Insights: June 2016

Market Overview and Performance

Looking back at May, returns for both stocks and bonds were largely unchanged and volatility slowly crept lower. Through that lens alone, the month was pretty unremarkable. However, as has been the case for much of 2016, the consensus view heading into the period proved to be wrong. The conventional thinking at the end of April was that the stock market had made a nice move higher off of the February lows and perhaps now was the time to "sell in May". Many also believed that after some weakness in the spring, the U.S. dollar would rebound causing both stocks and oil to fall. And of course, the perpetual threat of a deteriorating Chinese currency would re-introduce a global "risk-off" posture after a couple of months of relative quiet. Oh, and don't forget, stick with the defensive stocks that many people had rotated into earlier in the year. Well, perhaps not surprisingly, things didn't turn out that way. The May sellers never showed up. The dollar did in fact strengthen but both oil and stocks moved higher. The Chinese Yuan experienced its third worst month since 1994 yet volatility fell, bonds barely budged and the traditional safe haven, Gold, declined. As we indicated last month, we believe that the current scenario is setting up for a very volatile summer period. In the coming weeks, investors will be looking at an unusual amount of potentially de-stabilizing influences including a "Brexit" vote, contentious U.S. presidential conventions, and a Fed intent on raising rates. This all at a time when equity valuations are stretched as the market approaches all time highs, volatility is low and growth is seemingly slowing. Caution is therefore merited in our view.

As always, thank you for reading our latest Insights.

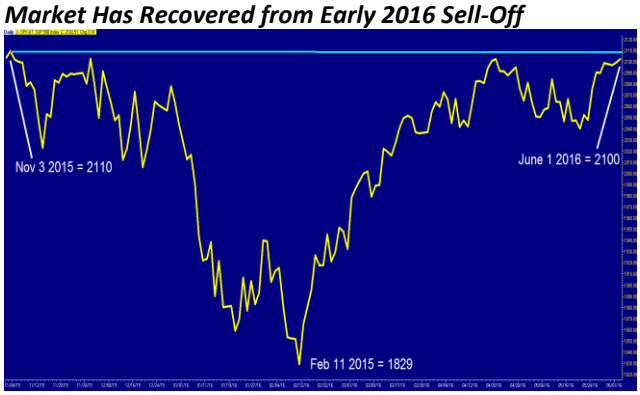
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.49	3.34
Russell 2000 Index	**2.25**	2.28
MSCI EAFE Index	-0.91	-1.10
MSCI Emerging Markets Index	**-3.73**	2.32
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.03	3.45
Barclay's U.S. Credit Index	-0.44	5.14
Barclay's Corporate High Yield Index	0.62	**8.06**
Barclay's Municipal Bond Index	0.27	2.70
Macro Measures		
Gold	-5.66	**14.77**
Crude Oil	**6.93**	**32.56**
CBOE Volatility Index	-9.62	-22.08
USD Dollar Index	2.92	-2.99

May Themes – No Selling in May, Equities Grind Higher; U.S. Dollar Strengthens but Oil and Stocks Pay Little Attention; Market Remains Range Bound Even as Investors Grow More Skeptical; Path of Rates Still in Question as Data Softens; Summer Period Looks Like it May be Volatile

Stock Market Floats Higher as Risks Mount

For the most part, a lot of what we wrote about last month continued throughout May. Markets were largely unchanged but mildly higher, investors were attracted to commodities and bonds, sentiment remains poor and the general outlook for the path of movements forward appears murky. A few things did pivot – most notably, the dollar reversed its recent weakness and moved higher relative to other currencies and the market's expectation regarding Fed policy and interest rates re-priced midway through the month. We will touch more on the reasoning behind those shifts, but taking a step back, one of the enduring themes that we have discussed for quite sometime now is the range bound market. May brought no new changes in this regard.

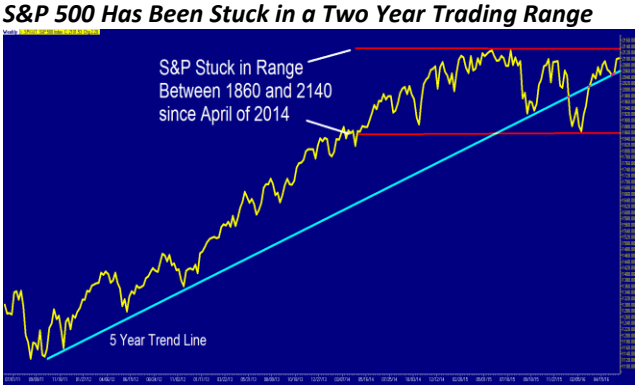
Market Has Recovered from Early 2016 Sell-Off



