MARKET
PERSPECTIVES

STC Investment Committee

Bruce L. Swanson, Ph.D.

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May Report

This May market report contains an update covering my perceptions of market reactions to the British vote to exit the European Union ("BREXIT").

While global markets were only modestly higher in May, that outcome is better than it might seem as positive economic developments convinced investors that a near-term Federal Reserve Board ("Fed") rate hike might be tolerable (or even potentially timely) as consumer prices rose at their highest rate since 2013. Despite Fed officials setting the stage for a summer rate hike and the subsequent stronger dollar, emerging markets were the only weak spot, with much of that simply due to a 14% loss in Brazil on profit taking after 50% gains through April.

The global economic news was supportive of risk-taking and investor confidence. In the U.S., second quarter growth was expected to bounce back to 2.5% on the strength of strong labor and housing numbers as home sales grew at the highest rate in a decade. Japan's first quarter growth beat expectations and hopes grew that more fiscal stimulus, or at least a delay in the scheduled sales tax increase, was forthcoming. Europe continued its modest, but above trend, growth and Greece finalized an $11B finance package with its official creditors. While driven by supply disruptions in Canada and Nigeria, oil's 7% gain was viewed positively, perhaps as a deflation-fighter.

Global equity markets gained 0.1%, with domestic equities up 1.8%, international developed markets down 0.9% and emerging market equities down 3.7% (on Brazil and overall currency weakness). Technology stocks were the standout, gaining 5% here and abroad. Growth outperformed value, particularly in the smaller capitalization issues. In developed markets, declines of 3% were seen in peripheral Europe as well as the metals-sensitive Canadian and Australian markets. Copper (-8%) and gold (-6%) fell back from year-to-date April highs. Emerging market equities continued their regional divergence, with Asia little changed as India gained 2% on good growth numbers, but with losses in emerging-market Europe (-7%), Latin America (-11%), Russia (-6%) and Brazil (-14%). For 2016 to date, global equities have gained 2%, with developed market equities the laggard, down 1% due to losses in Italy (-13%), Germany (-2%) and Japan (-3%).

The US dollar's 3% index gain understated its widespread strength as only the Lari (Georgia), Shilling (Somalia), Franc (Guinea) and the Rupee (Seychelles) had any real strength against the dollar. The British pound outperformed other major currencies, declining less than 1% as BREXIT fears eased. Emerging market currencies and Australia declined 5%, with the Mexican Peso (-7%) and South African Rand (-9%) particularly weak.

The flattening yield curve left Treasuries and high-grade corporate indices little changed. While the dollar spiked and Treasury yields into the intermediate maturities increased on hawkish Fed talk, the domestic high-yield market gained an additional 0.6%. This resilience reflected both greater economic confidence as well as supportive energy prices, with the energy-heavy junk bonds (CCC ratings) gaining 3.2% (+16% year-to-date). Emerging-market local-currency debt was this month's casualty, losing 5.4% as the victim of a strong dollar, including Brazil-specific weakness and profit-taking, cutting year-to-date gains to 8%.

June Preview / BREXIT

As the BREXIT news has wiped out much of the rest of our short term memory, it is easy to forget that June had been on track for a very strong, "risk-on" month across all asset classes. The strength came about despite, or because of, an unexpectedly weak employment report early in the month that all but removed the chance of an immediate Fed rate increase. The report also provided little evidence of a U.S. recession and the mid-month release of the Fed officials' forecasts of future interest rates (the

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"dot forecast") was surprisingly dovish, with six members seeing only a single rate increase in 2016. The dollar consequently plunged, with the Australian dollar, Japanese Yen and Swiss Franc all gaining 4-5%. Global equity markets responded with a 1% gain, led by a 4% gain in emerging markets, driven by a 3% currency move. Both bonds and commodities rallied, with natural gas up 18%.

