ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.
Newman Dignan & Sheerar INVESTMENT ADVISORS

Speculation / Crisis / Recovery

2nd Quarter 2016

ECONOMY & MARKETS

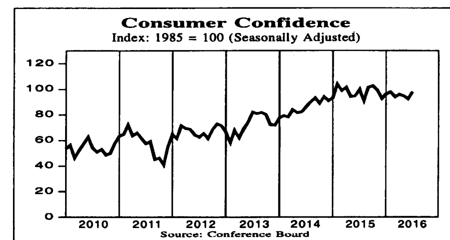
This Ground Hog Day-like cycle of Speculation / Crisis / Recovery, Speculation / Crisis / Recovery … well, you know how it goes, seems to never end. But patience and staying the course have once again proven beneficial to long-term investors. Trying to time the markets by going to cash and waiting out each "crisis" is simply too difficult to do with any consistency. After all, Punxsutawney Phil did not see his shadow this year so perhaps the winter of discontent is over. Don't worry, there will be another one – followed by a recovery.

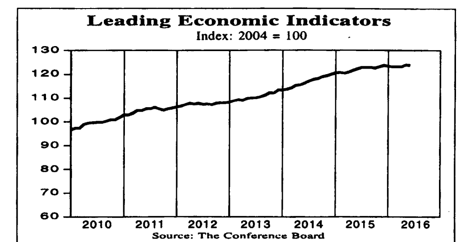
The market's Wrong-Way Corrigans were out in force and betting heavily on a decline over the past quarter. The despair among investors was palpable, but the markets were ultimately able to move past some significant concerns – especially the Brexit vote. Our domestic market sold off roughly 5% in a two day period only to rebound to finish the quarter at close to all-time highs. Of course, the financial repression exacted by central banks around the world only supported the move into risk assets.

For the second quarter of 2016, the **DJIA** moved higher by 1.4% while the **S&P** posted a gain of 1.9%. The tech-heavy **NASDAQ** closed lower by 0.6%. International markets, rattled by the Brexit vote, gave back some ground as the **EAFE** Index dropped 2.6% for the quarter. The appetite for bonds continues to grow as fast as kudzu on a Georgia highway. Bonds rallied on what will likely be a lower-for-longer interest rate environment. For the quarter, the Barclay's Aggregate **Bond Index** gained 2.2%. The benchmark 10 year US treasury closed at a paltry yield of 1.49% … down from 1.77% at the end of the first quarter.

U.S. equities finished the first-half of 2016 mostly in the green. For the year-to-date period, the **DJIA** is up 2.9% while the **S&P 500** is ahead by 2.7%. The **NASDAQ** is down 3.3%, and the **EAFE** index is off 6.3% despite lower valuation and higher yields than the U.S. market. Bonds are having a good year as the Barclay's Aggregate **Bond Index** is surprisingly up 5.3% for the year through June. At the end of 2015, it seemed like the odds of bonds rallying to this extent were about the same as the preseason odds for Leicester City winning the premiere league championship (and we know how that turned out with 5000 to 1 odds).

Economic conditions continue to gradually improve. Among the positives lately are: strong **job growth** and declining **unemployment**, sustained **low energy prices**, moderate **wage gains**, increasing **household net worth**, declining **foreclosures**, rising **equity values** in homes, improving **manufacturing** data (~15% of GDP), strong **auto sales**, decent **retail sales**, and improving **leading economic indicators** *(see below)*. Of course, all of this has led to improving **consumer confidence** – June's index rose to 98.0, up nicely from May's 92.4 level *(see below)*.

