Quarterly Economic Update

Second Quarter 2016

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This year has been a very inconsistent one for investors and it's only half over. Although recent events in the United Kingdom have dominated recent headlines, it was not that long ago when the big global concerns were about Asia. It also seems like the free fall of oil prices and highly contentious presidential primaries are distant memories.

The second quarter of 2016 was a period where investors were reminded once again of the market's volatility. At the quarter's end, the S&P 500 index added 1.9%. The Dow Jones Industrial Average gained 1.38% during the second quarter and the NASDAQ lost 0.56%.

While headlines might read that the stock market closed out the second quarter with modest gains, these closing numbers do not reflect the volatility that could have concerned even the most seasoned of investors. In order to finish the quarter in positive territory, the Dow Jones Industrial Average finished June with its best 3 days in 4 months. Investors remained in a buying mood on the quarter's last day as U.S. stocks rallied for a third consecutive day of gains of over 200 points. These gains recouped nearly all of the losses from the prior week's surprising United Kingdom's referendum to leave the European Union ("BREXIT"). ***(Source: Investing.com 6/30/2016)***

Confusing First Half of 2016

For many experts, the first half of 2016 seems to have shown an investment world that is upside down. Investors have been turning to stocks for income and bonds actually showed a source of capital gains. ***(Source: Barron's 7/4/16)***

This year has been a confusing one for investors. Within the U.S. equity markets, the biggest winners were stocks that offered dividend income like utilities, telecoms, and consumer staples. Many experts feel these equities can still provide dividend income but at their current valuations they may offer little, if any, growth. U.S. equity averages are once again within a few percent of their records and bond yields have fallen to record lows. U.S. treasuries and several other sovereign bonds now trade with yields that suggest low returns for investors.

When the year began, many analysts predicted higher interest rates and that would have fared poorly for bond investors. Three or four interest rate hikes were anticipated by the Federal Reserve and if that happened investors with long maturity bonds would have suffered. Instead, both 10 and 30 year U.S. Treasury Securities hit their lowest yields ever. According to Tradeweb data cited by the Wall Street Journal, the benchmark 10-year Treasury note traded at 1.385% in the wee hours of Friday July 1st which is below the 1.404% closing low of July 24th 2012, during the European debt crisis. ***(Source: Barron's 7/4/16)***

Oil prices, foreign currency valuations and corporate earnings are all still major concerns for investors. All of those issues took a back seat in late June as the United Kingdom's vote to withdraw from the European Union set off a shock wave of uncertainty which eased quickly the following week. Another highly anticipated and uncertain situation that should heat up in the next few months is who will reside in the White House next January. While that situation still has further to go, investors should also pay careful attention as to which party will control the Senate in 2017. All in all, 2016 is only halfway complete and the rest of the year could prove to be adventurous.

Interest Rates - "Lower for Longer"

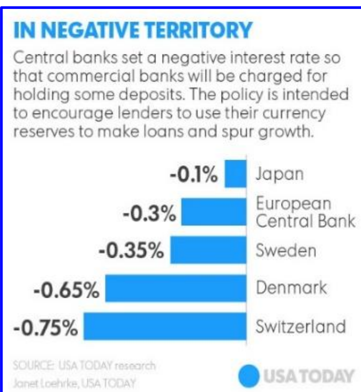
As of the end of the second quarter, central banks appear ready to keep rates lower for longer. So far in the United States, there has been only one rate hike since the end of the Great Recession. It was December 2015, when the Fed increased rates from near zero to a range of 0.25 to 0.5%.

Janet Yellen, Federal Reserve Chairwoman, told Congress on Tuesday June 21st that weak economic growth in the United States could force the Federal Reserve to hold off on any imminent interest rate increases. “Proceeding cautiously in raising the federal funds rate will allow us to keep the monetary support to economic growth in place while we assess whether growth is returning to a moderate pace,” she said. Despite all of her caution about the economy, Ms. Yellen did not see a recession on the horizon. “The odds of a recession are low,” she said. As always, she and her colleagues will continue to monitor the economy and inflation carefully. ***(Source: The New York Times 6/22/2016)***

In the United States, the expectation had been that the Fed could raise rates twice this year, with the first hike occurring in July. However, economists now say a Fed rate hike is off the table for the rest of this year. ***(Source: PressHerald.com 6/30/2016)***

The Fed is expected to keep the cost of borrowing money lower for longer than was previously expected. If rates remain low, then savers will suffer longer with low returns on their accounts. ***(Source: CNBC.com 7/1/2016)***

Negative Interest Rates



Since the global financial crisis of 2008, major central banks have implemented extraordinary monetary policies. This has included reducing interest rates to a near zero rate. Central banks used this strategy to promote growth and provide economic stimulus.

