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Market Update: July 2016

U.S. stocks advanced for the sixth straight month, with the S&P 500 gaining 3.6% during July. Foreign stocks, which gained nearly 5%, were the big winners for the month. Interest rates continued to tumble across the globe. Since bond prices rise as interest rates fall, U.S. and international bonds now boast year-to-date total returns of 5.98% and 12.86% (in dollars), respectively.

U.S. gross domestic product (GDP) grew at the lackluster rate of 1.2% during the second quarter of 2016, well below the 2.6% rate expected by economists. The Commerce Department also revised down their GDP growth estimates for the prior two quarters.

> **This means that since last September, the economy has pumped the brakes from the 2.2% average from 2012-2015 into the near-stall speed of about 1% … the current economy is easily the weakest since World War II.**
>
> **Review and Outlook – WSJ 7/29/16**

Other news from the U.S. investment and economic fronts:

- The unemployment rate stands at 4.9%, and wages are rising.
- Home sales hit a post-recession high.
- Consumer spending remains strong.
- Business investment declined for the third straight month.
- S&P 500 companies are expected to report a fourth straight decline in quarterly profits, down 3.7% in comparison to the second quarter of 2015. Revenues are also expected to decline by 1.2% for the quarter.
- Oil prices declined 14% to $41.60 per barrel (U.S. crude).
- The yield on the 10-year U.S. Treasury declined to 1.46% from 1.49% at the end of June.

Weak business spending continues to exacerbate economic growth. Capital expenditures improve employee productivity, and ultimately contribute to better wages and higher corporate profits. Businesses are apparently reducing capital investment by substituting labor for capital.

Instead of buying an expensive piece of machinery, businesses are hiring really cheap workers they can fire whenever they want.

Megan Greene, Manulife Asset Management – WSJ 7/29/16

The 19 country Eurozone also reported 1.2% GDP growth in the second quarter, down from 2.2% in the prior quarter. Weak export demand, a troubled banking sector, and strikes in France were just some of the headwinds. The Eurozone unemployment rate, at just over 10%, is double that of the U.S.

The financial crisis of 2008 prompted an aggressive global monetary response. This, in turn, caused financial asset prices to rise while wages basically remained flat. One of the unintended consequences has been the growing inequality of income and wealth.

As a result, populist movements have burgeoned in the U.S. and across Europe, fanning the flames of class resentment, anti-immigrant prejudice, and nativism into a white heat. No doubt, antiestablishment populist sentiment explains such events as Brexit. The rising tide of anti-globalization and growing inequality of wealth have also added to the tensions in U.S. cities and elsewhere.

Ruchir Sharma, Morgan Stanley – Barron's 8/1/16

Note that foreign trade accounts for about 30% of the U.S. economy. More than 1 out of 5 American jobs (41 million workers) depend on trade.

Short-term savings rates (i.e. money markets, CDs) have been hammered in this low-interest rate environment … a policy directive often referred to as *financial repression*. Governments, on the other hand, have enjoyed a tremendous windfall.

The national debt as a share of gross domestic product has more than doubled since 2007 … but net interest payments on the debt has actually declined … falling to 1.25% of GDP last year, the lowest level since 1968.

The Outlook – WSJ 7/24/16

Low interest rates have also propped up asset prices, as U.S. stocks are at new highs, and real estate prices are just shy of peak values reached in 2007. Net worth in the U.S. now exceeds 500% of national income. That level has only been reached twice …

from 1999-2000 during the technology bubble, and 2004-2008 during the housing boom.

> **Those inflated prices make it more treacherous to return interest rates to normal, the task facing the Fed …**
>
> **Greg Ip – WSJ 7/27/16**

Maybe the most crucial unintended consequence of zero-based interest rates is the direct impact on pension plan funding levels. Moody's recently estimated the unfunded liability for all state and local pension plans at $3.5 trillion. The American Enterprise Institute calculated the liability at a whopping $5.2 trillion. Also, according to Mercer, the combined pension deficit for all S&P 1500 companies reached $568 billion at the end of June.

> **Many states and local governments may be facing difficult choices if investment returns remain low. The money has to come from somewhere.**
>
> **Keith Brainard, National Association of State Retirement Administrators – WSJ 7/25/16**

Yes, the money has to come from somewhere. There are basically only three sources: taxpayers, current and future pensioners, or reductions in public services.

Global central banks have orchestrated a race-to-the-bottom. To be sure, asset prices have been propped up and government debt service has been reduced. But, has the economy really benefited from zero-based (ZIRP) and negative (NIRP) interest rate policies?

> **Negative rates aren't a naturally occurring phenomenon in finance but a creation of our ingenious central bankers. Furthermore, they seem to defy common sense. Interest rates exist because we want things now rather than later. That's the nature of human desire. Negative interest rates turn that on its head. So they are a sign not of constructive policy making, but of trouble.**
>
> **James Grant – Barron's 8/1/16**

Since the middle of 2014 (the past 8 quarters), global stocks have actually declined by 1.53% … staying within a relatively tight trading range. In an economic backdrop dominated by artificially depressed interest rates, investors need to remain patient. Stay diversified, stick to the plan, and anticipate your near-term cash needs.

Financial history shows that in the long run, investors get rewarded for doing what is hard, not what is easy. What is hard is to be patient and ornery.

Jason Zweig – WSJ 7/22/16

I know I have spent a lot of time focused on *the glass being half empty*. But on a positive note, 2016 has been good so far to investors. Also, the recent "jobs report" for July (released on 8/5/16) was very strong. So, maybe we should acknowledge that *the glass is still half full*, and take some time to relax and enjoy the great summer weather!

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