Economic & Market Commentary

Most of the second quarter was a benign period for U.S. equities. Unlike the prior several months (when volatility was very high and prices were jerked around by collapsing oil prices, fears that China and the rest of Asia would drag the U.S. into a recession, and the rogue actions of North Korea), U.S. stocks traded within a narrow range, at least until mid-June. Volatility returned after the surprising June 23rd vote in Britain to leave the European Union (E.U.). Stock markets in the U.S. (and globally as well) went into a free fall, as the outcome of the plebiscite caught investors by surprise (more on this later). However, five days after the vote, the U.S. equity markets were back to pre-vote levels, and have made new highs into July. U.S. stocks ended the quarter and the first half up modestly. Small and mid-capitalization stocks did better than large in the period and for the year to date, and value continued to outpace growth. Bonds produced returns two to four times that of stocks, depending on the maturity. Oil, which had collapsed earlier in the year, rebounded close to 80%, while gold had its best quarter since 2007. The character of the U.S. equity market continued its path of the first period, with the utilities and telecommunications sectors producing the best results, followed by energy. Globally only 16% of the 78 countries monitored by The Wall Street Journal outpaced the S&P 500 (in dollar terms) for the quarter.

The British vote in June was a surprising and significant event, which deserves more expansive commentary. The European Union (E.U.) had its beginning in April 1951, when six countries signed the Treaty of Paris, creating the European Coal and Steel Community (ECSC). This was followed in 1957 by the Treaty of Rome, which broadened the mandate to form the European Economic Community. The United Kingdom (U.K.) joined the E.U. in 1973, after the post-World War II loss of imperial power, hegemony, and weak economic performance caused it to consider geopolitical alliances. To further integrate, the E.U. adopted the Maastricht Treaty proposing a common currency, and the Schengen Agreement furthering the free flow of immigration. The U.K. and others negotiated to opt out of these and several other integration proposals. The six members of the original ECSC had 177 million people, four languages, and $1.6 trillion (2014 dollars) annual output. Today the E.U. has 28 members (19 members use the common currency), 24 languages, 505 million people and a GDP of $19 trillion. It is the world's biggest single market with some 500 million consumers. The Eurozone is not a single entity politically or economically. The currency of the 19 is common, but the treasuries are national and the economies are only partially integrated. Each country seeks to limit its liability for the debt of others and to prevent interference of peers in its economic policies (i.e. they demand their sovereignty). All 19 members have veto power, and actions must be ratified by their parliaments. This arrangement is awkward at best, and leads to the conclusion that a currency union without a fiscal union is problematic. These conclusions have been evident since the beginning stages of the financial crisis 10 years ago. Prior threats to the dissolution of the E.U. were staved off (remember Grexit), however, the June 23rd vote in the U.K. to leave the E.U. (Brexit), brings the whole question back to the forefront.

The vote itself in this plebiscite was stunning. Voter turnout was extremely high at 72%, and the demographics were highly skewed, where 73% of the 18-24 year-olds voted to stay, while 60% of those over 65 voted to leave. The urban vote was largely, "stay", while the rural vote was largely "leave". One could say it was a referendum on nostalgia. This was an advisory vote, not an election, and the process for settling the referendum is long and drawn out. The process must start with action by the newly chosen Prime Minister, Theresa May. Theresa May must invoke Article 50 of the Lisbon Treaty, which starts the process of separation. The British Parliament then must approve the invocation of Article 50 for the process to continue. There are more than 600 members of Parliament and it has been reported that about 2/3 of them are in the "stay" camp, so it is unclear whether there will be approval granted. This is particularly so, as it has been reported that many of those who voted to "leave" seem to be having a serious case of "buyer's remorse". Once Article 50 is in play, the parties have two years to negotiate a plan to disengage and to figure out how Britain will relate to the E.U. going forward. This is crucial since Britain and the E.U. have close economic ties currently. As mentioned, the E.U. market is huge, and 45% of British exports go there. Similarly a large portion of Euro exports end up in Britain. The E.U. is also the second largest provider of direct foreign investment to the U.K. In view of the Brexit vote, it is clear that the E.U. members do not look kindly at the British case, and it is safe to say they will not make it easy for a British exit. They will no doubt play hardball, and since the European Union Parliament must approve a plan in the majority, they clearly have a strong hand. This process is convoluted, cumbersome, and lengthy with the potential for unintended consequences high. Article 50 stipulates a two year time frame for developing a plan, or else the splitting party is summarily thrown out of the E.U. We can, therefore, look forward to a lengthy period of news flow which will be up and down, and potentially cause the financial markets around the world to experience high levels of volatility.