The U.S. Federal Reserve (Fed) has maintained an ultra-low interest rate policy, but the European Central Bank (ECB) and the Bank of Japan (BOJ) have implemented negative policy rates. Today, over 30% of the world’s global sovereign debt supply is now in negative territory. A negative interest rate means the central bank and perhaps private banks will charge negative interest; or instead of receiving money on deposits, depositors must pay regularly to keep their money with the bank. ***(Source: Broadleaf Partners 6/30/16)***

In Brief...

- **Investors faced a confusing and volatile first half of 2016.**
- **Interest rates look to remain low for longer.**
- **Several foreign central banks are using negative interest rates.**
- **The United Kingdom voted to exit the European Union (Brexit)**
- **Oil prices advanced but are still far below all-time highs.**
- **Investors need to consider their own situations first!**

“BREXIT”

In a move that surprised the markets, Britons voted on a referendum to leave the European Union on June 23rd. Known as “Brexit”, this event dominated the headlines the last few weeks of the quarter. While the long-term repercussions are still far from certain, equity markets around the world were reeling from the news.

U.S stocks suffered a drop of over 3% the day after the vote. U.S. markets then recovered almost all of their losses the following week. During this same time period, the Federal Reserve held a stress test of 33 of the largest banks. In a worst-case scenario theorized by the Fed, the banks tested had nearly twice as much capital as required (8.4% versus the prescribed 4.5%). Analysts feel this test should help allay fears that Brexit will not create a repeat of the 2008 crisis that threatened to take down the financial system.

Ultimately, Fidelity analysts summarized that this event could cause an increase in the likelihood for a British recession. The impact on the United States should remain relatively small due to consumer spending, and the Fed is not likely to raise interest rates the rest of the year.
(Sources: Barron’s 6/27/2016, Fidelity.com 6/26/2016)

Oil and Energy Prices

After a miserable start to the year, energy prices turned higher and were the best performing commodity sector during the second quarter of 2016.

The plunge in the price of oil over two years caused it to halve in value from 2014 highs, but in this quarter, crude oil posted impressive gains. Energy was the worst performing sector of 2014 and it repeated and took the dubious honor of being the worst performing sector of 2015.

Although the first six months of this year saw price recoveries for energy, analysts feel it is likely that there will be volatility in the second half of 2016 across all energy markets. There are currently so many things going on globally that could send the price of oil higher or lower in upcoming months. Equity markets do not like uncertainty and investors need to still keep a watchful eye on oil prices. ***(Source: Seeking Alpha 7/5/2016)***

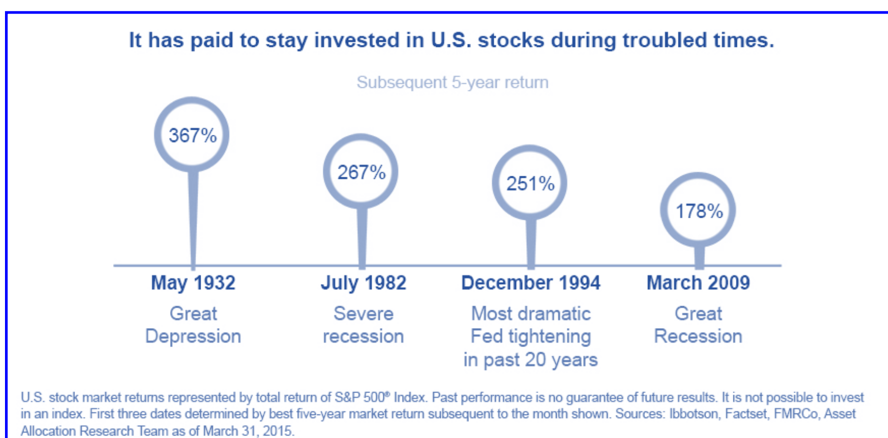
Should I Stay Invested?

