The **Philadelphia** Story

A Quarterly Commentary on the Economy & the Financial Markets July 2016

From: *Philadelphia* Investment Management Group

OVERVIEW

- *Economic Growth in the U.S. Remains in a Positive but Slow Upward Trend*
- *Geopolitical Storms Act as Temporary Headwinds to Growth and Markets*
- *Financial Markets Globally Continue to be Supported by Central Banks*
- *Equity Markets are Reasonably Valued and Need Added Earnings for Future Expansion*
- *Low Interest Rates and the Federal Reserve are Headwinds for Fixed Income Markets*

THE ECONOMY

The U.S. economy is stabilizing after another rough winter, shrugging off worries about a recession or prolonged slowdown. Economic gauges released during the second quarter generally showed a pickup in industrial output, plus momentum in the housing sector and firming inflation, all pointing to stronger, though still unspectacular, growth in the second quarter just ended. That joined other recent data showing rising consumer confidence and continued job gains.

The economy has made a habit, especially in the past three years, of stumbling in the early months of the year, only to rebound in the spring and summer, and this year appears to be no different. Recent economic reports suggest Gross Domestic Product (GDP) grew at a rate of between 2.5% and 3.0% in the second quarter. This compares to growth of a 1.1% annual rate in the first quarter. Personal spending, a gauge of how much Americans paid for everything from autos to airfare, rose 0.4% in May from a month earlier. That followed a 1.1% jump in April, the sharpest rise in nearly seven years, giving support to the recent quarter's increase. Even with the second quarter improvement, many economists expect growth for the year will remain near the roughly 2% rate recorded for most of the expansion.

While Britain's vote was momentous, its impact on the global economy and corporate earnings does not seem to be as severe as implied by the market's initial reaction. The European Central Bank estimated the vote could shave as much as 0.5% from Europe's year-ahead economic growth, hardly an earth-shattering calamity. In addition, the impact on U.S. corporate profits seems unlikely to be a game-changer but will help to delay an interest rate hike by the U.S. Federal Reserve until 2017.

Yes, the consumer is still carrying the greater load in the growth of GDP. Manufacturing, although only about one-third of the economy, has been flat since January, a sign that the factory sector remains weakened after more than a year of pressure from falling oil prices and a strong dollar. But a gauge of industrial sentiment, published by the Institute of Supply Management, signaled expansion for two months in the quarter for the first time since last summer.

Even with a second quarter improvement, the weak degree of business investment coincides with lower productivity gains since the middle of 2014. Steady hiring could indicate businesses are spending on labor instead of capital expenses; but without equipment and other investments, it is difficult for productivity to improve over time.

Multiple factors are holding back strong investment: The energy sector is retrenching amid low oil prices. A strong dollar and economic weakness overseas have depressed demand for U.S. exports. And while consumer spending in rising, retailers are closing stores as shopping shifts to online. Potential long-run growth in the U.S. has, thus, dropped from about 5% to about the 2% range since the recession ended.

Now, with the U.K.'s decision to exit the European Union, this headwind may rock the overall U.S. economy in coming months, but it is not likely to sink it. Once the initial market turmoil abates, the decision will become the latest in a long list of headwinds contributing to the American economy's sluggish growth. The U.S. has powered through a number of overseas risks in the seven years since the recession ended, and economists expect it will weather this one, too, allowing domestic concerns to again be out in the forefront.

The British decision is expected to affect the U.S. economy in at least three key ways: it will strengthen the dollar, weigh on business confidence and tighten financial conditions. As stated, appreciation of the dollar curbs demand for U.S. exports by making products and services more expensive to sell abroad. At the same time, it makes imports cheaper for U.S. consumers, containing inflation and restraining wage growth. And it pushes commodity prices down, weighing again on the U.S. energy and metals sectors.

Business confidence may also take a hit from Britain's decision. It could fuel economic and political uncertainty in the E.U., which is the largest single export market for American firms. Global market volatility tends to sour risk appetite among many U.S. companies. Thus, companies may hold off on investing in new products and projects as they wait for the post-Brexit storm to pass; again, a slower pace in productivity. Federal Reserve Chairwoman Yellen highlighted timid private sector spending as one of her biggest worries during Congressional testimony in late May and stated private investment has been very weak. That is one reason productivity growth has been so meager.

Finally, from a political point of view, Washington may feel that Brexit could cause strategic and diplomatic rifts between the U.S. and many of its global allies as they are no longer part of the Union. Other countries, in turn, may decide to go their own way.

