The Ten Themes of 2Q 2016

While there were some brief periods of angst and volatility, the second quarter of 2016 ended with U.S. stocks, as measured by the S&P 500 index, posting a gain of +1.90% for the three months ending in June. Combined with the gain for the first quarter, the S&P 500 finished up +2.69% for the first half of the year. Small cap stocks, as measured by the Russell 2000 index, performed even better during the second quarter by rising +3.40%; however, given that small caps posted losses in the first quarter, they were only up +1.41% in the first six months of the year.

While the 2016 gains have been modest, it should not be forgotten just how bad the year started. At one point in mid-January, U.S. stocks were off to their worst start in over 100 years. Therefore, it is remarkable how much stocks have bounced back. The S&P 500 index has now rallied +14.75% off its February 11, 2016 closing low. Small cap stocks have fared even better with the Russell 2000 index gaining +20.78% over that same time frame.

Bonds participated too. The yield on a ten-year U.S. treasury bond opened the 2Q 2016 period at 1.82% and finished the quarter all the way down to 1.49%. One reason why U.S. bonds rallied sending their yields lower is because despite what at first appears to be an unattractive yield, when comparing this yield to other countries, the U.S. offers a significantly better rate of return. As such, global investors purchased U.S. debt because of its more attractive yields over countries in Europe and Japan, where some rates of return are near zero or even negative.

Without question the driving force behind the movements in the stock and bond markets during the second quarter of 2016 was global central bank policies, as they have been the main driving force ever since the financial crisis of 2008. As we stated in our last quarterly update, whenever we begin to measure economic data weakening, on cue, a global central bank somewhere will step in and provide support by pumping liquidity into the economy. This is what Mario Draghi, head of the European Central Bank (ECB) did in early March as many European countries were on the verge of entering into a recession. Additionally, our own central bank chief, Janet Yellen, continued to keep interest rates “lower for longer” to accommodate growth. These actions by the ECB and the U.S. Fed helped pave the way for the rally in stocks and bonds.

Our internal research continues to forecast modestly improving economic trends for the 3Q 2016 period. However, some risks have increased, such as Great Britain’s decision to leave the European Union. That decision, by itself, likely will not have a material impact on overall global economic trade. The worry of which country will be next has created an added layer of risk. That said, we do not want to fight multiple central banks who seem willing to do whatever it takes to re-inflate growth. We are also keenly aware there are other problems and issues with the global economy. For this reason, it is hard to be overly optimistic. In the meantime, **here are the ten themes** that we believe **impacted financial markets the most during the second quarter of 2016.**

1. Rally in stocks
2. Central Bank Support
3. Earnings
4. NIRP
5. Bank of Japan
6. Brexit
7. Volatility
8. Developed International underperformance
9. Terrorism
10. Global stock market performance

Rally in stocks

Since mid-February, a rally has been underway in global stocks that few are acknowledging or believe can continue. Nevertheless, take a look at how much some major markets have rallied off their lows this year to close out the second quarter of 2016.

Country	Stock Index	Gains off 2016 Low	*2016 YTD
Brazil	Ibovespa	37.41%	18.86%
Philippines	PSEi	28.14%	12.14%
Greece	ASE	22.96%	-14.13%
Vietnam	Ho Chi Minh	21.15%	9.19%
U.S. Small Cap	Russell 2000 Index	20.78%	1.41%
Canada	TSX Composite	18.76%	8.11%
Thailand	SET Index	17.97%	12.19%
India	SENSEX	17.64%	3.38%
Russia	MICEX	17.58%	7.37%
U.K.	FTSE	17.47%	4.20%
U.S. Large Cap	S&P 500	14.75%	2.69%
Mexico	Bolsa IPC	14.16%	6.95%
Indonesia	JSE Composite	13.65%	9.22%
Hong Kong	Hang Seng	13.51%	-5.11%
Taiwan	TSE	13.08%	3.94%
South Africa	FTSE/JSE All Share	12.83%	3.01%
Turkey	BIST 30	12.66%	8.13%
Germany	DAX	10.59%	-9.89%
China	Shanghai Composite	10.32%	-17.22%

*Price change through June 30, 2016

Source: Bloomberg

Central Bank support

As we have stated, over the past eight years there have been times when macroeconomic and corporate earnings expectations deteriorated. Normally, the weakening economic data signals the initial stages of a recession. However, the last eight years have not been normal because when the data turns south, central banks seem to step in and provide support. They have done so by adopting ZIRP (Zero Interest Rate Policy) and providing massive amounts of stimulus into the economy under programs such as QE (Quantitative Easing). In our opinion, the central banks have done everything in their power to prevent a recession from occurring over the last eight years.

