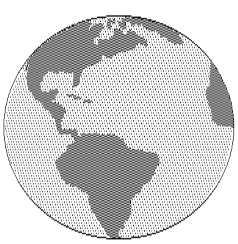
# Market Watch
## 2nd Quarter 2016

FINANCIAL PARTNERS, INC.

**July 2016** **MosaicFP.com**

## Summary


- Markets and returns were almost universally positive for the second quarter of 2016.
- The primary exception to the positive environment this quarter was Europe's pullback as a result of the "Brexit" vote in the UK. While most of the world quickly recovered from the initial shock, Europe as a whole has not quite made it back to "even."
- The one-year numbers reflected in this performance report still largely reflect the very difficult last half of 2015 and are quite different from the quarterly and half-year results.
- With the concerns about the direction of the world economy that had the markets in a tizzy in January and early February of this year, in addition to late June's Brexit pull-back, investors actively sought the safety of bonds. As a result, bond returns continued to be attractive.
- Results for alternative investments were pretty close to universally attractive in 2016, but the negative environment of 2015 creates an unhappy impression for one-year numbers.
- The US economy continues its slow and unsteady march forward, remaining among the world's strongest.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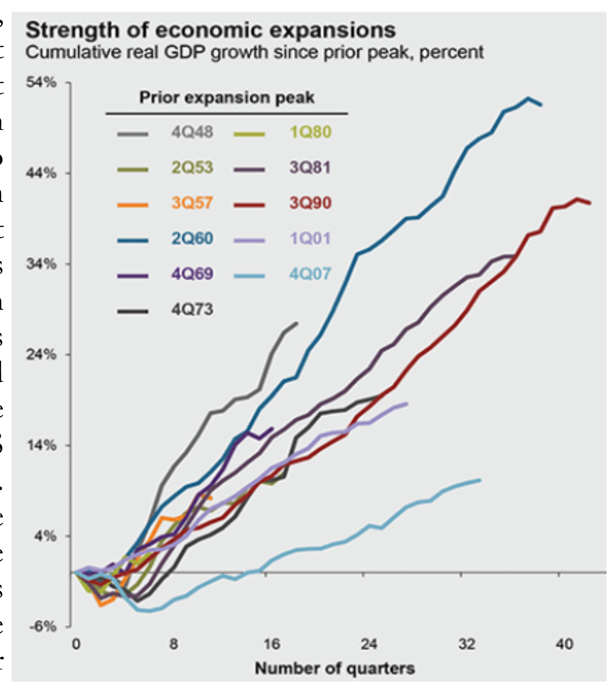
## Overview

Investing has had few consistent successes over the last couple of years. The second quarter of 2016 helped reaffirm the rationale for diversification. Most asset classes within our investment portfolios rose this quarter, except for the developed international stocks, which are still recovering from the late June Brexit vote and subsequent market reaction. Alternatives were one of the performance leaders this quarter, along with real estate. Bonds and emerging market stocks also enjoyed a positive quarter.

That said, the one-year performance numbers, which are reflected in your Mosaic report, still include the very difficult end of 2015. This overshadows the positive performance being seen in 2016. August and September of last year, and the first six weeks of 2016, were challenging for investors. In both periods, markets fell in response to worries that still grip investors who lost so much in the last two recessions. Whether it is concerns about the economy, terrorism, or political instability overseas, many investors have been quick to exit markets at the first signs or perception of bad news. The result has been globally volatile markets.

Uncertainty abounds in the current climate. Whether it is the outcome of the upcoming US elections, the longer-term impact of the Brexit vote, turmoil in the Middle East, or economic and political concerns in other parts of the globe, investors are keeping a nervous finger on the "sell trigger." Still, the American economy seems to be strengthening, and despite the global concerns that exist, economic growth continues in many areas of the world. This leaves us hopeful for the intermediate outcome.

In 2016's second quarter, probably the single biggest news story was the Brexit vote, in which the British people narrowly voted to pull out of the European Union. Because it's not yet clear to anyone what this could mean or what form it might take, the markets have largely recovered from their initial adverse reaction. Overall, the US market is up since the vote. European markets are mixed, but on average, are down slightly. US bonds have risen in value as some investors have sought their greater safety.




