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Market Review & Update

SUMMER 2016

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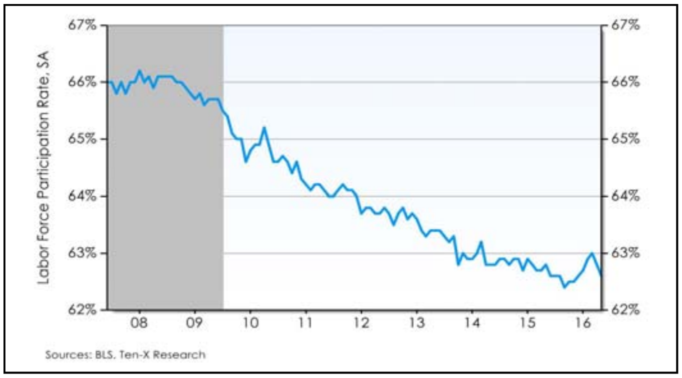
Fireworks indeed…Normally, we'd begin with something significantly American, like the latest jobs report, but now we're forced to place in the forefront that now-infamous day in June, when the United Kingdom became an oxymoron by narrowly voting to separate itself from the EU. The Brexit vote reinvigorated the hyperbole machine, roiling the markets and causing what can only be described as a rather embarrassing backlash. An online petition to reverse the vote has hundreds of thousands of signatures, little surprise when you consider the most frequent search in the UK after the vote was "what is EU"? Aside from the resemblance to the political environment in that upstart rogue nation that broke from the UK a few hundred years ago, what material impacts should we expect going forward? Clearly the fundamental metrics to keep an eye on going forward will be exchange rates of the major currencies, as they do have an impact on earnings and, therefore, GDP. In the near term, after a major uncertainty selloff, equity markets in the US and UK rebounded sharply, with the UK now leading all foreign equity exchanges. Uncertainty is disliked by the markets, but don't be at all surprised if at some point in the future, UK becomes an even more capital-friendly zone, free from Euro bureaucracy and regulation. More to come on this front. It was Milton Friedman who early on predicted that the Euro zone could not last, we'll see. For now, let us be guided by the words of Arthur, King of the Britain's "on second thought, let's not go to Camelot, it's a silly place…" This year, Independence Day carries so much more significance and prescience.

Back to the homeland. The uncertainty inherent in the Brexit dialogue has established a new low for interest rates abroad, thereby sending the US Treasury to an all-time low yield. This will further aid what we have repeatedly recognized as a very robust US consumer, manifesting the strongest consumption numbers in six years. How did we reward that?? With the worst job creation numbers

Labor Participation Rate

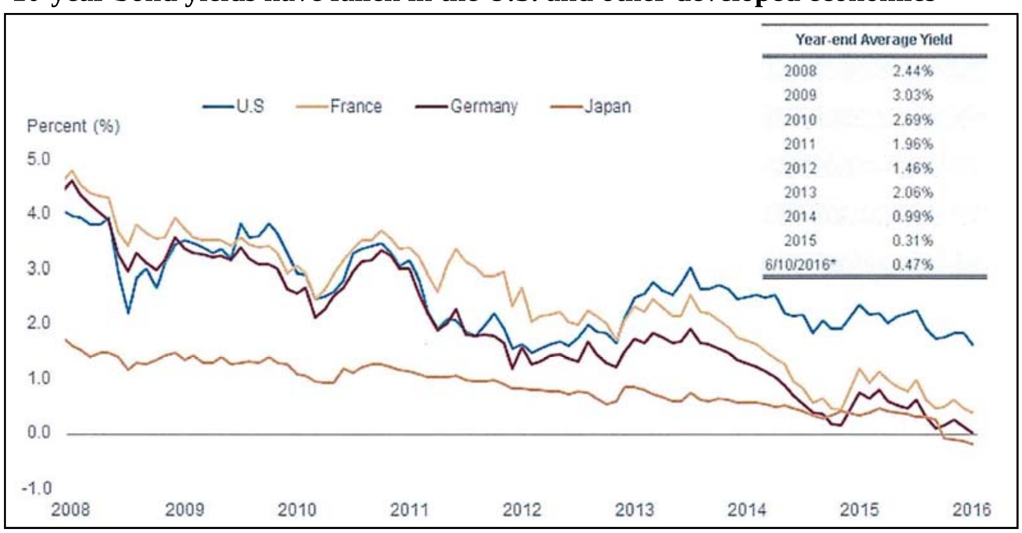


in a really long time. A paltry 38,000 jobs were created! That's so terrible that we must assume there will be an error factor in the counting. Jokes from the media included hiring UPS or Amazon to track jobs as they can locate millions of packages worldwide within a meter… Ok, even if the count is off, the number it gets corrected to will be equally flaccid. But, wait for the even bigger surprise, the reported unemployment number declined from over 5% to 4.7%. Yes, I said DECLINED…Magic!!! So how does one manufacture a huge drop in unemployment with meager job output? If you look at footnote 78 in the jobs report you'll see an entry in very small print that over 500,000 Americans simply decided to no longer participate in the labor force. The labor participation rate headed to new low territory.

So, a silly jobs report coupled with a silly Brexit vote will get us what? It's been the pattern of the branches of government to cooperate as little as possible, only to exacerbate in the final year of an administration, so not much to expect there. This once again places the problem on the doorstep of the Fed. You'll recall from the Spring writing that we are now operating under the Greater Gradualism umbrella. Weak jobs creation coupled with Brexit uncertainty and you can easily predict that gradualism, in what was already the slowest post-war recovery, will become even greater. It is now highly unlikely that we will see any Fed action for the remainder of '16. Prior to all this we were looking forward to the next four quarters. Recall that 2015 suffered from earnings impacted by a 50% decline in oil and a strong rise in the dollar. The next few quarters see an 80% increase in oil in the rear view mirror, and a potential for better foreign currency translations. We'll have to keep watch to see how current events will weigh on those trends. The US momentum of better housing sales, record auto deliveries and spirited consumer spend will likely persist. Many noteworthy sources, such as the Economist, concur that if greater growth is desired here and abroad there will need to be stimulus in the form of more supportive tax structure and reduced regulatory burden. Central bankers are achieving what they can.

Market strategists now point to many indicators to form their improving outlooks. Relative valuation has become obvious in an environment of the most expensive bonds in the history of mankind. The Swiss 50 year bond now trades at a negative yield, think of it as a 50 year tax on safety… In this interest rate environment stocks win the relative attractiveness argument. Institutional portfolio managers had a record level of cash built up in their portfolios, money we know will be put to work. Continued low levels of inflation and interest rates make most algorithms agree that the equity markets are not over-priced. All this makes volatility likely to remain as our travelling companion as this recovery, which began in '09, moves forward. Forward is good. Enjoy the summer!

10-year bond yields have fallen in the U.S. and other developed economies



Source: Bloomberg

We'll talk to you soon…