VERITY
Asset Management

Commentary

2nd Quarter 2016

Probably the two most notable market-related events since the end of the first quarter are the British vote to leave the European Union and the subsequent market rebound to new all-time highs.

Those two events perfectly frame the conundrum currently facing investors:

- The British exit, commonly referred to as "Brexit", may well be followed by similar events in other parts of Europe, as we have entered an era of renewed nationalism in European politics - and this risk of additional dislocations in the Eurozone is merely one item on a rather sobering list of serious and seemingly intractable global concerns.
- Yet, despite a lot of well-reasoned pessimism in much of the investment community, the U.S. equity market could now be positioned for a significant move higher.

A possible British exit was one of the macro issues cited in our last quarterly commentary as a significant risk to the U.S. equity market and markets worldwide. Yet, after only two days of reactive selling, the market rather dismissively shrugged the whole thing off and resumed its upward course. What should investors take from this?

The global economy continues to move further into uncharted territory as the world's central banks conduct live experiments with financial instruments and strategies which could hardly have been imagined only a short time ago. They are seeking in part to levitate their nations safely above issues that range from deep economic stagnation to potential credit crises to relentless demographic decline. To a significant extent, they are simply buying time in hopes that sufficient economic activity will ignite to resolve the problems, but as their efforts have become increasingly ineffective, it has seemed more like postponing – and possibly exacerbating – the inevitable. And meaningful segments of the world's population are frustrated to the point of beginning to rise up and demand that something change. It's a very unsettling outlook, to say the least.

Meanwhile, at home, the U.S. economy has continued to frustrate seemingly everyone – both the naysayers who have spent much of the past three quarters predicting imminent recession and the cautious optimists for whom intermittent flurries of strong data have fueled hope for a degree of genuine economic acceleration. The reality has been stuck somewhere in the middle, with no visible indications of a near-term recession but also no demonstrated ability to sustain a meaningful rate of growth.

The initial tally of second quarter GDP came in at 1.2%, much weaker than the widely expected 2.0% or higher. What observers likely failed to anticipate in the calculation was a significant drawdown in inventories, which at least has a bit of a silver lining – lower inventories mean a lower risk of cutbacks in production and employment moving forward.

Over the past month, surprisingly strong June numbers for jobs, retail sales, new home construction, and the ISM Non-Manufacturing index have again suggested the possibility of economic strengthening as second quarter came to a close.

- **The labor market** has remained consistently solid throughout the past year. Monthly payroll growth has slowed somewhat overall for demographic reasons, as described in our September 2015 commentary, but the rate of hiring remains strong, jobless claims have fallen to forty-year lows, the labor participation rate has stabilized, and average hourly earnings continue to ratchet higher. Two weaknesses obscured in the monthly headline data from the Labor Department have been the significant number of people working part-time due to an inability to find full-time work and the large pool of so-called "discouraged" workers who had dropped out of the labor force in the years following the financial crisis. However, the ratio of full-time to part-time workers – though still far from ideal – has been steadily improving, and "discouraged" workers rather inexplicably began pouring back into the workforce in sizeable numbers late last year.

- **Retail sales** surged in April but had tailed off somewhat in mid-quarter before posting a surprisingly positive June - a nice boost for the economic outlook as second quarter came to a close.

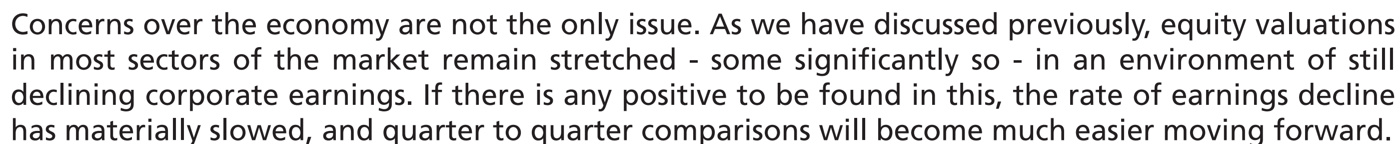
- **Housing** has been on a low growth trajectory but has continued to climb since the financial crisis. Housing data is particularly volatile, making it important to look at the overall trend more than individual monthly numbers, but a strong increase in June housing starts added to the end of quarter optimism.

