Q2 2016 Economic Commentary

"The best argument against democracy is a five-minute conversation with the average voter"

--Winston Churchill

"In theory there is no difference between theory and practice. In practice there is."

--Yogi Berra

The European Union (EU) is both an economic and political union of 28 independent countries. Though established post-World War II with the primary goal of securing peace between geographical neighbors, it has evolved over the ensuing 70 years into the operation of a single market where member states share complete freedom of movement of not only people but also all goods, services and flow of capital. A key goal of unification was to enhance the collective clout in the global economy to be one on par with the United States and, more recently, China.

In reality, the EU has struggled mightily (especially in times of crisis) to fulfill many of these ideals. Understandable, yet persistent, nationalism continues to limit the ability to create a fiscal EU authority to coordinate national budgets and centralize control of finances. The absence of a federal budget and deposit insurance continues to negate part of the pass-through effect of monetary policy to member states.

The United Kingdom joined a loosely aligned European Community in 1973. The signing of the Single European Act by Margaret Thatcher in 1987 truly created a region without borders that included the U.K.. Though the United Kingdom became a key member of the European Union upon its formation in 1993, they have always appeared more on the outside looking in and skeptical of the entire project. The U.K. requested an "opt-out" from the single euro-currency formed via the Maastricht Treaty in 1992 and is not part of the passport-free travel zone.

In recent years, as hundreds of thousands of eastern Europeans (mostly former Soviet bloc states) have migrated to England, hostility towards the EU has risen. More recently, the influx of illegal immigration from the refugee crisis has engendered a feeling of losing their cultural "home" threatening social stability. As the economy of the U.K. continued to improve, more and more of their money was redistributed across less affluent EU countries. This groundswell of populism continues to be underestimated in many developed countries and this is clearly the case with the results of the recent referendum on June 23rd by British voters to exit the EU.

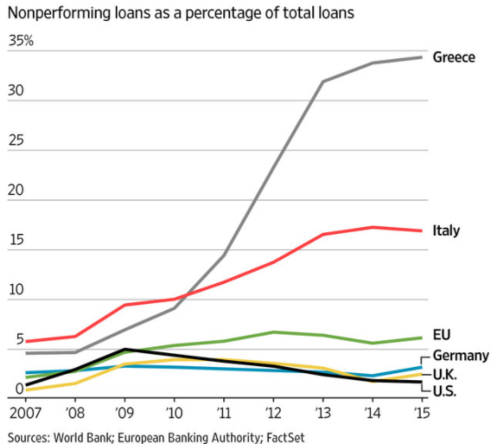
As we enter the third quarter, markets appear to have stabilized following the immediate post-vote reaction of a 6% retreat in global asset values. Left in the wake, however, is a country whose proud currency is now at a 31-year low versus the dollar (down 15% from prior levels to below $1.30/£), a prime minister who has tendered his resignation, and an opposition leader overwhelmed by the shock of the outcome. Meanwhile, Scotland and Northern Ireland talk of secession from the United Kingdom so they may remain as part of the EU. In early July, British Home Secretary, Theresa May, was officially named Conservative Party leader and successor of Prime Minister David Cameron avoiding a prolonged period of transition.

While the airwaves are full of pundits sharing mostly extreme predictions of the outcome of Brexit, we feel it is far too premature to draw many definitive conclusions. This process will take some time to play out as the Lisbon Treaty of the EU that lays out the process for such an exit allows two years from the time the seceding member invokes Article 50. Here is what we do feel has an increasing likelihood of occurring.

Despite over four million signatures to petition Parliament for a second referendum, this is unlikely. Though an active supporter of the United Kingdom remaining in the EU, May has expressed her commitment to Brexit. Still, the change in British leadership along with the deferral of the process should allow cooler heads in the EU and the United Kingdom to come to a more realistic compromise that may still include the United Kingdom remaining in the EU. The short term will certainly usher in great uncertainty for the U.K. regarding trade, political direction, and the fates of British workers abroad along with foreign workers currently in the U.K.. This uncertainty will increase the probability of a recession as business formation; (capital investment both domestic and foreign along with hiring) will most likely remain depressed. The precipitous decline in the value of the British pound will increase the cost of goods being sold into the U.K. but also may engender some offsetting positives. Indeed, we now expect both a surge in tourism along with increasingly competitive exports to blunt some of the economic headwinds.

Though Brexit is truly a political event there are usually economic consequences that bubble to the surface. For now, the EU will face election uncertainties in France and Germany while the National Front party in France talks of a Frexit vote. Italy, the Netherlands, Hungary and Austria all have elections and referendums that may continue to eat away at the structure of the union. The first economic signs in the U.K. may be the freeze in withdrawals from seven large U.K. commercial real estate funds due to liquidity pressures. In some mine found behind a bank vault in Europe, a canary may have just toppled.

The damage to the periphery of Europe may be the most immediate and serious concern, specifically in European banks. From pre-referendum on June 23, European bank stocks dropped 17% into the end of the quarter bringing losses to over 30% from the beginning of the year. With most economists now expecting central banks to keep interest rates lower for longer to counteract the anticipated slower growth, the accompanying strains on financial institutions in the European Union will intensify with Italian banks the most problematic (over 17% of existing loans already delinquent-see chart below). This will remain one of the most pronounced global concerns for the remainder of 2016 and the banks rather than immigration may drive the next leg of the Euro crisis.



THE FEDERAL RESERVE:

The goals of monetary policy are to promote maximum employment, stable prices and moderate long-term interest rates. By implementing effective monetary policy, the Fed can maintain stable prices, thereby supporting conditions for long-term economic growth and maximum employment. Those two sentences come directly from the website of the Federal Reserve.

During economic downturns when spending on goods or services decline, central bankers look for ways to raise the level of aggregate demand. The discount rate influences all interest rates in the economy as it represents the cost of borrowing and is, therefore, one of the primary tools used by central banks around the globe to stimulate loan demand and spending.

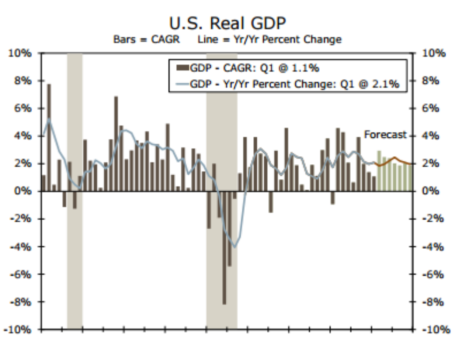
It is the view of the Federal Reserve that historically low and even negative interest rates (NIRP) impose an implicit opportunity cost on holding onto cash. In theory, this should give people and businesses an incentive to spend with the expectation of igniting a self-sustaining expansion. However, the reality is quite different and it has become painfully obvious that the economy is failing to respond to unprecedented and repeated rounds of stimulus. It appears that savings are stimulated, not spending.

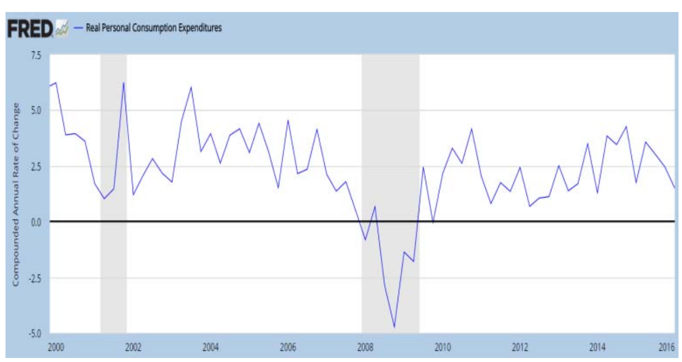
With rates near 0% and debt still historically elevated, people need to save more than ever for retirement as investment income is nil. It is also becoming increasingly likely that traditional economic models of credit cycles and wealth effects no longer apply as we are undergoing secular changes in consumer views towards discretionary spending, savings, use of credit and even home ownership. This has become clear as a large part of the cash flow windfall from the plunge in gas and heating prices since 2014 has been saved and not spent as was previously anticipated. Therefore, central bank policies perversely succeed only in diverting money from consumption and towards savings thus crushing demand and inflation.

