JULY 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

The month of June ended with an early taste of July 4th fireworks as the UK decided to vote to exit, contrary to all expectations, the European Union. This unexpected outcome quite naturally caused a spike in volatility in global equity markets and a flight to safety. As shown in Chart #1 the US equity markets dropped around 5% over the next few days before rebounding into the July 4th weekend.

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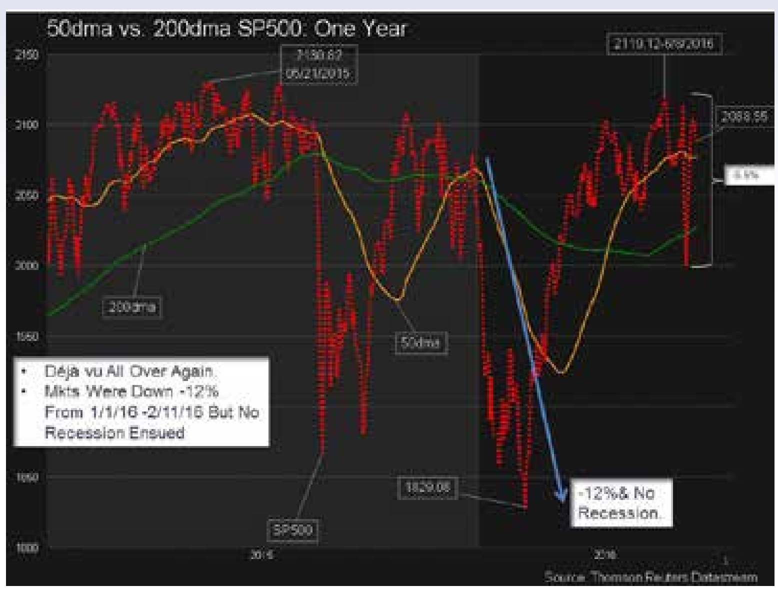

CHARTS 2-4

As shown in Chart #2 the market pullbacks in prior periods of financial crises, excluding the dot com and Lehman events, averaged about -15%. None of those corrections precipitated a recession and the markets eventually recovered. We expect the same thing to happen this time but remain watchful of the UK/EU divorce because it will be heavily influenced by the often irrational behavior of politicians.

Another major concern raised by the Brexit vote is that it comes about at a bad time for the global economy. As you can see on Chart #3, the global Purchasing Manager's Index is just barely in the expansion zone above 50. Since the consequences of the vote will likely remain unclear for years it will add uncertainty to business investment decisions and heighten volatility in global equity markets. Our more immediate concern is for the future of S&P500 earnings. As shown on Chart #4 these earnings were just beginning to recover from their February bottom but this momentum may now be at risk if the trend in flight to safety causes the US$ to get stronger.

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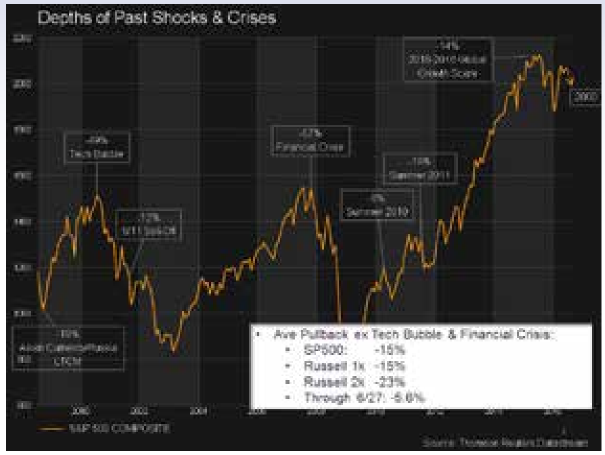

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CHARTS 5-6 In Chart #5 it is clear that, over the past several years, as the US$ got stronger the forward 12 month earnings estimates declined and as it weakened the estimates rose. This concern is widely shared by the US Fed and will likely influence their thinking about any future rate hikes. Chart #6 shows that the market's expectations of future overnight interest rates has fallen for the US, the Eurozone and, most dramatically, the UK. In fact, the odds of a Fed rate CUT for 2016 have turned positive for the first time in a few years!

