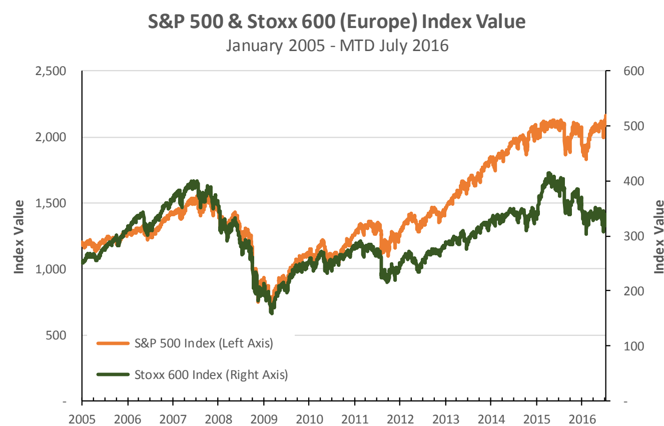
# Market and Economic Commentary
## July 27, 2016

The S&P 500 stock index reached a record high of 2,176 on July 20th on favorable U.S. economic and corporate earnings data. Investors also shrugged off the initial shock of the Brexit vote to reach these new highs and increased their assessment that the Fed would raise rates at least one more time in 2016.

With several positive "encores" available for the U.S. economy and capital markets (higher oil prices, exports to a recovering European economy, higher exports driven by the eventual rebalancing of the U.S. dollar vs. other currencies, increasing real wages), it seems we are enjoying a moment of economic bliss. *Over the next few quarters, as the U.S. economic expansion progresses, we believe there will continue to be surprises that will provide buying opportunities as well as peaks to exit markets with capital gains. More conservative investors should consider tactically adjusting their portfolios to take a more conservative stance and to lock in profits.*

As the U.S. moves through this phase of the economic cycle, we need to be alert for signs of a slowing economy or financial strain. Most importantly, we need to monitor the global interest rate bubble. Since the financial crisis, the support provided by central banks has kept interest rates at historic lows. As we go to press, over $12 trillion of government bonds trade at negative yields. When investors buy bonds with negative yields, they are guaranteed to lose money if the bonds are held to maturity. When interest rates eventually rise, the owners of fixed coupon bonds will sustain potentially large losses. If this unwinding occurs quickly enough, it may be the catalyst for the next financial meltdown or economic downturn. We will address this topic in a later issue. For now, let's enjoy the bliss.




*Source: Bloomberg as of 7/20/2016*

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## Brexit

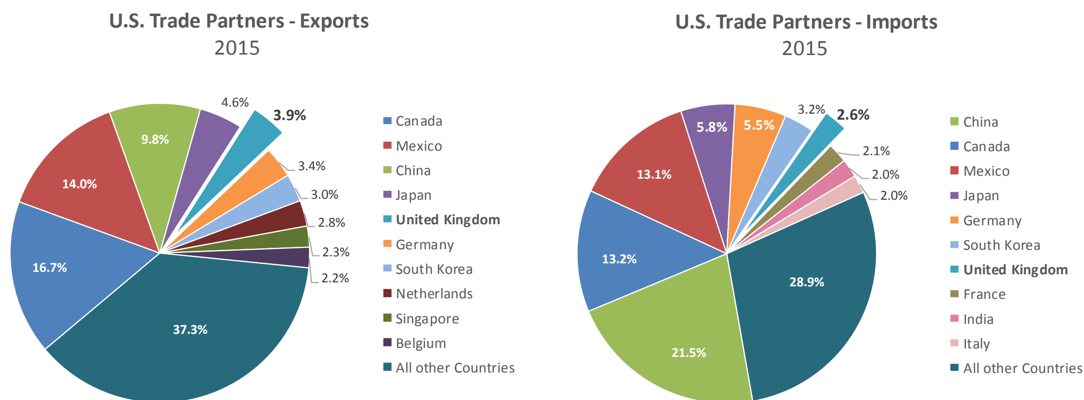
At the end of June, Britain held a referendum in which a narrow majority voted for Britain to exit (hence Br-exit) the European Union. Britain's decision to leave the EU trade bloc was driven by factors that were more political and xenophobic than economic. Exactly what form the separation from the EU will take is uncertain.

