Making Sense of Finance

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Second Quarter 2016 Review

STOCK MARKET

The second quarter of 2016 did not provide the same wild ride as the first quarter in the U.S. stock market. Domestic equities had positive returns in every month in the last quarter as measured by the S & P 500 index, which increased 1.90% during this period. For the most part the stock market volatility was fairly subdued. Prior to the Brexit vote, (the vote of the citizens of the United Kingdom to leave the European Union) there were only five days of swings of plus or minus 1% in the index during the quarter. However, during the last six trading days of the quarter, (which included the day of the vote on June 23rd), every day there was a movement of more than 1%, with the largest move coming on the day after the vote when investors were shocked that the vote was in favor of withdrawal . In knee jerk fashion, the stock market sold off as this was not the expected outcome. The S & P dropped over 3.5% in that one day, and had a two day decline of over 5%. Within a week, the market had recovered most of what it lost in the aftermath of the vote, as investors concluded that this change would take time and the net effect may not be so dire. The other major U.S. stock market indexes had different results last quarter. The Dow Jones Industrial Average returned 1.38% in the second quarter, while the Nasdaq Composite had a negative return of 0.56%, the second consecutive quarterly decline for this index.

Amongst industry sectors, the precious metal mining and energy related stocks (particularly the integrated oil and gas companies) again proved to be the winners. These stocks did well as the underlying commodities staged significant rebounds in price in the last quarter. Oil prices jumped 26%, natural gas prices soared 49% (largest quarterly percentage gain since 2005) and gold continued its rally up almost 7% for the quarter. Other industry groups that continued to outperform the general market were utilities and real estate investment trusts, both groups benefit from interest rates declining. Pharmaceutical stocks bounced back this past quarter and were among the better performing sectors. On the downside, many consumer discretionary stocks had negative returns last quarter; clothing, automobile and restaurant stocks were among this group.

By and large, foreign developed markets did not fare as well as the U.S. market last quarter. In particular, European markets had a rough time, especially when translated to U.S. dollars. In dollar terms, the MSCI European Union index declined over 5% in the second quarter. Interestingly, the FTSE 100 (an index of the largest 100 companies on the London Stock Exchange) was among the best performing developed world stock market indexes last quarter. On a local currency basis, the FTSE increased 6.5%, however

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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the decline in the British pound of over 6% in the same time period negated that gain for investors based in the U.S. Both Germany and Japan registered negative quarters in local currency terms. In this instance for investors in the U.S. the negative return on the Japanese TOPIX index of over 7% turned out to be a positive when factoring in the appreciation of the yen versus the U.S. dollar of more than 8% in the second quarter. The appreciation of the yen however is not welcomed by the large Japanese export companies as this makes them less competitive versus companies located outside of Japan.

BOND MARKET

Bonds continued to appreciate in the second quarter as the mantra "Lower For Longer" is the new reality. For how long this will continue no one is certain, but bond investors have done well this year. After a first quarter gain, the Barclays Aggregate Bond Index (a measure of various investment grade domestic bonds) continued its rise on a total return basis. After a formidable gain in the first quarter, this index had a total return of 2.2% in the second quarter, which now brings the return on this standard bond index to over 5% year to date.

All bond categories generated positive returns last quarter, but the longer maturities did the best. The 10 Year U.S. Treasury yield declined from a yield of 1.78% at the end of the first quarter to 1.49% yield by the end of June (bond prices rise as yields decline).Foreign investor demand is a large reason why Treasuries have risen in price. In some of the major economies worldwide, comparable yields are close to zero or are negative and therefore overseas investors have been drawn to the U.S. for comparatively better returns on their money. Current yield on the German 10 year Bund is now a negative 0.10% and the yield on the Japanese 10 year Treasury is currently a negative 0.29%! This extremely low rate environment in government bonds has spilled over to all investment grades of corporate bonds. In turn, this has continued to influence corporations into borrowing more to finance stock buy-backs, mergers and acquisitions and increase or start paying dividends. We are all waiting for interest rates to eventually rise, but as always not easy to predict when this will happen.

OUTLOOK

Brexit was a typical knee-jerk reaction based on emotions and a lack of analysis. We liken the vote to a person yelling "fire" in a theater. In this case, the fire may be tiny and easily extinguishable, but the rush to the exits may cause trampling and death from fleeing. To be clear, the vote for the UK to leave the EU is NOT legally binding but simply points to the citizens' desire to leave. It would take two years for this to actually occur, and concerns about cross-border trade could be ironed out by then. Also, if the government implemented new deals with the EU that satisfy the "leave" voters, that might be enough for them to change their vote to "stay". The resignation of the Prime Minister is yet another example of a sizable disruption, and change causes uncertainty. The vote to leave was actually very close, primarily because the arguments for leaving or staying essentially cancelled each other out, in our opinion. In general, we think that leaving the EU will be a net negative in the two –to – four year period, due to higher import costs and a weaker Pound, but longer term, the separation could potentially be beneficial to the U.K. The bigger loser in our opinion is the rest of the European Union, which will shrink substantially. Switzerland is a good example of a country that operates quite nicely outside of the EU, so there is reason for optimism.

The fallout from this event has been a stronger U.S. dollar, which may seem like a good thing to have, but it hurts exports because U.S. goods are now more expensive relative to the rest of the world. Of course, we are net importers, so this helps U.S. companies and citizens on the cost side.

The U.S. is still the place to be as evidenced by the strength of the dollar and huge influx of capital into its markets. This has pumped up equity and bond prices to the point where finding stocks with good value has become more difficult. Indeed, we think there are pockets of overvaluation in prices; ironically, in traditionally safer sectors, such as utilities and treasury bonds. Retirees have been particularly hurt by low yields and frankly, there isn't a great solution. There is still reason to be optimistic. Although the U.S. and global economies remain fragile, they remain stable with the possibility of greater GDP growth in the coming years. An accelerating global economy could justify the higher valuation mentioned previously, and even minimize the amount of risk in equities. Although bonds values continue to increase in value or hold steady, retirees will continue to suffer. Many investment companies have been touting "safe" alternative investments that produce healthy yields of 4%-6%. PLEASE, beware. Very rarely are people offered "a free lunch". Sales people are likely just repeating what they have been told by their companies without understanding the underlying risks involved. Often these investments are not liquid requiring many years before you can redeem. Furthermore, many of these yields may be teaser rates and are unsustainable. One has to ask, if these alternative investments pay out 4%-6% per year in cash, how are the companies offering these alternatives getting their returns?

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