- **The non-manufacturing** components of the economy, which collectively make up the bulk of the nation's economy, posted a sharp jump higher for June to the highest growth rate of the year, with particular strength in the all-important category of new orders.

- On a separate note, **manufacturing** remains unquestionably soft, but it has shown some overall improvement during the first half of 2016, bringing a bit of stability to a sector that had been a significant drag on the economy. Industrial production numbers came in surprisingly strong for June after a weak May, providing still another hopeful indicator as the quarter came to a close. The concern for manufacturing, though, is the potential for another period of dollar strengthening in the aftermath of Brexit, which would create a renewed headwind for exports.

The Atlanta Fed's GDPNow Forecast, which is updated every several days and has done a reasonably sound job of reflecting the largely tepid meandering of the economy over the past few quarters, came in at 3.7% in an early August read on the pace of third quarter GDP, by far the highest rate of growth it has posted this year. But we are very early in the quarter, with much of the July data still to come.

Perhaps the most worrisome component of the economy is a persistent weakness in **business investment**, which fell for a rare third quarter in a row - a serious negative for productivity and overall economic growth. Business concerns over the effects of Brexit on global demand and the strength of the dollar will not help; nor will uneasiness over the implications of the presidential election outcome. By far the primary drag on business investment has been a predictably huge drop in energy-related investment. However, any way one dissects the individual components, on a composite basis it is hard to envision the economy sustaining a meaningful level of expansion unless businesses begin putting more money to work.



Concerns over the economy are not the only issue. As we have discussed previously, equity valuations in most sectors of the market remain stretched - some significantly so - in an environment of still declining corporate earnings. If there is any positive to be found in this, the rate of earnings decline has materially slowed, and quarter to quarter comparisons will become much easier moving forward.

With all of this said, the market and the economy, though inextricably linked, are not the same. The market seeks to look ahead, factoring in anticipated future developments. Starting from a baseline environment where the economy is showing some improvement, interest rates are extremely low, and the Fed appears more cautious about the pace of rate increases in the aftermath of Brexit … if corporate earnings prove to be bottoming and turning higher again, we could begin to see a reasonable fundamental case for equities to move higher – though that's not the conventional wisdom at this point.

In addition, there is now in many respects a strong technical picture for equities - including very positive breadth, with market gains being experienced broadly across much of the market rather than only among a narrow group of stocks as was the case in 2015.

Finally, not every negative macro-event need be necessarily negative for U.S. equities, even if the initial reaction rattles the market. There is good reason to believe that a number of the potentially negative outcomes internationally could ultimately cause considerable capital flows over time to the relative attractiveness of U.S. equities, as investors in a world full of challenging economics seek opportunities in an area that appears to offer greater relative strength.

The bottom line is that the resolution of the sometimes tumultuous but largely sideways movement of the market for the past 18 months could be to the upside. This need not necessarily happen immediately - it could easily be preceded by another significant correction - but a number of conditions are in place for a move that would surprise most observers, with significant medium and longer term gains reasonably possible.

In sum, investors are faced with a market which could very plausibly continue to climb, despite daunting risks and considerable skepticism.

This gives investors two very different perspectives on the current investment landscape. The reality is that there may be an unusual dichotomy between the way relatively aggressive investors should look at the world versus the way more conservative investors should look at the world right now. Aggressive investors who can afford substantial drawdowns may want to weigh the potential for a significant opportunity here, so long as they recognize there could be violent ups and downs along the way. Conservative investors would be better advised to proceed with care, because the risks do indeed remain very significant.

Most investors of course live in the space between these extremes, making it perhaps as important as any time in recent memory to weigh carefully with your advisor the particular balance of strategies in your portfolio.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.

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