While the direct financial impact of Brexit is unclear, markets will price in those areas that are perfectly foreseeable. A strong dollar will hurt commodities and emerging markets. Political uncertainties in Europe and the United States will continue to delay investment worldwide. Only time will tell for all, but reasons enough to remain cautious towards the financial markets.

This has been the most unloved bull financial market in history. The seven-year rally in risk assets, led by equities, has been so joyless for two main reasons. The monetary policy by major central banks that has accompanied it has no precedent, so its long-term effects are uncertain. And the rally has been given only minor support by companies' fundamentals. Revenue growth is scarce; bottom lines have risen on cost cuts and share buybacks.

FINANCIAL MARKETS

EQUITIES

Entering 2016, investors faced medium valuation and slowing operating growth for stocks of all sizes. In the opening weeks of the year, falling commodity prices sparked fears of slowing demand, particularly in China, potentially sparking a global recession. Nevertheless, U.S. stocks rebounded and traded within a higher elevated range for most of the remaining four months through June, led by smaller stocks, which tend to be more sensitive to the U.S. economy. An interesting factor of the market is that the main indices continued to hold within 5% or so of their all-time highs, despite the long list of negative news events and concerns that investors, and really everybody, had during the period, as discussed above.

As we all know, the tranquil market trend was, once again, disrupted on June 24th, the day the Brexit result was announced. The dire predictions came against the backdrop of falling markets worldwide. Japan's markets dropped 8%; France's fell 10%, while the S&P 500 lost 5%. However, after a few weakened days of soul-searching, markets overall regained more than half of the declines in the last week of the quarter. The declines seemed to be dramatic, but the turnaround put the U.S. markets back up where they were three months ago.

Investors would do well to recall market overreactions from the recent past. The 2013 "taper tantrum" saw the S&P 500 drop nearly 5% and then recover the entire amount in ten trading days. The Greek debt referendum in 2015 caused an almost 12% pullback in the NASDAQ Composite, which recovered in nine weeks. The China growth crisis at the beginning of this year caused the Dow Jones Industrial Average to fall more than 11%, followed by a full recovery within seven weeks.

One thing we have to expect going forward is continued short-term market volatility, regardless of the long-term outcome. But this should not be cause for panic. Markets have absorbed the shock of the Brexit vote extremely well. While prices dropped, liquidity was strong. On the 24th, trading volume rose two times normal and ten times normal on the Treasury market.

After all was said and done, three of the four equity indices showed positive total returns for the quarter, led by the Russell 2000, an index of smaller, domestically-oriented companies, as reflected in the following table. For the year-to-date, the Dow, with its concentration of stable, higher yielding names, came in first.

	Equity Returns*		
Index	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	2.46%	1.35%	3.84%
Dow	2.07%	2.20%	4.31%
NASDAQ	-0.56%	-2.75%	-3.29%
Russell 2000	3.79%	-1.52%	2.22%

*Total: price change + dividend

A full year has elapsed since the stock market reached its peak on May 21, 2015, when the S&P 500 closed at 2130, and the Dow ended May 19, 2015 at 18,312. While stocks have made no net progress, even with dividends included, there have been recurring moves every two months or so in the past half year. High-water marks were reached last December and in April with the Dow around 18,000, and lows around 16,000, not including a short spike down to around 15,600 on February 11th, basically, a trading range move.

As we moved through the quarter, year-ahead profit estimates continued to erode, and both earnings and sales were expected to be lower again when announced within coming weeks. However, the consensus still calls for a turnaround in the second half of the year, with per-share profits up about 3% in the third quarter and 8% in the fourth quarter, subject to change, of course.

During most of the sideways action of the S&P 500 and Dow Jones Industrials, the traditionally defensive stocks that are generally higher in yield and lower in volatility have dominated the relative performance, as reflected in the following table, with many of the sectors, such as Utilities, Telecommunications and Consumer Staples, moving up to new all-time highs. Much of this stronger performance is from investors who are seeking less risk and more yield, as interest rates remain at historically low levels.

