Fixed Market Commentary

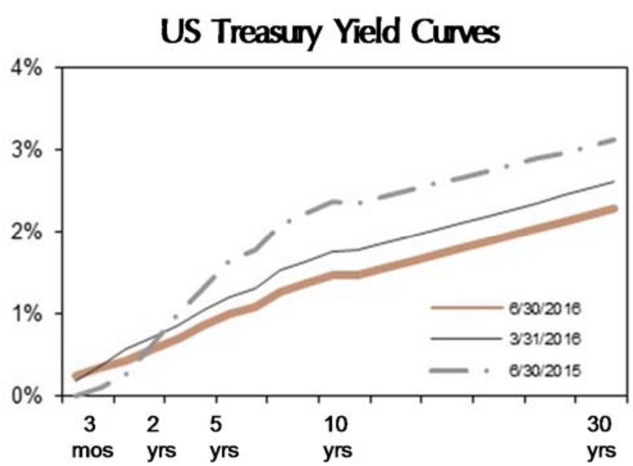
June 30, 2016

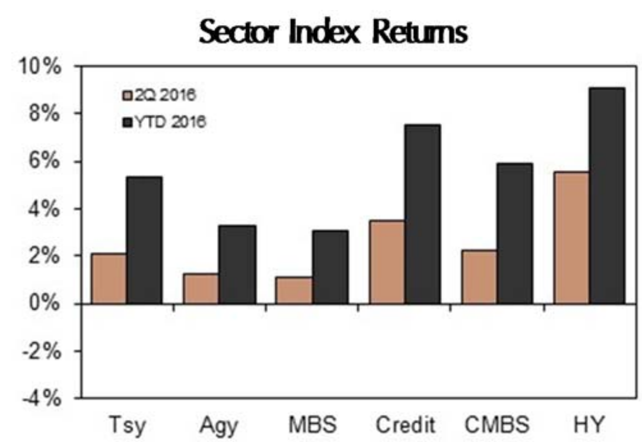
BREXIT – Too!

In last quarter's *Fixed Income Outlook*, we stated: "*If Great Britain votes to leave the EU, the impact on world financial markets could be significant.*" On June 23, despite an almost-universal belief that British voters would choose to "remain" in the EU, voters shocked the world by choosing to LEAVE. Equity prices plummeted across the globe, and interest rates in advanced economies tumbled. The Brexit-driven US interest rate collapse can be primarily attributed to: (1) "Safe haven" buying of US bonds; (2) Collapsing European interest rates (causing US rates to drop in sympathy); (3) The dwindling probability of a near-team Federal Reserve interest rate hike. In early July, the 10-year US Treasury yield breached a key technical level of 1.38%, which was the record low yield reached in July 2012.

The second quarter was certainly historic. Despite a great deal of fear, uncertainty and volatility, US investors fared very well. The S&P 500 was up 2.5% in Q2 and 3.8% YTD. The historic drop in interest rates led to strong fixed income performance. The Barclays Aggregate Index was up 2.2% in Q2 and 5.3% YTD. The 30-year US Treasury bond, which is very sensitive to interest rate changes, had a YTD return of 16.9%, which is the third best start to a calendar year in history.

From a job creation standpoint, Q2 was somewhat of a roller coaster ride. Job growth in April and May came in below forecasts. May saw a stunningly-weak 11,000 jobs added, which is the lowest monthly jobs gain since September 2010. However, payrolls rebounded strongly in June, with a gain of 287,000 jobs. In 2014, the Fed created a new metric, the Labor Market Conditions Index, to better gauge the state of the jobs market. The index reflects 19 measures of the labor market. The LMCI has now fallen for 6 straight months signaling that, despite June's increase, the labor market is slowing.





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In early July, Deutsche Bank released a research note that puts the odds of a US recession occurring within the next year at 60%, the highest odds since 2008. However, some would argue that economic data isn't all that important to US financial market performance. JP Morgan recently stated that (1) "The markets are agnostic about the strength of the domestic economy" and (2) "Global developments outweigh domestic ones." We tend to agree. The combination of global central bank intervention and foreign financial market volatility are likely to have much larger impacts on US financial markets than will economic data.

