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# Portfolio Profile

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**As we had stated in previous newsletters,** we expect to have a good stock market this year. So far the S&P 500 and Dow are marginally positive for the year, in spite of all the news. We expect that performance number to get better.

We had also discussed Brexit in our last newsletter as being our primary near-term concern along with China. Here are the steps we had taken to address our Brexit/ China concerns:

1). We extended maturities of our bonds and increased quality by reducing high yield to an insignificant portion of fixed income portfolios.
2). We sold growth stocks and increased our value allocation, which typically have better dividends.
3). We had previously bought gold as an insurance policy to hedge those currency and market risks particularly in light of risks pertaining to Brexit and China.
4). Prior to the Brexit vote, we sold a European fund that had been held in many accounts.

We still have concerns for possible fallout from the devaluation of the Yuan (Chinese currency) and the Chinese economy in general, which is continuing to slow. This may be our primary near-term concern. A longer-term concern is the possibility the Brexit decision in Great Britain could spread to other European nations.

**The following discussion** pertains to the big issue this year which is of course the U.S. Presidential election cycle. Aside from the implications based upon the outcome of the race, which we do not know the answer to, there are known economic implications which are basically good for stocks.

Primarily the "good" implication is infusion of capital (spending money) by government and central banks into the economic system of the country during an election year to stabilize the economy. This is fiscal stimulus. (Another fiscal stimulus is tax cuts. We don't expect that one to occur). This fiscal stimulus (government spending) comes with a price in the long term, but near term it is good for the economy and therefore should have a positive effect on corporate earnings. Subsequently, the anticipation of better corporate earnings has quite a positive effect on the stock market.

**Our annual Bar-B-Que** is Friday, October 14 from 4 p.m. to 6 p.m. We hope you can make it as we always enjoy seeing our clients.

**Market Review and Forecast.** Quick question: Did the U.S stock market go up or down from June 23 – 30 (6 trading days)? The astute reader of this newsletter first thought will be: "Of course it went down given the huge 5% two-day sell-off after the Brits voted to leave the European Union."

"Up" is the correct choice. For the first-time since the 2008 - 2009 recession the Dow Jones Industrial Average (Dow) was up or down more than 200 points six days in a row as it ended a volatile quarter, gaining slightly less than 2% (with dividends reinvested). No market expert would have thought a quarterly gain possible after the market's strongly negative reaction (down 871 points) June 24 and 27 after the June 23 British vote to leave the 28-member European Union (EU).

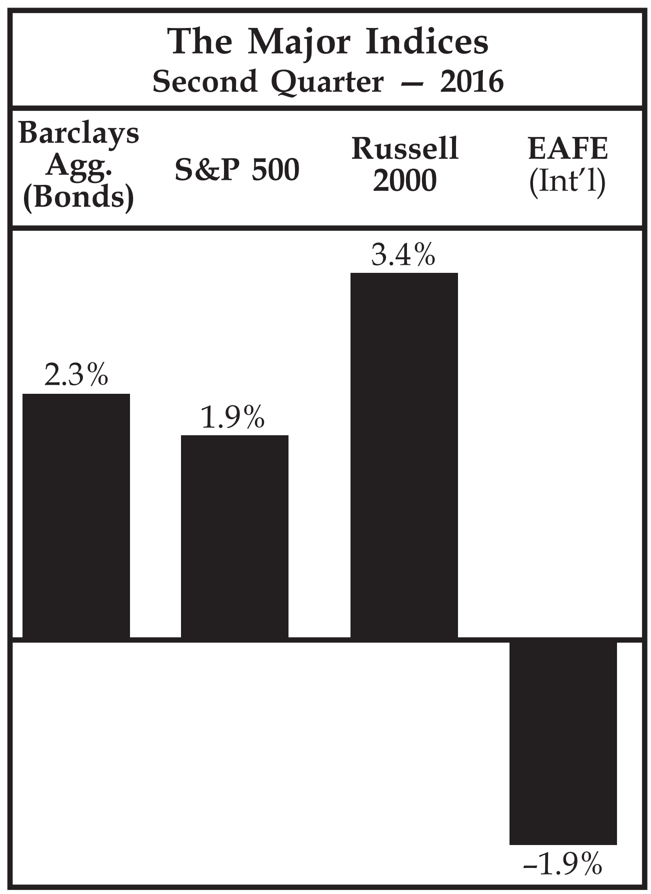
Newspaper headlines reflected the market pessimism: "Britain just killed globalization as we know it" (Charlotte Observer, June 26); British Government in Chaos" (USA Today, June 27); and the most entertaining, "What the Hell is Next?" (British newspaper, June 24).

However, by Tuesday June 28 it was obvious the market had overreacted. The British pound had fallen by more than 10% to the lowest against the dollar in three decades, making its exports cheaper and undoubtedly boosting tourism. The British economy has been the strongest among Europe's large nations, growing its GDP 2.2 percent during 2015's first quarter, far better than our anemic 0.8% rise.

Three consecutive 200+ point rallies to end the quarter lifted the Dow to positive territory for the quarter. Combined with a 230-point rise the day of the vote (June 23) when the betting was more than 4 to 1 that Brexit would fail, the four-day 1,024 point total Dow gain more than offset the two-day 871 decline.

That 871 two-day fall was more a reflection of how the market hates surprise and uncertainty than the economic situation. Under EU rules the British have two years to negotiate a withdrawal and, surprisingly, S&P 500 companies only earn 3% of their profits from British sales.