Experts agree that investors always need to consider the risks of investing when making decisions. Investors should always be prepared. A well-defined investment plan tailored to your goals and financial situation that considers the chance of normal ups and downs in the market can help investors during volatile times.

No one can fully predict the future and past performance is no assurance of any type of financial return. Investors do have historical information to review. In fact, what seemed like some of the worst times to get into the market turned out to be the best times. As the chart in our newsletter shows, the best five-year return in the U.S. stock market began in May 1932—in the midst of the Great Depression. The next best five-year period began in July 1982, amid an economy in the midst of one of the worst recessions in the postwar period, featuring double-digit levels of unemployment and interest rates. Other good five-year periods include the one following the 2009 Great Recession. ***(Source: Fidelity 6/30/2016)***

Today's low interest rates are not helping investors and retirees who might need current income. Pension funds and insurance companies are also facing difficulties in generating returns that meet their needs. At the midyear roundtable conducted by Barron's, a panel of stock market experts felt that stocks would rise by less than 5% in the second half of 2016. Although they predict a rise, they cautioned investors to be very selective when choosing investments. ***(Source: Barron's 6/13/2016)***

Some analysts are suggesting that with interest rates at or near historic lows we are in an era of **"TINA"** or **T**here **I**s **N**o **A**lternative to stocks. They cite that in a world where cash returns nothing and bond yields are little more, that equities might be the only source of return for investors. This will require patience for investors and your portfolio needs to be one that is adjusted to your specific situation. **If you have any questions about your investments call us or bring these concerns up at your next review.**
(Source: Barron's 7/4/2016)



CONCLUSION

As always, investors need to proceed with caution. We are carefully monitoring equity markets and interest rates so we can communicate with clients. Experts are predicting that the second half of 2016 could include uncertainty which typically causes quick and extreme volatility. Market volatility is a part of investing and it should be a reminder for you to review your investments regularly. So instead of being worried by volatility, try to be prepared.

Here are suggestions to help you prepare for volatile markets:

1. **Rethink your time horizons**- Market downturns happen often and recoveries could still provide long-term gains.
2. **Plan for your situation-** A plan that coordinates your risk tolerance with your goals and situation could help you cope with volatility.
3. **Avoid acting emotional-** The fundamentals of good investments do not change as quickly as investor emotions.
4. **Call us!** Our goal is to help our clients at all times, especially during volatile ones!

Equity investors should be prepared to take a long term approach when looking at returns. Your time horizon, goals, and tolerance for risk are key factors we consider in helping to ensure that you have an investment strategy that is created for you.

Now is good time to ask yourself:

- ✓ Has my risk tolerance changed?
- ✓ Have my time horizons or needs changed?
- ✓ What are my investment cash flow needs for the next few years?

Instead of focusing on the markets, focus on your situation. Your answers to these questions will govern how we recommend investment vehicles for you to consider. We can help you determine which investments to avoid and how long to hold each of your investment categories before making major adjustments. For example, if your cash flow needs have changed

for the next few years, you might consider different investments than someone who has limited to no cash flow needs.

We continually review economic, tax and investment issues and draw on that knowledge to offer direction and strategies to our clients.

We pride ourselves in offering:

- **consistent and strong communication,**
- **a schedule of regular client meetings, and**
- **continuing education for our team on the issues that affect our clients.**

A good financial advisor can help make your journey easier. Our goal is to understand our clients' needs and then try to create a plan to address those needs.

We continually monitor your portfolio. While we cannot control financial markets or interest rates, we keep a watchful eye on them.

No one can predict the future with complete accuracy, so we keep the lines of communication open with our clients. Our primary objective is to take the emotions out of investing for our clients.

We can discuss your specific situation at your next review meeting, or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial matters.

Benjamin Franklin. He was 70 years old.; South Carolina's Edward Rutledge. He was 26.; John Hancock had the largest signature and he was also the first to sign.

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In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Sources: Investing.com, Barron's, The New York Times, PressHerald.com, CNBC.com, Wall Street Journal, Fidelity.com, Seeking Alpha, Broadleaf Partners) Contents © 2016 Academy of Preferred Financial Advisors, Inc.