effectively paying a penalty to own government debt!

Second Quarter Review



The biggest news of the second quarter came in the final days of June, when voters in the U.K. voted on June 23rd to leave the 28-member European Union...a move unanticipated by most market participants. To the contrary, in recent years, four of the five members of the PIIGS (Portugal, Italy, Greece, Spain) were most speculated as potential firsts to exit the EU. Yet, in fact, the U.K. was the first one out. The British referendum dominated headlines in the weeks ahead of the vote and led to sharp losses in the global equity market in the two days after. The U.K.'s departure from the EU will be a multi-year process, and one with no clear road map or recent historical precedents. It is estimated that it could take the next 2 years to fully unwind

all of the commerce and other intertwined activities between the U.K and the remaining EU members. Following the vote, the resignation of Prime Minister David Cameron underscored that upheaval will be equally volatile politically and economically. The U.S. equity markets responded to by declining more than 3% on the day after the vote. The emotion-driven selloff was short lived, however, and U.S. stocks closed out the quarter with three days of sharp increases, bringing the major indexes back into positive territory for the year. Let us see if this was a turmoil driven buying opportunity for long term investors...or rather a moment when short term traders saw an opportunity to profit in the notoriously lower-trading- volume summer.

But perhaps equally important to Brexit was the fact the yield on 10-year government debt in Japan, Germany, the United Kingdom, Switzerland and Australia were negative for the first time and/or reach record lows. In addition, the amount of negative-yielding global government debt reached record highs (for now...) A report by Fitch Ratings states there is \$10 trillion in total negative-yielding sovereign bonds outstanding worldwide.



The theory behind negative interest rates that have lead major central banks down this road is that the policy will spur economic activity by discouraging investors and savers from investing in bonds and savings and encouraging them to instead a) invest in assets that offer higher return potential (albeit comparably more risk), and b) increase their spending. Central Banks assuming this policy of negative interest rates is a first and we will keenly watch from its impact over the next few quarters.

While the direct impact on U.S. corporate profits from Brexit and negative-rates on government bonds is expected to be relatively limited, these events come at a time when U.S. profits have fallen for four consecutive quarters. Labor pressures are also beginning to rise.

Just two days before the Brexit vote the International Monetary Fund (IMF) released a report in which it cut its outlook for U.S. economic growth for 2016 to 2.2 percent, compared to 2.4 percent forecast at the beginning of the year. The report cited several factors leading to this revision, including: 1) the impact of slower global economic growth, 2) the contraction in the energy industry due to low oil prices, and 3) a slowdown in domestic consumer spending in the U.S.

The IMF report also noted poor secular trends are merging with cyclical issues that may impede long-term growth in the U.S. economy. For example, the ageing of the US population and a surge of baby-boomers moving into retirement are combining with a troubling stall in productivity gains and a lack of investment in workers and physical capital.

The growth of income inequality and persistence high poverty are expected to exacerbate the drag of those trends on the U.S economy, as 46.7 million Americans (one out of seven citizens) are living in poverty, including 20 percent of all children. Working Americans' share of total income in the country has fallen by five percent during the last 15 years. And, the middle class is the smallest it has been in three decades.

According to the IMF report, the polarization in income distribution has effectively cut consumer demand by 3.5 percent since 1999 or the equivalent of losing one year's consumer spending out of the last 15 years.

IMF Managing Director Christine Lagarde stated, *"Not only does poverty create significant social strains, it also eats into labor force participation, and undermines the ability to invest in education and improve health outcomes". According to Lagarde, "Our assessment is that, if left unchecked, these four forces: participation, productivity, polarization, and poverty will corrode the underpinnings of growth (both potential and actual) and hold back gains in US living standards."*

The report noted, however, that the U.S. is growing more strongly than other leading advanced economies, with unemployment at a nearly nine-year low and inflation in check.

U.S. Equity Market

In an ironic end to the first half of the year, the turmoil at the end of the second quarter echoed how markets began the first quarter. In the first six weeks of 2016, equity markets and crude oil prices dropped together, as investors worried that slowing economic growth in China could ripple world-wide and even tip the U.S. into recession. As those concerns eased and the Federal Reserve (Fed) held back on raising interest rates, riskier assets like equities and high yield bonds rebounded. To the end the second quarter, the concern over China shifted to a fear over the EU's potential impact on U.S. economic growth and roiled the markets accordingly.

For the second quarter, the broad U.S. equity market as measured by the Russell 3000® Index rose 2.6% and the large-cap focused S&P 500 Index rose 2.5%. Small-capitalization stocks fared better than mid- and large-cap stocks. Style-wise, value-oriented stocks outpaced their growth-oriented counterparts across all market capitalizations. Of the 10 economic sectors within the S&P 500 Index which provides a proxy for the equity market, Energy posted a double-digit gain and two sectors Information Technology and Consumer Discretionary posted losses. Yes, it is good to see and experience the rise in energy stocks however they have ways to go to recover their losses from 2014-2015. Let us see if the tilt to value represents a turn away from growth stocks as the market shifts into the next phase of the cycle or... was it a flight to more conservative companies during a quarter of turmoil?