The Federal Reserve appears paralyzed and to be losing the confidence of the global markets. With the transmission system of monetary policy to our domestic economy apparently broken (or just awaiting different instructions) and concern as to the impact of a stronger U.S. dollar on a yuan devaluation and market volatility, we now see no interest rate hikes from the Fed for the remainder of the year

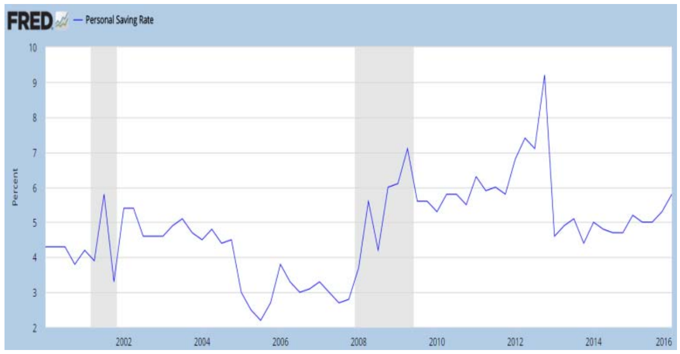
UNITED STATES:

Though full year 2015 GDP grew at a 2.4% annual rate (now considered above trend), there was a discernable slowing in the second half that bled into the new year seemingly led by a more frugal consumer. The United States followed up a tepid 1.8% GDP growth rate in the latter half of 2015 with a 1.1% print in 1Q (originally released at +0.5%). Real personal consumption expenditures (consumer spending adjusted for inflation) enjoyed a strong finish to 2014 and first half of 2015 averaging 3.4%. Since that time, there has been a downshift in spending that has continued through mid-year 2016 to a trailing one-year level of 2.3% (chart below right) with a recent 1Q reading of only 1.5%.





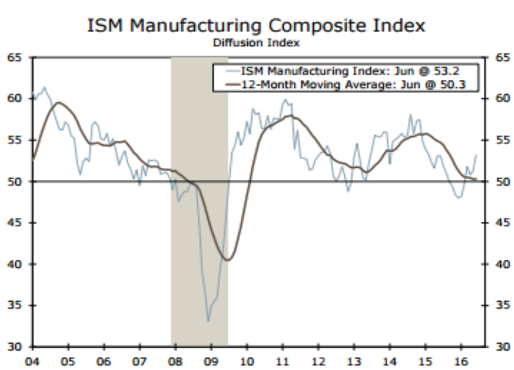
It had been our baseline view in 2015 that tightening labor markets and lower levels of inflation would awaken the long slumbering U.S. consumer and engender a cyclical upswing in consumer spending. It is becoming increasingly probable that the consumer (facing high levels of debt combined with near 0% investment income) realizes the only way to achieve financial goals is via increased savings (chart below).

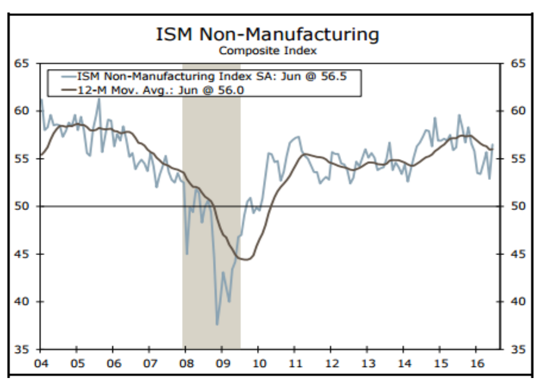


After increasing over 10% in 2015, housing starts are showing some signs of plateauing in 2016 up only 4.4%. However, residential investment still advanced at a rate exceeding 15.6% in the 1Q release and is now up over 10.7% y/y. Housing will continue to be a bright spot for the U.S. economy as rates continue to touch new lows. Net exports (the difference between exports and imports) was additive to topline real GDP growth in the first quarter though mostly due to slowing consumer demand for imports. Despite still weak global demand exacerbated by Brexit, the worst of the drag from slowing exports may now be behind us as headwinds from the strong currency abate.

We had noted in both our annual and 1Q commentary that weakness in the manufacturing sector (evidenced by five consecutive months in contraction) was due to factors that should decelerate, specifically the strength in the U.S. dollar and energy prices. Though overseas weakness along with the dramatic pullback in energy exploration and production are also factors, it has been our view that this area would stabilize. The most recent readings from the Institute of Supply Management (ISM) have borne out this expectation and have been above the 50-level indicating expansion with the most recent June reading at 53.2, the highest level since February of 2015 (see chart below left).

Though the manufacturing component of industrial production (a measure of the output of the industrial sector of the economy) had stabilized, the remaining inputs to this data of mining and utilities have yet to rebound. Industrial production has now declined in seven of the last 9 months and is now down -1.4% over the past 12 months and -2.2% on an annualized rate over the most recent quarter. Additionally, core capex orders (money spent by companies to acquire or upgrade physical assets such as plant & equipment, property & buildings) are contracting at a rate of -4.4% over the last year.

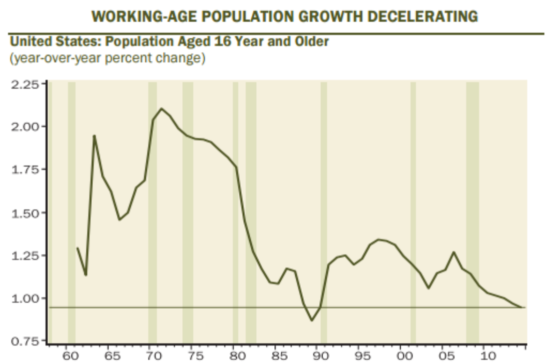




In only five months, the ISM non-manufacturing index (the sister index of the ISM manufacturing index that measures the economic state of the services sectors of the economy that is about 85% of the total) had declined from a cycle high in July of 2015 of 59.6 to a May 2016 reading of 52.9. However, concerns that the manufacturing weakness had spilled over into the previously strong services sectors in our economy were assuaged with a June reading of 56.5 the highest since October of 2015 (see chart above).

Growth in gross domestic product in a country is the product of labor force growth along with productivity increases. The United States is mired in a slow growth environment due to the secular impact of an aging demography in the developed world along with stagnating productivity growth. From 1960-2008, gross domestic product in the U.S. grew at an average annual pace of 3.3%. It is estimated that about 50% of that was due to an expanding labor force as baby boomers and women entered the work force in droves. Those tailwinds have changed course and since 2008, GDP has grown at a pace of only 2.0%.

Growth in working age population is running at a 25-year low of 0.9% y/y (see chart below). This contrasts with the 40-year average of 1.3%. As baby boomers entered the work force commencing in the mid-60s, labor force growth exceeded 1.75% per year for well over a decade.