The task before Britain's new Prime Minister, Theresa May, is to respect the voters' wish to Brexit, while engineering agreements on trade and immigration that will blunt the economic impact and loss of opportunity for younger generations. What is certain is the process will be a complicated multi-year endeavor.

While we expect Brexit to be a non-event for the U.S. economy over the short-term, the longer-term risk is to the stability of the EU as other countries now weigh their options. Despite the potential disruption of Brexit, we believe that we will continue to see moderate economic expansion across Europe.

The economic relationship between the U.K. and the U.S. is a strong one. In recent years, the U.K.'s economic growth has been stronger than that of the Eurozone but going forward the U.K. economy will be challenged to sustain its previous level of growth. We believe any slowing of trade between the U.K. and EU may lead to a tighter connection to the U.S. economy. One effect of the Brexit vote was to weaken the Pound, thus making UK exports cheaper globally. Greater exports will offset a portion of any reduced trade with the EU.

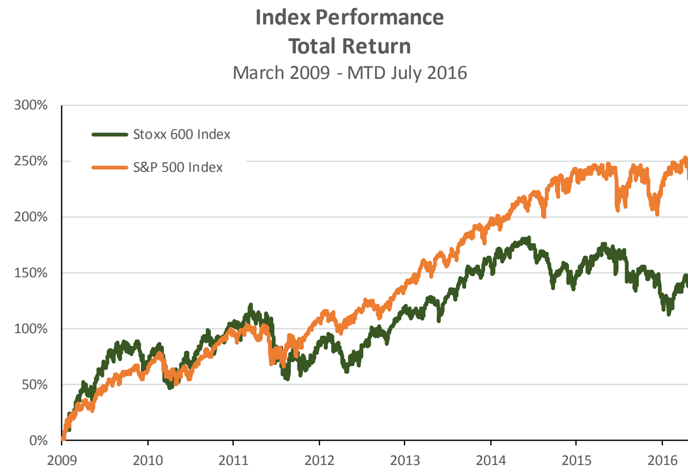
As the charts below indicate, the U.K.'s contribution to U.S. exports was relatively minor at 3.9% of the total in 2015.




*Source: Bloomberg as of 6/14/2016*

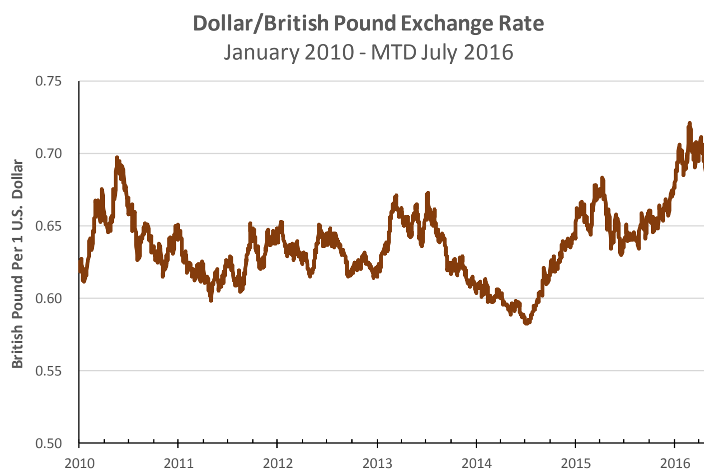
## International - Europe

Since 2012, the European stock markets (as measured by the Stoxx 600 index) have underperformed U.S. equities. Since March 2009, the S&P 500 has outperformed the Stoxx 600 by 113%. Although there will continue to be many sources of uncertainty across Europe, we believe this presents an opportunity for investors as European economies continue to expand as a whole.




*Source: Bloomberg as of 7/27/2016*

For U.S. investors, the eventual rebalancing of the dollar vs. European currencies will provide another source of investment return. As the dollar weakens, the value of European assets will rise in dollar terms.