Source: Thomson Reuters; Standard & Poor's

As you can see from the chart above, as of the first trading day in June, the S&P 500 had essentially retraced the entirety of its 13 percent drop since November of 2015. It has been a remarkable comeback mostly because of the severity on both the up and down side but also because of its persistence. As of the first week of June, the S&P 500 had traded for 42 straight days without a drop of greater than one percent according to Factset. That's rare. They claim that the last such period seen in the market was the summer of 2014. We are only a handful of months into 2016, but it's rather amazing to witness such a strong rally given that the first six weeks of the year were dominated by talk of recession and another potential global financial crisis. Of course, there are substantial headwinds present at the moment that we believe represent a significant level of risk for the coming months. Others share this view and as a result, we remain entrenched in the sideways trading range that began in 2014.

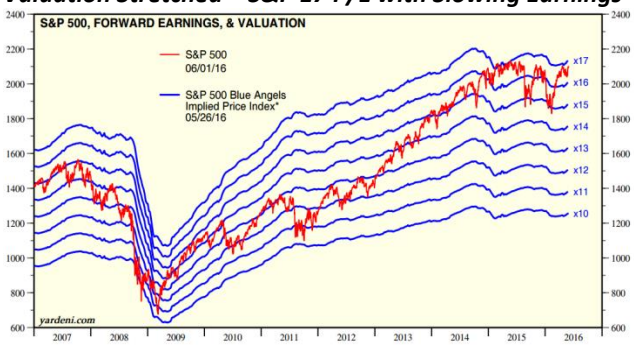
S&P 500 Has Been Stuck in a Two Year Trading Range



Source: Thomson Reuters; Standard & Poor's

From a bullish standpoint, the chart above illustrates the fact that the integrity of the market's five-year uptrend has not eroded and the market has now even climbed to the top end of the range. However, there is a cost to elevated market levels – prices become high particularly when earnings are declining as they are today. As you see below, the 2100 level leaves the S&P 500 trading at a rather expensive 17 times estimated 2017 earnings.

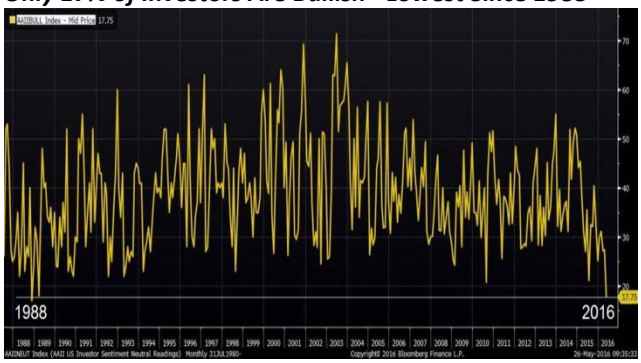
Valuation Stretched – S&P 17 P/E with Slowing Earnings



Source: Ed Yardeni

Historically high valuation levels are generally not good starting points for significant market moves higher. This is no secret to anyone, so its curious that the market has been able to sustain its gains given the fact that investors have taken on a very dour outlook for stocks going forward. Unlike the days of "irrational exuberance" when new market highs brought in even more buyers, investors as a whole are incredibly pessimistic about the future right now. As the chart below highlights, only 17 percent of investors are bullish at present – the lowest level since *1988*.

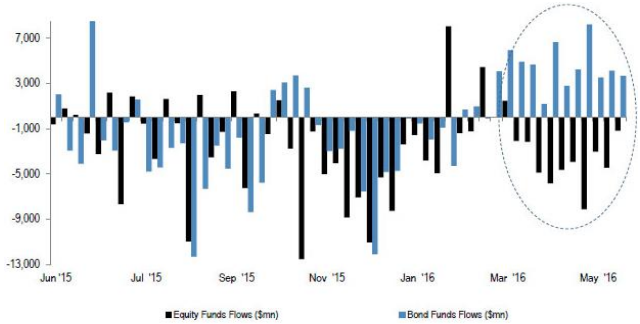
Only 17% of Investors Are Bullish - Lowest Since 1988



Source: Bloomberg; American Association of Individual Investors

Not only are they not bullish, they actually want out. Last month, we pointed out that Merrill Lynch had seen 14 consecutive weeks of client equity outflows. As seen below, JP Morgan suggests that this selling momentum continued throughout May with funds clearly moving out of equities and into bonds.