Despite poor corporate revenue and earnings growth, mediocre economic data and the shock from Brexit, the S&P 500 managed to reach a new all-time high on July 11, 2016. How can this be? In our view, stock prices are being inflated by super-charged global central bank monetary policy. While the Fed has no immediate plans to ease, the European Central Bank, the Bank of Japan and the Bank of England are all expected to launch new rounds of monetary stimulus in response to Brexit. Thus, world central banks are unleashing a tsunami of cash that will lower interest rates and prop up global asset markets. In the wake of Brexit, European yields have collapsed. The Bloomberg Eurozone Sovereign Bond Index has a market value of $6.4 trillion. $3.3 trillion of the bonds in that index, more than half, currently have NEGATIVE yields! Demand for higher-yielding US bonds has put upward pressure on the US dollar. A strong dollar makes US goods more expensive to the rest of the world, hurting both US exports and US corporate profitability. This acts as a quasi-tightening of financial conditions, which is a big concern for the Fed.

Interest rates remain near historic lows, but there are forces that could certainly push them lower. We will tactically adjust portfolio durations to take advantage of anticipated interest rate moves. Our client portfolios maintain a slight underweight in government securities as we see little value at current yields, however, they do provide liquidity and act as a hedge against "flight to quality" buying. We are overweight credit (US corporate bonds) and slightly underweight mortgage-backed securities.

June 30, 2016

BREXIT

The second quarter of 2016 was a positive one despite the market volatility derived from the Brexit vote in late June. April got us off to a decent start, followed by a pretty good May, just in time for the Brexit vote on June 23rd. With the outcome surprising market observers, global stock markets went tumbling. Many prognosticators had predicted a victory for Bremain. When the Leave camp won, global financial markets reeled from the shock. This is what happens when voters upset the status quo, a political class enabled by the media. It's a bizarre and unattractive spectacle. Chapter two could be written in this country with a Trump vote. In our opinion, voters are acting rationally. "Washington is ***causing*** our problems so let's burn it down."

For the quarter, the S&P 500 Index *gained* 2.46% while the average US stock fund *increased* just 1.8%. The Rockwood Strategic Equity composite was *up* 4.49%, with the Sector ETF Strategy also *ahead* of the market at +2.74%. Mid-Cap stocks were the best place to be for the quarter with the S&P 400 *up* 3.99%. Small-Cap's did well also *appreciating* 3.48%. Foreign stocks continue to lag domestic equities as the Morgan Stanley EAFE Index *declined* 2.6%. With interest rates falling during the quarter, bonds *appreciated* in value. The Barclay's Aggregate Bond Index *rose* 2.2%. The Balanced Composite Index *gained* 2.4%.

After somewhat of a roller coaster ride, stocks are higher for the year. It has been an interesting ride, from China's economic woes, to oil's rapid decline and subsequent stabilization, to the Brexit vote; investors have been challenged. Despite these challenges, market volatility seems to have eased in recent weeks as these headline speedbumps move into the rearview mirror. Investors have benefitted from staying the course and not letting emotions roadblock their future.

More recently, stock price action has been a byproduct of headline news events and less so of company fundamentals. As earnings season kicks off, investors will shift their focus away from the "noise" to what really matters: company fundamentals. Expectations have been revised downwards of late, setting the stage for upside surprises. Not to be overlooked is the Feds decision to keep interest rates low, at least for the foreseeable future. This too benefits stocks as investors are forced to search for higher yields (returns). A solid earnings season combined with an accommodative Fed should help drive equity prices higher by year end.

Equity Market Commentary

June 30, 2016

Looking back on the first half of the year, this market has had a lot to digest. We've faced the threat of interest rate hikes, uneven economic data, an unusual election cycle (to say the least!), and most recently, the "Brexit." Yet through it all, the market has "climbed the wall of worry." Our portfolios continue to be positioned somewhat defensively with heavier weights in *consumer staples* and *utility/telecom* stocks. Not many predicted it, but in a year in which the S&P is positive, the top-performing sector is none other than *utilities*. It's been a very strong first half of the year for defensive/interest-rate sensitive groups, and *utilities* have benefited the most. While these areas were rewarded in particular during the past quarter, based on our current research, we are likely to maintain that overall positioning.

At the same time, we are seeing early improvement in economically sensitive areas such as energy, industrials and basic materials groups. This is very constructive but still too early to aggressively pursue. We'll be patient and add here if opportunities present themselves. If those emergent economically sensitive trends hold up, it would make for a great catalyst for a strong finish to 2016 and beyond.

Our trend reversal summary is positive again in July as twenty-four (24) issues reverse upward and nine (9) issues turn downward. The upward list is tilted towards *commodity* and *industrial* companies again while the downward list has a notable *consumer discretionary* (travel) weighting.