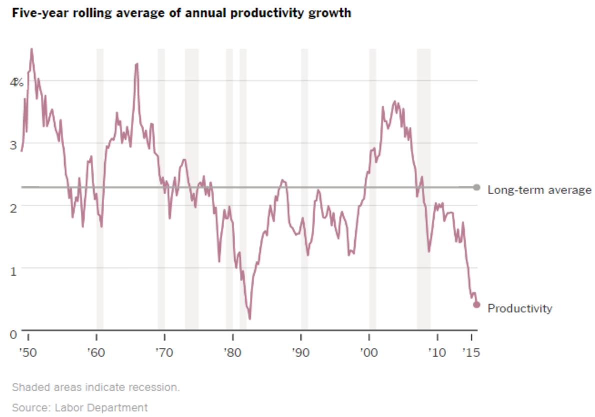
The median age of the population has increased over time, therefore, aggregate spending needs have slowed. Older people tend to be savers rather than borrowers. Younger people, by contrast, tend to be borrowers. As the U.S. has moved from a manufacturing base to a service-oriented economy, this has a greater impact on growth. The contribution of the consumer in such an economy has grown from 55% of GDP to a current level around 70%. Much of the GDP deceleration noted above is due to the slowing of real consumer spending from a post-World War II average of 4.1% to 2.2%

This aging demography is also deflationary and affects productivity. More savers and fewer borrowers drive interest rates lower simply due to supply and demand. More money flowing into savings means the banks and other institutions gathering those savings need not boost rates to attract those deposits. In addition, aggregate hours worked falls as the population ages and workers move into retirement. Lower aggregate labor input reduces the amount of output produced by each unit of capital. This in turn acts to reduce the real return from investing in capital. Demographics are critical.

Productivity (defined as a measure of output such as revenue or inventory per unit of input of labor or capital) is one of the most important yet least understood areas of economics. Though volatile in the short term and subject to mismeasurement concerns, it is the only pathway toward higher levels of prosperity. It is the primary reason that despite slower economic growth an American worker makes much more today than a century ago and enjoys the benefits of a higher standard of living.

From 2011 through 2015, the government's official labor productivity measure shows only 0.4 percent annual growth in output per hour of work (see chart on following page). That is the lowest for a five-year span since the 1977-to-1982 period, and far below the 2.3 % average since the 1950s. The trend is heightened recently with productivity for 1Q 2016 representing a sequential contraction at a rate of -0.6% following a -1.7% slowdown in 4Q 2015.

Lack of productivity growth in turn has major implications for the job market and the recent slowdown in hiring may be a manifestation. The conundrum during the economic recovery as to why the labor market was so strong yet gross domestic product so weak lies in lack of productivity. From the 4Q of 2015 through the end of 1Q 2016, aggregate hours worked rose at a pace almost two-and-a-half times total business output. The need for additional labor is muted in such an environment and will not continue.



As a more service-based economy than decades past, there are limits to how much productivity can be enhanced via automation relative to manufacturing sectors. However, capital investment by corporate America has been at the lowest levels over the last decade than it has in over 30 years. Many economists feel that maintaining interest rates as low as the Federal Reserve has chosen should make businesses inclined to invest. This may be another perverse result of zero interest rate policy by central banks. It is likely that monetary policy is now incenting businesses to consolidate with their competition rather than investing in productive assets and competing for market share as it is less expensive to do so.

OIL, U.S. DOLLAR & INFLATION:

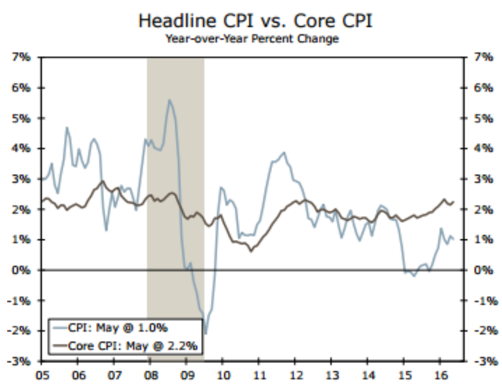
Following the collapse in oil prices from over $115 per barrel in the middle of 2014 to just over $26 per barrel in January of this year, crude prices have finally started to stabilize finishing the second quarter at $48.33 per barrel an increase of over 25% during this period. Though we viewed this event as a giant transfer of resources from oil producers to consumers, the magnitude of the decline overwhelmed much of that benefit by unsettling global markets within the resource sectors.

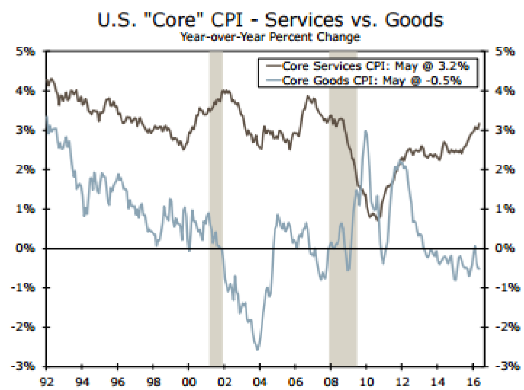
Despite a history of booms and busts, this has been the deepest downturn for the oil industry since the 1990s.Record profits have turned to major losses and oil companies have decommissioned more than 2/3rds of their rigs and sharply reduced investment. Estimates are that over 125,000 workers in the U.S. have lost their jobs. As the energy sector accounts for about 1/3rd of all capital expenditures in the United States, it is easier to understand the overall economic impact of such dramatic declines in infrastructure builds, hiring and investment.

After rising as much as 20% on a year-over-year basis as recently as July of 2015, the trade-weighted US dollar has stabilized in a more narrow range and should now present less of a headwind to exports and profits from U.S. multinational companies over the next few quarters. For consumers a strong dollar is net positive as it makes all imports less expensive. The stronger dollar also benefits those companies that import most of their goods but sell domestically. However, multinational companies are very affected by a stronger dollar that negatively impacts both sales and earnings. The largest impact, however, is on international trade where a rising dollar makes exports more expensive.

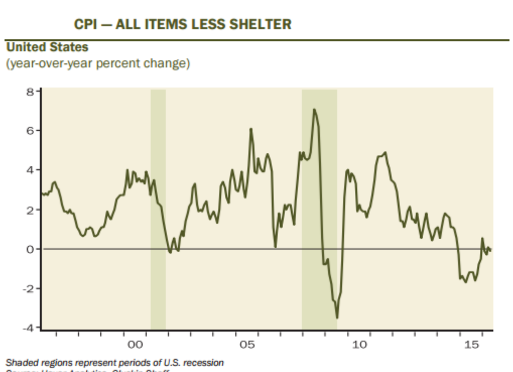
Though this recent stabilization (as seen in the chart below of both oil and the U.S. dollar) should provide some clarity going forward as the headwinds are removed, we must note that the currency is still almost 19% higher than levels of mid-2014. U.S. exports are, therefore, less competitive unless prices are cut and profit margins reduced. Depressed GDP and S&P profits figures have already reflected this.

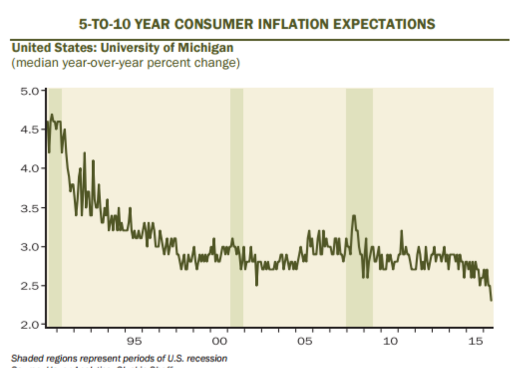
Despite the secular global concerns of deflation, in the United States we are continuing to see inflation at both the headline and core (ex-food & energy) levels gradually move up. The most recent reading for May (charts below) continued to show strengthening in the services (+3.2% y/y) strong enough to offset continued deflation in the goods component (-0.5% y/y). Core inflation continues above the Fed target of 2% (currently 2.2% y/y) and the headline level, that had been negative through much of 2015, is now up 1.0% y/y. This should rise towards 2% over the next few quarters as the impact of declining oil fades in the rear view mirror.





