ECONOMIC OUTLOOK

bounty management
unique investment insight

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Should We Stay or Should We Go?
British Indecision Reflects Political and Economic Strains

The relatively clear United Kingdom referendum vote to leave the European Union (EU) is a result of an electorate ever more disillusioned with both the so-called establishment and globalization. The protracted damage to real incomes and ensuing inequality wrought by the deep recession of 2008-09 has not been repaired. Voters, ever more unimpressed by the political hierarchy, sought a scapegoat, with EU membership the prime candidate. The foreign (Brussels' based), and on some dimensions unelected, set of institutions could also be blamed for the apparent immigration problems that clearly have been at the heart of electoral misgivings. Worries about establishment and globalization are not unique to the UK electorate and politicians throughout Europe and elsewhere will now be even more aware of how fickle their own electorates may be.

The vote also reveals the inherent tradeoffs between competing aims of increased globalization, democracy, and national sovereignty. The European Union aims to boost economic and political integration by sacrificing the decision-making process to supra-national institutions including the European Central Bank, European Parliament, and European Commission, among others. However, there is little recourse once rules and regulations are agreed upon, often by technocrats. While the issues are different, the backlash echoes revolts against austerity measures in peripheral eurozone economies in recent years with the ongoing debt issues in Greece a prime example.

For the UK and Europe, the economic consequences would be grim if the political and economic union fully ruptures. In 2015, 44% of the UK's exports went to EU countries and 53% of its imports came from the EU. Business confidence has already been damaged along with financial intermediaries. Firms are likely to take a wait and see approach on any expansion and make contingency plans for a messy exit. Central banks will provide what backstop they can by extending or expanding monetary support, and markets have been conditioned to respond to the ring of the stimulus bell. The move to fresh lows for global sovereign yields should help to offset tightening financial conditions created by market volatility. Lower rates are also a symptom of diminishing growth and inflation expectations. Business is reluctant to spend and invest in capital to expand if markets are uncertain and growth is low. Even if more benign scenarios play out, events are a shot across the bow to globalization, and reinforce that returning to "old normal" policy rates will be a Sisyphean task.

U.S. Economy

For the U.S., the fallout is likely to be more limited than for investors in Europe. The UK economy is only 4% of global gross domestic product and the U.S. export sector comprises about 13% of GDP. The S&P 500 is much more global with 40% of earnings and revenues coming from outside the U.S. This leads the stock market to be more sensitive to global shocks than the U.S. economy. GDP growth has been moderate, 2016 Q1 at 1.1% annualized after 2015 Q4 1.4%, a consequence of weak net exports, a strong dollar, slower growth in inventories, and a collapse in energy sector investment. The Atlanta Fed's tracking estimate for the second quarter suggests a number closer to 3%, led by an increase of 4% in consumer spending. Labor market improvement has slowed, and corporate profits are on track to contract for a fifth consecutive quarter. The Federal Reserve in June edged further toward the low-rates-for-longer camp with the market now predicting a less than 50% chance the Federal Reserve hikes rates even once by the end of 2017. The Federal Reserve's growth projections continue to decline: December's 2.4% forecast for 2016 was lowered to 2% in June. Our 2016 U.S. growth forecast in the range of 1.5% to 2.0% seems to be on target.

Employment and Wages

After averaging 282,000 new jobs in Q4 and 196,000 in Q1, payrolls averaged just 147,000 in the 2nd quarter after a dismal increase of 38,000 in May. On the bright side, a loss of job growth momentum could be a natural result of nearing what policymakers call "full employment." Yet, the downshift was abrupt and may reflect heightened uncertainty and caution amid weak corporate profits. The Bureau of Labor Statistics' three-month diffusion index of job gains, a measure of how many industries saw advances versus declines, fell to a six-year low. Average hourly earnings tilted higher to 2.5% y/y on average in Q2, holding on to a quicker pace than the 2.2% on average from 2013 through 2015. Job openings hit a fresh high of 5.8 million in April, many in health care, food services, and retail trade. Services, in general a lower paying job sector, continue to power the U.S. economy.