	S&P 500			
		Returns		
Sector	**Weight***	**2nd Qtr**	**1st Qtr**	**YTD**
• Materials	2.8%	3.71%	3.61%	7.46%
• Industrials	10.2%	1.40%	4.99%	6.46%
• Telecommunications	2.9%	7.06%	16.61%	24.85%
• Cons. Discretionary	12.3%	-0.91%	1.60%	0.68%
• Consumer Staples	10.6%	4.63%	5.57%	10.46%
• Energy	7.4%	11.62%	4.02%	16.10%
• Health Care	14.7%	6.27%	-5.50%	0.42%
• Info Technology	19.8%	-2.84%	2.60%	-0.32%
• Utilities	3.6%	6.79%	15.56%	23.41%
• Financials	15.7%	2.12%	-5.06%	-3.05%

*06/30/16
Source: Standard & Poor's

Eventually, we feel investor confidence will improve, which will benefit the more growth-oriented groups of the stock market, but we are not currently detecting much in the way of improvement in attitudes yet. The daily news keeps us distracted from a longer-term trend that may develop as the cycle, in time, slowly shifts from defense to offense and changes from yield to growth.

The typical U.S. stock currently trades at a premium to long-term norms, and we are skeptical the broad market can maintain its momentum without a better outlook for corporate earnings. Defensive areas, like Consumer Staples and Utilities, have seldom become more expensive in the recent search for quality and yield, so the outlook for more cyclical groups, such as Consumer Discretionary, Financials, Industrials and Technology, is crucial to carry the market forward.

Investors know that valuations are somewhat expensive in certain sectors and that earnings are declining. Yet, the broad market has advanced slowly with the cyclical areas showing improved relative strength as we moved through the latter part of the quarter.

There will continue to be binary risk, like Brexit and the U.S. elections in November; thus, we feel portfolios should be well diversified across all market sectors with a blend of both growth and defensive groups. Furthermore, to see stocks go much higher, we need to have earnings growth, and overall, it appears that the jury is still out on whether we will see the degree of growth in the second half of the year that is expected.

The three percent drop in major stock indexes in response to the surprise British vote does not mean the end of the long bull market dating back to 2009. U.S. stocks are more insulated than any other major equity market, as American companies generate 70% of revenues domestically. That compares to 58% for Japanese companies and 49% for Europe, based on a Morgan Stanley report. Other pluses are U.S. corporate balance sheets are strong, interest rates are low and the U.S. economy is on track for a 2.5% expansion in the last quarter. In addition, more than 60% of stocks in the S&P 500 index carry a dividend yield higher than the 10-year Treasury note.

The main catalyst for equity prices remains the earnings backdrop. The quality of earnings has deteriorated, as stated, over the past several quarters, but we do not believe corporate health is failing. As global economic growth regains traction, we expect earnings will improve, especially if we do not see a renewal of the oil rout/dollar rally trend. Assuming corporate earnings can recover, we think it is more likely than not that equity markets will advance over the coming year.

FIXED INCOME

Recently, U.S. taxable fixed income investors have found themselves in a challenging market environment characterized by low yield levels, bouts of volatility and a longer, drawn-out normalization cycle. Ten-year Treasury benchmark yields fell throughout the early part of the year, as turbulent global financial markets and less-than-encouraging economic data decreased the likelihood of a rate increase in March. However, the lack of Federal Reserve action in raising rates passed us by. As we moved through the second quarter, the World Bank cut its global growth outlook and polls began suggesting an increased chance that voters would push for the U.K. to leave the European Union, which they did on June 23rd.

The pressure from these additional factors led investors to shift toward a decidedly "risk-off" posture. The flight to quality pushed global yields to new lows, with the 10-year Treasury yield at levels not seen since before the 2013 "taper tantrum" and German 10-year bund yields falling into negative territory for the first time. The decline in yields for base rate U.S. Treasury issues is reflected in the following table, and it occurred across the full yield curve (short-to-long interest rates). The yield curve continued to flatten as demand for yield intensified, with the spread between two-year and 10-year notes at 89 basis points, down from 122 basis points at year-end 2015, a nine-year low.

Base Interest Rates

	U.S. Treasury Yields				
	---------- Maturity ----------				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2015	0.16%	1.05%	1.76%	2.27%	3.02%
Mar 31, 2016	0.20%	0.70%	1.21%	1.77%	2.61%
Jun 30, 2016	0.26%	0.58%	1.00%	1.47%	2.29%
Change:					
3/31-6/30/16	0.06%	-0.12%	-0.21%	-0.30%	-0.32%
12/31-6/30/16	0.10%	-0.47%	-0.76%	-0.80%	-0.73%

For rates to be so low and the yield curve so flat have suggested to some, in the past, economic weakening and fragile markets. To many, the world, including the U.S., is coming around to the view that the potential for growth is lower. However, there are reasons for the lower Treasury yields that have little to do with the U.S. economy, which actually grew faster in the second quarter than it did in the first.