Much of the rising inflation is confined to the 42% weighting in the index that represents housing and rents that are up near 3.5% y/y. Excluding the shelter component, inflation is basically flat over the last year. It will not be the CPI or even the PCE (the Fed's preferred inflation indicator that is currently 1.6% y/y through May) that will prevent the Fed from raising rates as much as long-term inflation expectations for consumers that remain at historic lows (chart below right). Such concerns tend to be self-fulfilling and would curtail spending and increase risks of an economic reversal.

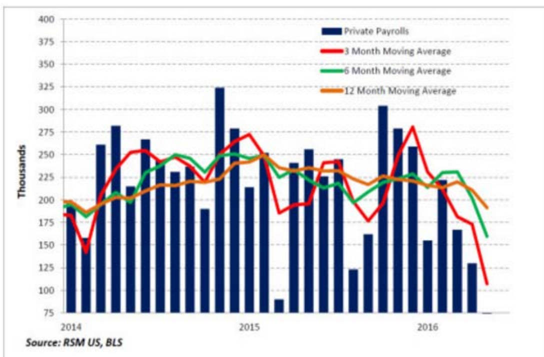


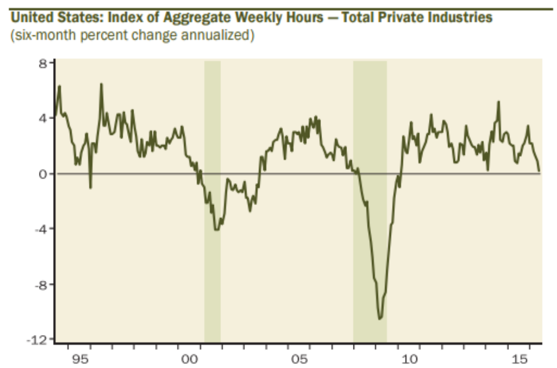


EMPLOYMENT & WAGES:

The monthly release of the jobs report from the Bureau of Labor & Statistics may be the most watched and anticipated economic release. Unfortunately, it also may be the one most subject to errors and revisions. Therefore, it is wise to place little emphasis on any single month reading but rather view the data in the context of longer trends. The most recent two jobs reports are exhibit A and B as May showed an employment market slowing precipitously with a now revised gain of only 11K jobs. Conversely, June reaccelerated to a powerful gain of 287K jobs.

As an economic cycle matures, much of the excess slack of the labor market dissipates and the job growth should decelerate as the unemployment rate falls. After averaging payroll growth over 230K per month for the entirety of 2014 and 2015, we are now experiencing this slowdown. The chart below on the left shows the current decelerating pattern over the last three, six and twelve month averages. The first quarter of the year saw job gains slow to a still robust 196K but the second quarter dropped to an average of 147K.

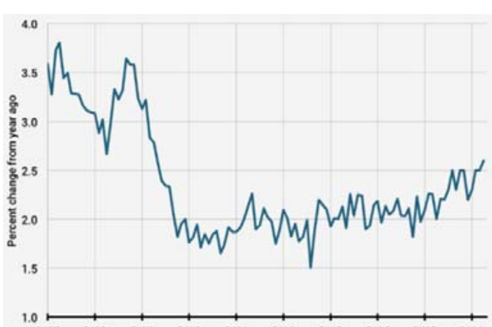




As the slack in the labor market dissipates and job gains slow, the labor market tightness generally puts upwards pressure on wages. This is what we have been expecting for the better part of two years but the data from the Bureau of Labor & Statistics (BLS) on average hourly earnings did not corroborate.

Though average-hourly-earnings (AHE) is the most popular barometer of the gauges measuring wage growth, we have pointed out previously certain critical limitations similar to those affecting our declining labor force participation. Just as the changing demography of the American population is redefining what "full employment" looks like (increasing numbers of baby boomers leaving the work force), this same aging of the labor force is also masking an underlying increase in average wage growth. We, therefore, need to look at alternative measures of wage growth to adjust for this composition bias.

According to data from the BLS, average hourly earnings growth has risen to 2.6%y/y as of the most recently released data from June (see chart below left). Though still below desired growth levels, this represents a cycle high not seen since the middle of 2009. By contrast, the most recent measure of the Federal Reserve Bank of Atlanta's wage tracker is depicting a much healthier rate of growth of 3.5% competitive with wage growth prior to the recession (chart below right).

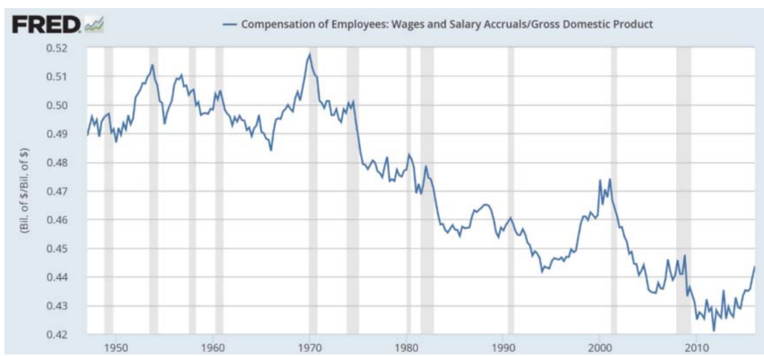


The major difference between the Atlanta Fed's measure and the commonly reported BLS metric is that the latter does not adjust for demographic changes. For example, the BLS measure would show that average hourly earnings declined in the event that a baby boomer retired and was replaced by a millennial working for three-quarters of that pay. The Atlanta Fed, meanwhile, tracks how wage pressures for the same individuals evolve over time, thereby removing this cohort effect.

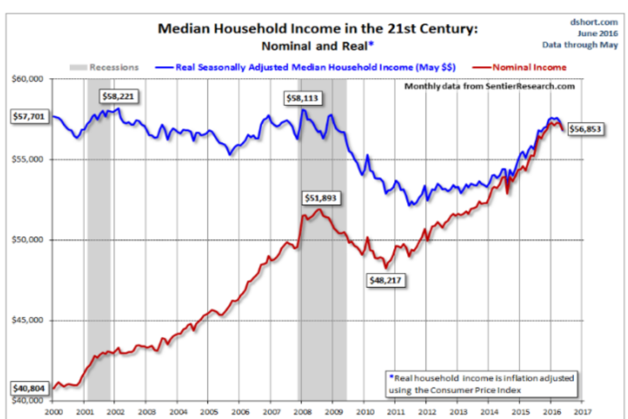
CONSUMER:

Our long held view that we are in the embryonic stages of a shift from capital to labor remains a theme of ours for 2016 and beyond. We continue to expect wages and real incomes to rise at a greater level than is currently anticipated. Despite recent stabilization, a strong dollar and low commodity prices will continue to slow net exports and manufacturing. However, the winner in this environment should be the U.S. consumer who benefits from lower oil prices and reduced prices of imported goods. Whether manifested on the income statement (via spending) or the balance sheet (via savings) the consumer will continue to be a critical component to economic growth and one we anticipate to be in an improving trend.

In late June, the Washington Center for Equitable Growth reported that 2015 was the best year for real income growth for the bottom 99% of income earners since 1998, as the impact of a tightening labor market and deflationary forces from abroad flowed through to workers. Wage data from the first-quarter GDP report suggests that 2016 will continue this trend: Wages and salary accruals as a percentage of GDP reached a seven-year high, and stands higher than at any point during the credit boom years of 2005-6.