*Source: Bloomberg as of 7/20/2016*

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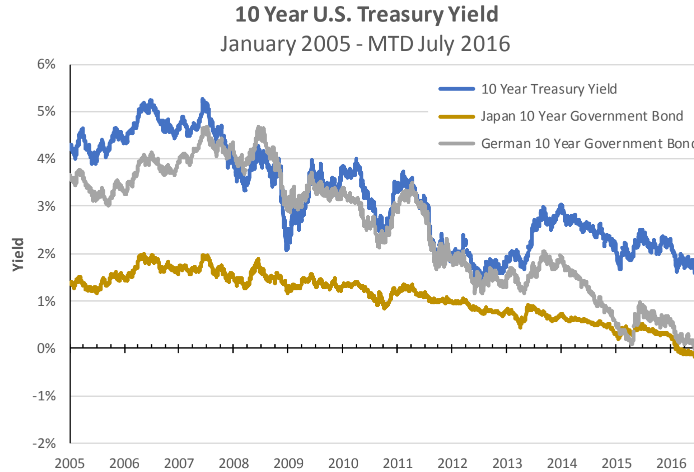
## Global Interest Rate Bubble

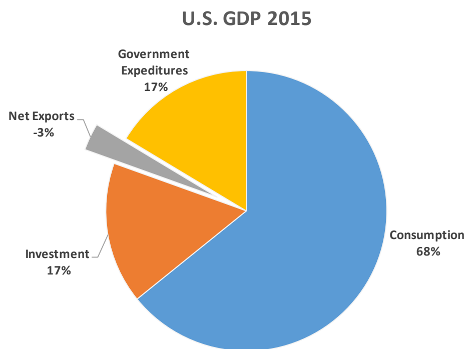
Low interest rates persist across the globe while relatively higher risk-free yields can be found in U.S. treasuries. As global investors seek higher returns they have increasingly purchased U.S. treasuries, thus, driving U.S. treasury yields to record lows. Nevertheless, U.S. treasuries continue to yield the highest risk-free rate worldwide.



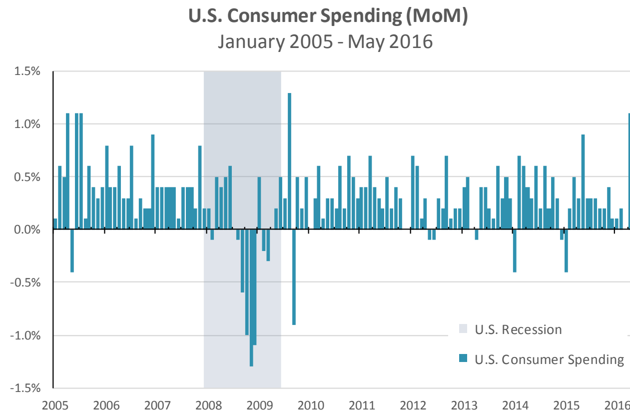

*Source: Bloomberg as of 7/27/2016*

## U.S. Economic Stability

Consumer spending accounts for about two-thirds of U.S. economic growth. In the 2nd quarter of 2016, we have seen U.S. consumer spending rebound from the 1st quarter of 2016. Currently, the strength of the labor market is serving as the primary driver for U.S. consumption. It is our belief that U.S. consumption will be able to sustain GDP growth through the end of 2016.

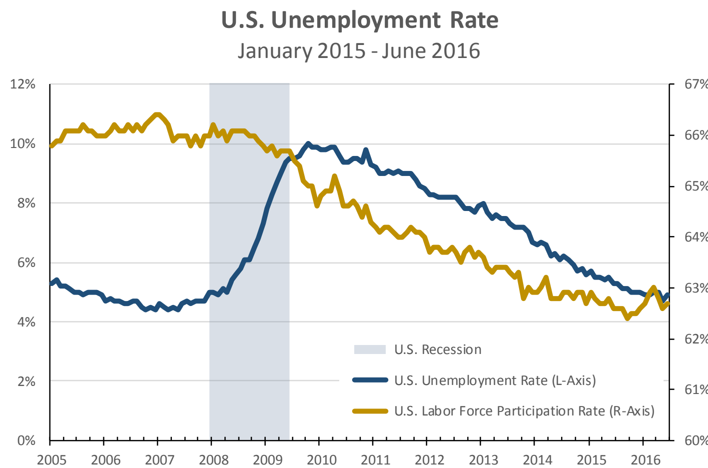



*Source: U.S. Bureau of Economic Analysis*




*Source: Bloomberg as of 7/7/2016*

As long as job creation continues to drive the unemployment rate lower or wages higher, we expect to see continued U.S. economic expansion. We believe that when the labor market reaches "full" employment (between 4.75% - 5.25%) the job market gives employees greater confidence to bargain for higher wages. At full employment, employers will be forced to compete over smaller pools of available workers which will place pressure on U.S. wages and drive wage growth upward, which will, in turn, drive consumer spending. We expect firmer household earnings to provide consumers with more disposable income that will support a faster pace of U.S. consumption through year's end. Increased consumption will then drive domestic economic activity and thereby provide insulation for the U.S. economy from sluggish global growth.



