Second Quarter 2016 Investment Environment

- It was another quarter of low single-digit positive returns for U.S. stocks but the action during the quarter was anything but dull. U.S. stock returns briefly dipped into negative territory for the year over two trading days following the U.K. Brexit vote on June 23rd but rallied over the final three trading days of June to recapture all the losses and to finish modestly higher for the quarter.
- U.S. small caps slightly outperformed U.S. large cap stocks during the quarter but still trailed large caps during the first half of 2016.
- Developed international equity market returns continue to face headwinds and can't gain any traction. The year to date return spread between the S&P 500 Index and MSCI EAFE Index is now 8.2%. The Brexit vote was just the latest event that shook investor confidence in pan-European stock markets and its financial sector. Japanese stocks have been hurt by the continued rise in the value of the Yen, which gained 8% on the U.S. dollar during the second quarter.
- As global growth slows, and many international sovereign bond yields have gone negative, U.S. bond yields continued to move lower. The U.S. 10-year Treasury bond yield declined to 1.46% by quarter end and the 30-year U.S. Treasury bond yield hit a record low.
- While stocks struggled to stay in positive territory, high yield bonds have put on a significant rally since the February sell-off and were the best performing asset class during the second quarter. Second quarter returns were helped by a recovery in oil prices, which lead to a sizable rally in many high yield bonds issued by energy related companies.
- Oil posted strong gains during the second quarter as West Texas Intermediate (WTI) oil ended the quarter near $48/barrel.
- Gold benefited from the flight to safety trade given stock market and currency market upheaval.
- The table below shows the returns for major asset classes during the second quarter and first six months of 2016.

	QTR	YTD
S&P 500 Index (large cap U.S.)	**+2.5%**	**+3.8%**
Russell 2000 Index (small cap U.S.)	**+3.8%**	**+2.2%**
MSCI EAFE Index (large cap int'l)	**-1.5%**	**-4.4%**
MSCI EM Index (emerging mkts.)	**+0.7%**	**+6.4%**
Barclays Aggregate (invt. grade bonds)	**+2.2%**	**+5.3%**
Barclays High Yield (non-invt. grade)	**+5.5%**	**+9.0%**
Barclays Short-term Treasury bills (cash)	**+0.1%**	**+0.3%**
Gold	**+7.0%**	**+24.2%**
WTI Oil	**+26.0%**	**+34.3%**
Lipper Balanced Funds Average	**+2.2%**	**+3.2%**

- The most important U.S. macro data point during the second quarter was the U.S. Federal Reserve reducing expectations for future rate hikes. It was a major about face for the Fed. Fed officials went from making very public comments in the beginning of the year about pending rate increases to crawling back into a bunker by June. Global macro data is not cooperating, monthly U.S. job gains have recently fallen off, and the pending Brexit vote situation made the Fed uncomfortable with raising rates in the face of rising uncertainty. The Fed would like to raise rates but the fact is they can't. They are painted into a corner and it's an increasingly uncomfortable place to be.

Third Quarter 2016 Investment Outlook

Bugger Off

In my early teen years, I became a huge fan of Monty Python's Flying Circus comedy show on PBS. I would watch it on Saturday nights while enjoying a pizza from my local favorite Pizza Junction. It took me a few years to get up the learning curve of the sarcasm, irony, and wit of English comedy and British slang. To this day I am always searching for funny British shows that satisfy my craving for British wit and humor. I recently found a new one in The Detectorists, a show on BBC that can be found on Netflix that has quirky British characters engaging in dry humor and sarcastic dialogue. Brilliant!