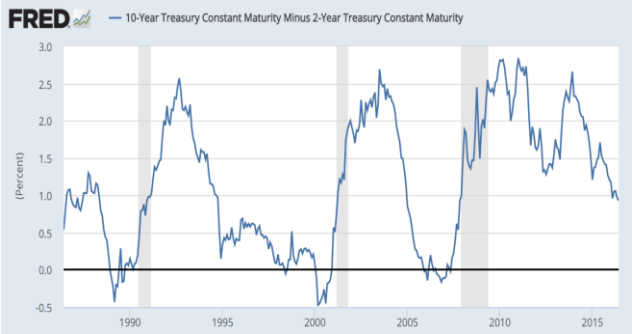
Fund Flows Have Reflected Investor Pessimism



Source: JP Morgan; ICI

Money flowing into bonds will drive prices higher and yields lower, but looking beyond just the low absolute yield levels, another important gauge of investor sentiment is represented by the steepness of the yield curve.

Yield Curve Continues to Flatten – Back to 2008 Level

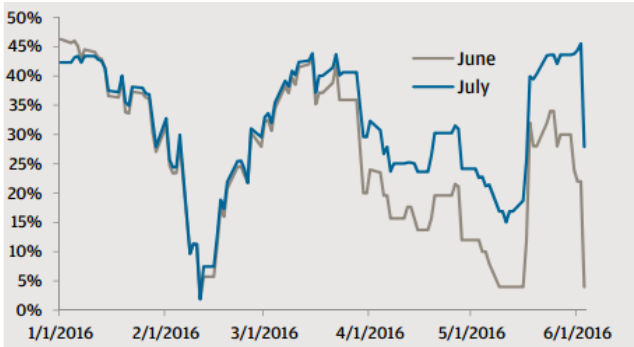


Source: Federal Reserve Bank of St. Louis

The graphic above charts the difference between the yield of the 10-year Treasury and the 2-year Treasury bill. The difference right now is small – very small, less than one percent. When the gap is narrow like this the yield curve is flattening which traditionally has been a sign of an outlook for a weaker economy and mild inflation. The yield curve can become inverted, meaning short term treasuries yield more than longer term instruments. We are a ways away from that, but the curve is now the flattest it's been since 2008. It is concerning since all five recessions over the past 40 years have been preceded by an inverted yield curve.

Adding to the angst in the fixed income market is the looming Fed interest rate hikes. After sparking higher on strong U.S. data for the month of April, the probability of June rate hike collapsed when May employment numbers came in far below expectations. The miss was a big one with payroll additions of just 38,000 compared to a 12 month rolling average of well over 200,000. The interpretation in the market was clearly that the economy is nowhere near stable enough for the Federal Reserve to push rates higher.

Probability of June Rate Hike Collapsed From 35% to 4%



Source: JP Morgan Asset Management; Bloomberg

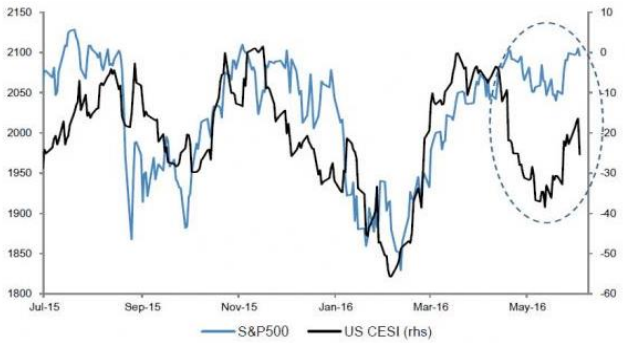
Beyond just June or July, it is important to acknowledge that the labor component of the economy is now sending out warning signals. When you cut through all of the noise that commands market attention from day to day and month to month, the labor picture has been the one unwavering bedrock of the recovery. Now, the employment picture is still very healthy and one data point is often meaningless, however, changes do appear to be developing.

Labor Market Conditions May Be Deteriorating

Source: Bloomberg; Federal Reserve

Consider the Labor Market Conditions Index. This is a measure created by the Federal Reserve in 2014 that is comprised 19 indicators of the labor market. It is designed to give them a better tool to assess the overall health of the labor market, and as you see above, it has been trending negative since the start of the year. If we think about the economy as whole, other caution signs are popping up as well. In February, the Citigroup Economic Surprise Index preceded equity markets higher (it is a leading indicator for markets). As you can see below, the surprise index has been falling since late April however equity markets have yet to follow suit.

