Investment Update

Second Quarter 2016

Global stock markets ended the second quarter of 2016 with modest gains, and in contrast to many recent periods, the US stock markets did not experience much volatility until the last few days in the aftermath of the Brexit vote. Although it is more common for bond prices to move in the opposite direction to equities, this quarter saw yields continue to fall to record lows in a flight to safety, triggering in an increase in bond prices; the result was positive returns for both major asset classes in the quarter.

Equity Markets (Total Return)	2Q16	1-Year
Dow Jones Industrials	1.89%	2.61%
S&P 500	2.03%	3.47%
S&P Mid-Cap	3.79%	1.15%
S&P Small-Cap	3.57%	-0.19%
MSCI All-Country World	2.18%	-2.99%
MSCI Foreign Developed Markets	0.95%	2.47%
MSCI Foreign Emerging Markets	2.20%	7.03%
US Bond Markets (Total Return)	**2Q16**	**1-Year**
Barclays US Gov't/Credit Intermediate	1.74%	4.66%
Barclays US Gov't/Credit Long	7.61%	18.05%
Barclays Municipal Intermediate	1.86%	6.67%

A week before the Brexit referendum, the US stock market weakened on polls showing a closer race than anticipated, signaling a possibility of a "leave" victory for the first time. However, as the vote approached, polls and betting odds in particular (usually a quite reliable indicator in the UK) increasingly indicated a "stay" vote and markets rallied in to the Thursday of the vote. When news of the results came out late that evening, global stock markets started to fall and continued to do so sharply over the next two trading days with major markets ending down anywhere from 3% to 11%. The US was a relative outperformer, only falling back to levels of a week earlier, with the UK stock market falling slightly more and European stock markets suffering the most on uncertainty about the future of the European Union. With echoes of the nationalist fervor present in the US political environment heard throughout the UK and the Continent, there is now concern that other countries within the EU will move to hold similar votes.

Within hours, disillusionment over the results grew in the UK. Google reported a spike in searches for the likes of, "What does a departure from the European Union mean?" (something that perhaps should have been Googled *before* the vote), and supporters of leaving realized that the politicians behind the movement were starting to back-track on key points and also did not have an actual negotiating plan.

Within days the press and others started to map out scenarios in which an actual Brexit might not ultimately occur, or in which the UK will exit the EU but end up with a substantially similar set of trade rules to those that currently exist. At the very least, there was a realization that this will be a long, slow process, with both the nuances of an exit deal, and the effects thereof, very difficult to predict today. By the following Friday after the vote, the S&P 500 had rallied essentially right back to where it was before the final votes were tallied.

This quick return to calm notwithstanding, we do expect the process to be dynamic with mixed reactions from the stock market over time. More so than usual, things could change the moment this investment update is published. What should be kept in mind at the moment are the following:

- EU leadership has said that they will not negotiate on a deal until the UK invokes Article 50 of the EU constitution, which irrevocably sends the UK towards an exit and allows for a two-year negotiating window. This possibly creates a game of chicken where the UK is unwilling to move forward without more clarity on the terms.
- Having supported the "stay" campaign, Prime Minister David Cameron understandably announced intentions to step down in three months, leaving negotiations over an exit to his successor.
- While politicians on both sides of the vote promised to honor the will of the people, the referendum is ultimately non-binding on Parliament.
- The EU and UK will always be quite interdependent economically, and many "leave" supporters would likely be satisfied simply with more political independence from Brussels (where the EU is headquartered) rather than a wholesale change to the relationship.
- The UK has both its own currency and an independent central bank, easing the strain of any exit relative to that of a similarly-sized economy using the euro and ECB.

Easily missed in the news the day following the vote, the Fed released results of annual bank stress tests, and all received a passing grade with the exception of two US subsidiaries of European banks. The banking system is significantly stronger than it was in 2008-'09 and thus is unlikely to serve as a transfer mechanism to the broader economy as it did then from what ultimately is a political crisis this time (to the extent that Brexit constitutes a crisis at this point).

Markets dislike uncertainty. Business decision-makers dislike uncertainty even more. Provided this does not lead to other countries voting to leave the EU, the single biggest effect of a Brexit will be a long period of uncertainty over the rules which business decisions will be subject to in the future. As we have seen in the recent past in the US when the possibility of major tax law changes loomed, this uncertainly will likely stifle economic activity.

We expect the dollar and the US economy and stock market to continue to be a safe haven as economic and company fundamentals continue to be relatively positive if not necessarily robust in absolute terms for this stage of an economic recovery. Rate hikes in 2016 now seem unlikely and Fed Funds futures markets now do not fully price in an increase until 2018, but the Fed is not alone amongst central banks in having limited further tools to improve the situation; fiscal stimulus is the remaining option, whether through tax cuts, additional spending, or both. Longer-term bond yields have rallied worldwide to never before seen levels. While this does increase their value today, it undermines their value to portfolios as producers of income (the 10-yr US Treasury yields approximately .85% less than the S&P 500 as of this writing) and providers of safety as they now carry material downside risk.