Market Commentary

Second Quarter 2016

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We usually begin our market commentaries by stating what transpired in the financial markets during the past quarter. However, investors seem to only want to talk about what has transpired since the stunning June 23rd referendum in which the UK voted to leave the European Union (EU). US Equities had been modestly higher for the quarter through the day of the vote, but pulled back sharply, declining by 5.3% in the two days following the referendum before recovering strongly into the quarter end. This left the benchmark S&P 500 Index with a total return of 0.26% during the second quarter. The uncertainty following the UK vote will continue for several more weeks or even months as government and business leaders attempt to discern what this will mean for companies both inside and outside the UK. The flight to quality and away from risk pushed the yield on the benchmark 10-year US Treasury Note down to 1.49% on June 30, 2016, much lower than the 1.78% at the end of March and approaching historical lows. The decline in yields boosted fixed income returns during the quarter, leading to the best six-month return for US Treasuries since 2010.

Economic and Market Outlook

Looking at the UK vote to leave the EU, we could write several pages of what "might" happen. However, in uncertain times like this, the most prudent advice is usually to sit back and see how events develop. This is ***not*** similar to the Lehman bankruptcy with its myriad knock-on effects to global finance. It was a referendum – non-binding, we add – in which a small majority voted to leave the EU. The British Parliament has several choices in front of it. It could follow the vote by moving to exit the EU, it can choose to ignore the referendum and remain in the EU, or it could call for another vote, now that its citizens have a better understanding of what a vote to leave actually could mean. In fact, the BBC has reported that a petition calling for a second referendum on the UK leaving the EU garnered more than two million signatures in less than 72 hours. Even if Parliament decides to move ahead with leaving the EU, the process could take years. Unfortunately, this is more uncertainty, but uncertainty is far better than a certain negative event. The sharp reaction in financial markets globally is due to the fact that none of the "smart money" thought the leave vote would succeed. Emotions need to subside and allow investors to focus on fundamentals again. As an aside, we note that the number of Google searches within the UK for "What is the EU?" surged immediately after the vote, testimony to the confusion surrounding the event.

What we can say with some confidence is that the referendum vote will lead to more disinflationary pressures globally. This means interest rates in most developed nations will stay near generational-low levels for an extended period of time. Low interest rates benefit governments that run deficits. More monetary easing is likely in many countries to counter the uncertainty. The US Dollar will likely gain some additional strength versus the British Pound as well as the Euro, which puts downward pressure on commodity prices. Lastly, we think the UK vote is evidence of more global trends towards nationalism and away from politics as usual.

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We continue to share the frustration of many about the sub-par economic growth in the United States. For most of the past decade, real GDP growth has approximated 2%, below the 3% or higher rates that had been common in the decades before. This seemingly small difference of 1% or so annually has a sizable effect on employment and wage growth. The slower growth restrains businesses from investing during uncertain times, delaying capital purchases and hiring more slowly than they otherwise would do.

We still believe there will be fewer rate hikes over the next 12-18 months than most believe, and that rates will remain lower for longer. The UK vote to exit the EU has added enough uncertainty in financial markets that the Federal Reserve will likely be on hold through late 2016 at least. However, we are not as sanguine as Fed Funds futures would indicate. Currently, the futures show a greater chance of a rate cut than a rate hike through November of this year. Additionally, we have to go out to early 2018 to show a greater than 50% chance of the next rate hike.

Portfolio Positioning

Portfolios continue to see a modest movement towards more growth-oriented holdings, furthering a conscious shift we began about nine months ago. With robust growth in most companies increasingly difficult to find, we believe a premium will be paid for growth companies over the next several quarters. At times this leads us to move down the market capitalization scale to find companies that can show organic top- and bottom-line growth. These somewhat smaller companies tend to derive a greater percentage of their revenues from domestic sources and thus are not as affected by a rising US Dollar. As the economic cycle lengthens, we believe it is prudent to balance strong dividend paying stocks with some more rapidly growing companies that may or may not provide a current yield. We continue to forecast modest returns for both equities and fixed income and we expect earnings comparisons to be easier for most US companies as the year progresses.

Conclusion

As we move further into the US Presidential election season, polls on the election could have a more pronounced effect on US markets. The election, along with interest rate policy, the UK/EU divorce, and corporate earnings will be the driving factors for US stocks and bonds over the remainder of 2016. We are striving to provide decent returns during what can charitably be defined as a challenging period for most asset classes. As recently as 2000, investors could earn 7% annually merely by investing in ultra-safe 10-year Treasury notes. With the same 10-year note now yielding less than 1.5%, greater risk must be borne to earn the same 7% return. This pushes investors further out the risk spectrum towards equities. We do not see any signs of a recession in the US economy, but rather more of the same sub-par growth we have become accustomed to over the past eight years.

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