Some of my favorite Monty Python skits included the Cheese Shop, which sold cheese but never had a single variety of any cheese the customer inquired about. The customer (John Cleese) rattled off upwards of 50 obscure varieties of cheese, each time given some lame or bizarre excuse by the proprietor (Michael Palin) as to why a particular variety wasn't in stock. The customer finally determined that getting any cheese was futile and being completely annoyed, he shot the owner (back when gun related humor could be funny, especially in Britain where guns are not readily available to the public). Another favorite skit was the Ministry of Silly Walks. Ministry employees walked to work down the streets London in the most absurd manner as a testament to the seriousness of their government positions. In the Ministry, every employee had a unique and bizarre manner of walking the halls of the Ministry. A very proper British gentleman came to the Ministry to request a government grant for the development of his own unique silly walk. He demonstrated his silly walk concept and the Ministry employee shot it down as not being silly enough including and a harsh critique of not using his left leg in a silly enough manner. Monty Python inspired me to practice my own silly walk on the way to junior high. Another skit was the Silly Olympics, which included the Marathon for those with incontinence problems. As soon as the starter gun went off, all participants immediately ran into the nearest bathroom and the coverage on the course captured frequent peel-offs by runners into the woods to get relief. There was also the 100 Meter Dash for sprinters with no sense of direction. When starter pistol went off the contestants ran off in various directions. The Olympic Hide and Seek Men's final event featured a Brit and a Paraguayan (which itself is hilarious since when does anyone from Paraguay make the Olympics?). The event started in Trafalgar Square in London. The Paraguayan put his hands over his eyes and counted to 100 and the Brit immediately jumps in a London cab to go to the airport to fly out of the country to find his hiding spot in some remote Spanish fort. It took the Paraguayan 11 years, 2 months, 9 hours, 3 minutes, and 27 seconds to find the Brit. The event ended in a tie, much to the bitter disappointment and shocking disbelief of both contestants.

Absurdity was the hallmark of Monty Python's humorous skits. They could take very serious subjects such as death, war, religion, and politics and turn them into hilarious events. Nothing was sacred to the Monty Python troupe (which did include one American) including skewering the executives of the BBC (British Broadcasting Corporation), the government controlled television entity that frequently censored some of their material. The skits in each weekly show were so unconnected that they were frequently strung together with Monty Python's famous tag line "And now for something completely different". Speaking of which, let's move on to something completely different, an issue with global economic ramifications that reached the level of absurdity of the humor of a Monty Python skit, except without the humor. The Brexit Vote.

The U.K. held a referendum on June 23rd about leaving or staying in the European Union. In the final weeks and days leading up to the vote, the polls showed a very tight race between the Leave and Stay camps. It was a high level and serious national decision. 82% of eligible voters voted. The U.S. can't even get close to that level of voter participation in our Presidential elections and we are supposed to be the global symbol of democracy. It was such an emotionally charged event that a British politician was shot and murdered on the street in her home district by a deranged man who disagreed with her Stay position. Whackos with guns are everywhere nowadays. Despite the tight polls, most believed the Stay vote would win out in the end, especially U.K. gamblers who bet large sums on the Stay outcome. Surprisingly, 52% of Brits said bugger off to the rest of the European Union. When the vote outcome was announced, it was a major shock and a major negative event for global financial markets. On June 24th, global stock markets plunged 6-10%, the British pound suffered its largest one-day drop in history and hit its lowest level in 31 years, British bank stocks declined an average of 20%, and British Prime Minister Dave Cameron resigned. Bloody hell, indeed!

In 1776, the Continental Congress voted to leave the British Empire and issued the Declaration of Independence. The American colonies had enough of having no say in the political process over the policies that dictated their lives, liberties, and fortunes. Taxation Without Representation and Give Me Liberty or Give Me Death and all that. The Brexit vote was partially about the U.K. taking back some control over its own sovereignty and no longer being dictated by policies issued by an unelected, bureaucratic entity in Brussels Belgium. Shades of 1776. The Brexit vote has cast a new shadow of uncertainty over the global economy and will create a growth shock to both the U.K. and European economies. Many economists are now forecasting the U.K. economy will fall into recession by early 2017 as the wheels of commerce slows further. There will be an extended period of negotiating the U.K.'s exit from the European Union and new trade agreements and policies will have to be renegotiated (high on the list is immigration). Other members of the EU may now demand concessions to remain in the EU or some countries may hold their own Stay/Leave referendums (France could be the next big one). How all of this shakes out is a huge unknown. What is known is the uncertainty level just went up another notch at a time when the global economy does not need more uncertainty.