High global demand for U.S. fixed income securities, which yield much more than bonds of other developed countries, is a big part of the story. Recent Treasury auctions indicate demand from foreign buyers is at record levels. The European Central Bank started buying member-country corporate bonds in June, helping to drive down corporate rates in the U.S., as well.

The flattening of the yield curve is sending a slower economic growth message in response to the prospects of more rate hikes. The yield curve, as measured by the difference between two- and 10-year Treasury yields, has been hovering near its narrowest levels since late 2007 and is at its "flattest" since just before the recession. Conversely, as in the past, when the yield curve steepens (longer-term rates rise more than short-term rates), the market is sending a growth signal. However, as stated above, global demand by overseas investors, both individuals and central banks, has been insatiable and will continue for most of the year. Thus, one has to take the flatter yield curve and low 10-year Treasury yield with a "grain of salt," at least for now.

Given the decline in interest rates during the second quarter and full six months of the year, the investment grade taxable sectors and municipals showed positive returns for the periods, as indicated in the following table. Both intermediate and long maturity sectors, as well as quality areas, participated in the demand for yield in the ongoing environment of no rate increases by the Federal Reserve, another period of beating the equity markets.

Fixed Income Returns

Index	2nd Qtr	1st Qtr	YTD
Corporate/Govt.	2.68%	3.50%	6.27%
Int. Corporate/Govt.	1.58%	2.44%	4.05%
Long Corporate/Govt.	6.50%	7.33%	14.30%
U.S. Treasury	2.24%	3.35%	5.66%
- Intermediate	1.25%	2.31%	3.59%
- Long	6.38%	7.90%	14.79%
Corporate	3.50%	3.92%	7.56%
- Intermediate	2.28%	2.82%	5.16%
- Long	6.67%	6.87%	14.00%
- Quality			
- AAA	3.30%	4.42%	7.87%
- AA	2.67%	3.68%	6.45%
- A	2.94%	3.64%	6.69%
- BBB	4.27%	4.27%	8.72%
Municipal	2.72%	1.64%	4.41%
- Intermediate	1.17%	1.12%	2.30%
- Long	3.72%	1.97%	5.76%

Source: BofA Merrill Lynch

In the second quarter, all three groups achieved positive returns of 2%+, while longer maturities captured the higher returns due to their greater yields. For the year to date, they captured mid single-digit gains with longer government and corporate maturities in the high range of 14%.

At mid-year, the Fed and bond markets remain far apart on the path of future interest rate hikes. The gap between what the Fed says it will do and what the market expects it to do has increased, once again, after narrowing through the first few months of 2016.

Credit spreads (the yield difference between corporate bonds versus the yield on comparable maturity Treasury issues) have tightened during the period from their sell-off at the end of 2015. The rise in oil has been the primary catalyst. Going forward, we expect corporate bonds to provide a good source of yield and income, given the positive outlook for the economy, though further price appreciation may be limited and volatility will remain.

While the municipal sector underperformed its government and corporate counterparts, the group has posted positive returns for the past 12 months. Overall, their performance tends to lag the two, both in an up or down market, due to the more "buy and hold" aspect of their client base. Performance has been supported by lower new supply, a healthy demand for tax-exempt yield, plus the Fed's patient posture in raising interest rates.

All in all, we continue to maintain a constructive outlook for municipal bonds, going forward. Our view centers on the idea that investors continue to need and seek: attractive relative yield in a low-rate world, low volatility and stable return, and ballast to equity and corporate risk.

The recent sharp fall in government bond yields has provided a tailwind to fixed income asset classes. Concerns about U.S. growth, a re-pricing of Fed rate hike expectations and global demand have been the driving factors. We think the market reaction has been overdone, as we believe the U.S. economy remains on a good growth path. We, therefore, expect that, in time, yields will move higher, eventually weighing on bond returns.

The Federal Reserve, to a degree, looks for any interest rate tightening cycle to be more gradual and finish at a lower level than in past history. Gradually rising rates help limit the immediate price risk to fixed income holdings, but they do not bode well for future total returns. On average, the coupon return, with reinvestments, account for roughly 75% of the total return. Given that the normalized level of coupon rates (market yields) are likely to be lower in this cycle, bonds are, therefore, poised to produce more moderate returns over the next several years.

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