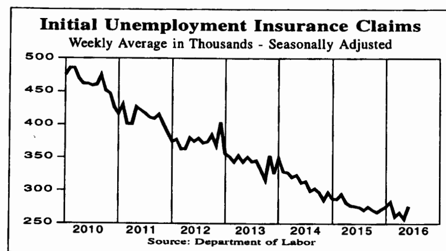




We have mentioned many times that in order to get sustained economic growth we need to see better labor market conditions *(not just smoke and mirrors)* … we are now finally seeing signs of sustainability in job growth. June's

unemployment rate fell to 4.9%. The unemployment rate is now lower than the Fed's long-run estimate of full employment (5.0% - 5.2%). U.S. employers added 287,000 jobs in June … much better than consensus (although mostly just making up for May's large shortfall of only 38,000 jobs). Continued job growth will likely lead to stronger wage growth … the year-on-year rate of growth for **average weekly earnings** (~2.3%) is showing up in better consumption data. A few clouds remain in the labor market - the U6 unemployment rate *(includes discouraged workers)* is at 9.6% vs. 9.7% in May, and it suggests that a number of part-time workers would prefer full-time jobs. Nonetheless, the jobs data are encouraging *(see below)*.

Good News 2→



A few **strong headwinds** will contribute to ongoing volatility and uncertainty (as always …). The **UK's decision to leave the European Union** will, of course, lower short and intermediate term global growth expectations. The good news is that markets adapt – they always have and they always will. Businesses will change course to maximize profits and prices will reset. **Declining productivity growth** remains a real concern – not only in the U.S, but also abroad. Worker productivity – *the output of goods and services per hour worked* - has been slowly declining for most of 2016. Since the beginning of the economic recovery in mid-2009, output has increased an average of 1.3% per year … the worst seven year stretch since the mid-80s. A few obvious reasons for the low output are regulatory and tax drag *(see next page)*, rising wages and weak final demand. Productivity numbers around the world do not offer much more hope. As such, global growth estimates remain constrained.

Brexit →

Growth↓

OUTLOOK

Bottom Line –A reasonable first half to the year for the markets will likely be followed by a late summer sell-off before moving higher into year-end. We suspect that the upcoming presidential election will include a few fireworks! Stay buckled-up and ignore the headline news. An interesting tidbit – according to the Stock Trader's Almanac, the S&P 500's average quarterly gain in the 3rd quarter of presidential election years since 1950 has been less than 1 percent.

Market valuations are higher-than-average as the S&P 500 is trading at a forward P/E of 17.9X *(next twelve months)*, according to Bloomberg. The 10-year median forward P/E is 15.2X. No doubt, low inflation and low interest rates help to mitigate today's valuation levels. Higher valuations, however, will temper future gains … history is quite clear. Will state and federal pension plans finally admit this?

Bond prices should move a bit lower over the next quarter as today's ultra-low yields give way to some profit taking. Of course, geopolitical challenges could temporarily move bond prices higher and yields lower on a flight-to-safety *(we've seen this before!)*. We would rather not chase yields and risk principal so we anticipate keeping average durations in the short-to-intermediate range.

We remain constructive on equities even as the risk-reward calculus for equities is diminishing a bit. With interest rates so low the oft-heard rallying cry seems to be TINA – *There Is No Alternative*. *Small and mid-cap equities* still add value to an overall asset allocation strategy, and the stronger US dollar will play to their strength. We plan to add to small-cap on weakness. We continue to be sanguine on *international equities* – both *developed* and *developing,* as their valuations remain relatively attractive. Large-cap domestic equities - *particularly those with higher quality attributes and increasing dividends* - remain overweight in portfolios. We are somewhat agnostic to growth and/or value. *Commodities* are enjoying an oversold bounce. *Alternative assets* should continue to provide good risk-management for portfolios – particularly during times of volatility.

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance.

Happy Summer!

SSA.GOV ↪

Too Many Regs! ↪

Social Security Primer

Determining when to collect social security benefits is one of life's most important financial decisions. There are a number of factors one should consider before electing to take Social Security, and we are always happy to review one's individual situation.

An individual's monthly benefit amount depends on two things, one's Primary Insurance Amount (PIA) and when one begins receiving benefits. An individual's PIA can be retrieved from one's Social Security statement along with his or hers full retirement age. One can begin taking Social Security starting at age 62, but that person will be permanently reducing their monthly benefit by 25% (30% if the person is born in 1960 or later) from their full retirement amount. Many people can maximize wealth accumulation by delaying Social Security benefits to full retirement age or later especially if they intend to continue working and/or cash flow needs are adequate. For those who delay taking Social Security past their full retirement age, they will receive an 8% annual increase in benefits which is capped at age 70 (the latest one can delay taking benefits).