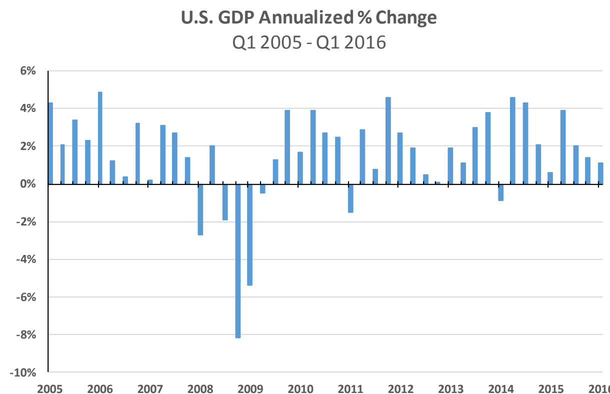

*Source: Bloomberg as of 7/7/2016*

*Currently the unemployment rate is 4.9%, which represents an increase from 4.7% in May. The increase is largely due to an increase in the labor force participation rate.*

## U.S. Economy

The current U.S. economic expansion is now one of the longest periods of expansion that the U.S. has experienced. Signs of a stronger U.S. economy such as labor market data, GDP growth, higher oil prices and an acceleration in consumer spending all support expectations of continued growth.

The first quarter slowdown in GDP was less pronounced than initially thought. U.S. GDP growth during Q1 2016 was revised upward from an annualized rate of 0.8% to 1.1%. We believe that the U.S. economy still has room to grow; growth which will be driven primarily by U.S. consumption.




*Source: Bloomberg as of 7/7/2016*

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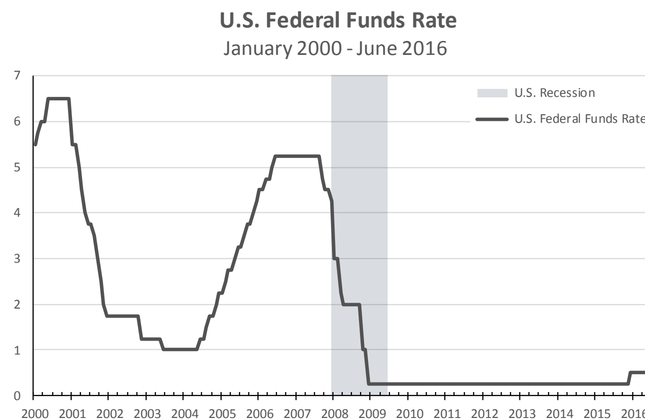
**Fed Watch**

The U.S. Federal Reserve is set to have its July Federal Open Market Committee (FOMC) meeting later this week to decide on another federal funds rate increase. Due to uncertainty surrounding Brexit, it is highly unlikely the Fed will vote to raise the rate at this point in time.

Although the Fed views the potential impact of Brexit on the U.S. to be relatively modest, we anticipate the governors will employ a "wait and see" stance. The Fed is also waiting to see signs of sustained inflation before implementing a rate increase. The PCE, the Fed's preferred inflation index, has yet to hit the target rate of 2.0%. It is our belief that we will not see another federal funds rate increase until the outlook on the global economy is more positive or until the U.S. economy demonstrates clear signs of robust growth.

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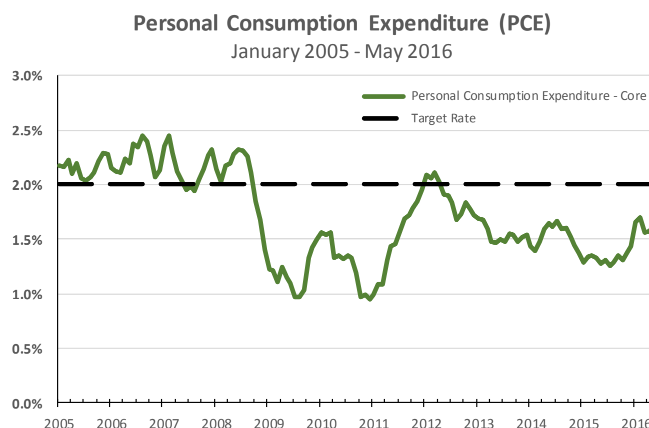


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