Second Quarter 2016

Economic Update: Brexit – what does it mean?

The British vote to leave the European Union (EU), also known as "Brexit", caught many by surprise. The main issues that won the day were the Brits' desire for sovereignty and immigration control. In the near term, the tepid global economic growth that we have written about will likely be weakened because of uncertainty about doing business with UK companies and their trading partners. Longer term, if the UK's departure marks the beginning of the end for the EU, the resultant uncertainty will likely further hinder economic growth. France is even less happy about being in the EU. According to the Pew Research Center, 61% of French people have an unfavorable view of the EU (only 48% of the British were displeased) – the only country with a less favorable view is Greece[1]. The Transatlantic Economy comprised of the USA and the EU is the largest and wealthiest market in the world, accounting for over 50% of world GDP in terms of value[2]. Disruptions in this market are likely to have significant economic ripple effects.

Another probable side effect of the Brexit vote is lower-for-longer interest rates. The US Federal Reserve is unlikely to raise interest rates this year given the overseas uncertainty. Savers and banks will continue to struggle.

Capital Markets: Volatility grows

S&P 500 earnings have declined the past six quarters (since the third quarter of 2014), through March 31, 2016[3]. The cumulative earnings decline over those 6 quarters is -18.4%. Over that same timeframe, the S&P 500 index has essentially moved sideways, up *+4.14%.* This divergence is unusual. Either earnings will recover or stock prices will fall to reflect lower profit expectations.

The S&P 500 had been cruising along since the middle of February, getting close to new highs just a few weeks ago. Our various risk indicators were, for the most part, positive and supportive of taking risk. The British vote to leave the European Union may be the trigger event that changes that. Capital markets dislike uncertainty. Additionally, stocks and bonds continue to be priced at historically high valuations, making prospective returns low and downside risk high. As you can see in the following chart, the 30 year US Treasury bond has been on quite a run since the dot-com era. The latest rally is due to the relative safety of US government bonds and the US dollar. On January 3, 2000, the yield on the 30-year US Treasury bond was 6.61%; the yield on

[1] Euroskepticism Beyond Brexit, June 7, 2016
[2] EUintheUS.org Facts & Figures
[3] Per Standard and Poors

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the 90-day Treasury bill was 5.48%. Today those yields are 2.28% and 0.27% respectively. We don't expect bond prices to get much higher, but they could stay at or near these levels for some time yet. We expect that bond returns are likely limited to their current yields (interest rate).

Portfolios

Our portfolios handled "Brexit" just fine. Our stock and bond holdings had minimal direct exposure to the European Union countries and the United Kingdom although most global stocks experienced declines after the British vote. During the second quarter, we bought some cheap countries (GVAL) and home construction companies (ITB). These investments represent two areas of the stock market that we believe are undervalued and offer compelling return potential. As of March 31, the cheap countries included Austria, Ireland, Portugal, Spain, Italy, Russia, Poland, Greece, Czech Republic, Hungary & Brazil. We like the home construction niche. According to housing analyst Ivy Zellman,[4]single family housing inventory is at 30-year lows and the US is still 35% below a normalized level of housing starts. Home builders retrenched after the 2008-9 crash and the survivors are stronger for it. They should be well-positioned to grow their business and profits over the next several years. We like the prospects. Our three-pillar investment approach (stocks, bonds, alternatives) continues to smooth out our overall performance.

[4] Barrons magazine, June 4, 2016

Thank you for your continued trust and support.

Trevor K. Holsinger and Steve Small

Disclosure:

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