Most of the data we review is aggregate data. The major limitation here is that large outliers may skew it. In the case of the consumer, income inequality clearly has this effect and it is often useful to view the data of the median. On this front there is improving but still sobering news. According to data from Sentier Research, the real median household income (chart below) from the most recent data in May is $56,853 (+1.8% y/y) continuing an upward trend that has been in place since the lows of November 2011. The less good news is that this level is still -2.2% from the levels in January of 2008.



The Federal Reserve Flow of Funds report tracks the aggregate balance sheet of U.S. households. For 1Q total household net worth reached a nominal record of $88.1T. Though the overall value of equities declined by $160B, this was more than offset by rising real estate values that increased by over $498B. The aggregate balance sheets of U.S. households have risen by more than $33T since the financial crisis after declining by more than $12T during that period.

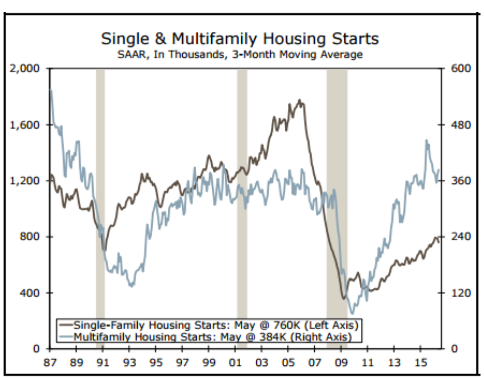
One key difference in the rise of total net worth today versus a decade ago is that Americans are not taking on as much debt. In fact in the first quarter, total liabilities rose only $17 billion (up only 2.7% y/y in 1Q while savings rose 13%) and remain lower than their level during the financial crisis. Every key measure of household indebtedness has now improved dramatically from the credit bubble peaks. While we are painfully aware that the asset side of the balance sheet may be ephemeral, it is very comforting to understand that the gains in household net worth contain considerably less leverage than the credit-fueled debt binges that preceded the financial crisis.

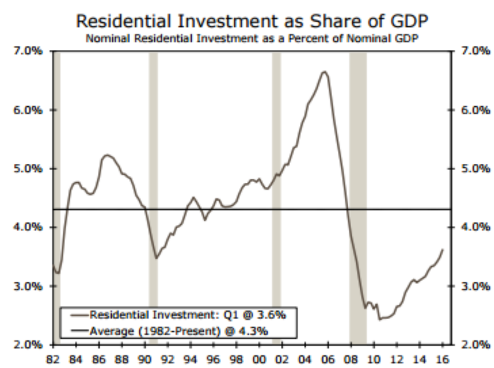
Continued steady job growth along with rising wages and stronger household balance sheets are also now supporting the fastest year-over-year pace in revolving credit growth during the expansion. Revolving credit has only increased modestly relative to the levels prior to the recession especially compared with the growth in student loans and, to a lesser extent, auto loans. However, recent gains to over 5.6% over the last year are consistent with a consumer enjoying personal wage growth and solid levels of confidence.

HOUSING & AUTOS:

Outside of consumption spending on housing (rents, utilities, etc..) the main contribution of housing into our calculation of GDP is through residential investment. Residential investment includes all construction of new single and multi-family units along with remodeling, manufactured homes and all brokers' fees.

Though in a positive and continuing uptrend, one can see in the chart below left that the current level of combined housing starts (currently annualizing at 1.164MM units) is far below historical averages. In fact, the level of single-family housing starts (recently 760K a/r) is consistent with levels rarely seen outside of a recession. Despite these low absolute levels, housing is continuing to be an increasing contributor to overall GDP growth. In 1Q, residential investment contributed over half of the 1.1% level of overall GDP growth and residential investment growth is estimated between 8%-10% for 2016.





In 2006, residential investment as a share of GDP peaked around 6.7% before plummeting to 2.5% in 2011. As the housing market continues to recover, this share of growth has grown to 3.6% but still far below the historic average of 4.3%. The current smaller share reflects a correction for overbuilding of single-family homes during the previous housing cycle. With current supply now far below historic inventory levels, this correction is behind us and we look for residential investment to gradually trend higher towards its historic share of GDP growth over the next three to five years contributing to GDP at increasing levels.

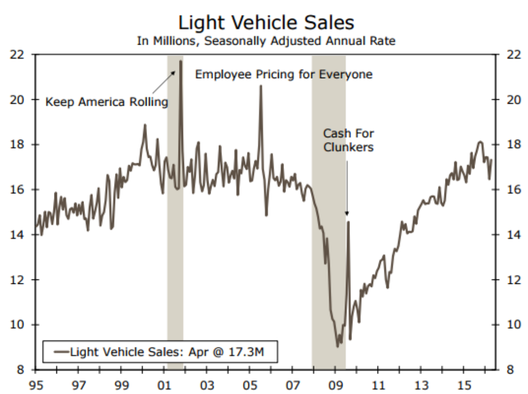
We have long noted the continued weakness in the first time buyer cohort. Home ownership for the under 34 year old cohort in 1Q 2016 dropped to an all-time low of 34.1%. A major issue continues to be the lack of supply. These low inventory levels in turn engender home price increases at a pace exceeding that of income growth. The stagnation of this part of the housing market has a stunting impact on each rung of the house price ladder. New homes under $200,000 made up 19% of U.S. sales last year, down from 38% four years earlier. By contrast, homes sold between $300,000 and $500,000 accounted for 34% of new home sales last year, up from 22% in 2011.While it may appear simple for builders to fill this gap, regulatory issues emanating from the housing collapse still resonate.

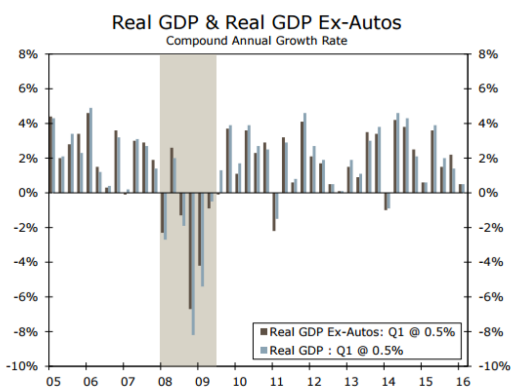
Builders face many cost constraints besides permitting fees in recent years, including rising costs of labor, land and supplies. But for entry-level construction, an analysis by Zelman & Associates, a housing research firm, notes the major impediment of "impact fees". These fees fund the local infrastructure needed to support a growing population—schools, transportation, environmental mitigation and utilities. These fees were raised by cities following the housing crisis to make up for declining revenues and are now up 45% since 2005. At a current national average of around $21,000, they represent approximately 6% of the average selling price. As these fees are flat, the impact on margins is far higher on entry-level homes than higher end.

Shifting to autos, auto sales have remained an integral part of consumer spending during the economic recovery representing about 3.5% of real personal consumption expenditures (PCE) since 2013. Additionally important is that auto sales also boost growth in the manufacturing area via inventory builds as auto producers and dealers anticipate continued strong demand.

From 2002 through the beginning of the recession in 4Q 2007, auto sales averaged 16.7 million units annually before plunging to a cycle low of 9.4M units in 1Q 2009. According to research by Wells Fargo, during the depths of the recession, auto sales removed as much as 1.5% annually from GDP (see chart below right). With auto sales rising to a peak of 18.1M units during the 4Q of 2015, we suggested that a cycle peak might be upon us.

May auto sales continued at a slower but strong pace of 17.4MM annualized vehicles and are actually now down 6% from May of 2015. June slowed even further to an annualized pace of 16.6M lowering the 2016 monthly average to a pace of 17.1M units. Though still at solid levels, a slowing in auto sales will have ramifications for overall consumer spending as in the last five years, car sales have risen in excess of 6.6% per year while the remaining components in the retail area have grown at less than 3%.