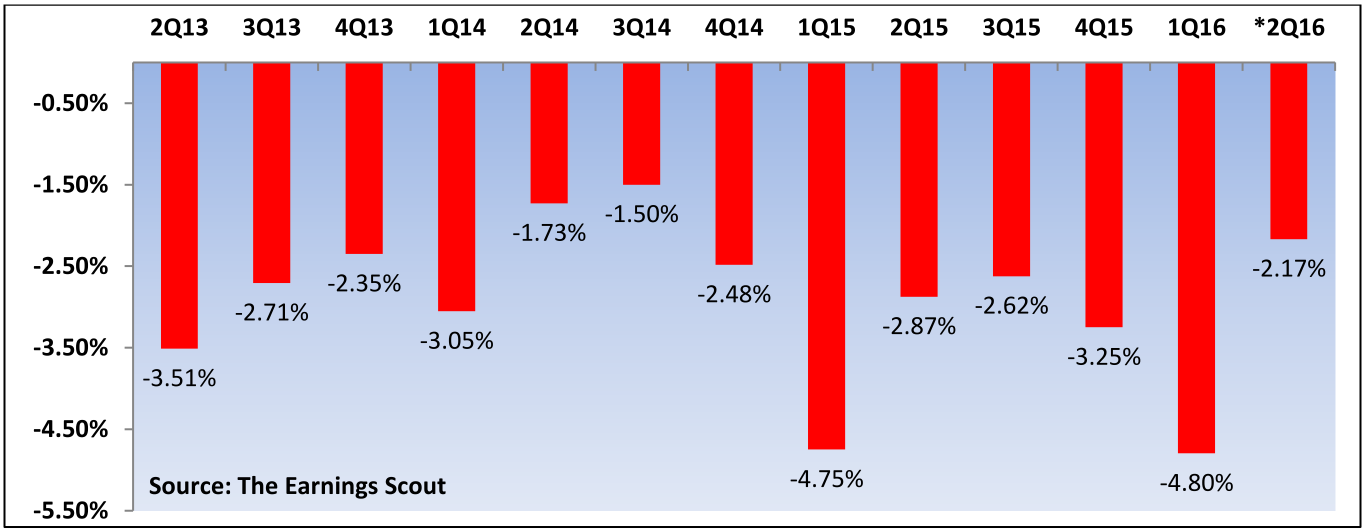
In early 2016, economic conditions began to weaken and the chances of a looming recession were rising. However in March, Mario Draghi, the head of the European Central Bank, announced plans to: cut interest rates further into negative territory, increase its QE bond buying program, and begin to provide essentially free funds to targeted financial institutions across Europe. In addition, the U.S. Fed, which was expected to raise short-term interest rates four times this year, has refrained from hiking rates in 2016. We believe a “lower for longer” strategy with regards to interest rate policy keeps U.S. monetary policy accommodative and is a big reason why global stocks have rallied.

Earnings

In April, a vast majority of companies reported their 1Q 2016 quarterly results. The numbers were not great. In fact, they were the worst we have measured, in terms of year-over-year growth, in over seven years. This is a big reason why many investors were puzzled at how stocks could rally in the face of the worst earnings tracked in quite a long time. There is no puzzle though. No riddle either. The answer is simple. Stock prices do not trade off of what has happened in the past. That is exactly what we learned as most companies reported their quarters ending in March in the month of April.

What does move stock prices is the direction of future earnings expectations. Therefore, this was an important stat of the past earnings season: As companies in the S&P 500 reported their 1Q 2016 results, 51% of them had their 2Q 2016 EPS estimates reduced, on average, by -2.17%. On the surface this may seem bad. However, it compares to 70% of the companies in the S&P 500 having their 1Q 2016 EPS estimates cut, on average, by -4.80% in the prior quarter. This improvement in earnings expectations (or more like less bad) is a very big factor as to why stocks have rallied. (We believe it has central banker thumbprints all over it too.)