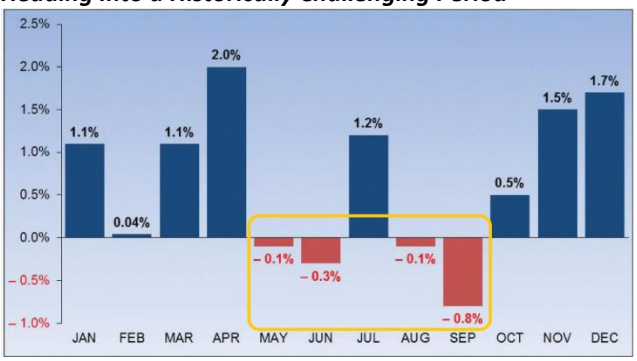
Stocks Have Yet to Follow Economic Data Lower



Source: Bloomberg; JP Morgan; CitiGroup

This does not instill a lot of confidence as we head into what is historically the weakest portion of the trading year.

Heading Into a Historically Challenging Period



Source: Stock Trader's Almanac

Certainly, the calendar does not dictate returns, however, this summer is shaping up to possibly be particularly challenging. As we discussed earlier, markets are near their all time highs, valuation levels are stretched and economic data looks to be softening yet the Fed remains fixated on raising rates at some point sooner rather than later. And of course, this is an election year with two not very popular candidates at the helm of their respective parties. And that is just the scenario here in the U.S.

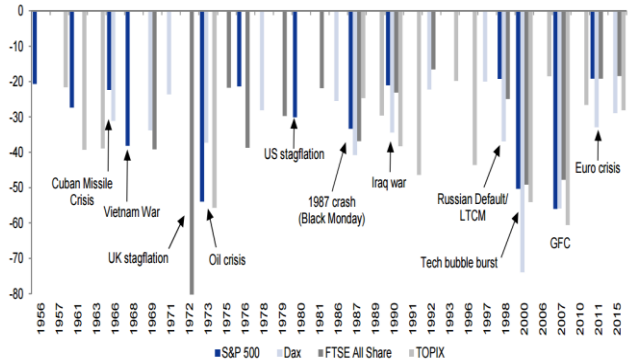
Perhaps more worrisome are the events unfolding overseas. As we have discussed, the U.S. equity markets have proved surprisingly resilient. But if we look globally as in the chart below, you can see that the S&P 500, Japanese Nikkei and EuroStoxx50 had moved by and large together since May of 2015 until February of this year when the S&P sharply rebounded while Japan and Europe languished around Bear market levels.

Global Markets Have Hit Bear Market Levels – Except US

Source: Stockcharts.com; Allstarcharts.com

As Goldman Sachs highlights in the chart below, 20 percent drawdowns in equities are fairly common, but since the late 1990's, they have become more global in nature with the bulk of the major global markets falling in unison. Right now, we have three of the big four down over 20 percent since 2015 with the U.S. being the lone standout. Given the challenges we have discussed, it seems unlikely that the U.S. could truly diverge and separate from the dynamics of the other regions at this point.

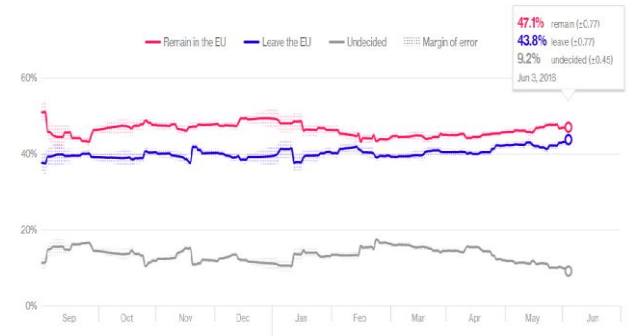
20% Drawdowns Globally Are Frequent and Coordinated



Source: Goldman Sachs Investment Research; DataStream; Bloomberg

As we said in our opening paragraphs, the usual poster child for global turmoil, China, has been a bit shaky recently, yet the market essentially yawned and moved on. By far, the biggest threat to global financial stability is just days away. It is the referendum in United Kingdom to leave the European Union on June 23rd. The so-called "Brexit" vote. The outcome of this vote has far ranging consequences for the U.K. and E.U. most directly, but also on the global economic, financial and social systems. And as you can see below, as of June 3rd, less than three weeks away from the actual event, the outcome is too close call.