*Source: JP Morgan*

## The US Economy

The Brexit vote caught the financial markets by surprise. The UK's disentanglement from the European Union will be a long and uncertain process, but the impact on the US economy should be relatively modest. Trade with both Europe and the UK should continue largely unhindered.

Recent data suggest a pickup in US economic growth in the second quarter, led by a rebound in consumer spending. The contraction in energy exploration should be near an end (no longer a drag on overall growth), but soft global growth and election-year uncertainty may restrain business investment in the near term. At the beginning of 2016, spending on home construction and remodeling grew at its fastest pace in more than three years. This helped support an otherwise relatively weak quarter for economic growth.

The chart on the prior page reflects data from the US Bureau of Economic Analysis (BEA) as of June 30, 2016. It illustrates the growth rate of the economy following the last 11 recessions going back to 1948. As you can see in the chart, the current rate of economic expansion has been by far the slowest of any of these recoveries (though the recovery has persisted longer than most). There are many theories as to why this expansion has been so slow, but this slow rate of growth is a part of what has caused so much argument at the policy level.

### Federal Reserve

Lowering interest rates is one of the Federal Reserve's classic tools to move the nation from a deep recession (2007-09) to a more stable, growing economy. But for this tool to be available when the next economic downturn hits, interest rates need to rise from their current basement levels. Inevitably, higher interest rates will cause the value of the dollar to rise (unless other countries also raise their rates). A stronger dollar will make it harder for American businesses to sell their products and services abroad. This could in turn cause unemployment to rise.

The Fed, therefore, has to proceed with extreme caution. The uncertainty about the impact of the Brexit vote has made the Fed's job that much more difficult. The most aggressive forecasts are now for only one interest rate increase in 2016.

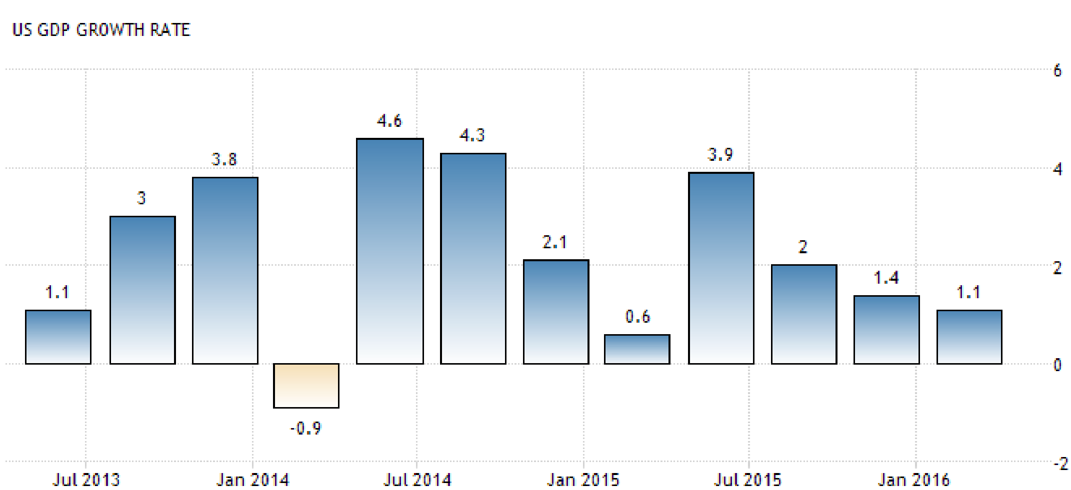
### Forecast on GDP

According to BEA June revisions, the US Gross Domestic Product (the value of all goods and services produced), increased at a 1.1% annual rate in the first quarter in 2016 and seems to have accelerated in Q2. But uncertainty following the Brexit referendum poses a risk to the growth outlook for the rest 2016.

So far this year, consumer spending has rebounded to help economic growth. Corporate profits are projected to increase as a result. US Manufacturing may also finally shift into a higher gear. The Institute for Supply Management report said that its index of manufacturing activity rose to 53.2 in June from a level of 51.3 in May. (A reading above 50 indicates that factory activity is expanding while a reading below 50 signals contraction.)