The outcome of this process, of course, is impossible to predict. The best would be if the E.U. leaders agreed on a plan to keep Britain as closely attached to Europe as possible without it being a member (like Norway). The worse would be if Euro skepticism grows, others try to leave and the E.U. unravels. This would cut investment across the continent, stop spending, and create an untenable situation for European banks. The global financial complex would be deeply affected and we could have another crisis akin to eight years ago. Realistically, the outcome will probably be somewhere between these, with negotiations protracted, but not ending in crisis. In the meantime, U.K. consumers and businesses sit on their hands, slow spending and investment, while the pound remains weak. In any event, the U.K. will, at best, experience a slowdown in economic growth, and at worst even experience a recession.

According to the Economist, a decent rule of thumb is that Europe will experience a reduction in GDP growth about half that of Britain. Current guessing is that Britain will experience a 1-2% decline in growth over the next 18 months, leading to a 0.5-1.0% decline in growth for the E.U.

The impact of Brexit on the U.S. should be manageable under a middle scenario. The relevant data points of the U.K. certainly point in that direction.

- The U.K. accounts for just under 4% of world GDP
- Only 4% of U.S. exports go to the U.K. and exports are 13% of U.S. GDP
- 2.9% of S&P 500 profits come from the U.K. 5% of S&P 500 revenues come from the U.K.

If, however, we get a “worst case”, the story would be different. 45% of S&P 500 profits come from outside the U.S., and financial chaos could occur if the dominos begin to fall. Under most circumstances China and its outlook is more important to us than the Brexit shock. As we have noted in recent writings, China’s growth is slowing, but the pace is still strong enough to keep global growth moderately positive. Therefore, we see no reason to alter our long held view of the U.S. economy. We are moving along in a plodding fashion in a below trend +2% world, which will be with us for some time. Businesses are reluctant to make spending decisions, so the burden of growth remains with the consumer and housing. Interest rates now appear to be in a “lower for longer” mode for the duration, as the expectation of a Federal Reserve (Fed) rate increase has been put off at least until late this year. These factors play to the strengths we see in the U.S. economy, so we have no reason to change our view of the path of the U.S. or global economic growth at this time.

World financial markets reacted to the Brexit vote with a large hiccup as would be expected. Since then, markets have recovered and are making new highs. In the U.S., both stocks and bonds are up, and at this writing are at record highs. All of this at a point in time when risks, as we see them, are at elevated levels. Uncertainty abounds, and we know markets don’t like uncertainty. In a 2% U.S. growth environment, and a stumbling global environment bonds are at all time high (the 10 year U.S.Treasury is yielding 1.4%) and U.S. stocks are trading at 18 times 2017 earnings. From these levels it is hard to see significant money making opportunities in either asset class. A premium is being paid for safety and certainty. Money is flooding into U.S. Treasury securities from around the globe, and utility, telecom, and consumer staple stocks are selling above their long-term valuations. These areas are perceived to offer less economic sensitivity with greater certainty and safety. Add to this the phenomenon of massive flows towards passive management – index funds and ETF’s - to the point where Vanguard and Blackrock become the “market”, and you have a strong rationale why large cap “safe” stocks have been outperformers. Basically cash is flowing into the same handful of issues regardless of economic characteristics or valuation.

From an economic point of view, corporate earnings growth has been meager the past few years, and the outlook is for more of the same going forward. Revenue growth is slow and tough to come by, while profit margins are at all-time highs. The case that returns to capital have peaked is easy to make. Stocks trading at 18 times current 2017 estimated earnings (when 15X has been the historic norm), are not exactly “cheap”, based on most measures of value. About the only data point that yields a “cheap” verdict is interest rates. Yet to say stocks are cheap relative to a greatly overvalued asset class is hardly comforting. The predictive power of the yield curve has been undermined by the unprecedented influence of unconventional global central bank policies. (Some 35% of global sovereign debt is at negative rates.) Under normal circumstances interest rates are low only when monetary policy is stimulative due to an underperforming economy, while stocks are highly valued when the economic outlook is robust. Which is to say that stocks and bonds today appear to be giving contradictory signals. Yet, the current interest rates situation is being strongly impacted by world-wide monetary policies that are extreme, flooding the world with liquidity that seeks “safe” assets. It is hard to know the weighting of each

causality, but clearly they are both present. When you throw in the increased frequency of global terrorism, the increased instability in the Mid-East, the most rancorous U.S. Presidential election in our memory, this says to us that risks are higher than they were 6-12 months ago, yet prices of most assets are higher as well. As we have often written, we look for businesses that have or will have above average profitability metrics, but where stocks are valued at levels below what we think is fair. At today's prices, these situations are more difficult to find, yet with our expectation of increased volatility going forward, we believe attractive investment opportunities will occur. Valuation is a key component of our investment process and we will use it to allocate our clients' capital to the stocks that we believe should produce the most attractive risk-adjusted returns.