How has the world changed since the unexpected (market odds of 95% in the "remain" camp hours before voting) vote? Since posited post-BREXIT outcomes range from a near-term "do-over" on the referendum at one extreme to a breakup of the European Union ("EU") on the other, the situation is quite fluid. Nonetheless, it is worth staking out a working baseline scenario. First, no other country is likely to leave the EU, as the United Kingdom ("UK") is a special case in terms of its Euroscepticism as well as its relatively low economic dependency on the EU. On those scores, Italy is the biggest risk and the October vote on governance reforms could be decisive. Scotland would not qualify to be an EU member and the EU has more pressing concerns in any case. Second, the UK will remain a member of the EU for more than two years. However much EU officials would like the UK to trigger Article 50 and start the two-year clock, UK political considerations will likely delay this until the fall. Third, it is unlikely that the UK will be able to negotiate a bi-lateral deal that preserves the existing "passport" of financial services from the UK to the EU. While a free trade deal in goods is likely, the EU has never negotiated a financial services deal and will be tempted to rescind the passport in the hope of diverting foreign direct investment to Frankfurt and Paris. Fourth, while some make a case that the sharply weaker Pound and likely monetary accommodation will support 2017 growth close to 1%, I think the UK will do well to avoid recession due to its disadvantageous starting conditions in the form of an output gap, a current account deficit, a quantitative easing-induced real estate bubble, a leadership void and a multi-year period of uncertainty that will hit foreign direct investment, which had been running 3% of GDP in recent years. Fifth, while I don't see a breakup of the Eurozone, neither do I see BREXIT as the catalyst for greater integration and reform. Given the uncertainty, both the UK and the Eurozone are likely to see a negative effect on business spending, including foreign direct investment. While the UK could prosper in the long-run with bilateral free-trade deals and a more market friendly business environment, the economy will be worse for a few years before it gets better.

As long-time readers are well-aware, while we often have macro-views, tactical positioning is based upon valuation considerations, not crystal balls. The macro-views, such as the preceding BREXIT commentary, only serve to either reinforce or dilute the valuation-based conclusions at the asset class level. At a global level, BREXIT has crushed my hope that the Fed would begin to normalize interest rates in mid-2016; in fact, the July Fed forecasts are now focused on odds of a rate cut.

While this has direct implications for the Treasury market and financial stocks, the bigger concern is that without the Fed taking the lead in normalizing rates, it is hard to identify monetary policies in Europe and Japan that might be supportive, given the damage to the banking systems already caused by negative interest rates. The risk of the implementation of even more unorthodox monetary policies in those markets, with unknowable outcomes, has increased. Thus, while some have noted that the EU is a small part of the world economy (UK is only 2.5%; rest of the EU 13%) and have estimated the drag on global growth to be less than 0.2%, I am less optimistic given the challenges BREXIT presents to developed-market central banks and financial institutions. Having said that, while an inflation-inducing burst of accelerated growth is now less likely and protectionist-policy risk has increased, global growth in 2017 is still likely to be in line with that of the last two years. While the dollar has rallied in a flight to safety, with the Fed now on hold into 2017, the rally is unlikely to continue. This reduces the risk of a disorderly devaluation for the Chinese Yuan and is a positive for emerging markets overall.

The return patterns from the first two post-BREXIT trading days could be described as ugly, but orderly. This is good in the sense that the market appears to be functioning and re-pricing assets appropriately, but bad in the sense that I do not see such obvious outliers that would trigger a major change in tactical allocation targets. World equity markets have declined 7%, with Japan and emerging markets relative outperformers and the UK and Eurozone down 15% (Italy more than 18%). In the U.S., the defensive utility sector actually gained 1%, while financial stocks declined 8%. A strong safe-haven bid appeared in Treasuries, with longer-dated maturities up 4-5%. The U.S. high-yield market declined 1%, without notable stress in the lower-rated issues. Commodities were mixed, with a 5% gain in gold offset by a 7% fall in oil. The trade-weighted dollar gained 3%, with noteworthy weakness seen in the British pound (-11%) and Mexican Peso (-5%); Japan was the outlier at +4%, while emerging-market currencies were only modestly lower.

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After viewing the last two days within the context of the entire month, I see little that would cause significant changes from prior tactical asset class positioning. For example, domestic equities remain 20% overvalued despite the 4% monthly decline. While still more attractive than US equities, the 9% monthly decline in EAFE (international developed market equities) is not an occasion to increase targeted levels, as the decline seems to properly reflect the prolonged uncertainty, central bank and financial system challenges, and the risk that hoped-for earnings growth in Europe may once gain fail to appear. We are modestly reducing fixed income exposures given the strong monthly gains (intermediate Treasuries up 3%), but with recognition of the risk that with the Fed on hold, the very flat Treasury bond curve is vulnerable to bearish steepening (yields rise in longer-term but not shorter-term maturities.

In summary, despite the BREXIT outcome, including the incredible downward move in the British pound (a 23 standard deviation move as calculated by one manager), I see a need for only modest adjustments to our asset class positioning as the market response has been frustratingly rational.

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

sentineltrust.com