Inflation remains low, with little on the horizon to make us concerned.

Total employment in the US continues to grow confirming that the economy has regained speed. Reported job creation surged beyond expectations in June with the unemployment rate falling to 4.9%, as more people entered the labor force.



*Source: US Bureau of Economic Analysis*

At the same time, wage growth remains sluggish even as the labor market tightens. Average hourly earnings increased only two cents (0.1%) in June.

### US Housing

Housing continues to be a bright spot in an otherwise choppy economy. Steady job creation and low borrowing costs pushed the sales of existing homes to

*Source: US Bureau of Labor Statistics*

their highest level since 2007 and prices climbed to a new peak in May. Nationally, housing prices have steadily risen since 2011. Still, the average price for an existing single family home remains below its peak of $275,930 that was reached in October of 2005. With interest rates continuing near all-time lows, the debt service on mortgages relative to incomes is lower than it has been going back to 1980. Lending standards for new loans are as strict as they have ever been.

## The World Economy

Brexit is the dominant concern in looking at the world today. While most forecast a slowdown in world trade as cross-border connections become more complex, some project that trade activity might actually be enhanced. Theresa May, the new British Prime Minister, will be charged with working with a contentious European Union to determine which of many possible formats the new relationship will take. Any doomsday forecasts are almost certainly excessive. Growth in China continues to decelerate as President Xi Jinping grabs ever-more political control. Domestic nationalism challenges are mounting in a number of Eurozone countries. Terrorism appears to be increasing its impact across the globe. And clearly, political uncertainty will be a factor in the United States ahead of the November presidential vote as opinions are increasingly polarized.

### Europe

The Eurozone economy picked up pace in the first quarter of the year. Robust growth in the domestic economy drove the recovery and improving labor market boosted private consumption growth. The Eurozone's GDP grew 0.6% in the first quarter, pushing the annual growth rate up to 1.7% with almost zero inflation. The unprecedented monetary stimulus from the European Central Bank has helped spur a modest recovery, bringing unemployment down to 10.1% (its lowest level since 2011).

The act of a country leaving the EU is unique, and involves many uncertainties. In the near term, we anticipate that financial and media speculation on future outcomes will lead to increased volatility in Eurozone financial markets, and additional pressure on the euro.

Over the last 12 months, US investors have lost ground investing in Europe. Developed international returns are down roughly 9.5% for the last 12 months. About half of this decline occurred following the late June Brexit vote. Prior to the vote, 2016 returns had been largely stable.

### Japan

Japan's stock market grew handsomely in 2013-15. More recently, the Japanese market has fallen as the Japanese economy struggles to find its footing.

Despite the aggressive efforts of the Japanese Central Bank to boost the economy and lower the value of the yen, the Brexit vote chased traders into ports of safety, including the yen. As a result, the yen strengthened to levels last seen in early 2014. The resulting pressure on Japan's fragile economy caused Prime Minister Shinzo Abe to defer a controversial sales tax hike which was intended to cure part of Japan's budget deficit.

Abe was elected promising major economic reforms. Until these reforms are meaningfully underway, Japan's potential growth will continue to be seriously constrained. For US investors, Japan's markets fell about 8.5% for the year, but were positive this last quarter.

### China

China, the world's second largest economy, continues to grow, but at a more sustainable pace. Gross domestic product rose 6.7% in the first quarter versus a year earlier. Continued growth in private borrowing has spurred a property sector rebound. This does raise questions about the sustainability of China's debt-fueled expansion.

China still appears to grapple with industrial overcapacity resulting from its earlier massive stimulus package following the global financial crisis in 2008. In an attempt to encourage lending, last month China again reduced the reserve requirement ratio for state banks. The government has also cut interest rates six times in the past year and a half. After the unexpected devaluations of the Chinese yuan in August and December 2015 triggered major turbulence in world financial markets, the Chinese central bank has now moved to a more gradual depreciation of the trade-weighted yuan.

President Xi continues his personal march toward total dominance of China, squelching dissent while trying to encourage broad-ranged economic growth. The longer term implications of his policies are unclear.

