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JUNE 30, 2016 INVESTMENT MARKET COMMENTARY

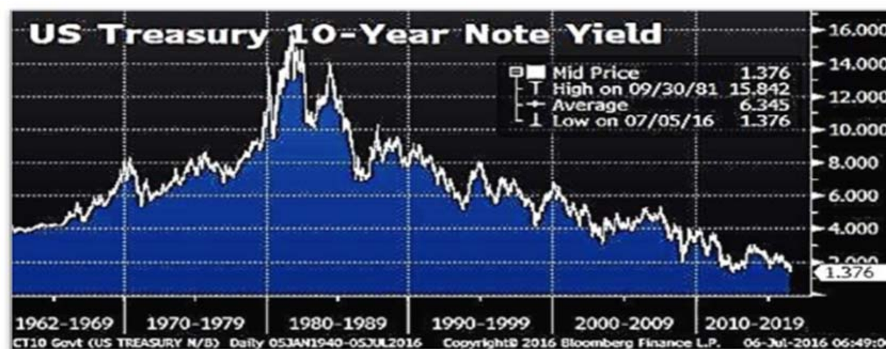
US equities finished a volatile spring quarter with small gains, while most of the rest of the world was flat or down. Interest rates continued to melt toward, or in some places below, zero. Most all global currencies depreciated further in reaction to weak economic conditions and heightened political instability. The period witnessed several notable events, including the following that contributed to the wide price swings:

- **Interest rates worldwide declined dramatically**, primarily reflecting strong investor demand for safety and liquidity. The graphic below illustrates the historically low level of the 10-year US Treasury note, and the yields of most high quality bonds have followed suit. Outside the US, quite amazingly, there is in excess of $15 trillion of global bonds that now carry negative yields (yes, the investor actually receives less in return than originally invested). This situation is unprecedented and is greatly influencing all areas of the investment spectrum;

- **Global economic conditions remain fragile**, with many countries on the edge of recession. The US economy is the best of the lot in many respects, though it can hardly be described as vibrant;

- **Europe's travails were thrust back into the news with the surprise referendum vote from the United Kingdom to exit the European Union (BREXIT).** While the long-term implications of this development are unclear, and may end up being net positive, the near-term uncertainty has intensified volatility as investors fear that BREXIT may presage the ultimate end for the EU;

- **Demand for high quality dividend paying stocks has been strong** despite the shaky economic backdrop. This demand can be directly attributed to the ultra-low interest rate environment, as dependable, above average and growing dividends are relatively appealing, compared with most other investment opportunities. So long as the current backdrop endures (weak economies and earnings together with negligible inflation and interest rates), this trend seems likely to continue.



The Stock and Bond Conundrum…Which Asset Class is Right?

While stocks and bonds have been performing fairly well of late, the underpinnings supporting each asset class present a stark inconsistency. Positive bond returns are being driven by falling interest rates which, in turn, reflect little to no economic growth, and a myriad of other challenges, financial and otherwise. In other words, rates have dropped dramatically because investors are worried. At the same time, stocks are rising. Typically, equities move higher when earnings and cash flows are improving and valuations are compelling, or at inflection points when bad news is already reflected in prices. This is not the case now. Therefore, it is quite possible that one of these asset classes is mispriced, presenting a potential risk to investors.

Our past reviews have noted the concept of 'TINA', the acronym for 'There Is No Alternative'. This notion suggests that with bond yields so low, investors are 'forced' to own stocks in order to generate acceptable returns. While we do not fully ascribe to the wisdom of this concept, **there is validity to the strategy of owning stocks of high grade companies, particularly those that pay decent and growing dividends, as opposed to longer term bonds at yield levels that do not exceed inflation.** Indeed, recent stock market corrections have provided opportunities to purchase such equities at reasonable valuations. History has shown that owning superior companies of this type has been a fruitful investment approach over meaningful periods.

At this time, the yields of many foreign government and corporate bonds are negative, which ironically makes the US fixed-income market relatively attractive in the world of global bond investing. Given these circumstances, **the primary value of owning fixed-income securities is the safety and liquidity they provide**. **In fact, during the several equity market downdrafts over the past 12 months, bonds (and cash) did their job in providing some level of stability in balanced portfolios**. This steadiness provides many investors with the comfort needed to maintain appropriate levels of stock exposure through volatile times. As a result, though short-term fixed income securities return very little today, we are not averse to maintaining some level of reserves, either in money market accounts or short-term bonds. This seems prudent in light of above average valuations for most asset classes and the obvious areas of uncertainty spread across the globe. With nations now so interconnected, it is commonplace to have unforeseen events in far reaching corners of the world reverberate across financial markets. Having investment reserves protects, in part, against these circumstances and, importantly, provides the wherewithal to take advantage of opportunities that may emerge.

Looking Ahead

As investors we must simply accept the fact that today's world is fraught with uncertainty, with the BREXIT vote being the latest example. Moreover, additional market volatility (both up and down) may occur as numerous events unfold, including the US presidential election, central bank activities, and potential disappointments related to the sluggish business environment. It would be preferable, of course, to have a more benign market backdrop and one free from the heavy influence of government policies. Regardless, we strongly believe that an investment approach focused on the core fundamentals of quality, liquidity and value will be resilient, and that portfolios of high grades assets, structured appropriately to meet one's near and long-term objectives, will withstand the inevitable ebbs and flows, and prosper over time.