People around the world are clamoring for decisive actions that can turn around this low/no growth world and get it headed back in a positive direction again. The surprising outcome of the Brexit vote and the unexpected success of Donald Trump's Presidential run (despite saying something weekly that offends some constituency) tells you the natives are restless and the peasants are grabbing their pitchforks. The level of angst is quite high and the stakes seem to rising every month. Thank goodness the Summer Olympics in Rio De Janeiro in August is just ahead to take our minds off of more serious things. Yes, that's me being a bit cheeky (smart arse).

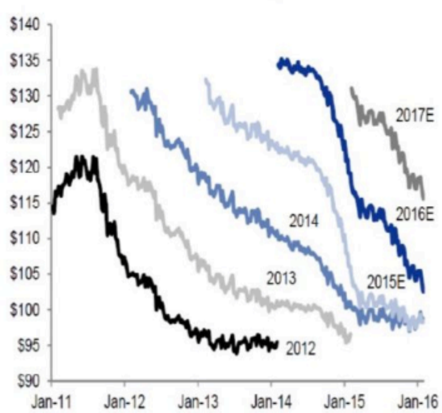
I've Fallen and I Can't Get Up!

Economic growth has consistently disappointed to the downside since the Global Financial Crisis began in 2008 or now eight consecutive years. Over that time, global central bankers have implemented a plethora of policy actions to turn the tide against weak economic growth. To date, these policy measures have failed. The next chart shows how global GDP growth and earnings have trended by year since 2011. Every year since 2011, growth expectations started higher but ended the year much lower than expected. Importantly, on the left side chart, you can see that the forecast for 2017 global GDP growth (grey line second from right) is now BELOW GDP growth expectations for 2016. On the right side chart, the far right grey line represents 2017 global earnings estimates, which at the time this chart was produced, were still above 2016. However, given the Brexit vote decision and likely fallout, global GDP growth expectations for 2017 will get marked down even more which will lead to more cuts to 2017 earnings estimates. For example, GDP growth estimates for the U.K. have been marked down to close to 0% for 2017 from 1.8% before the Brexit vote and many economists believe the U.K. will go into a recession during the first half of 2017. So, those of the view that the Brexit vote was a major overreaction and temporary blip may need to rethink their thinking. 2017 will become the ninth consecutive year of low global growth. U.S. multi-national companies with meaningful European revenue exposure are likely to downgrade their earnings outlooks for the back half of 2016 when second quarter earnings calls begin in mid-July. Weaker earnings growth is a major headwind to stock markets being able to move higher.

Exhibit 6: World GDP has been revised down consistently
Consensus G7 Real GDP growth expectations

Source: Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 7: Global earnings have followed a similar pattern
I/B/E/S consensus MSCI World earnings estimate revisions



Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

U.S. Stock Valuations and Future Return Expectations

Stocks have been stuck in neutral since May 2015 although there have been five major swing moves higher and lower since then. A major reason stocks can't push through the previous May 2015 high is that valuations leave no room for a move to the upside. The next chart shows six different metrics investors use to value stocks. The left column labeled Aggregate shows the valuation of U.S. stocks for all six metrics and how those valuations compare to their historical percentile. Using forward PE as one example, the current 16.8X forward PE multiple would put it in the 86th percentile of its valuation history. The higher the percentile ranking, the more expensive stocks are valued. The average percentile ranking of the six valuation metrics is 86%. The right column takes the median stock valuation and shows the median stock is now in the 99% percentile of its valuation history. In short, U.S. stocks are expensive based on history. Importantly, let's not forget that a key factor as to why stocks have high valuations is the extremely low interest rates that central banks have forced upon the world. If interest rates move up, especially off of the current very depressed levels, stocks valuations will go lower.

	Aggregate		Median stock	
Metric	Current	Historical %-ile	Current	Historical %-ile
Price-to-Earnings growth (PEG)	1.4 x	89 %	1.8 x	100 %
EV / Sales	2.0	91	2.5	100
EV / EBITDA	10.9	86	11.1	99
Forward P/E	16.8	86	17.5	96
Price / Book	2.7	66	2.9	83
Cyclically adjusted P/E (CAPE)	22.3	73	NA	NA
Median metric		**86 %**		**99 %**

Source: Goldman Sachs

Taking a queue from the table above, it is possible to look back in history when stock valuations were at similar median PE ratio levels to see how stock returns fared over the next 10-year window. The next table shows this data going back to 1989. The starting dates highlighted in red represent times when the starting median PE ratio exceeded 20X, just as it was as of 12/31/15. The 10-year forward annualized return of U.S. stocks for these four time periods was 2.0%. By comparison, as shown in the three time periods highlighted in green (1989, 2008, 2009), when the starting median PE ratio was in the low teens, the forward 10-year annualized return was always north of 10%.