For US investors, Chinese markets were down over 20% for the last 12 months. Most of the declines occurred in 2015 with more stable recent results.

**Emerging Markets**

The performance of the emerging markets saw large variations by country. The best news was seen in Russia, which enjoyed its fastest rate of economic growth since February 2013, buoyed by the rise in oil prices. Both manufacturing and services expanded rapidly in the last four months, putting on hold widespread expectations of an increasingly difficult recession.

With its political leadership in upheaval, Brazil is struggling to regain its economic footing and remains the worst performing of the four BRIC (Brazil, Russia, India and China) economies.

Latin America, like the rest of the world, shows negative returns for the 12 month period ending June 30, but year-to-date, Morningstar reports that Latin American-directed funds were up over 26%, reflecting a hope that many of the more problematic economies are improving.

## Investments

**US Equities**

The last two years have been anything but smooth, as shown by the above chart of the S&P 500. From beginning to end of this period, the major index of large US companies rose in total just 6.1% (plus about 2% per year in dividends). There were several pull-backs, each time with the market recovering. The low for this two-year period was in February of this year. The market has been climbing steadily since that time despite a few uncomfortable hiccups, like the two day drop after the Brexit vote.

Despite the Brexit vote and its immediate market reaction, the US markets rallied at month end. The S&P 500 Index ended the quarter up 2.71%. The Dow Jones Industrial Average also finished higher, gaining 2.07%, while the Nasdaq was pretty much flat, finishing the quarter negative 0.23%. All three indices were positive for the period until the sharp drop following the surprise Brexit vote.

A decline in expected corporate earnings also weighed on market performance in 2016. Of the 10 major sectors, 6 reported negative growth during the first quarter of 2016. The depth and breadth of the current earnings slump is quite rare outside of an economic recession. It remains to be seen what second quarter data will indicate.

Using the forward P/E (current stock price divided by estimated future earnings over the next 12 months), the S&P 500 index is now priced at 16.6 times forecasted earnings. This is slightly above the 25-year average of 15.9. This suggests the stock market is fully valued and therefore less likely to see a big jump in stock prices (short of unexpected earnings increases). The second quarter corporate earnings report will bring more clarity to market valuations. The current dividend yield for S&P 500 index was 2.3% at the end of June.

One of the struggles our portfolios have had over the last few years has been our emphasis on "value" investing versus so-called "growth" investments. While both growth and value styles of investing will have their periods of stronger relative performance, over longer periods of time, value investing has had a decided advantage. We don't believe this relationship has fundamentally changed. Year-to-date and in the 2nd

**S&P 500—the last two years: Much Ado About Nothing**

quarter, value handily outperformed growth, as can be seen in the chart below.

| Value versus Growth | YTD | Q2 |
|---|---|---|
| **Large Value** | 6.30% | 4.58% |
| **Large Growth** | 1.36% | 0.61% |
| | | |
| **Small Value** | 6.08% | 4.31% |
| **Small Growth** | -1.59% | 3.24% |

*Source: JP Morgan*

### International Equities

In contrast to largely positive investment news from the US, international markets experienced a different result—thanks both to the slower economic progress in Europe and Japan and to the June Brexit vote. As measured by the MSCI Europe Australia Far East Index (EAFE), developed international markets declined by 1.19% for the quarter, 4.04% year-to-date, and were down 9.72% for the last 12 months.

The Emerging Market economies posted modest returns for the quarter but stronger returns year-to-date. The MSCI Emerging Market Index rose 0.80% for the quarter and was up 6.60% YTD. The overhang from last year still has them down 11.71% for the last 12 months.

### Bonds

The US bond sector was a clear winner this quarter. The Brexit vote shocked investors and triggered $2 trillion in losses in global stock markets the day after the referendum as investors fled equities in favor of bonds. This pushed yields on the 10-year Treasuries down to 1.49% at quarter end. The Barclay's US Aggregate Bond Index rose 2.21% for the quarter and is up 5.31% year to date.