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CHARTS 7-8 It is therefore no surprise that this turmoil has driven investors back into defensive sectors such as Utilities, Telecom., and Consumer Staples. In Chart #7 you can see that defensive sectors have outperformed cyclical sectors to a greater degree than during the February correction! Although these sectors may continue to outperform, their valuations are approaching elevated levels, Chart #8.

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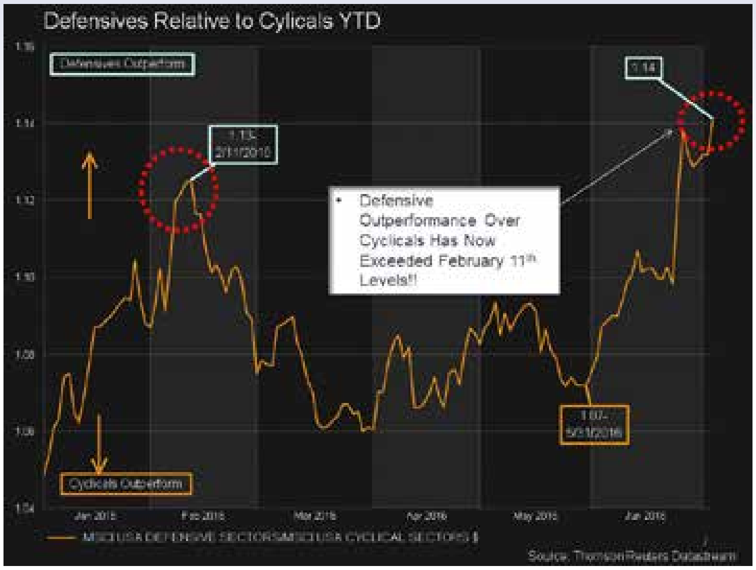

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CHARTS 9-10 We began this report by pointing out that the forward P/E of the S&P500 is near elevated levels and that earnings need to improve to support these valuations. We do, however, need to look at valuation from a relative perspective and, when we do, the market does not appear to be overvalued. In Chart #9 it is clear that the market's earnings yield is over one standard deviation cheap relative to its historical relationship to the 10 Yr. Treasury yield while at the same time the financial stress index is near historical lows! The low stress in the financial system is confirmed by the fact that the credit spreads for High Yield and BAA bonds are well below their February peaks, Chart #10.

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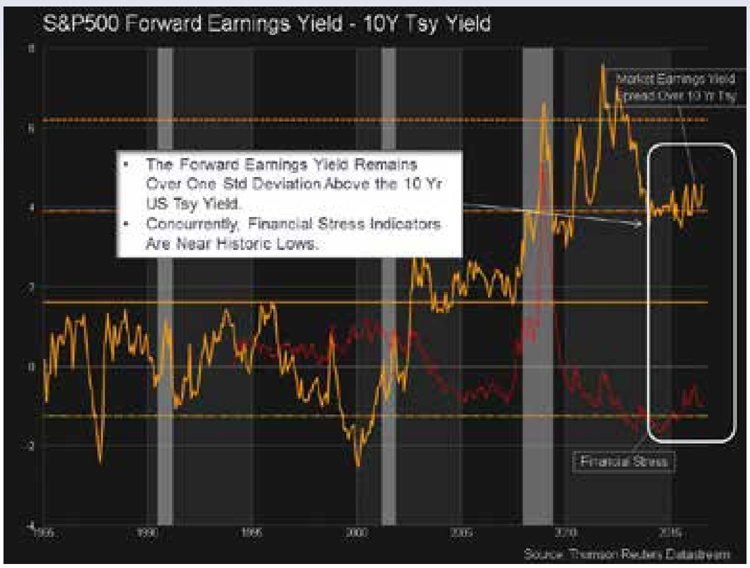

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CHART 11-12 It is difficult to envision a collapse in the markets given the relatively good US economic data that has been lately reported. Although durable goods orders were disappointing, they may well be in a bottoming phase. The ISM surveys for both Manufacturing and Non-Manufacturing sectors have surprised to the upside, Chart #11. In Chart #12 you can see that the new orders components are strengthening and that they are a strong leading indicator for corporate earnings while Chart #13 shows a strong relationship between the changes in the ISM Non-Manufacturing Survey and the S&P500 year over year change.