Starting Median P/E Ratio & 10-Year Returns

Starting Date	Starting Median P/E	10 Yr Annualized Return
12/31/1989	13.9	15.28%
12/31/2000	20.6	-0.48%
12/31/2001	23.5	0.92%
12/31/2002	18.8	4.94%
02/28/2003	16.9	6.06%
12/31/2003	21.2	2.17%
12/31/2004	20.3	5.54%
12/31/2005	19.0	5.24%
12/31/2008	12.5	13.21%*
02/28/2009	11.0	16.69%*
12/31/2015	22.0	???

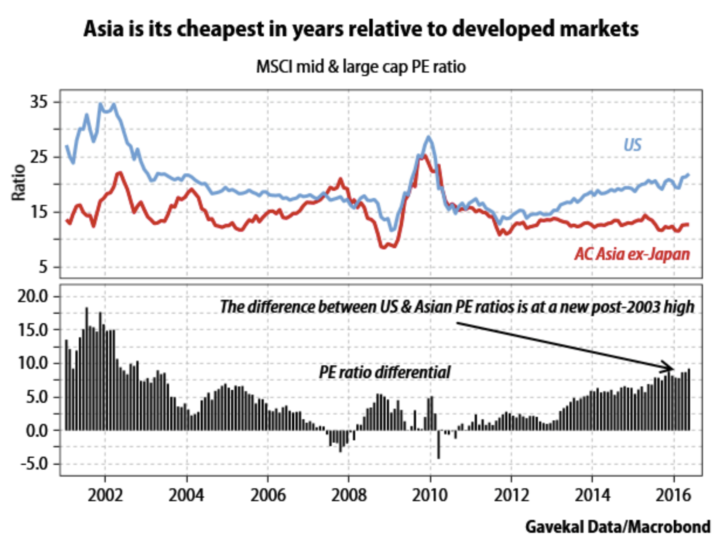
* Less than 10 years (through December 2015)
Source: CMG Investment Research, Ned Davis Research, Worldscope

If history repeats, U.S. stocks are most likely to generate low single-digit annualized returns for the next 10-year window (out to 2025). This low level of return is likely to be a shock to many who assume that stocks should generate 8-10% annualized returns. While that return profile for U.S. stocks is typical over many decades, given current valuations, it is highly unlikely the next 10 years will offer anything close to 8-10% for investors in U.S. stocks.

Across the Pond

With U.S. bond yields hitting record lows (they are even lower outside the U.S. where $12 trillion of bonds now have negative yields), and with the expectation that U.S. stocks will most likely generate low single digit annualized returns over the next 10 year horizon, how exactly will U.S. investors make any money for retirement over the next decade? It's going to take a lot of hard work (if you're smart, aided by a trusted and experienced investment advisor) and a significant increasing in savings as well. As global investors have flocked to U.S. stocks as the preferred place to invest risk assets, which has caused U.S. stock valuations to become more expensive and stretched, non-U.S. stock markets now offer a significantly better risk/reward setup for the next 10 years.

The next graph is one example of how stretched U.S. stock valuations have become when compared with another region of the world. The chart compares U.S. stock PE ratios with Asian Ex Japan stock market PE ratios. When the 2008 financial crisis hit, the chart shows that the PE ratios of both regions plummeted but then recovered together. However, since the start of 2012, U.S. stock valuations (blue or upper line) have continued to march higher while Asian valuations (red or lower line) have gone nowhere. The valuation spread between the two regions has now exceeded the past peak in 2003 as shown in the bottom part of the chart. 30% of the Asia Ex Japan region is China, which has struggled since 2012. One could easily argue that there is more risk in the Asia Ex Japan region given China's debt situation. While that is true, the PE valuation spread between both regions now reflects this fact. Any investor with at least a 10-year investment horizon and seeking return opportunities greater than the low single-digit returns likely to come from U.S. stocks and bonds must increasingly look outside the U.S., even if that means accepting higher levels of volatility to achieve higher returns.



