Quarterly Economic Update 2Q 2016

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The quarter in brief. Weaker U.S. GDP, softer employment data, and the U.K.'s referendum ("Brexit") to leave the European Union was not enough to keep most asset classes from posting positive returns in Q2.

Economic news. The Bureau of Economic Analysis reported its third estimate of Q1 GDP of +1.10 percent, higher than the prior estimate (.80 percent), but lower than the +1.40 percent reading of Q4 2015. The market seemed indifferent to the number as analysts believed that Q2 would be much better. Unfortunately, advanced estimates of Q2 GDP (+1.20 percent) reported in July did not confirm this optimism.

The employment situation rebounded following a very slow start to the quarter. Total nonfarm payrolls increased by 287,000 in June, reversing the downward trend seen in April (144,000) and May (11,000), while the unemployment rate increased .20 percent to 4.90 percent. Average hourly earnings increased by 16¢ in the quarter, a 2.6 percent increase year-over-year. Early estimates for July came in at 250,000 and May and June numbers were revised higher by 18,000, proving that the weakness in Q2 may have been an anomaly. The University of Michigan noted that the U.S. has now seen job growth for a record 70 straight months.

The manufacturing side of the economy improved, evidenced by the ISM Manufacturing Index increasing from 50.8 percent in April to 53.2 percent in June. That follows five straight months where the index was below 50 – a level indicative of a contracting manufacturing sector.

Investors were shocked on June 23rd when the United Kingdom voted to leave the European Union (E.U.) in a referendum many thought to be just a formality. Markets got clobbered, the pound plummeted, and Britain lost its AAA rating on their bonds. While a clear majority was achieved, there was far from consensus across the region. England and Wales voted decisively to leave the E.U., while Scotland and Northern Ireland overwhelmingly voted to remain.

The E.U. is like a co-op that includes 28 different European countries as its members. It acts as a single market for trade and allows people to travel across the region freely. It has its own currency and its own rules relating to trade and immigration. Many believe that the vote was a rejection of overly restrictive regulations and ineffective immigration laws and less about economics.

To begin the process, the U.K. must invoke an agreement (Article 50 of the Lisbon Treaty) which gives the two sides two years to negotiate terms. This means that we will not truly understand the end-game of Brexit until 2018. Given the overwhelming task of renegotiating treaties and other agreements across 27 different countries, many believe it will take much longer.

The uncertainty going into the Brexit vote made it easy for the Fed to leave the fed funds target unchanged (.25 percent to .50 percent) at the June meeting. The futures market is now assigning a very low probability of a rate hike at all this year. The Fed's own estimate for where the funds rate will end 2017 was slashed to 2.75 percent, and the year-end 2018 expectation was lowered by .60 percent to 2.35 percent.

Markets. Stocks traded within a fairly tight range for most of the quarter until the Brexit vote caused Wall Street to panic. The harsh market reactions across multiple asset classes clearly showed that investors were caught off guard by the results. However, stocks quickly rebounded, nearly erasing the 5 percent drop by the end of June. The S&P 500 Index returned 2.46 percent during Q2. Small companies performed better (Russell 2000 +3.79 percent) than large caps, due in part to their higher domestic market exposure. Value stocks outperformed growth as investors rewarded companies with cheap valuations and higher dividend yields.

Index Performance	Q2 2016	Q1 2016	YTD
Domestic Equity			
S&P 500	2.46%	1.35%	3.84%
Russell Mid Cap	3.18%	2.24%	5.50%
Russell 2000	3.79%	-1.52%	2.22%
International Equity			
MSCI EAFE	-1.46%	-3.01%	-4.42%
MSCI Emerging Markets	0.80%	5.75%	6.60%
Fixed Income			
Barclays Aggregate	2.21%	3.03%	5.31%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

International stocks under performed U.S. equities, as slowing growth in China and Brexit concerns in Europe had a negative impact on results. Slow growth continues to plague the rest of the world, despite the aggressive efforts of central banks. The MSCI EAFE Index (developed international) fell by -1.46 percent. Latin America and China were the strongest performers with Europe the poorest relative performer. Emerging markets performance was modestly positive, as the MSCI Emerging Markets Index gained +0.80 percent.

All bond categories posted positive returns for the second consecutive quarter. Interest rates fell, credit spreads tightened, and long-duration bonds outperformed. The "risk-off" sentiment at the end of the quarter pushed 2-year treasury notes from 0.72 percent to 0.58 percent, and the yield on the 10-year treasury declined .30 percent to 1.47 percent. The yield curve (the difference between the 10-year and 2-year Treasury) shrank to only .88 percent by the end of Q2. In terms of total return, the Barclays Aggregate Bond index was up 2.21 percent for the quarter.

S&P 500 Sector Performance	Q2 2016	Q1 2016	YTD
Consumer Discretionary	-0.91%	1.60%	0.68%
Consumer Staples	4.63%	5.57%	10.46%
Energy	11.62%	4.02%	16.10%
Financials	2.12%	-5.06%	-3.05%
Healthcare	6.27%	-5.50%	0.42%
Industrials	1.40%	4.99%	6.46%
Information Technology	-2.84%	2.60%	-0.32%
Materials	3.71%	3.61%	7.46%
Telecommunications	7.06%	16.61%	24.84%
Utilities	6.79%	15.56%	23.41%

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Performance within the ten economic sectors was mixed. A rebound in oil prices and investors' unrelenting quest for yield made energy, utilities, and telecommunications the strongest performers in Q2, delivering gains of +11.62 percent, +6.79 percent and +7.06 percent respectively. Many active managers held underweight positions to those sectors, making it difficult to outperform their benchmarks. The economically sensitive groups like technology (-2.84 percent), consumer discretionary (-0.91 percent), and industrials (+1.40) stocks trailed.

Outlook. The U.S. consumer continues to lead economic growth, buoyed by a healthy jobs market, improving wage growth, energy savings, and rising wealth. At the same time, U.S. business spending remains weak in the face of economic and political uncertainty. While the recovery has been less than impressive, and is over 7 years old, a U.S. recession seems unlikely in the near-term.

Brexit creates another level of complexity, but what it means to investors will take years to understand. From an economic perspective, most academics and policy makers agree that exiting the European Union will be negative for Britain, and to a lesser extent Europe. It is important to remember that the U.K. accounts for only 4 percent of global GDP, so it is unlikely that the U.K. alone can push the world into a global recession. The big problem is the uncertainty surrounding details of Brexit, the possibility of other countries wanting to do the same, and how all the uncertainty effects consumption and business investment.

For U.S. investors, it probably means lower rates for longer and a stronger U.S. dollar. U.S. economic trends are heavily driven by the U.S. consumer (roughly 70 percent of GDP) and are impacted very little by the vote in the U.K. The uncertainty surrounding Brexit also gives the Fed (and most other central banks) ample cover to remain accommodative with their monetary policy. While monetary stimulus has become less and less effective across the globe (see Europe and Japan), it would seem plausible that fiscal stimulus (tax cuts, government spending) may be the next entrée on the menu to keep growth moving forward.

U.S. stocks have performed remarkably well, up over 9 percent from the post-Brexit low on June 27. But in reality, not much has changed. The U.S. still is the pillar of economic strength while the rest of the world struggles to find a path higher. Now with the uncertainties that come with Brexit, the probability that the economy quickly turns higher in the Eurozone is low. While we believe that we remain in a bull market, the advanced age of the rally and the outlook for slower growth globally, means returns are likely to be below historical norms and volatility is likely to increase. However, this wouldn't be all bad given the low growth/low interest rate world that we're living in.