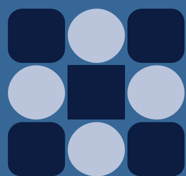

Quarterly Commentary

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Second Quarter 2016

Global market reaction to the "Brexit" vote on June 23 was dramatic, sending equities down and bond prices up. While some equity indices recovered much of the lost ground by quarter end, the significant decline in bond yields has held steady, leading the Barclays Aggregate Index to a gain of 2.2% for the quarter. Bond yields appear to be anticipating the possibility of further declines in growth and a long period of heightened uncertainty.

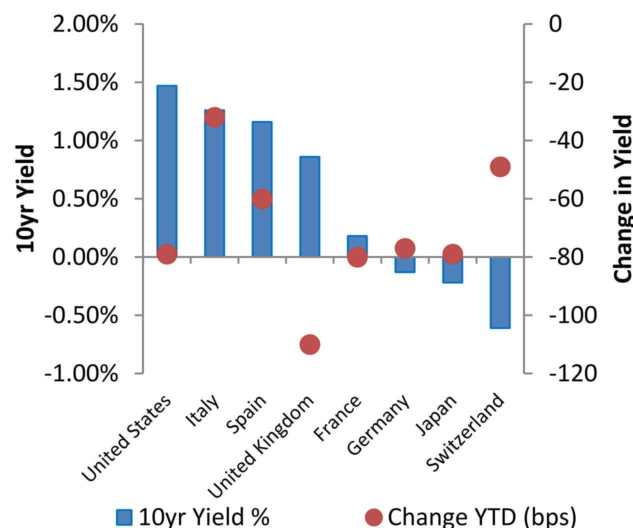
Impact of U.K.'s decision will be far-reaching

It is fair to say the U.K.'s momentous vote to leave the European Union stunned world markets. While the full ramifications will not be known for some time due to the unprecedented and complex set of issues needing to be resolved, there will certainly be many significant changes to the economic, political, and social fabric of Europe. Indeed, the very survival of the EU and its currency may now be at stake (after being tested repeatedly by the Greek crises) and the enormity of the challenges ahead will sorely test the area's leaders. Much has already been written about the process which lies ahead as well as the potential implications, but the immediate implication for US investors is still-lower yields for longer, a theme we have mentioned once or twice before!

US economic fundamentals remain solid if unspectacular

Although first quarter GDP growth was quite low (coming in at a now-revised 1.1%), much of the data on consumer spending has been solid and we expect second quarter growth to rebound nicely as consumers continue to benefit from low energy prices. In the years since the Financial Crisis, consumers have reduced their reliance on debt-financed consumption and relied instead on income-based spending. While income gains have remained low, they have nevertheless been steady and resilient, due largely to the favorable job gains experienced in the last few years. As seen in the May employment report, these job gains have started to fade a bit now that the unemployment rate is below 5% and companies are perhaps having more difficulty finding qualified workers. In short, we do not expect the job market to collapse nor do we expect monthly payroll gains of 200K+ indefinitely, but the backdrop for the consumer remains supportive.

Exhibit 1: Select developed nation 10-yr interest rates as of June 30, 2016



Source: Bloomberg

One key area of weakness in the economy has been the manufacturing sector and even here, recent data indicate some improvement of late. However, a major obstacle to more robust growth continues to be lackluster capital spending by businesses which may be part of a negative feedback loop whereby low growth begets low confidence which begets low investment spending. This weakness is not just a domestic phenomenon: China's slowing growth is a result of its determination to move away from heavy investment spending toward a more balanced consumer-driven model.

In order for US growth to move much above the 2% pace of the last several years, consumer spending must be matched by solid gains in both business and

government spending along with higher exports, a prospect which remains unlikely to develop in the near term now that heightened uncertainty is emanating from Europe and the strong dollar is again hindering exports.

In any event, this focus on economic growth is somewhat moot in light of the enormity of geopolitical issues now taking center stage. There has essentially been a decoupling of economic fundamentals and interest rates, and the Fed remains hostage to these and other considerations and therefore is expected to remain on the sidelines for the rest of the year. Last fall, before the Fed had raised rates, this was referred to as "one and done."

A few last words

Since the Financial Crisis, we have commented numerous times about being in uncharted territory. Now that the Brexit vote has been cast, we are once again finding that markets are being tested as never before due to unprecedented political and economic developments, even while unconventional monetary policies remain in effect. When markets approach extremes in valuation, big moves become more likely and this seems to be what is now unfolding. Our approach during such times is to exercise caution and keep risk in check since low yields means low reward for taking risk (assuming spreads are unchanged) and that is the current situation.

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