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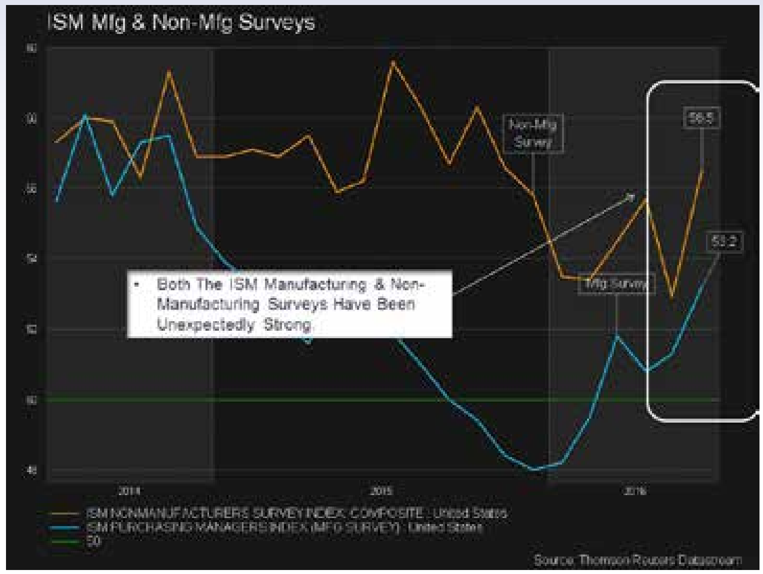

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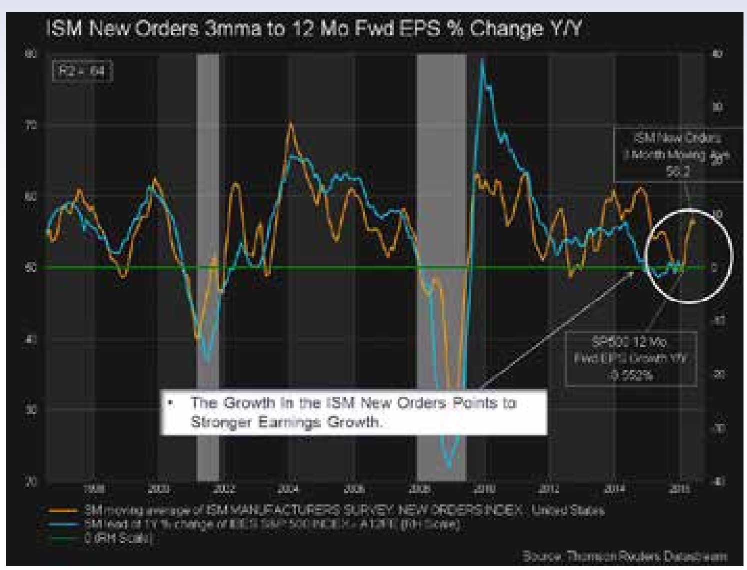

CHART 13 We are currently in an historic environment where interest rates are at generational lows; central banks around the world are pursuing easy monetary policies; and, the US economy is demonstrating a resiliency not shown by other G7 countries. We could go on and on listing the risks and uncertainties emanating both globally and domestically but all of them are known and very likely priced into the markets. No doubt that they will make their contributions to future volatility which, if the past is any guide, will also create opportunity.

Please feel free to discuss the content of this report with your advisor.

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