Overseas Markets

In overseas markets, non-U.S. developed markets equity, as measured by the MSCI EAFE Index (net of taxes), declined 1.5% for the period. In contrast, emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), rose 0.7%. It will take years to sort out the Britain's new relationship with the EU, and the U.K. and the EU now must navigate an unprecedented separation while trying to prevent further political and economic turmoil. The British vote to leave the EU is not legally binding until Parliament passes a law to make Britain's exit a reality, which likely will not occur until after the elections this fall. I am also taking note that while investors did pull money out of the U.K post Brexit, data we received from EPFR Global and IGM Data showed that Germany, Spain, and Italy had higher mutual fund outflows than the U.K. Was this just a blip on the radar or is the EU in more trouble than the U.K?

Bonds

U.S. Treasury bond yields continued to decline (and bond prices continued to rise) in the second quarter, reflecting strong demand amid soft global growth, low inflation, a cautious Fed and continued unconventional monetary stimulus in Japan and Europe. In addition, investors sought safe haven government bonds on the heels of the U.K.'s vote to leave the EU, sending the yield on the benchmark 10-year U.S. Treasury to a near-record low. The yield on the 10-year U.S.

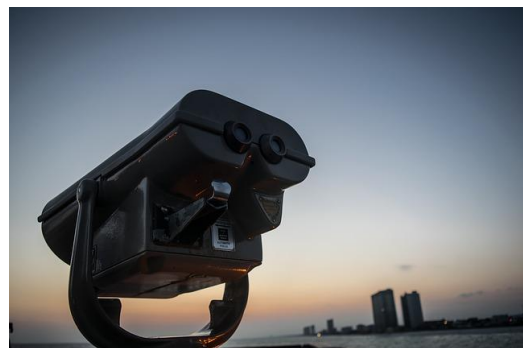


Treasury, a foundation for global finance, ended June at 1.49 percent, down sharply from 1.78 percent at the end of March and 2.27 percent at the end of 2015.

The decline in U.S bond yields partially reflects the falling yields in advanced economies. Yields in Japan, Germany, Switzerland, the U.K., Sweden and Denmark all hit record lows during the second quarter. Government bond yields in Japan, Germany and Switzerland dropped into negative territory during the quarter. When yields are negative, demand is so high that investors are paying more for the bond than they would recover when the bonds come due. Lower yields overseas, in turn, have continued to draw buyers into U.S. Treasury fixed income securities that offer more attractive yields, sending U.S. yields down to near their all-time lows. The bond yields decline also reflects growing investor expectations that major global central banks may need to take action at a time when the global economy is running at a sluggish pace and is particularly vulnerable to shocks. In addition, the U.K.'s vote has highlighted risks to an already sluggish global economy and prompted the Fed to adopt an even more patient posture on interest rates. Due to the uncertainty created by the recent U.K. vote to leave the EU, investor expectations that the Fed will raise rates in the coming months have dropped. Many investors expect the Fed to postpone its plans to raise short-term interest rates this year.

A Look Ahead

Everything we saw this quarter is consistent with my general capital market viewpoint from last quarter: that in 2016 volatility (sometimes at panic level) will remain across the financial landscape amid diverging global growth and monetary policy expectations. Clearly, the U.K.'s departure from the EU heightens risks for an already fragile global economy, and will be a multi-year journey across uncharted waters. Investors must add the longer-term impact of Britain's vote on European economic





growth to the existing questions about global currencies and interest rates, Fed monetary policy, U.S elections, and global political instability.

As such, this is probably not the time to be heroic as an investor. Give consideration to rebalancing portfolios by trimming positions that have risen beyond sound policy targets. Just like quality energy stocks looked cheap in the first quarter, emerging markets and some international small and mid cap stocks look like the cheapest assets today. Additionally, continued desire for liquidity by some asset owners will provide private investment opportunities with favorable terms and/or potential upside. Of course these asset classes are on the riskier end of the investment landscape. While emerging and international small investments have been down for a few years, there is no guarantee that this quarter definitively marks their rebound.

As investors, it can be challenging to resist the flight instinct in the midst of negative headlines and geopolitical uncertainty, yet staying invested in a well-thought asset allocation, may provide opportunity to capture the next market upswing. In my view, active portfolio and risk management and maintaining a long-term focus, as well as exercising patience and discipline, will help you avoid the temptation to focus on short-term market movements and better position you to achieve long-term success. Continue to stay a disciplined, selective and tactical investor within your asset allocation seeking favorable long-term opportunities created by short term market turmoil.

The first half of the year has flown by and the second half of the year is now here. Let's make sure we review your portfolio together to ensure the asset allocation we have in place is still suitable for your current plans and circumstances. As always, if you have any concerns, questions, or general thoughts about your portfolio, long-term strategy or any other matter, please never hesitate to contact me. I wish you continued health and happiness as you get out and enjoy the Summer.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poor's, Reuters, Federal Reserve Board, Nasdaq.com, International Monetary Fund