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It's Brexit With A Twist

Stocks high... bond yields low... what's next?

The first half of 2016 is behind us. Where does the time go! And it's been three weeks since a surprising vote by the UK to exit the European Union. This historic decision caught most by surprise. As with many unexpected events, markets reacted with volatility and weaker stock prices…for a couple of days. Since then, the S&P 500 has rebounded over 8% to new record highs. The MSCI EAFE Index of foreign, developed market stocks, while still more than 30% off its record, has surged over 9% from its post-Brexit low.

Though Brexit concerns have diminished for now, there remains a great deal of uncertainty going forward for the UK, and to a lesser extent the European Union. For Britain, the political implications of Brexit have already been significant. David Cameron has stepped aside as prime minister. His successor is Theresa May, the first woman in the post since Margaret Thatcher. Like the Iron Lady, May is known for being tough. She has even been described as a "bloody difficult woman." But her renowned negotiating skills may be just what is needed now. She will have to spearhead new trade deals with the EU, the U.S. and other countries. The overall economic impact of this to Britain will be determined over time. It will largely depend on the access she and others negotiate to the EU's internal market. As for the U.S., trade negotiations will wait until after the elections in November.

Also in the wake of the Brexit vote, Euro skepticism—a lack of confidence in the EU model—is on the rise. Recently the union has been unable to coherently address security fears surrounding large refugee streams and the uncontrolled movement of people across borders. A lack of voice on these and other matters at the national level is driving nationalistic movements in some parts of Europe. These trends, and the ultimate results of Britain's negotiations, will influence how cohesive and durable the EU will be going forward.

Recognizing the concerns, the International Monetary Fund (IMF) released a report on July 8th, 2016 titled "Euro Area at the Crossroads: No time for Complacency". Here is a telling quote:

"Recovery in the euro area has strengthened, but the medium-term outlook remains weak and is endangered by a lack of collective action to address common challenges. Members must rebuild faith in the monetary union. …. Unless collective problems are resolved, the euro area is likely to suffer repeated bouts of economic and political instability leading to crises of confidence and economic setbacks. The EU should redouble efforts to ensure the benefits of economic integration and thus rebuild flagging faith in the monetary union. Countries should rapidly integrate refugees into their labor markets, while the block should reform its common border and asylum policy to protect social cohesion and preserve the single market."

Because of uncertainties such as these, European equities have significantly underperformed U.S. equities in recent years. One result is comparatively low valuations in Europe. If the EU finds ways to address the issues raised in the IMF report, it might bolster hope of a productive post-Brexit relationship with the UK. This could create positive surprises in the market and the potential for outsized returns.

In the U.S., June non-farm payroll data rebounded to the highest level since last October, growing by a seasonally adjusted 287,000 jobs. This alleviated concerns the economy may slip into a recession. Consumer spending—which is almost 70% of U.S. GDP—stands to benefit from the favorable employment trend, as well as from rising wages and a solid housing market. All of this supports the likelihood that the U.S. will continue on its trajectory of modest growth, somewhere in the neighborhood of 2% for 2016.

FactSet estimates that second quarter S&P 500 earnings will decline by 5.6%. This is the first time we have seen five consecutive quarters of year-over-year decline since 2009. The energy and materials sectors of the economy have provided the biggest drag to earnings—a result of the decline in oil and commodity prices over the past year. However, earnings are expected to rebound in the 3rd and 4th quarters and provide a narrow full-year increase of .7%. Full year 2017 earnings estimates look much more promising, with estimates for 13.5% growth.

Asset Class Outlooks

Domestic Stocks:

The S&P 500 is now valued at 16.6 times 12-month forward earnings (FactSet, July 8th). This P/E is above both the 5-year (14.6) and 10-year average (14.3). Considering this, returns from here will likely be driven by improving profitability rather than increases in multiples. One valuation factor strongly in favor of stocks at this juncture is the dividend yield on the S&P 500. At 2.2%, it compares very favorably to 10-year and 30-year Treasury bonds at 1.5% and 2.2% respectively. And with corporate earnings poised to strengthen, stocks have a good chance to outperform bonds in the remainder of 2016.