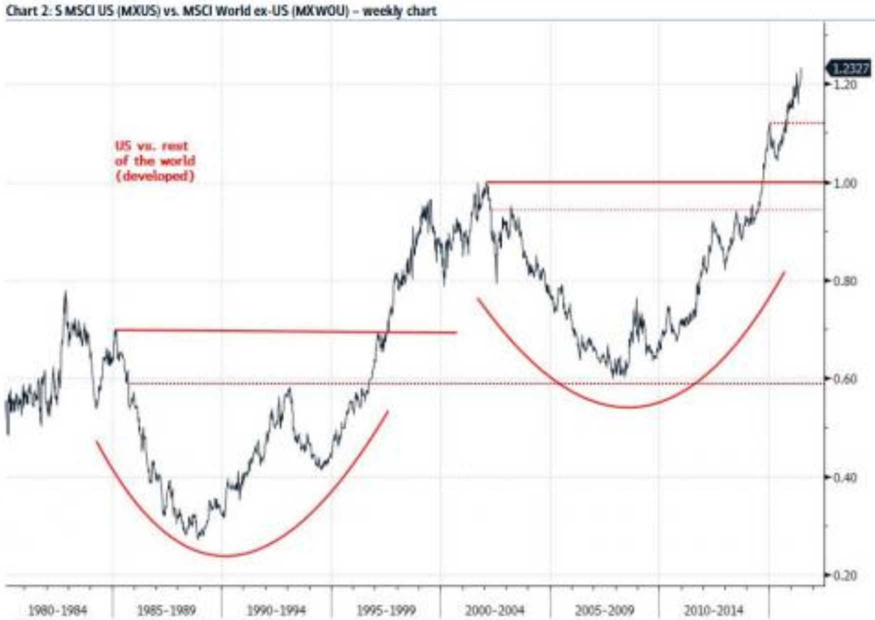
The next chart also captures the valuation-spread discrepancy between the U.S. and Asia Ex Japan, this time using the EV/EBITDA valuation metric. The story here is the same. U.S. stocks are at the most expensive levels of the past 20 years going back to the Tech Bubble peak.

Figure 5: On trailing EV/EBITDA metric, Asia ex-Japan is at 40th percentile since 1995, while the US is at the 90th highest percentile

Source: BofA Merrill Lynch Global Research, Bloomberg, FactSet, Based on MSCI Universe

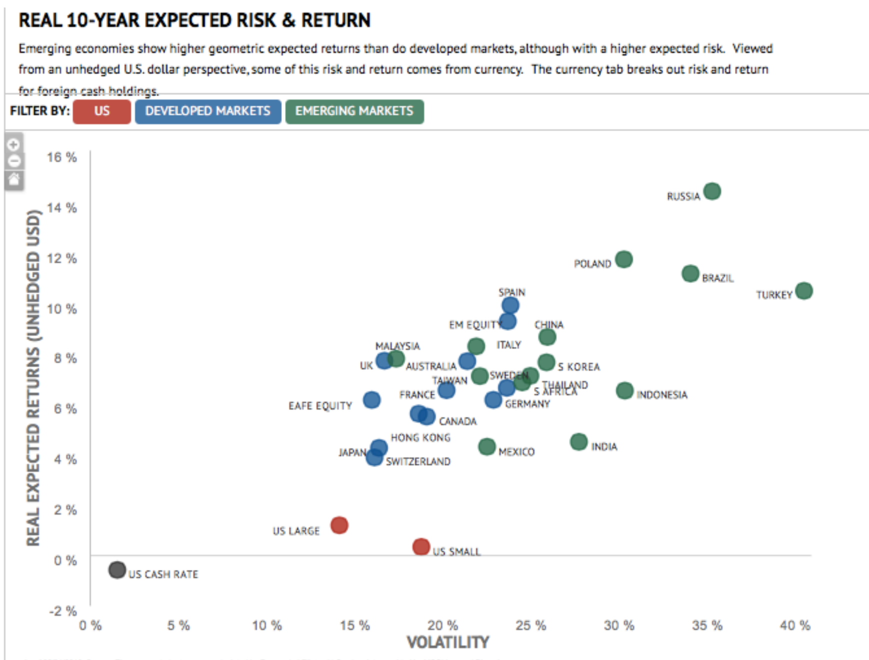
The degree of outperformance of U.S. stocks is not isolated to just the Asian Ex Japan region. The next chart shows the relative returns of the MSCI U.S. Index compared to the MSCI World Ex U.S. Index going back to 1980. The chart shows that outperformance of U.S stocks versus the rest of the world and vice versa can last for extended periods of time. Non-U.S. stocks outperformed U.S. stocks from 1999 (when the U.S. stock market hit the Tech Bubble valuation peak) to 2008 or 10 years. Since 2008 or now eight years running, U.S. stocks have significantly outperformed non-U.S. stocks. Over the past year ending June 30th, U.S. stocks outperformed non-U.S. stocks by just over 10%. The return spread against European stocks is even wider as the U.S. stock market outperformed that region by 15% over the past year (aided by the Brexit vote fallout).