Real Estate

Although sales of newly built homes fell in May, June sales rebounded and builder confidence is growing. The Case-Shiller 20 city home price index rose 5.4% y/y in April and 5.5% in the first quarter as limited supply drove up prices. Low mortgage rates helped with the 30 year mortgage rate 3.5% at quarter-end, down from 3.9% at year-end 2015. Low interest rates and job growth have supported the market with the rental side remaining hot in many markets. Still, the share of multi-family housing units started has come down recently, averaging 27% of total residential starts in the three months through May vs. 32% in 2015. That compares to 10-15% on average in the mid-2000s single-family boom. Purchases by non-resident foreigners fell $10 billion to $44 billion in the year ending March 31st due to a stronger dollar, higher home prices, and weakening economies in South America and China.

Consumer and Manufacturing

Consumer sentiment held up as the second quarter progressed. The University of Michigan survey strengthened slightly and the Conference Board's measure weakened due to its higher weight on economic expectations. Inflation expectations trended lower with over 40% of survey respondents predicting a range of 1-2% price inflation in the years ahead. The Institute of Supply Management (ISM) Manufacturing Index provided a glimmer of hope in the second quarter, rising to 53.2, a sixteen month high. Industrial output continues be split across sluggish manufacturing and a severe drop in mining, all amid stronger dollar and foreign headwinds. U.S. energy production continues to moderate and manufacturing payrolls are down a cumulative 35,000 in 2016 after rising 26,000 in 2015, and 208,000 in 2014. Oil and gas rig counts rose 4.2% in June, the first increase in a year after a cumulative 79% decline since September 2014.

World Economy

Europe

Before the UK vote to leave the EU, the growth backdrop had been improving based on survey and lending data, and the European Central Bank (ECB) turned more accommodative in March. A bounce in Purchasing Manager's Index (PMI) manufacturing in June from 51.5 to 52.6 (a six-month high) is encouraging, but the services PMI dropped from 53.3 to an 18-month low of 52.4, undermined by clearer softness in terms of new orders. The German manufacturing PMI rose to a 28-month high. Overall Eurozone GDP growth softened slightly to 1.7% y/y in the first quarter. The regional breakdown show performance at around that pace in France (1.3%) and Germany (1.6%), while Italy lags (1.0%) and Spain continues to surge ahead (3.5%). Spain's unemployment rate of 20.1% in April, compared to a Eurozone average of 10.2%, suggest there is still plenty of slack in the economy. The mood in Europe after the UK vote is unstable and eurozone break-up hypotheses are swirling around with some even suggesting a northern mini-eurozone with only the stronger economies. Germany is particularly vulnerable to a UK departure since Germany exports roughly €80 billion in goods to the UK and imports only €40 billion.

Japan

There is a strong chance the Bank of Japan significantly eases policy in July after introducing a negative interest rate regime in January. Still, that would come after a surge of almost 20% in the yen versus the dollar in 2016, paired with significant doubts about the effectiveness of both monetary policy stimulus and the Abenomics narrative more generally. Outright fiscal expansion financed by money printing may be next, and intervention in the currency market is possible. In real terms, the trade-weighted yen has retraced half of its decline since 2012. The second quarter Tankan Survey of large manufacturers held steady at a three-year low while small firms' outlook worsened for both manufacturing and services. This is despite a nearly $2.5 trillion increase in the central bank's balance sheet over the last three and a half years. Government bond yields are negative through 15 year maturities, and the 40-year yields a paltry 0.1% (down from 1.4% at the start of the year). Japan's Nikkei stock market is down about 20% year to date.