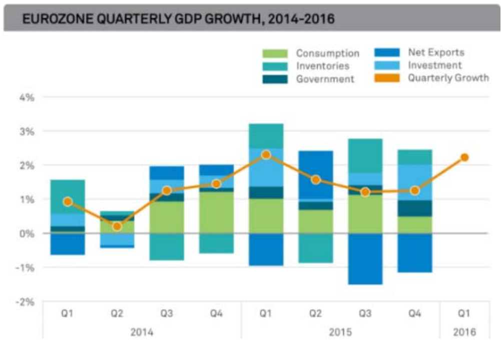


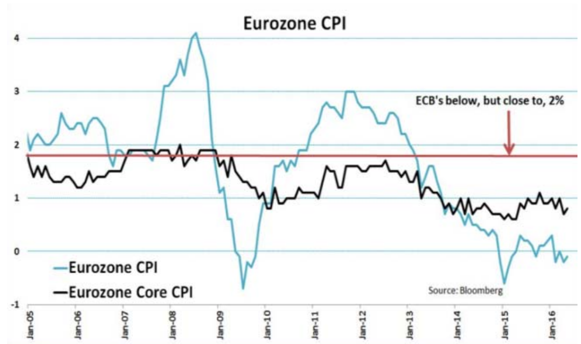


INTERNATIONAL:

EUROZONE:

Prior to the referendum on Brexit, the Eurozone was temporarily enjoying the best-annualized growth of the major developed regions in the early part of 2016. Consumption (chart on the following page left) has been a strong contributor to growth over the last year and a half, and consumer spending likely contributed to the first quarter uptick with Gross Domestic Product (GDP) annualizing at a 2.2% rate, the strongest in over a year. Easier credit, rising employment and greater purchasing power due to wage gains are credited with driving this consumer recovery. We are, however, suspect of the fragility of this recovery and following Brexit have lowered our 2H GDP estimate to 1.2% and from 1.6% to 1.4% for the full year.





The efforts of the ECB to reflate the economy and move inflation to the target of 2% continue to fall short. Though core inflation (excluding food & energy) continues to hover around 1% (most recent reading in May of +0.9% y/y seen on chart above right), the headline rate is -0.1% over the last year. The recent ECB inflation forecasts of 0.1% in 2016, 1.3% in 2017 and 1.6% in 2018 are quite sobering and suggest more easing might be needed. However, what could the ECB still do, and will it work?

In June, the European Central Bank launched the latest effort to stimulate the EZ via outright purchases of corporate bonds. This buy will be in addition to the 800+ billion euros of government bonds it has bought since March 2015. The ECB continues to attempt to ignite inflation by lowering the cost of borrowing. With interest rates at new lows, European public companies have been issuing new debt at a record pace this year. The ECB will continue to drive rates even lower and possibly negative.

Aging societies, debt overhangs and lack of productivity growth are common factors holding down economic expansion in many industrialized countries. With an incomplete monetary union, the Eurozone has additional idiosyncratic factors hindering its recovery. The absence of a common federal budget along with high levels of sovereign debt reduces fiscal capacity. The lack of federal deposit insurance to reduce bank runs or panics blunts the pass-through of ECB monetary policy to member states. With growth at stall speed and policy rates already rock-bottom, the Eurozone appears caught in a liquidity trap and pushing on a string.

We noted earlier that ground zero for the next Euro crisis appears to be in the European banking system with Italy front and center. As the chart below shows, the market value for European banks have collectively fallen to levels not seen since the depths of the region's debt crisis in 2011. The index is down over 40% during the last year (see chart below).

Italy (the third largest country in the Euro Area) owes creditors over $2.45T or more than 130% of GDP. This is actually a higher debt ratio than any EU country other than Greece. The most concerning aspect as noted earlier is that Italian banks hold more of their country's sovereign debt than lenders in any other euro area nation, with over 17% (over $400B) of that labeled non-performing loans. This is more than 25% of the total held by euro area financial institutions and risks devastating the balance sheets of these banks.

Unlike 2011, the backing of the ECB and QE should remove the primary concerns of refinancing and liquidity making the risk of contagion among European bank defaults low. However, the need to recapitalize may still have a deflationary impact as Italian investors are left holding the bag. Prime Minister Matteo Renzi is holding off on state intervention to support the banks without including the bondholders assuming a large "haircut" on the debt. This, in turn, may create a political and confidence crisis that may have more contagion impact on depositors and investors who are also voters. The risk of an investor and depositor flight is definitely present and the market action appears to be reflecting this.

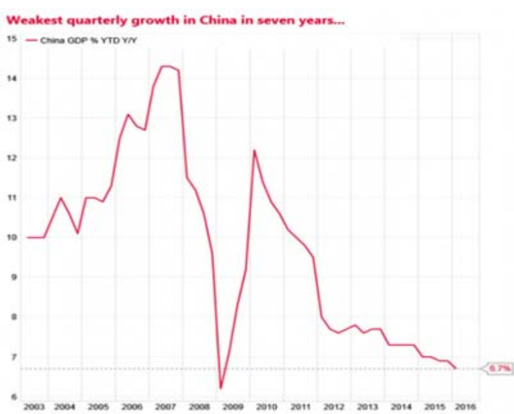
Though we are trying to avoid any definitive conclusions on European growth due to Brexit, recurring rounds of political instability (U.K., France, Italy, etc...) create a chaotic backdrop. There is little doubt that the fallout from the referendum vote will be severe on the economy of the U.K. and, in turn, a European economy that is already at anemic levels.

CHINA:

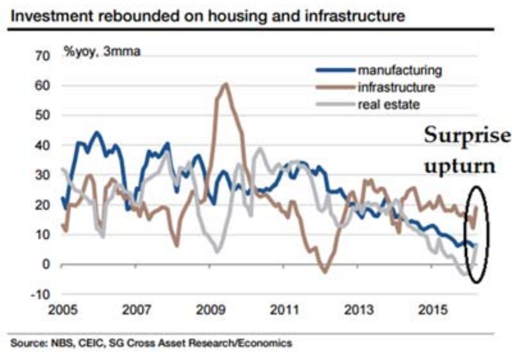
As we enter the second half of 2016, the markets appear to view everything through the prism of Brexit and reverberating consequences globally. One of the most pronounced are renewed concerns about potential for a Chinese devaluation of the yuan that could unleash a wave of deflation across global markets. However, Reuters has noted that the PBoC is willing to let the yuan weaken versus the dollar to the equivalent of last year's 4.5% decline. With the yuan already valued at the lowest level in more than five years, a gradual decline is also in the best interest of China as an outsized move could trigger capital outflows and backlash from trading partners.

Meanwhile, China stands to be one of the biggest beneficiaries from the chaos in the European Union despite enduring a similar short term hit that a smaller, less stable European market will have on all exporters. In theory, the EU as a whole should wield significant power in pressing Beijing to open its markets and play fair on trade. Instead, European nations have routinely squandered that advantage by competing with each other for Chinese investment and favors. Longer term the benefits of a less coalesced union will most likely benefit China in its ability to strike better trade bargains.

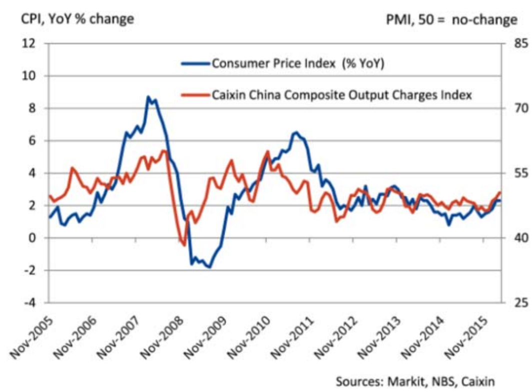
Though better than feared, China's growth rate for 1Q slowed to 6.7% the lowest in more than 7 years (1Q '09 of 6.1%). This followed a full year growth rate for 2015 of 6.9%, the lowest since 1990.