How 2Q 2016 EPS estimate changes compared to changes in prior periods



- It is NOT a coincidence that when the rates of change to S&P 500 EPS estimates were improving (i.e. falling at decreasing rates) in 2013 and 2014 that stock prices went higher.
- In 2015, when the deltas to S&P 500 EPS estimate were negative (i.e. estimates falling at increasing rates), stock prices struggled.
- The rally underway in stocks can be justified by the improving trends seen between estimate changes for the 1Q 2016 and 2Q 2016 periods.

NIRP

NIRP (Negative Interest Rate Policy) has been adopted by the European Central Bank and the Bank of Japan. While most of the policies adopted by these central banks has been accomodative, the jury is still out on NIRP. We are inclined to believe it is causing more harm than good. In theory, negative interest rates should cause borrowers to want to borrow more at cheaper rates and savers to spend more. Both of which would boost economic growth. In reality, NIRP coninues to hurt bank profitability and is causing savers to save more as they need to offset their decreased income. At the very least, NIRP is not working to boost economic activity and could ultimately backfire on central bankers. Further, the move by central banks to adopt NIRP, has led many investors to flock to gold, where the yellow metal rose +6.77% during the 2Q 2016 period and is up +24.10% YTD at the Chicago Mercantile Exchange.

Bank of Japan

Japan’s economy has struggled over the last 20 years despite efforts by its central bank, the Bank of Japan (BOJ), to keep interest rates at 0.00% and inject liquidity into its economy to reflate growth via Quantitative Easing (QE). While this has kept the country afloat, it has not been enough to lead to a self-sustaining economic recovery. In recent months, the BOJ has refrained from adding to its QE bond buying program. There have been reports this is because the bank has run out of bonds to purchase in the open market. This calls into question whether the BOJ has run out of ammo to combat its deflating economy. Japanese stocks, as measured by the Nikkei index, are down -18.17% in 2016 and are off -24.11% from their 2015 highs.

Bank of Japan Governor, Haruhiko Kuroda

We highlight the Bank of Japan because many believe the ECB and our own Fed may also be running out of bullets to combat the weak growth environment. If that is the case, and economic data does not improve, will central banks have the necessary tools to deal with this into the future?