Bonds:

Improving U.S. economic data has not had the usual effect on domestic interest rates. For example, despite upbeat June jobs growth, 10-year Treasury yields remain near record lows. The fact of the matter is that rates are still being held down by demand from foreign investors chasing higher yields than are available in their own markets. As long as monetary policy stays soft in the UK, EU and Japan, this dynamic could continue, and possibly even push U.S. yields even lower.

But at some point domestic forces, especially inflation, should move the needle toward higher rates. Inflationary pressures generally grow as employment growth bumps against tighter labor markets. Core consumer prices in the U.S. increased 2.2% year-over-year in May, accelerating from 2.1% in April. For now the international hunt for yield is still dominating. But as a bond holder, be prepared for a sea change, and volatility as investors adjust to higher rates.

All things considered, Treasury securities remain desirable as a risk offset to credit bonds and equities, but fail to be compelling on a yield basis. We do like both 5 and 10-year Treasury Inflation-Protected Securities (TIPS). These are currently priced for inflation expectations below 1.5%. Since core inflation has been running at 2% or greater for the last 7 months (and may move higher) TIPS look attractively valued.

Credit spreads for the Bank of America Merrill Lynch High Yield Master II (bond) Index are currently 5.7% above comparable Treasuries. While this is an enticing gap, the trailing 12-month U.S. high yield bond default rate finished the first half of the year at 4.9%. That is a significant figure. With corporate losses continuing, especially in the energy and materials sectors, investors should not be aggressive in the high yield space at present. Within our fixed income portfolios we are following a barbell approach—seeking both yield and safety by holding both Treasuries and corporate bonds. And we continue to keep duration on the short side.

Emerging Market (EM) Bonds:

Slow global growth, low inflation and easy money policy in the U.S., EU and Japan all support low interest rates in emerging markets. Overall, we remain moderately constructive on EM bonds. But we prefer sovereign to corporate, as corporate leverage has been rising and interest coverage weakening. Spreads relative to sovereigns do not adequately compensate for this risk. Furthermore, refinancing risks are elevated as new issuance has declined.

Commodities:

Crude oil has risen 75% from the February lows and is up 24% year-to-date. Gold is up 25% year-to-date. Oil still looks like it has some upside between now and year-end. Firm-to-higher oil prices would be important to improving earnings and confidence in the U.S., as well as other oil-producing nations. Gold, on the other hand, thrives on monetary policy uncertainty and low real interest rates. The current environment may provide fuel for further gains in gold in the near term. But tightening Federal Reserve policy and/or a much stronger dollar could derail the gold train.

Real Estate/REITS:

Economic conditions remain good for commercial U.S. real estate. Interest rates are low and rental growth is rising faster than inflation. Supply of new properties is generally low and relatively balanced across property types. Income will likely account for a majority of total returns in the year ahead, as properties have become more fully valued.

Summary

The Brexit vote came and went without disrupting the markets for long. No matter which way the vote went, we didn't expect it to lead to a sudden collapse of demand in either the UK or the EU. But uncertainty from Brexit will persist for at least another year or two as negotiations for new trade agreements move ahead. This may create a small headwind to world growth, but in the U.S. the effect should be negligible.

Because of slow global growth and lingering Brexit concerns, the Federal Reserve may delay rate increases until late in the year or even into 2017. We expect the central banks of Europe and Japan will continue bond buying. Japan may even increase their QE program in a desire for inflation. This means the gap between U.S. yields and those of Europe and Japan should persist. Before the Brexit vote, U.S. 10-year nominal Treasury yields were trading below core inflation rates. So any evidence that inflation is accelerating here in the U.S. could trigger an investor exodus from bonds and other income assets of longer duration. Evidence of real inflation in Europe and Japan would be even more impactful. It could mark the beginning of the end of their easy money programs. That could trigger an even bigger exodus away from income assets.

As we wait and watch for this, we suggest investors remain broadly diversified and avoid large concentrations in those segments of the markets that appear overvalued. These include utilities, staples, REITS and long-dated, developed market sovereign debt. Diversified exposure to international developed market equities and emerging countries like India, Mexico, Indonesia and others should offer growth opportunities. Remember that returns tend to revert to the mean eventually. And international equities have underperformed the U.S. for several years now.

That is how things look from where we stand in the second half of 2016. Staying on top of the economy and markets requires constant vigilance as conditions change. It's a never-ending process, but also a never-boring one! I will continue to monitor developments and be in touch with important news. Thank you for reading and if you happen to be a client, thank you for your business!