Fixed Income Review and Outlook

By most measures bonds had a good quarter, easily outperforming most equity indices, although they did so with a high degree of volatility. Bond prices were initially driven by changes in the consensus view about whether and when the Fed would raise interest rates during the course of the year. The initial thinking was perhaps a June increase. The dismal May jobs report poured cold water on that thought, driving down bond yields. Finally, the U.K. vote to leave the European Union (Brexit) stunned investors, driving yields even lower as investors sought the safety of U.S. Treasury bonds. This caused Treasury yields to fall to levels lower than those reached during the 2008 financial crisis, as the 30-year Treasury bond yield fell to just 2.26% on June 27th, before plummeting to a multi-decade low of 2.09% on July 8th.

Our steadfast view this year has been that the Fed would not raise rates in June for two reasons. First, although the economy was moving in the right direction, it hardly showed signs of robust growth, and was far from meeting the Fed's expectations. The second was simply a matter of timing. We believed the Fed would not make any drastic moves before the U.K. vote. It made far more sense for the Fed to wait at least until their July meeting to take any action.

After Treasury bond yields fell sharply immediately following the June 23rd vote, yields began to rise (bond prices fell) two weeks later as investors' fear about the impact on European economic growth subsided and a new, well-regarded leader (Theresa May) for the U.K. was chosen in rapid fashion. Despite this small upward movement, Treasury bond yields have fallen this year to extraordinarily low levels. As was mentioned earlier, this typically indicates that bond investors believe there is an economic recession on the horizon for the U.S. and potentially globally. At the same time, the U.S. stock market has reached record highs after recovering losses sustained in the first few days immediately after the British vote. This is seemingly a paradox.

We believe that in this case the record low Treasury yields are heavily influenced by the extraordinary global monetary policies, which have injected excess liquidity and driven global investors to the higher yields and safety of Treasurys. With close to 35% of global government bonds offering negative returns, even the meager interest rates paid on U.S. Treasurys are better than paying someone just to hold your money. The demand for certainty and safety of Treasury

bonds was amplified in the wake of the uncertainty caused by the U.K.'s decision to leave the E.U. For these reasons, we believe the record low yields for Treasurys are primarily the result of insatiable demand for relatively higher yields and safety offered by them, rather than a strong signal that the U.S. economy is headed into a recession.

The Treasury yield curve continued to flatten this quarter which means the extra yield investors can earn from buying longer maturity bonds diminished. For example, the 30-year Treasury only yielded 0.80% more than the 10-year Treasury on June 30th, compared to 0.85% on March 31st, while the difference between the 10-year and 2-year Treasury yields also fell from 1.05% to 0.89% during this quarter. We continue to focus on buying short-to-intermediate maturity bonds, while trying to spread out bond maturities, so we have cash becoming available at regular intervals to take advantage of buying opportunities. For example, the yield spread in the financial sector temporarily widened 20-30 bps this quarter, due to the aforementioned political events and created a buying opportunity, even as overall corporate bond spreads tightened (fell).

We also would like to highlight that the strong performance and high demand for municipal securities this year, due to their perceived safety and tax-advantaged status, has resulted in lower yields relative to other fixed income securities. We analyzed the after-tax returns of corporate bonds compared to municipal bonds and found that corporate bonds currently offer an extra 40-60 basis points of annual return compared to equivalently-rated municipal bonds on average and an even greater yield pickup in certain sectors. For this reason, we are purchasing taxable bonds in accounts that traditionally only held municipal bonds, while continuing to evaluate returns to see which sector offers a superior after-tax return. In addition to the greater yield earned, we believe that clients' taxable portfolios can benefit from the added portfolio diversification obtained by owning both municipal and corporate securities.

Our fixed income portfolio strategy has remained consistent this year through the unusually volatile fixed income market sentiment surrounding whether the Fed would raise rates first ahead of its March meeting and then again ahead of the June meeting. Our view throughout this year has been the Fed would not raise rates in March or June and that any potential rate hikes in 2016 would come towards the end of the year, if at all. Meanwhile, bond market prices and yields have whipsawed, based on whether or not the consensus view of the month happened to be forecasting a rate hike. We have invested with the mindset that rates will be lower for longer than the market expected and used the elevated bond market volatility to take advantage of temporary drops in bond prices. In addition, we have taken the opportunity to sell some Treasury bond positions and reinvest the proceeds into higher-yielding, high quality credit securities. We think it is important to avoid investing primarily based upon on the short-term swings in market expectations for Fed rate policy. Instead, our aim is to use the unusual bond market volatility to opportunistically make purchases for client portfolios, while maintaining a base of core fixed income positions.