Despite Global Headwinds, The Fundamentals of the US Economy Remain Solid.

After declining for much of the spring, market volatility once again increased in the face of ongoing geo-political risks, concerns about the U.S. labor market and the surprise Brexit vote by U.K. citizens to leave the European Union (EU). Despite these headwinds, the S&P 500 ended the 2nd quarter up 2.5% and is up 3.8% for the 1st half of the year. The market rally from the lows seen in mid-February was led by the more income-oriented and defensive sectors of the market like Telecommunications, Utilities and Consumer Staples. With interest rates low globally, investors are searching for income opportunities. While investors' search for yield will likely continue to benefit income-oriented sectors, as we move into the 2nd half of the year, we expect that moderate year-over-year earnings growth will help drive returns for more growth oriented stocks.

The outcome of the June 23rd Brexit vote came as a surprise to the financial markets. While the polls showed a narrowing gap between the Remain and the Leave vote, most expected Remain would win the day. The subsequent global market sell-off was a reflection of both the surprise of the outcome and the uncertainty of how this plays out going forward. The initial impact was felt across global equity, currency, bond and commodity markets.

This vote by British citizens is just the beginning of a long process and not a final action. Markets are currently reacting to a political event and not an economic or financial event. To be sure, the economies of the U.K and the European countries will be impacted over the near-term as the exit process gets underway. However, it is important to remember that the U.K. and Europe have had long-standing economic, trade and defense relationships that pre-date the forming of the EU. While emotions are running high, we believe that it is in the best interests of both parties to maintain the ties that are mutually beneficial. New Prime Minister Theresa May will be charged with seeing the U.K. through this process which is expected to be finalized by December of 2018. The long-term impact of this decision will not be known for a long time, but we would expect volatility to remain elevated as the process moves forward.

Domestically, an unexpectedly weak jobs report for May added to investors' anxiety, but a strong rebound in June helped lessen those worries. As we have seen in the past, labor market data can tend to be very volatile on a month-to-month basis due to short-term impacts such as weather or a labor strike. While it is very likely that we will see the pace of jobs gains slow from the rapid pace seen last year, the labor market remains strong. The U.S has seen over 1 million new jobs added this year and 2.4 million over the last 12-months. The unemployment rate remains below 5% and many people who had previously stopped searching for work are re-entering the labor market. With wages moving modestly higher and more people employed, consumer spending should remain solid.

Despite investor concerns early in the year, economic data continued to highlight that the fundamentals of the economy remain solid. The economy grew at a 1.1% pace in the 1st quarter and 2nd quarter growth is expected to top 2.0%. The housing market continues to show signs of strength with new and existing home sales remaining in a positive trend. Housing activity is supported by low interest rates and continued modest year-over-year increases in home prices. The improved housing market is leading to increased spending on home improvements and large ticket items such as appliances. With solid consumer spending and a positive contribution from the housing sector, the economy is well-positioned to grow at a moderate pace.

Since raising the Federal Funds rate in December, the Federal Open Market Committee (FOMC) has held the fed funds rate steady. Speculation about the timing and magnitude of future rate hikes has added to market volatility. While the FOMC had promised a moderate pace of policy normalization, what we are seeing is a glacial pace. Despite a strong labor market, the Fed has pointed to other concerns including global economic uncertainty as rationale for not continuing the process. The Federal Reserve remained on hold at its June meeting citing global uncertainty regarding the potential impact of the vote in the United Kingdom, as well as May's surprisingly weak non-farm payroll numbers. Regardless of the continued growth of the U.S. economy and near full employment, it seems likely that the Fed will not raise rates for the remainder of this year and probably well into next year. The FOMC generally does not make changes in the months just prior to a Presidential election and this year should be no different.

Outside of the U.S. we continue to see very accommodative central banks. The Bank of England is likely to cut rates this summer in order to stimulate growth and offset the impact of the Brexit vote. In addition to rate cuts, the European Central Bank (ECB) has expanded its quantitative easing program. We continue to see Japan experiment with negative rates, quantitative easing and fiscal stimulus in order to improve economic growth. Along with the Bank of Japan, several global central banks are experimenting with negative interest rates including the ECB and the Bank of Sweden. Negative rates are meant to encourage banks to make loans to consumers and businesses rather than hold cash. However, early results have shown that low-to-negative rates alone are not sufficient to incent businesses or consumers to borrow money they do not need. It will likely be a while before the full impact of negative policy rates can be fully understood.

U.S. interest rates declined for most of the 2nd quarter, particularly after the U.K. vote as investors sought the relative safety of Treasury bonds. Even as the equity market recovered at the end of the quarter, interest rates continued to decline. This is likely due to investors' continued search for relatively safe yield. Outside of the U.S., easy monetary policy has led to negative interest rates in Japan and across major European countries. In total more than 11.7 trillion dollars of global sovereign debt are now trading with a negative yield. For the first time ever, the German Government issued new 10-year bond with a negative -0.05% yield. The combination of a higher yield and a more stable and growing economy has made U.S. income-producing securities even more attractive. This, along with a Federal Reserve on hold should keep interest rates near record low levels for longer than expected.

To summarize, we expect to see bouts of uncertainty and volatility in the market although the sources of this uncertainty may shift over time. Earlier in the year, the markets were worried about the impact of slowing growth in China, rising geo-political tensions, commodity price declines and potential rate hikes by the Federal Reserve. More recently investors have begun to worry about the longer-term impact of the Brexit vote, heightened racial tensions, increasing acts of terrorism and the impact of a highly contentious political season. Through it all, we will continue to separate the short-term reactions from the longer-term impacts. We will continue to monitor global and domestic events, but as always our focus remains on the underlying fundamentals of the economy and the companies in which we invest. Given the solid labor market, healthy consumer and outlook for continued moderate economic growth, we will stay fully-invested. We continue to take a long-term approach and do not anticipate making any changes to our strategy or portfolio positions unless we see a change in the fundamentals.