There are some concerns that the achievement of above expected growth came less from the desired service areas. As is widely known, China continues to transition from a growth model based on massive investment and construction, fueled by state-directed bank lending, to one based on household consumption and services. However, the latest data shows that this rebalancing is still tentative at best and even stalling. Service sector growth slowed from 8.2% in 2015 to a disappointing 7.6% in 1Q of 2016. In addition, there were big upside surprises in infrastructure and real estate output (see chart below) indicating further government intervention.



The return of modest inflationary pressures in the 1Q give hope that deflationary fears have subsided and stimulus measure have taken root. The official government CPI remains elusively below the government target of 3% leaving scope for further stimulus to help boost demand and stem job losses.

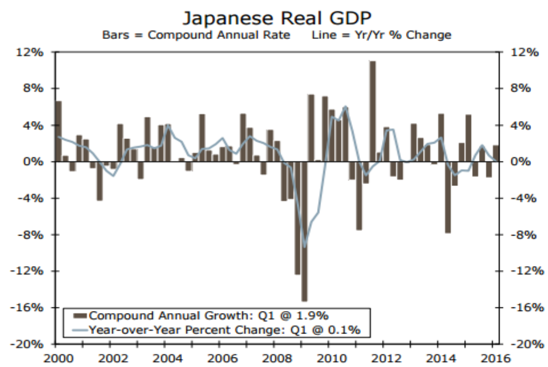


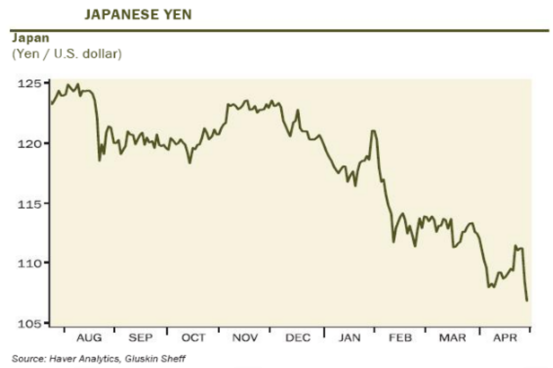
JAPAN:

For all of 2015, growth in Japan managed only a 0.4% gain well below the oft-stated goal of Prime Minister Shinzo Abe of 2.0%. Indeed, the Japanese economy had actually contracted in five separate quarters since 2013 leading the Bank of Japan (BOJ) to announce in late January a move to negative interest rates of -.1%. The goal of these negative interest rates (NIRP) was to further weaken the yen (already down over 50% in the prior three years versus the dollar) to arrest the nearly 7% decline in exports in the first quarter. In another indication as to how global central banks have miscalculated the global environment, the result in the first quarter was a reversal in the yen, which rose over 10% versus the U.S. dollar.

The yen's resurgence has added more pressure on the BOJ. Following Brexit fears, investors searching for seemingly "safe haven" assets bid the yen to the highest level against the U.S. dollar since August of 2014 also regaining all the ground it lost versus the euro since late 2012 or prior to the quantitative easing program under BOJ Governor Kuroda.

Derailing additional expectations for a big stimulus package was data from the first quarter showing growth in gross domestic product of 1.9% on an annual basis. Strong consumer spending surprisingly lifted growth in the first quarter. But economists at BNP Paribas said in a note that without the extra day in February, private consumption would have been flat, leaving public demand as the driver of growth. A weaker yen's sharp decline had until recently raised corporate profits in Japan, but the expected wage increases ended up being minimal and has weighed on consumer spending. Now the reversal of the yen threatens to undo what little progress has been made to move Japan out of deflation, a cycle of falling prices, spending and investment that suppresses growth.



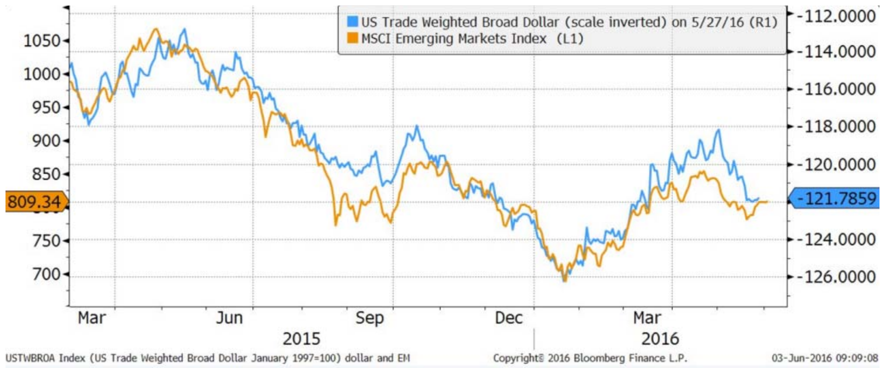


EMERGING MARKETS:

Renowned American economist, Hyman Minsky, coined the phrase, “stability breeds instability”. The inference would be that stable periods induce certain common behavioral responses anticipating the continuation of this equilibrium. These responses in turn actually introduce fragility in the economic system weakening its ability to withstand adverse shocks. We find this prevalent throughout much of economics and markets.

Prior to the late 90’s, emerging countries would fix their currency exchange rates to the U.S. dollar in order to control inflation and reduce risk to companies and investors. Interest rates in these economies were usually much higher than U.S. rates so domestic companies and governments could borrow more cheaply in dollars. In turn, foreign investors would lend and invest in the local currency earning higher returns. This worked as long as the equilibrium between the currencies held.. The confidence that this relationship would persist, thus perversely encouraged the accumulation of so much foreign currency debt that it made the peg more vulnerable. Rising inflation and the overvaluation of the currencies, precipitated the withdrawal of foreign capital during the Asian crisis of 1997-98, putting so much selling pressure on the local currency that it collapsed. Unable to repay their foreign currency loans, companies, banks or governments went bust.

Since then, emerging markets adopted orthodox macroeconomic policies and floated their exchange rates. Floating currencies made the cost of foreign currency borrowing less predictable, so countries did less of it (the opposite of the Minsky effect). As the IMF notes, about “75% of emerging market government debt is now denominated in local currency, compared to zero in 1995, as is about 70% of emerging market corporate debt, compared to 5% in 1995. Flexible exchange rates appear to have helped some emerging markets mitigate the slowdown in capital flows so far by dampening the effects of global factors.” However, as the chart below depicts, the correlations between the U.S. dollar index and emerging markets remain very high.

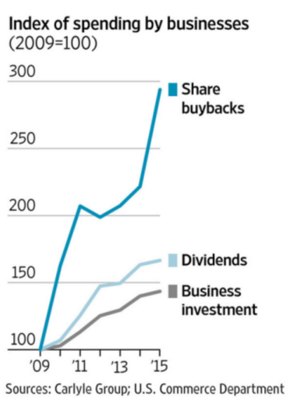


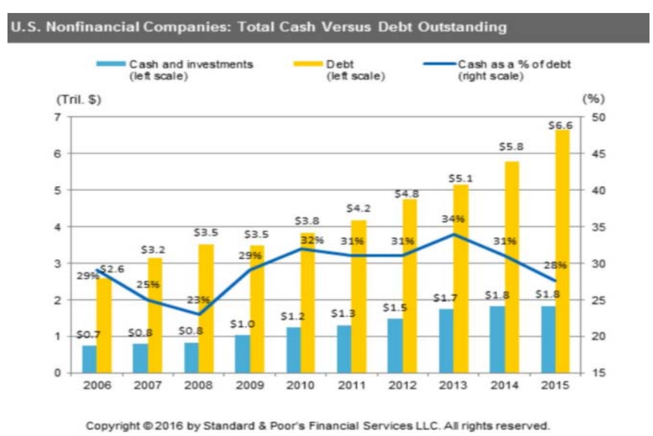
Emerging markets are thus another area where the impact of Brexit bears scrutiny with markets that are already struggling with broad-based economic slowing. This may be a two-pronged impact as the slowing in industrial nations reduces export demand but mostly, again, in this exchange rate channel. As the flight-to-safety trade flows to the U.S. dollar, emerging market currencies take the relative hit and are already down about 4% since May. Christine Lagarde of the IMF views the U.S. dollar to be "10%-20% higher than economic conditions warrant". Greater exchange rate flexibility and markets that are dramatically undervalued relative to the U.S., may make emerging markets attractive prospectively should these trends reverse.