- One can retrieve their Social Security statement by creating a log-in and password on the Social Security Administration (SSA) website (www.ssa.gov)
- While SSA offers most services now online, they do have a network of offices around the country for face-to-face assistance.
- Social Security was intended to supplement roughly 40% of one's "retirement paycheck".
- Generally speaking, the breakeven for deferring benefits from 62 to 70 is age 80.
- As of May 1, 2016, the popular "File and Suspend" strategy was eliminated as an option.
- Depending on an individual's "combined income", up to 85% of social security benefits can be taxable.
- If an individual continues working past the time they begin to receive social security benefits, then that individual may be subject to a reduced payout depending on "combined income".

Regulatory Drag: The "Secret" Burden on our Livelihood

The economy has been growing at a sub-par 2% rate during this recovery. Extrapolators argue that this is the "new normal" … that we must adjust our expectations to this level of mediocrity. We have argued that the dramatic increase in the federal regulatory burden must also be considered. Our June 20th Weekly Commentary discussed the FCC's recent efforts to regulate the internet. Another example is the EPA's efforts to impose regulations on America's farmers [isn't that the job of the Agriculture Department?].

These observations have recently been quantified by researchers at George Mason University, who have calculated that increased regulatory burden since 1980 is imposing 0.8% annual drag on real GDP growth. The total regulatory burden is estimated at more than $2trillion/year, or ~10% of GDP! Distressingly, the Federal regulatory machinery is accelerating: 229 major regulations were enacted during the last seven years, while "only" 126 major regulations [imposing $100M+ in annual costs] were imposed during the previous eight years.

The New Year, with its new Administration, brings hope that a more rational regulatory approach will be adopted. Let's hope that it will be more effective than the long-forgotten Paperwork Reduction Act of 1995.

2nd QUARTER 2016 SCOREBOARD

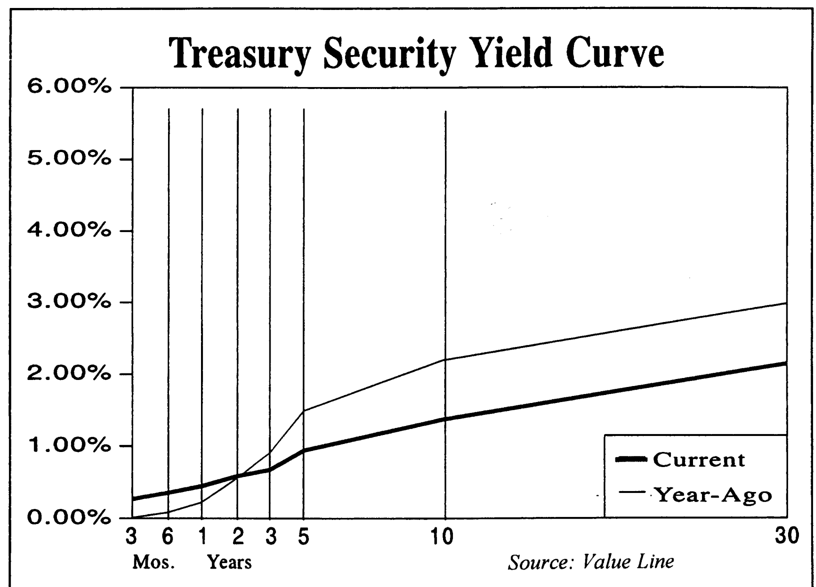
Index	Close	2nd Quarter % Change	Year-to-Date % Change
DJIA	17929.9	1.4	2.9
S&P 500	2098.9	1.9	2.7
NASDAQ	4842.7	-0.6	-3.3
Russell 2000	1151.9	3.4	1.4
MSCI EAFE	1608.5	-2.6	-6.3

3 Month T-Bill	0.26%	Fed Funds Rate	0.25% - 0.50%
5 Year T-Note	1.01%	Prime Rate	3.50%
10 Year T-Note	1.49%	Gold	$1318.40
30 Year T-Note	2.30%	Oil	$48.33

Index returns are price only

Gold is up 24% in 2016 while oil is higher by 30%.

Lower-for-Longer



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