During the 2nd quarter, prices in nearly all major bond sectors rose, reflecting a flight to safety arising from investors' uncertainty surrounding the "Brexit" vote and anxieties about the approaching US presidential elections. When investors turn to "safe haven" assets, demand pushes bond prices higher while yields fall in response. This reduces the future income these investors will receive relative to the price they pay for their bonds.

During the quarter, the Barclays Capital Aggregate Bond Index rose 2.21% and is up 5.31% year to date. The yield on 10-year Treasury Notes fell to a low of 1.47% (from 1.78% in Q1).

Although inflation remains low, US Treasury Inflation Protection Securities (TIPS) were up 1.71% for the quarter and are up 6.24% year to date. This reflects the "flight to safety" noted.

### Alternatives

Alternative holdings produced solid returns in Q2.

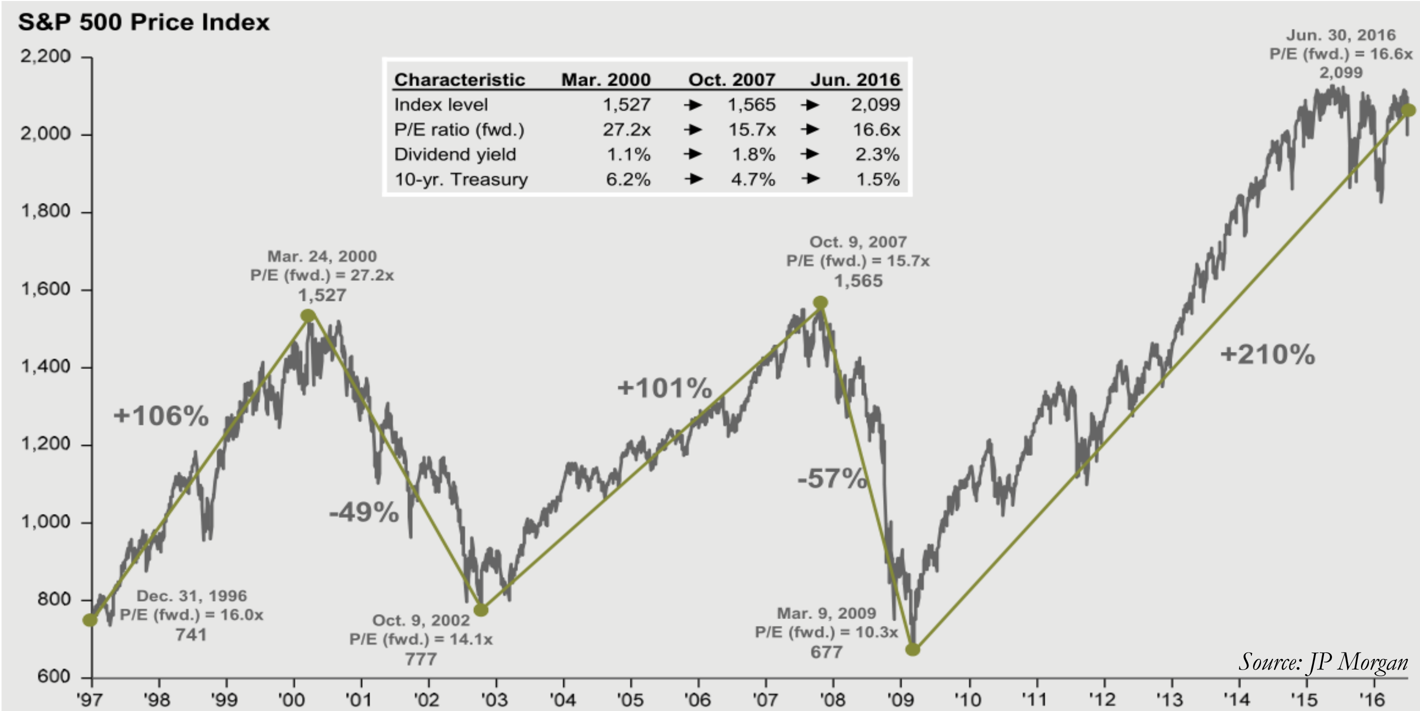
- The Alerian **Master Limited Partnership Infrastructure** Index, which tracks energy transportation and storage facilities, gained 20.56% for the quarter and is up 13.75% year to date. While we continue to argue that the results of this investment should be independent of the price of oil (since producers still have to pay rates for transportation or storage of the goods regardless of the price of oil) the recent results do largely echo the rise (and previous fall) in oil prices. While the outlook for the industry continues to be strong, one-year numbers are still negative, reflecting the falling prices from 2015 that carried into early 2016 before turning upward.

