Market View

July 2016

Challenged by weak economic growth and political uncertainties, global equity markets generally produced modest gains or lost ground in the first half of 2016. Longer term interest rates continued to decline. Britain's referendum in favor of leaving the European Union surprised the financial markets. Investors must remain disciplined during this period of economic uncertainty and difficult markets.

Financial Markets

US equity markets experienced continued volatility during the second quarter of 2016 as investors exhibited concerns about weak global economic growth and Britain's decision to leave the European Union. At mid-year the Standard & Poor's 500 Index had produced a lackluster total return of +3.8% while the higher quality Dow Jones 30 Industrial Averages returned +4.3%. Many other stock indices produced returns close to zero during the six-month period. The EAFE Index, a measure of non-US developed economy stock markets, was a notable exception with a decline of –3.0%.

Interest rates on longer-term US government bonds continued to decline during the quarter. The yield on the 10-Year US Treasury Note ended the quarter at 1.47%. At the start of the year the 10-Year Note yielded 2.27%. US interest rates are attractive compared to the very low, and even negative, yields on government bonds of many other developed countries.

Economic Growth

By most measures the US economy has continued its slow and uneven expansion. The first quarter's growth rate is now estimated to have been +1.1%. The US economy has grown at an annual rate of about +2.1% since the 2008-2009 credit crisis. In recent years many slow-growth first quarters have been followed by somewhat stronger periods. US employment and housing trends have continued positive while industrial production-related statistics have continued weak.

Market Indicators 6/30/2016

	Total Return	
US Stock Markets	**12 Mos**	**Year-to-Date**
S&P 500 Index	4.0%	3.8%
S&P 400 Mid Cap	1.3%	7.9%
Russell 2000 Small Cap	-6.7%	2.2%
International Stock Markets	*ETF Returns in US$*	
EAFE Index *(Europe, Australasia, Far East)*	-9.5%	-3.0%
Japan *(MSCI Index)*	-8.9%	-4.4%
China *(Xinhua 25)*	-23.6%	-2.3%
Emerging Mkts Index	-11.2%	7.6%
US Fixed Income Yields	**12/31/15**	**6/30/16**
6 Mo US T-Bill	0.48%	0.35%
2 Yr US T-Note	1.05%	0.58%
10 Yr US T-Note	2.27%	1.47%

Brexit

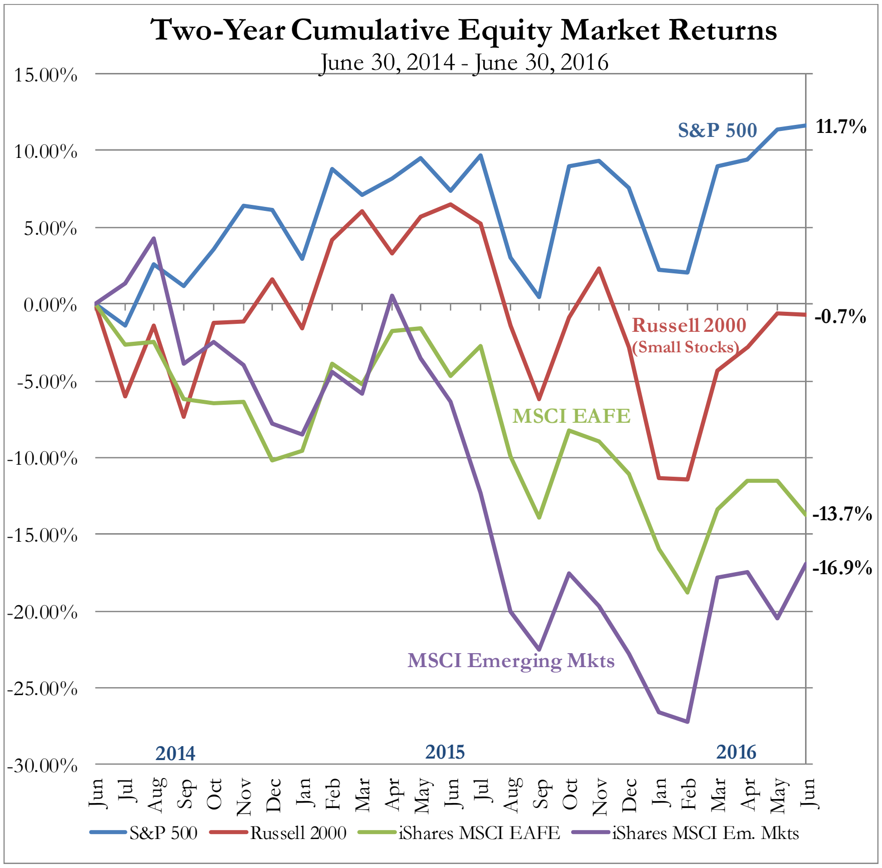
In a June 23rd referendum British voters decided to leave the European Union (EU), a political-economic union of 28 countries which formed a single market and assured the free movement of people, goods, services and capital. Those in favor of leaving the EU generally argued that independence would allow Britain to once again control their own immigration policies and business-related regulations.

The vote to leave the EU caught political pundits and the financial markets by surprise. There are many unanswered questions about the impact both inside and outside the UK but the change is generally assumed to be a drag on economic growth.

In the United States some are drawing a parallel between Britain's surprise vote to leave the EU and the possible election of Donald Trump. Trump has voiced concern about US immigrants in much the same way as the pro-leave camp's concern about UK immigrants. While not a new US political theme, calling for a radical change in Washington has certain similarities to Britain's desire to cut their relationship with the bureaucracy of the European Union.

Low Returns Everywhere

In the last twenty-four months the Standard & Poor's 500 stock index has returned only +11.7%, an annual return of +5.7%. As illustrated in the accompanied graph, riskier and international asset categories have done worse. Careful equity investors who focus on selecting well positioned companies have produced better, but still unspectacular, returns over the last two years. Investors who have ignored risk or who have attempted to time the markets have potentially exposed their portfolios to meaningful losses. Given the current slow US economic growth and an increasing list of global economic and political uncertainties it is difficult to see an immediate change in the current pattern of low returns for equity investors.



The fixed income markets also appear to offer little in the way of prospective returns. Interest rates in the US are very low. Many government bonds in Belgium, France, Germany, Japan, the Netherlands, Sweden and Switzerland trade with negative yields. The Wall Street Journal recently reported that more than $11.7 trillion worth of international government bonds trade with negative yields.

How should investors react to a period of low returns? While esoteric and non-liquid asset categories may sound like enticing alternatives, such investments frequently entail complex and hidden risks. Long-term investors should stay focused on their core strategy. US interest rates will eventually rise and offer investors an opportunity to achieve adequate fixed income returns. In the meantime, minimizing the risk of loss suggests maintaining a relatively short maturity fixed income portfolio.

Low, or even negative, periods of equity returns are not uncommon throughout financial history. Trying to time markets is problematic at best and can produce major losses. The equities of well-run businesses with sustainable competitive advantages have historically produced attractive long-term returns while also offering liquidity and the comfort of owning very successful businesses. Investors should always consider upcoming cash needs and plan well in advance.

Conclusion

We believe investors should stay the course with a primary equity focus on well positioned domestic companies with strong financial characteristics. Fixed income investors need to accept paltry interest rates in exchange for safety. The current period of low financial returns will not last forever. History suggests the markets will suddenly improve when most investors least expect it.

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