Despite the double digit sell-off the first six weeks of 2015 and Brexit, the benchmark S&P 500 is hanging in there, up 2.7% this year after gaining 1.9% last quarter. International stocks were down 1.9% for the second quarter while small caps did best, gaining 3.4%.




Certainly there is still plenty to worry about. For example, worldwide economic growth is slowing. China's growth rate is the slowest in 35 years but it is still reportedly over 6%. Last July the IMF predicted world economic growth would average 3.8% for 2016 and by this April it had been lowered that forecast to 3.2% with another lower estimate expected in late July.

The strong dollar and slower growth is damaging corporate profits here. It is estimated that when U.S. second-quarter profits begin to be reported later this week, S&P 500 companies will show a combined 5% profit decline over last year's second quarter. It will be the 6th quarter in a row that profits have declined year-over-year. Most economists think that streak will end when third quarter's results are reported in the fall. We agree and think third and fourth quarter earnings will be quite good which bodes well for the stock market. Also, current forecasts are surprisingly optimistic for 2017 — predicting double-digit profit increases.

Despite this year's gains, investors seem discouraged given the market is still about 2% below its all-time high reached in May last year. Stocks aren't cheap given that profit-to-earnings ratios (P/E's) are near 18, well above the long-term 15.5 average. Political rhetoric doesn't help either as many candidates have pointed out how anemic this recovery continues to be.

Yet the economy is expected to have grown at least 2% for last quarter and predictions are near 2.5% for the third quarter. Interest rates continue to fall as worried investors buy bonds, driving down the 10-year Treasury yield to a near-record low at 1.47% on June 30.

More and more homeowners are saving big bucks as they refinance at 2.75% for 15-year loans and for 30-year loans as low as 3.375%. Very-low interest rates have helped new home sales as well as new car sales that are close to record highs. Year-over-year new monthly home sales have now grown 5% or more for six months in a row.

Given the absence of inflation, the Brexit vote, and slowing global growth, it is now somewhat doubtful that the Fed will raise our interest rates this year. The English Central Bank Governor Mike Carney announced Thursday that it was likely that the Bank would lower interest rates this summer. Low interest rates certainly help prop up stocks.

Given the uncertainty created by the Brexit vote and the relative safety of our stock and bond markets that provide by far the largest pool of capital in the world, many argue that money from overseas will flow into the U.S. markets given their lower risk and overall potential for better returns. Foreign investment dollars may have contributed to the strong rallies we had the last three days of the quarter when both bonds and stocks surged.

A good omen for the U.S. economy came when the Chicago Purchasing Managers Index, a reflection of Chicago area economic activity, reported a 56.8 reading for June (50 reflects neither economic growth or decline), a 13.9 rise since last December. It was only the ninth time since 1967 that it had a six-month gain of 13 points or more.

Unemployment is currently 4.9%, the lowest since 2007, but mostly because so many Americans have given up looking for jobs or retired. (Every day, more than 10,000 Americans turn age 65.)

Listed job openings are at an all-time high and new weekly unemployment claims are averaging the lowest since the 1970s. Consumer confidence is the highest since last fall and 84% of Americans reported in a Gallup Poll last December that they were satisfied or very satisfied with their own lives. However, only 27% thought conditions in the United States were satisfactory.

Certainly the market could fall double-digits between now and the end of the year but a 20% "bear" market is extremely unlikely unless the U.S. heads toward a recession, which seems a very remote possibility. Fed Chief Janet Yellen testified to Congress June 21 that recession risk is "quite low" and "the U.S. economy is doing well."

Given extremely low interest rates and a pick-up in economic growth, we expect stocks to outperform bonds the rest of this year.

**Interest Rates.** As this newsletter is in draft, the 10 Year Treasury, which started 2016 yielding 2.27%, is currently yielding 1.35% in a post "Brexit" world. This move in yields (as bond prices increase their yields decline) produced an YTD return for the fixed income benchmark of 5.6% through the end of June. The 10 Year impacts rates in the mortgage industry, among others, and today a borrower can get a 15-year fixed mortgage at rate of 2.79%. These are remarkable times in many ways.

As mentioned in our previous newsletter, the junk bond (high yield) market had a rough start to 2016 but has seen a turnaround as investors rush to find a decent yield. Given the overall robust returns in the broader bond market categories, in conjunction with the global volatility in the markets, our current position is that the additional risk taken when investing in junk bonds is not prudent for fixed income investors at this time.

Corporate bonds have returned 7% on average so far this year, while shorter term fixed income investments are yielding between .25% and .55%. Investors in the fixed income arena have certainly had a nice 2016 thus far which comes as a relief after last year's flat bond market. Much of what is driving the most recent returns in the bond market is the overseas money that has and will most likely continue to flow into the safe haven of the U.S. bond market. Although June employment numbers have come in stronger, the likelihood of the Federal Reserve raising rates this year seems to be fading quickly.

**Gold** is among the top performing commodities this year (lean hogs is number one). In the midst of the global uncertainty surrounding the future of the European Union, gold surged to close the quarter at $1,325 per ounce. The last time gold topped $1,300 an ounce was in July, 2014.

We believe the easy money policies that will undoubtedly continue from global central banks as well as uncertainty as to the true value of paper money will continue to push most precious metals higher. We plan to hold our gold position for now and will continually assess the outlook for the yellow metal. We, of course, will not hesitate to sell if the outlook for gold turns negative.

If you have any other questions about your account or any concerns, please give us a call at 336-998-7000. We always enjoy talking with our clients.