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2ND QUARTER 2016

Market Commentary

The average income of all the inhabitants of the world increased between seven and eight times from 1820 to 1992. At the same time, the fraction of the world's population in extreme poverty fell from 84 to 24 percent.
- Angus Deaton
Winner of 2015 Nobel Prize in Economics

Past performance does not necessarily predict future results
- US Securities and Exchange Commission

Global equity markets posted mixed results after a turbulent second quarter that first saw markets continuing the rally off the February lows, followed by Brexit-driven volatility in June. The US market gained 2.5%, bringing the year-to-date total to 3.8%. Emerging markets delivered modest gains and remained the top performing geographic sector, up 6.4% for the year. Europe declined -2.7%, adding to the first quarter losses. Japan, negative during the first quarter, experienced small gains during the second quarter. Value and high dividend stocks performed well while growth stocks, last year's winners, continued to lag. The recovery in MLPs continued as the second quarter earnings season passed with no significant negative surprises and modestly positive distribution announcements. The termination of the merger agreement between Energy Transfer Equity and Williams Company at the end of June added further clarity to the outlook for the sector.

The expectation for second quarter S&P 500 earnings per share currently stands at $24.77, a slight decline from first quarter earnings of $24.98. Since profit margins peaked in 2014, earnings have declined by 4.2%. Only rising P/E ratios kept the index return positive for the past eighteen months. This decline reflects the impact of the global economic slowdown that began nearly two years ago. The slowdown was concentrated in the manufacturing sector, where growth has hovered near zero for the past year. As the center of manufacturing activity now lies in Asia, particularly China, the direct impact on the US was muted.

China and the other emerging markets continue to show signs of economic recovery. The rally in equity prices excluded China and India and instead was concentrated in Brazil, Russia and other countries that had suffered the worst currency and market declines in 2014 and 2015. Growth strategies concentrating on emerging market consumers generally underperformed while value strategies did well. Typically the segments of the market most punished in the downturn perform best during the early stages of the recovery. For example, the financial stocks that suffered the worst losses in 2008 led the recovery in 2009. As the recovery progresses, higher quality names that avoided the worst losses tend to resume market leadership.

Despite the modest rally this year, **valuations of Emerging Market stocks remain below where they were of the bottom of the market in 2008** and comparable to the lows of the early 2000s. However, these countries today are much richer than they were 15 years ago, with economies that support a much broader range of domestic industries. Emerging Market economies, particularly China and India, contributed nearly half of the world's economic growth over the past twelve months. Corporate governance and rule of law, while still below Western standards, continues to improve. Emerging markets remain a higher risk investment, but valuations relative to developed markets now more than adequately handicap this risk.

The victory of Leave in the Brexit referendum roiled financial markets. Aside from the vote adding further uncertainty to the future of the European Union, it is not clear what economic impact the vote will have. While the initial reaction of Germany and other Eurozone members appeared to reject any trade compromises, in reality the Eurozone exports far more to the UK than it imports. Germany's net trade surplus with the United Kingdom alone comprises nearly 1.4% of the country's GDP. Emigration from the Eurozone into the UK, a contentious issue in the Brexit debates, provided a much needed safety valve for stagnant Continental economies as Britain offered the most vibrant job market in Europe. While British GDP has more than recovered from the declines caused by the 2008 Financial Crisis, the Eurozone economy remains well below its 2007 peak. The UK's large trade deficit with the European Union directly resulted from the country's attractiveness to foreign capital flows, as the balancing entry for a trade deficit is a capital surplus. In the immediate aftermath of Brexit, a portion of this capital found a new home in the US, further expanding US trade deficits and dollar appreciation.

As economic growth slows, a significant threat to the expansion now comes from the lack of income growth for middle and lower classes in the US and Europe. The rise of Asia as a global manufacturing center to some extent came at the expense of workers in the developed world. While globalization increased the overall level of wealth in the developed world and led to dramatic declines in poverty rates in the developing world, workers in developed countries now face direct competition from those in emerging countries. The newer high tech businesses being created in the West offer few opportunities to those without advanced educations. Furthermore, as economic historian Robert J. Gordon notes in his recent book, *The Rise and Fall of American Growth,* advances in the standard of living in the West since 1970 have been primarily concentrated in information processing, entertainment and communications. The rate of advancement in housing, transportation, food and healthcare slowed dramatically after a period of sustained growth during the period of approximately 1870-1970. Asian economies, such as Japan and South Korea, that compressed this century of growth into a few decades, now face similar issues related to slow economic growth. While rapid progress continues to be made in many fields, two-thirds of US consumption is spent on services so far resistant to technological disruption such as rent, healthcare, education and personal care. Politicians so far have been unable to create adequate policy responses to alleviate the decline of traditional blue collar career opportunities in the US and Europe. This has led to disillusionment with political elites and support for both right and left wing populism. The risk is that legitimate voter dissatisfaction leads to counterproductive economic policies that only exacerbate the current growth and distribution problems. The Brexit vote serves as a wakeup call that investors have become perhaps too complacent in discounting political risks in the developed world.

Whether the Brexit vote becomes looked back upon as the first step in the breakup of existing global economic order or merely a blip in the long slog back from the 2008 Financial Crisis, **investors need to remain mindful of their strategic allocation and long term goals.** Reacting to headline events usually destroys value. However, with elevated valuations in US stocks and bonds and the emergence of political risk factors, a focus on defense makes sense. Maintaining a tilt toward high quality assets and an adequate reserve of liquidity remains the best strategy. Alternative investments, particularly managed futures, have added value through this volatility.

- Stephen C. Browne, CFA
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