"Brexit" Vote Too Close to Call – June 23rd Vote



Source: Bloomberg

There are myriad of unanswered questioned specific to the U.K. should they choose to leave the E.U., but almost certainly their economy would be thrust into a recession virtually overnight. Leaving the E.U. is also unchartered territory so there is no playbook. Essentially, the U.K. would have to renegotiate terms with its largest trading partner, the twenty-something block of counties that comprise the E.U. This at best would be a laborious process. There is also the small matter of their currency which has been sold aggressively as the vote nears, and the future status of the large proportion of their labor force who are E.U. citizens.

Even if the transition somehow progressed in an orderly fashion (unlikely), perhaps the grander issue at hand is the future of the E.U. itself. The U.K. is a significant global and European influence and the very threat of its departure has exposed the tenuous nature of the network that holds the E.U. together.

The very same weekend as the Brexit referendum, voters in Spain will be going to the polls to settle their future government. At present the very E.U.-unfriendly Podemos party looks to make significant gains, perhaps leading to their own future referendum. Similarly, the problems in Greece have never really gone away. They owe the European Central Bank $2.3 billion Euros in July which looks like a tall order and as you may recall, their own anti-austerity (read anti-E.U.) party, Syriza, has already made significant headway in their governing body. Additionally, Reuters released data in early June claiming that 42 percent of Italians support leaving the E.U. And last but not least, the French economy has stalled as union strikes cripple critical services like their refineries, nuclear power stations and railways…not to mention their sanitation systems.

In short, since Germany more or less imposed austerity across southern Europe in 2008, life for many Europeans has been difficult and remains so. It is easy to understand how it would not take much to incite demands for change and the potential Brexit debate only adds fuel to that fire. As a result, we are preparing for a very challenging investment environment as the summer of 2016 progresses.

Going Forward

As we stated last month, given the fact that markets have moved to the upper end of their two year range within a short time frame, we have used the strength in equities to take profits and remove some risk from our portfolios. We continued to do so during the month of May and hold the assets in either cash or municipal bonds. As we approach the summer months, we feel that the likelihood of a pull-back is now substantially higher than it was even one month ago. There are a number of upcoming events that could potentially create uncertainty and angst among investors. Most notably the June and July Fed policy meetings , a June "Brexit" vote and increasing momentum for EU membership referendums across Europe; unresolved debt issues in Greece and Puerto Rico; and a contentious U.S. presidential party conventions in July. We are therefore positioned defensively in our portfolios in anticipation of a decline that we feel will present a good re-entry opportunity for gains toward the end of the year.

Within equities we continue to favor the large cap segment of the U.S. market. Since the sharp sell-off experienced at the start of the year, traditionally defensive sectors such as utilities and consumer staples have drawn outsized investor favor and are overvalued in our estimation so we prefer to limit exposure to those areas despite our near term caution on the market. The energy sector has been an area of focus for us in 2016, however, with oil moving above $50, we feel that upside may be limited from here. We continue to feel that there is value in the healthcare, technology and financials sectors. These groups have underperformed year to date and are therefore reasonably priced, yet they also offer the potential for above average growth.

While we are believers in the strong U.S. growth story, we think that areas of outside of the U.S. appear attractive as well. As we have stated for quite some time, the potential for positive surprises in Europe is probably the highest of any global region. Economic data within Europe has in fact improved markedly, however shares have yet to respond. Japan continues its efforts at reforms that are risk-asset friendly and a weakening Yen this month combined with a better than expected GDP growth figure has helped improve performance.

As we said last month, after an extended period of underperformance, emerging markets are becoming more of an interest. As a group they have held their own this year but were hit hard in May by the stronger U.S. dollar. Additionally, the slowing growth scenario in China combined with what appear to be worsening conditions in Brazil and Venezuela could present challenging conditions going forward.

While we do not view traditional fixed income as being undervalued, we have shifted some assets toward fixed income as a result of profit taking within equity exposures. In a rising interest rate environment, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has performed well relative to other asset classes.

Despite a three month rally, commodities remain structurally challenged in our view. That being said, we believe that high quality names within the energy sector represent good long term value since share prices and the price of the commodity have not moved in lock step higher. In light of the sharp rally, a pull-back in the price of oil would not be unexpected. Thus far in 2016, gold has been the one asset class to both serve its purpose as a diversifier and provide attractive returns. Given the macro outlook, we are not buyers of gold for fundamental reasons however we have maintained a small position in certain portfolios as a hedge which has performed well year to date.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.