Wealth Advisory Group – Market Review and Outlook – Q2 2016

Economic and Market Review

Economy – The slow and steady economic growth of the last several years came under question during the second quarter as weaker employment numbers pointed to a less robust economy. Consequently the Federal Reserve has held off on additional rate hikes and is like to continue to do so until economic conditions show signs of firming. Further complicating the worldwide economic growth outlook was the unexpected result of the referendum in England where the UK voted to leave the European Union, the so called "Brexit". While the actual extrication will take years to unfold, the uncertainty clearly clouds the visibility for European growth going forward. Given all the crosscurrents, we will continue to closely monitor key economic indicators like consumer spending, employment, business investment, trade and the housing market, for telltale signs of economic direction.

Interest rates – Interest rates closed the quarter at all-time lows as the 10 year US Treasury finished with a yield of 1.49%. Events in Europe have forced central bankers there to increase support for their economies with additional liquidity and lower rates. Negative interest rates are now the norm across Europe with Germany, France and other countries all with yields below zero on their short and intermediate term bonds. The long term implications of negative rate monetary policy is still an open question, which only time will fully answer.

Equity Markets – US markets brushed off the unexpected results of "Brexit" referendum with a strong late rally to finish the quarter on a positive note (S&P 500 +2.46%) to further extending the modest YTD gains (3.84%). Small stocks outperformed, as did Value oriented issues. Energy, Telecom and Utilities were the leading sectors, extending their strong YTD performance. Lagging sectors included Consumer Discretionary and Technology. Overseas the developed markets fell significantly as Europe was especially hard hit late in the quarter by the Brexit news (MSCI - EAFE -1.46%). Emerging markets continues to do well (MSCI – EM +0.66%) lead by strength in Latin America.

Commodities – Commodities continued to show strength as oil rallied early in the quarter only to soften slightly as Brexit clouded the worldwide economic outlook. Gold was strong late in the quarter providing a safe haven as uncertainty and volatility increased.

Dollar – The US Dollar was relatively flat during the quarter then staged a late rally as volatility and interest rate differentials increased due to the events in Europe and investors sought out safety.

Outlook

Economy – The US economy is entering a critical phase as the slow, steady growth of the last several years shows signs of weakening. While the headlines are focused on events in Europe, we believe domestic issues will play a much more important role over the near term in determining our economic fate. We will be paying especially close attention to economic indicators to better understand the future path of the economy. The presidential election will also have an important impact, primarily from a psychological standpoint, as political rhetoric heats up and candidates' fortunes rise and fall. The uncertain direction of the US economy will lead to increased volatility for a range of asset classes placing an even greater premium on the correct asset allocation.

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Equity Markets – Over the long run equity markets returns are a function of the level of economic activity, the profits and dividends companies are then able to generate and the price investors are willing to pay for those profits and dividends. US companies are facing the potential of a slower economy which will challenge their ability to grow profits and dividends. Current valuations are moderately above average potentially limiting the upside even further. Although US equities will continue to benefit from being the "best house on a bad block", investors should temper their long term expectations for US equity returns. While foreign markets, both developed and emerging, have faced a number of difficult years and challenging current conditions, the longer term return prospects may prove to be better than expected given the depressed valuations and the potential for economic turnaround.

Fixed Income – Lower for longer is the mantra for fixed income investors and while fixed income will continue to play an important role in diversifying portfolios from an asset allocation standpoint, investors looking for income will continue to be disappointed. The 10 year US Treasury has returned over 7.0% annualized total return over the past thirty five years. Going forward the math of fixed income is going to make those numbers very difficult to replicate. Total return for bonds is determined by the initial yield and the impact of changing rates on principal value. In 1981 bonds benefitted from near all-time high yields (13.9% - 10 year) and a long, slow fall in rates to the current all-time lows, which generated principal appreciation. Going forward the math is exactly the opposite with ultra-low initial yields and the threat to principal from rising rates. We continue to look for fixed income alternatives which provide investors with higher yields and principal protections.

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