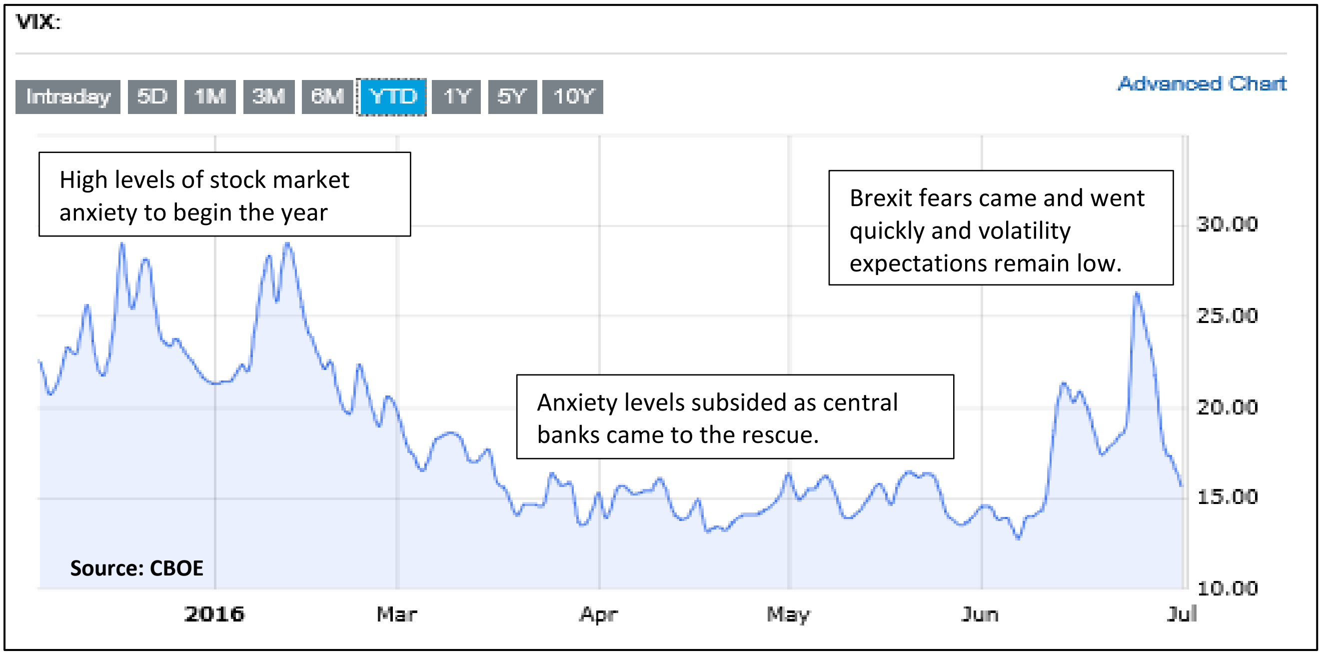
Brexit

In late June, the people of England spoke via a 51.89% vote to invoke Article 50 and start the formal and legal process of leaving the European Union (EU). David Cameron, the prime minster of England, who wanted to remain in the EU announced his resignation immediately after the vote. The vote surprised financial markets and triggered a massive global stock sell off and the flight to safety in bonds. But, once the Brexit dust cloud settled, cooler heads prevailed as investors realized that a country (U.K) that represents roughly 4% of the global economy, and is not going to zero, should have little impact on overall global economic trade. Stocks soon recovered almost all of their losses afterwards. The worry of Brexit, by itself, was no worry to us. We do, however, wonder if other countries are thinking of doing the same and would an unraveling of the European Union or even the Eurozone create more anxiety in the future?

Volatility

Volatility in financial markets spiked at the beginning of the year on increased fears the global economy was sinking into a recession. One way we meaure volatility is based on the Chicago Board of Options Exchange Volatility Index (or VIX). This index is a gauge of what markets believe stock market volality will look like over the next 30 days based on actual trading activity on the exchange. For most of the second quarter, volatility was low, but it rose dramatically after the Brexit vote, only to subside back to calmer levels as the quarter came to a close.

Chicago Board of Options Exchange Volatility Index (VIX)



Developed International stock underperformance

U.S. stocks, as reflected by the S&P 500 index, posted a gain of +1.90% for the quarter. Emerging Market returns were not as great (+0.32%) but were able to keep their 2016 lead. The glaring underperformance is coming from Developed International markets, as reflected by the MSCI EFA index, which is heavily weighted to markets in Europe and Japan where NIRP reigns supreme. Under negative interest rates, we forecast Developed International stocks will continue to underperform in the 2nd half of 2016.

Asset Class	2Q 2016	**2016 YTD
Domestic U.S.	1.90%	2.69%
*Emerging Markets	0.32%	6.74%
*Developed International	-2.34%	-4.94%

*MSCI EEM & EFA indices

**Price change through June 30, 2016

Source: Bloomberg

Terrorism

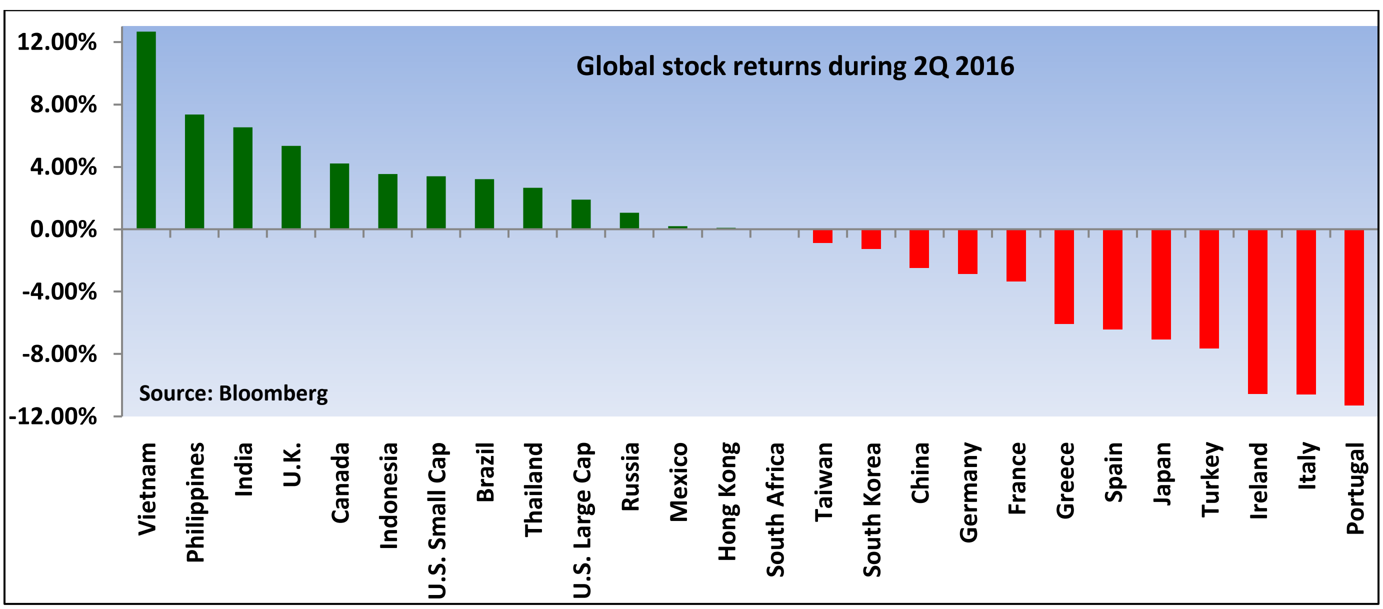
We list terrorism as one of the ten themes of the second quarter of 2016 not because of how it impacted global financial markets, but because how terrorism no longer seems to have a material impact on financial markets. Unfortunately, having to deal with the threat of a terrorist act has increasingly become the new normal. This could be why that while the events that unfolded from Orlando to Istanbul are clearly horrific, markets may be informing the terrorists their cowardly acts will not deter the direction of global trade.

