INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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Second Quarter 2016: Bumping Along

Worldwide, markets kept their footing through most of spring, continuing their recovery from a mid-winter drop. U.S. stocks led major equity markets, with the S&P 500 returning +2.5%. Overseas, Asian and emerging markets equities inched forward, and only European stocks fell short on the quarter, down -2.7% after their post-Brexit spasm.

S&P 500: Sideways Trending Higher

Chart Source: BigCharts.com

In the U.S., big companies outperformed small ones, and value stocks across all market capitalizations continued to beat growth stocks; both these dynamics played in favor of our positioning. U.S. fixed income markets stayed strong too, with the Barclays U.S. Aggregate up +2.2%, mostly due to price appreciation as bonds advanced ever deeper into the maw of low interest rates.

Now in early July, the U.S. 10-year Treasury is yielding less than 1.5%, and the 30-year yields just over 2.1%. Meanwhile, abroad, well over $10 trillion of foreign debt – more than a third of the global sovereign bond market – is pricing at *negative* yields, whereby lenders pay borrowers. Welcome to the mind-bending world of quantum financial mechanics, and a seeming renunciation of common sense. Our motto more than ever: look to your cash flows.

"And Now for Something Completely Different" (Just Not Quite Yet, Mind You)

Image Source: The Daily Bell

In the weeks since Britain's vote to exit the European Union ("Brexit"), we've heard a refrain something along the lines of, "it's a big deal in the short run but not the long run." We take a different view. Short-term, Brexit embodies the global zeitgeist of populist fear and dissatisfaction but doesn't yet do much other than cause some British politicians to vacate their chairs. Long-term, it really matters.

First now, there's a staring contest. The UK is disinclined to invoke Article 50 formalizing their intent to depart until they know what new terms of trade they can negotiate, and the EU is disinclined to discuss new terms until the UK has invoked Article 50. This stale mate makes for an information vacuum, which may incline UK and European consumers and businesses in particular to sit on their hands rather than spend and invest. Prospects of chilled economic activity and an uncertain range of negotiation outcomes and knock-on effects merit a higher investment risk premium, and notwithstanding a brief dip at the end of June, the markets aren't priced to reflect one; indeed, early July's "risk-on" enthusiasm suggests the opposite.

We don't think this has to end badly, but we hesitate to dismiss that possibility. Global market integration has dominated the last quarter century. With a backdrop of populism potentially hostile to enterprise, this shot across the bow of globalization shouldn't be written off as anomalous, or even close to over.