"Brexit" and Other Unresolved Issues

Market Update

Similar to the first quarter, stocks continued to shake off and look through many negatives. This quarter those negatives included multiple terrorist attacks, a continuation of the decline in corporate earnings growth, a move deeper into negative interest rate territory for many global bond markets and of course the "Brexit".

For the second quarter, the S&P 500 Index advanced by 1.9% and global stocks were higher by 1.1%. International stocks bore the brunt of the market reaction to the late June Brexit outcome and posted a decline of 2.6% for the quarter.

In a replay of the first three months of the year, bonds recorded strong returns in the second quarter with the U.S. Barclays Aggregate Bond Index posting a gain of 2.2%. The positive performance in the fixed income markets can be explained by a number of factors – including – investors' continued flight to high-quality assets, the relative attractiveness of U.S. bonds given the negative interest rate environment in many global bond markets, concerns over global economic growth and low inflation expectations. In 2016 fixed income performance has been driven much more heavily by the significant decline in interest rates than by coupon interest payments. The drop in interest rates is a much different outcome than the beginning of year predictions by analysts and strategists where the debate centered around how many times and by how much the Federal Reserve would raise rates.

While many questions remain unanswered and issues unresolved, a number of the concerns that rattled markets in January and February have eased to some degree. Oil prices have continued to advance in the second quarter after stabilizing in mid-February. This has resulted in some relief to the stress in equity and credit markets as well as to the banking sector. Also, while China is still seen as slowing, there have been some signs of stabilization in their economy and a decline in the wild volatility of their stock market. In addition, the steep increase in the value of the U.S. Dollar has leveled off with our currency actually showing a slight decline so far in 2016. If these trends continue it should help to turn recent formidable headwinds into tailwinds for U.S. corporate earnings growth and exports.

Economic Update

While difficult to describe as robust, growth looks to have rebounded in the second quarter. Current estimates for second quarter GDP growth are tracking at 2.7%. This represents a significant improvement from the growth rate of 1.1% registered in the first quarter. Second quarter retail sales data pointed to a still healthy U.S. consumer, manufacturing data improved slightly in a number of areas and the housing market continued to show momentum in terms of both new home starts and home price appreciation.

While the bounce back in overall growth is encouraging, employment gains eased substantially in the second quarter. Employment gains averaged roughly 81,000 in the second quarter. This is a measurable decline from the average monthly gains of 228,000 jobs in 2015 and also represents a significant decline compared to the results from the first quarter of this year. With our economy at or very near full employment levels, it is not surprising to see some degree of moderation in the pace of job growth. However, recent results have been below expectations and determining if the weakness in second quarter employment data is an aberration or a longer lasting trend will be a key area of focus going forward.

Brexit

The story of the quarter was the United Kingdom's (UK) referendum to remain or exit the European Union (EU). Leading up to the June 23rd vote, expectations were firmly in favor of the UK remaining in the EU. In fact, the betting odds (widely viewed as a better measure than polling data for predicting political outcomes) showed a 92% probability of a remain vote with polling data firmly in favor of that outcome as well. However, in a surprising move, the UK voted 52% to 48% to leave the EU.

The uncertainty associated with the outcome resulted in a dramatically negative initial response from investors. Global equity market value declined by $3 trillion over the two trading days following the referendum vote. Investors piled into high-quality bonds which led to a sharp decline in Treasury yields to near record lows. However, consistent with recent history, equity markets rebounded quickly with the S&P 500 Index closing the quarter at roughly the same level as before the Brexit vote. And surprisingly the UK stock market finished the quarter about 2.5% higher compared to the closing level before the referendum outcome.

While markets have weathered the short-term storm, the longer-term implications and consequences of the Brexit vote are complex and unpredictable. Some of the variables that add to the uncertainty include – Britain's Prime Minister, David Cameron as well as a wave of additional pro-"remain" politicians have resigned making it unclear who will lead the negotiations with the EU. Over 4 million people have signed a petition calling for a "re-do" or a second referendum vote. Scotland and Northern Ireland have made it clear that they wish to remain a part of the EU. The UK has yet to formally declare it wants to leave the EU. The UK will remain an EU member for a period of at least two years while the process of trade agreements and linkages with the rest of the EU is negotiated. This list could be expanded but the main point is that the final outcome is incalculable and will not be known or resolved in the near-term.

We expect a measurable negative impact to growth in the UK economy as businesses may delay investment and hiring decisions in face of the uncertainty. The Brexit is also likely to have some spillover effects to the broader European economy. But the impact to the U.S. and the global economy look limited as the UK economy represents less than 4% of global GDP. We also view calls from pundits that the Brexit will translate into some sort of "Lehman moment" as being too negative. We view the most significant risk of the Brexit outcome as being political risk associated with the potential for other European countries, especially those that actually use the common currency, to break away from the EU. Will the concerns over immigration, regulations and diminished control over domestic affairs cause other EU members to break away? Only time will tell but this is a situation we will be monitoring closely.

Portfolio Positioning

We viewed the backdrop of the late June Brexit fueled volatility as a buying opportunity and increased equity exposure across investment policies. We ended the quarter with equity exposure only slightly below the one step above mid-point level and with the intentions of completing the remaining equity addition in the near future. The increase in equity exposure was funded by reducing our fixed income allocation and cashing in some gains on one of our bond funds that has performed ahead of our expectations this year.

We also made a few characterization adjustments to our equity positioning in the second quarter. While we still maintain a bias towards high-quality, higher yielding stocks that generally exhibit a lower volatility profile than the overall stock market, we took some profits in certain sectors such as utilities and telecommunications where valuations looked a bit rich after significant share price appreciation. These proceeds were reallocated to stocks and strategies where we view valuations and long-term growth prospects as more attractive.

Other than realizing some gains and adding some incremental preferred stock exposure for certain investment policies, not much has changed with our fixed income positioning or views. We still maintain significant diversification across strategies and exposures. We still feel that long-term bonds look unattractive given the low yield environment and the asymmetrical risk-to-reward proposition associated with the outcomes if interest rates were to rise. This view is amplified by the recent decline to all-time, historic lows in bond yields in the U.S. and many other global bond markets.

Second Quarter Performance Attribution

We are generally pleased with the second quarter performance results. The majority of our domestic equity mutual funds outperformed the S&P 500 Index. In addition, while the broad international equity index finished the quarter in negative territory, our international mutual funds posted positive performance results and continue to exhibit low volatility even in periods of market turmoil. Our significant exposure to healthcare stocks contributed to performance results as that sector bounced back nicely in the second quarter after being weighed down earlier in the year by headwinds associated with drug pricing issues. Similar to the previous quarter, our tilt towards value oriented equities was beneficial as the outperformance versus growth stocks continued in the second quarter.

Our fixed income allocation produced returns firmly in positive territory for the quarter with several of our higher yielding and more economically sensitive fixed income strategies continuing their rebound from the beginning of the year decline. However, given our relatively short duration positioning and the significant decline in interest rates, keeping pace with longer maturity bond indices proved to be a difficult task. Many investors have probably heard the phrase "picking up nickels in front of a bulldozer" referring to investment opportunities where the reward for being right (nickels) is not adequate compensation for the consequences (bulldozer) of being wrong. We think this is a solid analogy to use to describe the current risk-to-reward dynamic associated with long maturity bonds.

Closing Thoughts

We are by no means calling for the "all clear" signal in regards to the global macro-economic issues that have caused and may continue to cause uncertainty and equity market volatility. However, we end the second quarter encouraged by a number of factors. The U.S. economy looks to have picked up some steam. We are seeing less pressure and stress on the economy and financial markets due to low energy prices and a strong U.S. Dollar. The decline in corporate earnings growth may have bottomed out in the first quarter. And equity markets continue to be very resilient and have bounced back in short order from all of the recent declines and bouts of uncertainty.

So where does this leave us? The domestic stock market has been stuck in a "trading range" for about two years. We ended the quarter with the S&P 500 trading at the top end of that range and less than 2% away from the all-time high. It remains to be seen if this is yet another test of the trading range or if now is the time that stocks can finally "breakout" and move meaningfully higher. With equity market valuations higher than historical averages, we are not confident that multiple expansion (or investors paying higher prices for the same level of corporate profits) will be the impetus for meaningfully higher equity returns. In our view, the catalyst will need to be a return to solid corporate earnings growth. Expectations are for a gradual improvement in the earnings picture over the next few quarters and for a significant rebound next year. We will be monitoring the outcome very closely.

We welcome all Roof Advisory Group clients to attend our interactive online webinar discussion scheduled for 1:00 pm EDT on Thursday July 14th. The purpose of this webinar is to provide a more in-depth overview of the most recent quarter, financial market conditions, portfolio positioning, as well as our firm's outlook going forward. Invitations to register for the webinar are currently being emailed to our valued clients.