Global stock market performance during 2Q 2016

Country	Stock Index	2Q 2016 Return	*2016 YTD
Vietnam	Ho Chi Minh	12.66%	9.19%
Philippines	PSEi	7.35%	12.14%
India	SENSEX	6.54%	3.38%
U.K.	FTSE	5.33%	4.20%
Canada	TSX Composite	4.23%	8.11%
Indonesia	JSE Composite	3.53%	9.22%
U.S. Small Cap	Russell 2000 Index	3.40%	1.41%
Brazil	Ibovespa	3.20%	18.86%
Thailand	SET Index	2.65%	12.19%
U.S. Large Cap	S&P 500	1.90%	2.69%
Russia	MICEX	1.07%	7.37%
Mexico	Bolsa IPC	0.19%	6.95%
Hong Kong	Hang Seng	0.09%	-5.11%
South Africa	FTSE/JSE All Share	-0.06%	3.01%
Taiwan	TSE	-0.89%	3.94%
South Korea	KOSPI	-1.28%	0.46%
China	Shanghai Composite	-2.47%	-17.22%
Germany	DAX	-2.86%	-9.89%
France	CAC	-3.37%	-8.62%
Greece	ASE	-6.06%	-14.13%
Spain	IBEX	-6.42%	-14.47%
Japan	Nikkei 225	-7.06%	-18.17%
Turkey	BIST 30	-7.63%	8.13%
Ireland	ISE	-10.56%	-16.92%
Italy	MIB	-10.59%	-24.37%
Portugal	PSI	-11.29%	-16.18%

*Price change through June 30, 2016

Source: Bloomberg



Conclusion

Our overall view on financial markets is relatively unchanged as the 3Q 2016 period begins. We still anticipate central bank policy actions taken during the first three months of the year, with the potential for additional action the way, may lead to continued improvement in macroeconomic expectations. We are no longer bearish on stocks as we were in 2015 and to begin 2016.

Near the of the end of the first quarter we made the decision to deploy some cash and move back to stocks at more neutral levels with a bias toward U.S. equities. We did so because our research suggested that the worst of the negative earnings estimate revisions for corporate America was over.

Given the increased risks from Brexit and that much of the improvement in macroeconomic expectations was based on central bank stimulus, we remain somewhat cautious though and do not want investors to over-allocate to stocks at weights greater than normal. Quite simply, we do not believe that central bank stimulus initiatives offer any long-term solutions. Instead, central bankers are “buying time” with their policies. As such, they likely thwarted a recession from occurring in 2016. However, until we see top-line sales of major corporations improve, we cannot be overly bullish on stocks at this point.

On the fixed income side, near the end of the second quarter, we began investing the cash that had been earmarked for domestic bonds back to more neutral levels. Based on current policies of central bankers around the world, it does not appear that holding funds in cash in anticipation of higher yields will likely happen soon.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Scott Hohman, CFP®, AIF®

Mark Klopfenstein, AIF®

Nick Raich, CFA®

Erin Zylka, MBA