Chart 2: $ MSCI US (MXUS) vs. MSCI World ex-US (MXWOU) – weekly chart



Source: BofA Merrill Lynch Global Research, Bloomberg

The next chart captures another way to look at the forward 10-year return expectation for various global stock markets using Shiller PE ratios. This chart plots individual country return volatility on the X-axis (horizontal) against the 10-year real return expectation on the Y-axis (vertical). Note that U.S. large and small cap stocks are plotted as the red dots towards the bottom of the expected real return axis (appr. 2%). Emerging markets are represented by green dots and developed international markets are represented by blue dots, every one of which should generate real higher returns over the next 10 years compared to U.S. stocks. Yes, U.S. stocks are expected to exhibit the lowest return volatility of all global stock markets. However, when comparing 10-year future expected returns, U.S. stocks are also expected to generate the lowest real return over the 10-year forward window by virtue of the fact that current valuations are starting at very high levels. Also, U.S. stocks have experienced such an extended period of outperformance against non-U.S. stock markets over the past eight years that the odds of a reversion to the mean move in the opposite direction is increasingly likely.



Summary

The total ramifications of the Brexit vote remain uncertain at this point but it is clearly not positive in the short-term. Like the 100 Meter Dash in the Silly Olympics, no one has a clue where the fallout of the Brexit vote is headed. Let's just hope the Brexit backlash doesn't last as a long as the Men's Hide and Seek final. A multitude of knock-on effects could arise in the months ahead. How quickly a disengagement from the European Union can be negotiated (the dreaded Article 50!) will determine how long a cloud of uncertainty hangs over the global economy and financial markets. Britain joined the EU in 1973 so there is a 43-year integration history that now must be unwound and renegotiated. The Brexit vote decision has cratered British bank stocks and the domino effect is causing other European banks and financial institutions to see large drops in their stock prices as well. A banking crisis in Italy seems imminent given that 20% of loans there are non-performing. Currency markets are in upheaval. The precipitous 14% drop (so far) in the British pound since June 23rd increases pressure on other export dependent countries and will likely lead to policy responses from other countries to weaken their currencies in order to maintain trade competitiveness. The Chinese in particular may be forced to further devalue the Yuan, which would lead to another round of global market volatility such as occurred last August when global stocks plunged over 10% after China unexpectedly devalued its currency. It should be noted that none of this seems to matter to the Teflon coated U.S. stock market, which recovered all of its post Brexit losses in early July.

With a global economy already struggling to generate growth, the Brexit vote outcome couldn't have come at a worse time and is likely to mean another leg down in global growth into 2017. There is also a rising tide of anti-globalism and nationalism taking hold. Blimey, it's enough to make a bloke want to go out to the pub with his mates and get pissed over a few pints of brew. Brilliant! Cheers!

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IMPORTANT DISCLAIMER: