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INVESTMENT PERSPECTIVES

>> THIRD QUARTER 2016

Picking up the pieces after Brexit

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In the early days of personal computers, *Datamation* magazine ran a front cover cartoon showing a man at his desk, staring forlornly at the smoldering remains of a desktop computer that had, quite literally, exploded. Shrapnel was strewn around him, and his face was smudged with ash. The thought-bubble read, "It's never done that before."

Welcome to the strange new world of Brexit — an unprecedented moment in history when a pillar of global stability seems to be in danger of similarly exploding. In the immediate aftermath of the June referendum, many investors fled the British stock market, fearful that withdrawal from the European Union would isolate and weaken the island nation.

We saw it differently: Brexit is unlikely to have a meaningful impact either on the U.K. economy or on the rest of the world. The U.K. accounts for less than 4% of U.S. trade, for example. Britain is among the most mercantile trading economies, and it is foolish to think that Americans or Europeans (or people anywhere else) will dramatically alter their trading behavior with British companies.

If anything, the plunge in the value of sterling (to levels not seen since that Datamation cover was published in 1985) makes British exports considerably more competitive. That, in turn, can begin to alleviate Britain's chronic balance of trade deficit and stimulate the domestic economy. A steep recession is hardly inevitable. In any event, the effects of Brexit are likely to be gradual and to play out over a long period of time.

Politically, however, Britain faces a more daunting challenge. The two leading political parties seem utterly lost, although the prompt election of Theresa May as Prime Minister certainly calmed the Conservatives; whether she will be the strong statesman the country needs is yet to be seen. Meanwhile, Labour's leadership has completely splintered. The biggest risk to investors in British securities isn't economic; it's political.

From a longer-term perspective, we think the old World War II tune got it about right: *There'll be blue birds over / The white cliffs of Dover / Tomorrow, when the Brits are free. / There'll be love and laughter / And peace ever after / Tomorrow, if Tories and Labour agree.*

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>> PERSPECTIVES ON THE ECONOMY

The American consumer perks up

By Christina Lakich
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In a year of unusually high volatility and risk, investors have been whipsawed from one "crisis" to another: plunging oil prices; dismal business investment; Brexit; deceleration in China; deflation in Japan; and negative interest rates seemingly everywhere. Hovering like a black cloud over all of that is the Presidential election, in which it seems almost certain that half of the electorate will wake up November 9th in a deeply depressed mood.

Through it all, the American consumer has been a rock of stability. The latest data indicates positive news regarding the U.S. consumer and points to a significant rebound in domestic economic growth.

Consumer spending accelerated in the June quarter. Retail sales, which hit a two-year high in May, signal that inflation-adjusted consumption is growing at almost 4% annualized. Recent employment data have been mixed: Non-farm payrolls have been softer than expected, but initial unemployment claims remain close to a 40-year low. Further, new job openings have touched a record high, and the unemployment rate remains below 5%.

Surveys of consumer confidence touched an eight-month high in June, suggesting that consumer spending should remain strong for the remainder of the year. After a weak first quarter, fresher monthly data suggest that the consumer will lead GDP growth higher. We are forecasting an annualized GDP growth rate of 2.5%-3% through the summer, with growth for 2016 holding steady around 2%.

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>> FOCUS ON EQUITIES

The irrational rationale of equity markets

By Tim Garvey
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In many New England towns, summer's highlight is the arrival of the county fair with its prized livestock, blueberry pie-baking competitions, and of course the Midway carnival attractions. Some fairs even have roller coasters, the perfect emblem for this year's global equity markets. Through just the first six months, investors have been forced to deal with fears of a slowing Chinese economy, oil prices in the mid-$20s, dismal earnings growth, and Brexit. It's been a stomach-churning ride.

Yet equity markets have been resilient, recovering from each scare and even surpassing their previous levels. Stock prices are inherently volatile and will experience the occasional steep sell-off — but if the fundamentals are sound, the wisest action is simple persistence through the ups and downs. Take any 20-year stretch over the past half-century, and you will find equity returns of about 8% to 12% per year — even if the chosen timeframe includes the vicious bear markets of the 1970s or 2008-09. Time and patience are the investor's greatest allies.

This year's roller-coaster proves the point, in microcosm. The market sold off sharply in January and early February, over concerns that China's economy was slowing while oil prices had fallen all the way into the mid-$20s. The S&P 500 dropped nearly 12% as investors worried that the fallout from China and low oil prices could start causing significant damage to economies around the world. Yet after bottoming in mid-February, the S&P 500 advanced 15% over the next two months. The worst thing investors could have done would have been to sell stocks during February's gloom, because they would have missed out on the rally that ensued.

A similar lesson can be learned from what transpired following the U.K.'s vote to leave the European Union. In the two days after the vote, the S&P 500 plunged 5.3%, driven by fears about what effect Brexit would have on the global economy. Yet over the next several days, the S&P 500 rallied 5.1% to close the quarter within striking distance of its all-time high set in May 2015. The second half of 2016 promises more uncertainties; as history shows, the market is resilient and will ultimately bounce back.

>> FOCUS ON FIXED INCOME

Zero is not the bottom for yields

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Government debt continues to trade at unprecedented high price levels as central banks around the globe have instituted more unconventional policy measures to stimulate sluggish economies — policies such as negative interest rates and asset purchase programs. More than $10 trillion worth of government bonds now trade with yields below zero — meaning that investors are paying for the right to lend governments money.

Negative rates from other countries have led to strong demand for U.S. Treasuries, which still offer positive yields. The inflow of funds from international investors has pushed domestic yields lower. The 10-year Treasury note and 30-year Treasury bond both hit all-time low yields on the last day of June, at 1.38% and 2.26% respectively.

Even so, Treasury yields can still move even lower. Foreign central banks are committed to their current ultra-accommodative policies. The Fed was too optimistic in January when it telegraphed four hikes for 2016; it may still be too optimistic today in anticipating just one hike by year-end. Interest rate futures indicate that the Fed will keep the federal funds rate unchanged during the second half of the year.

With rates low and likely to remain so, investors are seeking yield through longer maturities and lower credit quality. Oil prices have doubled from their lows back in January, so high-yield energy bonds no longer pose serious credit risks. Lower quality bonds are once again attractive with yields of about 6%, as bankruptcy fears have subsided.

RECORD AMOUNT OF 5-YEAR SOVEREIGN DEBT TRADES AT NEGATIVE YIELDS