China and Developing World

Not being front and center on the risk stage has allowed the People's Bank of China (PBOC) to quietly weaken the currency a further 3% versus the dollar in Q2. Rebalancing the economy toward household spending is occurring slowly as debt rises. Real retail sales rose 9.7% y/y in May, slowing from 10.6% in 2015, while industrial output has stabilized around 6% y/y, based on official statistics. Portions of the domestic real estate market remain hot, as average selling prices in Shenzhen accelerated to 93% y/y in May, while those in Beijing moderated to 23% y/y and Shanghai 16%. Brazil is set to host the summer Olympic Games in the midst of severe recession and high inflation (9.3% y/y in May, compared to a 4.5% target). Gross domestic product fell 5.4% y/y in the first quarter, after Q4 -5.9%. Unemployment touched 11.2% in May, up from 8.1% the same period in 2015, and 7% in 2014. The International Monetary Fund (IMF) in July cut its world growth forecast for 2016 from 3.4% to 3.1% after disappointing world growth of 2.4% in 2015. Our world GDP forecast is 2.6% due to the effect of the UK vote, struggling emerging market growth, and an increased risk of currency devaluations.

Investment Perspective

Although the dust is far from settled from the Brexit shock, the global impact is expected to be modest and analysts forecast a hit to world growth of about ¼% to ½%. The impact to the UK could be much more severe - the IMF warned of a drop in GDP of 0.9% in 2017 and as much as 4.5% in a few years depending on whether or not the EU allows the UK access to its single market. Interest rates across major developed economies have plummeted in a flight to safety amid lower global growth forecasts and are now near post WWII lows. With slow growth and the threat of deflation, global central banks continue to support the markets with monetary easing. Low rates may help stabilize the markets, but also suggest weak underlying growth. The percentage of global debt trading below 0% is now over $13 trillion (30% of debt), up from $8 trillion in March. In Switzerland, a bond due in nearly half a century is yielding below 0%. In Germany, government debt is negative as far out as 2031. No wonder a 10 year US Treasury at 1.5% looks attractive. Low interest rates have pushed savers and retirees to take more risk to try to gain higher returns. Many pension plans with stated 7 - 8% return objectives are flat since 2014. Pension plans for the S&P 1500 are increasingly under-funded: liabilities rose $164 billion to $568 billion in the first 6 months of 2016!

For equities, earnings for the S&P 500 are estimated to decline 5.3% in the second quarter. Profits have fallen for the past four consecutive quarters. Recent developments will not help: the UK's vote to leave the EU has strengthened the dollar, hurting companies that do business overseas. On the positive side, housing, retail, and cheaper energy are all contributing to earnings. Equity and asset prices are still supported by extreme global monetary easing. Stock buybacks continue at a record high level, a symptom of low interest rates, a lack of investment opportunities in a slow growth world, low trading volume, and executive conflict of interest (e.g., pay tied to EPS growth and options grants). Precious metals continued to shine in the second quarter with gold up 24% in 2016. Gold's rise can be attributed to 0% interest rates, global monetary expansion, and a lack of faith in paper-based currencies printed by countries that continue to issue more debt. Oil prices recovered from first quarter lows in the $20s to a range of $45 to $50 a barrel as demand finally eases some of the over supply.

We continue to favor sectors such as industrials, telecom, healthcare, and technology. We remain underweight in financials as profit margins are squeezed by low rates, slower growth, and increased regulation costs. For balanced accounts, we hold shorter-term bonds, inflation-protected bonds, and municipal bonds to counteract the risk of holding stocks during downturns. We are cautious on corporate paper as companies have loaded up on debt, defaults are rising, and the credit cycle shows signs of deteriorating. As we wrote in our letter last month after the UK exit vote, markets tend to overreact. We have found that the best course is to create portfolios with a mix of stocks, bonds, and cash that balance growth and income. We continue to focus on companies with solid financials, strong management, and growth prospects at reasonable valuations. Dividend income is an important element of total return. During times of turbulence, it is important to avoid the timing risk of moving in and out of markets. Given the situation we will continue to invest with patience, focus on the long-term, and remain vigilant.

June 30, 2016
DJIA: 17,929.99
S&P 500: 2,098.86

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.