MARKETS:

Over seven years into an economic expansion, corporate risk aversion globally remains ubiquitous impacting investment, productivity and even wages. According to analysis from the Carlyle Group, since 2009, U.S. firms have boosted capital investment by 43%, dividends by 67%, and stock buybacks by 194% (see chart below). Capital investment is the key to productivity and concerns about aggregate demand along with fiscal and regulatory concerns are holding this back.

Early in the recovery, we lauded corporate America for taking advantage of low rates to term out higher yielding debt to reduce interest expense and refinancing risk. The efficacy of this strategy has changed dramatically over the last two years as the economy and liquidity (end of QE) has slowed. As the chart below indicates, over the last two years, U.S. nonfinancial companies have increased total debt by $1.5T to a record $6.6T while cash holdings grew only $100B decreasing the cash/debt ratio from 34% to 28%. Underneath the hood, it may be a little worse. A study released in May by S&P indicates that over 50% of this cash ($945B) is held by the richest 25 companies. For the remaining 99% of companies, cash as a percentage of debt is at the lowest level in the last decade.

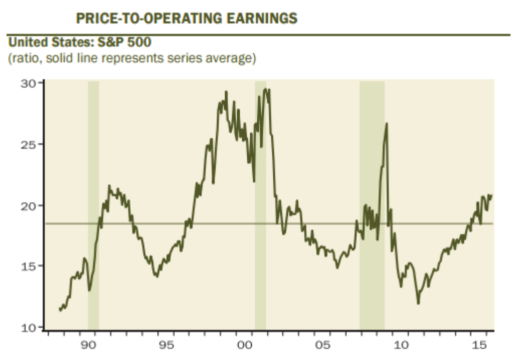


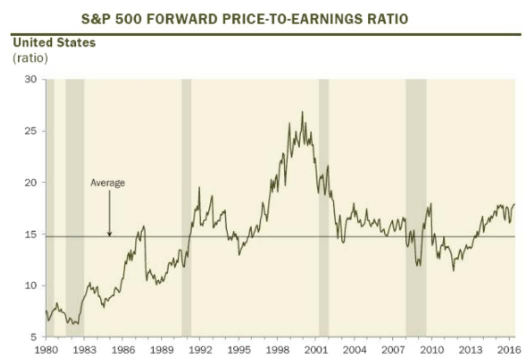


Rather than investing back in their businesses, companies have increasingly looked to the debt markets to finance share buybacks. While in many cases these capital allocation decisions are prudent uses of cash, the short term benefit of increasing earnings per share (by reducing the denominator of total shares outstanding) without any gains in aggregate profit may come at a future price. Companies are able to borrow at such low rates due to a low growth environment that paradoxically lowers the expected returns from investing in expansion. Unfortunately, buybacks to do not provide a future stream of returns that may be necessary to service that increased debt. Additionally, they may elevate earnings artificially over the short term but without top line revenue growth, the cash flow needed to maintain these purchases abates.

The rally in global government bond markets is telling us the global economy is slowing. The post-Brexit stock market rally seems to indicate something else. With fully 36% of global sovereign debt offering negative yields and 77% less than 1%, stocks no longer seem to be about growth but rather the desperate search for yield in a "no yield" world. Only 6% of global sovereign debt even yields more than 2%, a level that most major stock markets generate. While supply and demand move markets in the shorter term, valuation will ultimately determine future returns. On this front, we are more circumspect.

Corporate profits, as defined by S&P 500 operating earnings, rose at an annual rate of over 24% from 2009-2011. Since the beginning of 2012, earnings have grown only 1% per year. The over 60% increase in the S&P 500 since the end of 2011, has been driven entirely by the expansion in the P/E multiple from 13x to over 20x trailing earnings. This metric compares to a 25-year average near 17x. As Wall Street often looks to future earnings, the chart below right shows the S&P 500 currently valued at 18x broker estimates for 2017 profits versus a longer run average of 15x. The light is flashing yellow.





To justify current valuations, Wall Street analysts are looking for an increase in second half earnings of almost 5% and for 2017 to increase over 12% according to data compiled by Factset. The headwinds of a strong U.S. dollar and extremely weak energy prices have clearly abated as noted previously and are now basically flat with year ago levels. Additionally, we will soon anniversary the worst of the earnings picture for the energy sector. During 2015, the collapse in oil prices and the impact on energy sector earnings shaved over 10% from total profits for the index. While only a moderate contributor in the quarters ahead, the worst of the decline in energy profits appears to have passed.

Ending the quarter with a quick 5% gain following the surprise Brexit vote, the S&P 500 index managed to move into positive territory for the 2016 first half with a gain of 3.8%. The strong rebound in the Energy sector (+16.1%) benefits the value indices and the Russell 1000 Value strongly outperformed the Russell 1000 Growth (+6.3% vs. +1.4%) interrupting a three-year trend. The domestic-oriented Russell 2000 Small Cap index trailed with a still positive 2.2% return.

Returns in international equity markets were quite divergent. The respite from declining oil prices (Latin America +25.4) and dramatic currency moves continued to propel the Emerging Market index (MSCI EM) to a solid gain of 6.4% for the first half of 2016. Dragged down by the weight of the financials in Europe, the developed global market index (EAFE) declined -4.2% so far this year, though the headlines may have indicated an even worse outcome.

The strongest returns so far this year though have come from the fixed income markets. As investors globally rummage through the microscopic yields offered, U.S. bonds have shocked strategists who for much of the prior four years have pounded the table on the bubble in bonds. The Barclays US Aggregate

Bond index and the Barclays High Yield index gained 5.3% and 9.1% respectively. However, the Barclays US Aggregate Long Treasury index enjoyed the greatest gains for the few who were contrarian enough to invest returning over 15.1% so far this year.

In a continuing low interest rate environment, secure and rising dividends are critical to growing and preserving income streams. According to Factset, S&P aggregate dividends hit an all-time high for the trailing twelve months ended in 1Q. Dividend growth, however, decelerated to 7.5% and is estimated to slow to a growth rate of 4.9% in 2016. As dividends are paid from profits, the near flat earnings growth of the prior three years has increased the payout ratio (percentage of corporate profits paid out as dividends) from 27% to 39%. As profit margins moderate and earnings growth remains slow, we can expect the growth rate of dividends to continue to slow into 2017 but provide an even more meaningful portion of total return.

At Coho Partners over 40% of our holdings have already increased their dividends this year by over 10%, and we estimate the total increase in income compared to 2015 to be in the high single-digit range. Our research focus remains on the long term operating and financial strategies of companies that have what we believe are advantaged business models supported by strong balance sheets. These types of companies tend to provide protection during corrections and yet they participate meaningfully during market advances.

Sincerely,

Rick S. Wayne, CFA