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Market Commentary

Summer 2016

Q2 Key Takeaways

U.S. markets were initially range-bound for most of the quarter until June, when the relative calm in global stock markets came to an abrupt end. Upending most forecasts and taking world financial markets by surprise, the United Kingdom voted to leave the European Union on June 23. In the wake of the vote, British pound sterling fell 11% overnight against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar, while global equities temporarily plummeted.

Then in the week following Britain's historic vote, global equities rallied, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit. When the dust had settled, developed international and European stocks remained in the red, while U.S. stocks edged into positive territory.

Before the Brexit vote, the big story in financial markets had been bonds, specifically negative yields on government bonds across the globe. By month's end, the amount of government debt sporting negative yields had soared by nearly $1 trillion. Falling yields have been driven by economic growth concerns; central banks' interest rate policies and intervention in bond markets; and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact.

The quarter's market upheaval was yet another reminder that successful investing requires patience and the understanding that investing is part of a process, not a one-off decision, toward achieving your long-term financial goals. There will be inevitable and unpredictable shorter-term market ups and downs along the way, and through these periods, it is our job to remain focused on the long-term objectives of our clients, maintaining a consistent investment discipline to guide our decisions over time.

Q2 Investment Commentary

It has been said that "markets climb a wall of worry." As we review the second quarter of 2016, it seems that that wall has grown taller and the list of worries has grown longer. True to form, the market has steadily drifted higher, perplexing investors and perpetrating doubt and distrust in the length and strength of this advance. Despite recent market gyrations, rates remain historically low and earnings in certain sectors have actually produced positive surprises. Perhaps world events have colored investors' outlook, as countries have shocked us with their political decisions (see "Brexit" Flash email), and terrorists, both foreign and domestic, have called into question the basic civility of all mankind. Throwing in an election that by any measure is as unusual as they get, and it is easy to understand why markets and economics are viewed suspiciously.

The Stock Market

While not flashy or robust, the bull market remains intact. It may be lengthy compared to historical averages, but the "over-heatedness" that accompanies the late stage of a business growth cycle is not present. Inflation is under control, industrial capacity is nowhere near its peak, and job growth has not lead to wage pressures. The rate hikes from the Fed have, if not off the table entirely, at least been pushed out.

The expectation is that earnings look to accelerate in the second half of the year. We would caution this has been a frequent expectation in recent years that did not materialize. However, as alluded to, we are seeing pockets of solid growth. The dollar, which would have strengthened on rate hikes, has stabilized. In fact, had it not been for Brexit and a flight to the dollar, the dollar likely would have weakened as rate hikes came

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off the table. A lower dollar improves profits of U.S. multi-national firms, which would help drive markets higher.

We find it perplexing that the experts in the media state the market is expensive. In fact, for years we have heard the Shiller P/E (a metric that averages out P/Es over 10 years) shows the market is overvalued. Had you followed this metric, you would have missed most of the recovering market since 2009 as it flashed a sell signal in May 2009 which turned out to be one of the best times to buy stocks in a couple decades. Jeremy Siegel, a prominent professor at University of Pennsylvania cited a study that showed this particular metric shows the market was overvalued 416 of 422 months from 1981 to 2015, which was one of the best performing bull markets in U.S. history.

The forward twelve-month price earnings ratio is just slightly above its 25-year average. Valuation is inversely correlated with interest rates, so with lower rates, there is more justification for higher multiples. The risk, of course, is that if rates trend upward, it could pressure the markets.

However, with the extreme lows in rates, many investors may continue to reallocate money from bonds and cash to the stock market, particularly dividend stocks. This flow of funds into the market has been a key factor that has driven the market higher. We expect dividend stocks to continue to be a sweet spot in the market as long as interest rates remain low, but we would also caution that the valuation of some particular sectors, such as the consumer staple stocks, look extended.

Market Volatility

Volatility has found its way back into the markets. Last December, the market sold off due to falling oil prices and the corresponding fear of a recession. After a 10%+ drop to start the year, the markets have rallied back more than most expected. In fact, the S&P bounced back nearly 15% from its February 11th low by the end of the second quarter, and even more so since last July. After very calm markets in 2013, 2014, and through August of 2015, the stock markets have had their swings. In fact, prior to the 10% correction last August, the market had not corrected in over 1,400 days, which was over four times the average duration between corrections. Another correction followed a few months later, bottoming in February, and setting the stage for a solid, if not unexpected, comeback. We feel going forward that these moves in the market will continue as global geopolitical events have tripped a sense of apprehension. This is a condition that we do not fear, but one that we acknowledge and can position to our advantage.

Bond Markets

We remain in unprecedented territory with respect to bond yields. We understand why rates in certain parts of the world are negative, but we do not understand why the central banks in those countries are employing this strategy. If 1% interest rates fail to spur economic growth, why would negative rates do any better?

With global slowdown fears in the minds of investors, as we suggested, the interest rate hikes set forth at the start of the year are likely off the table. Ten-year yields have fallen from 2.30%% at the start of the year and hit a record low of 1.36% on July 6th of this year. Unless the recovery in the second half of the year greatly exceeds expectations, we think rates will likely stay

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low. Even with the prospect for an improving economy, we think rate increases would be slow, and not materially impact the overall bond market for some time.

Summary

As you have read in many of our commentaries, we have stressed that we believe markets are efficient over time, emotions are the investors' worst enemy, and our valuation models, which we continually upgrade and refine, keep emotional over-reaction out of the equation.

This approach offsets the tone and tenor of the news cycle, the day-to-day ebbs and flows of data, and myopic short term thinking that runs contrary to long-term investment success. We will continue to use data and its analysis along with solid common sense to employ capital efficiently in striving to generate attractive returns.