**Market Returns**

| 2015 | YTD |
|---|---|
| REITs 2.8% | REITs 13.7% |
| Large Cap 1.4% | Comdty. 13.3% |
| Fixed Income 0.5% | High Yield 8.7% |
| Cash 0.0% | EM Equity 6.6% |
| DM Equity -0.4% | Fixed Income 5.3% |
| Asset Alloc. -2.0% | Asset Alloc. 4.0% |
| High Yield -2.7% | Large Cap 3.8% |
| Small Cap -4.4% | Small Cap 2.2% |
| EM Equity -14.6% | Cash 0.1% |
| Comdty. -24.7% | DM Equity -4.0% |

*Source: JP Morgan*

- **Global real estate**, represented by the NAREIT Real Global Index, rose 3.57% over the quarter, and was up 8.83% since the beginning of the year and 10.49% for the last 12 months.
- **Emerging market bonds**, as helped by a stronger dollar: these dollar-denominated bonds posted positive results in the second quarter gaining 6% (versus 0.34% for bonds issued in their local currencies). The category was up 12.29% YTD and 13.22% for the last 12 months.
- **Timber**, as measured by the FTSE NAREIT Timber REIT, was down 1.12%, but is up 4.15% in 2016 and up 5.86% for the 12 months ending June 30th.
- **Managed Futures**, as measured by the S&P Diversified Trends Indicator Index, which represents this category, posted a gain of 2.46% for the quarter and up 3.84% year to date.




- **Business Development Corporations**, as represented by the Wells Fargo BDC Trailing Index, were up 4.10% for the quarter, 8.77% YTD and 2.71% for the 12 month period.

- **Merger/Arbitrage**, as represented by the Credit Suisse Merger Arbitrage Liquid Trailing Index, fell 3.17%, 1.06% and 0.51% respectively.

## Summary

Asset class returns for 2016 year-to-date were largely positive, despite a rough start to the year and a turbulent June. Positive returns aren't yet enough to offset the price declines that occurred in the second half of 2015, and this is reflected in the return number for the most recent 12 month period. Another positive sign is that two of the investment biases we employ—value and alternatives—have helped performance.

The first six weeks of the year had many investors worried we were entering into another major recession—the result of the weakening global economy. In mid-February, oil prices bottomed and began to rise. This changed the economic landscape—and with it the performance of the financial markets. The Brexit vote brought another market shock: for two days, investors questioned whether this was the trigger that would lead to another recession. Each time, the markets recovered.

A natural inclination when the markets panic is to want to "take some action" to avoid a potential meltdown. Investors have been striving to do this from time immemorial. And, each time, they find that they sold too late, or (more importantly) that they lack the confidence to get back in the market once it begins to advance. A loss on both fronts.

While we wish we could predict market movements and position our investments accordingly, we don't have this ability and there is little evidence that anyone can do so reliably. More often, those attempting this are undone by trying to time the market.

While both domestic and international markets experienced sharp sell-offs after the Brexit vote, as of this writing, the markets closed at an all-time high that would have been missed by those who joined the escape. Investors with diversified portfolios experienced less volatility and faster rebound due to the lower correlation between US and foreign equities. You hopefully appreciate benefits of diversification and the importance of a disciplined investment approach. We firmly believe that not overreacting to short-term pullbacks is critical to your long-term investing success.

Our duty is to lead our clients during times of uncertainty and to remind you to focus on your goals rather than worry about the fluctuations of the always varying markets. We thank you for your confidence, and for allowing us to be of service to you.

*Your Team at Mosaic Financial Partners*

**Sources:** *Morningstar, JP Morgan, Bloomberg, Charles Schwab, US Bureau of Labor Statistics, US Bureau of Economic Analysis, the Institute for Supply Management.*