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MARKET REVIEW & OUTLOOK

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THREE SECOND-HALF PREDICTIONS

The wild start to the year led to a rather quiet second quarter up until the final days when Brexit dominated headlines. The media hates quiet, and they latched on to Brexit because they had little else to report after the volatility from the New Year subsided.

Their recipe for panic required two very simple steps. First, ignore facts about Brexit such as how it was nothing more than a referendum to see where its citizens stand and is not legally binding in any way. Second, push the headlines that matter, which included stronger consumer confidence, housing, and manufacturing data, to page eight (right below to the obituaries).

They achieved their goal, and world financial markets sank over a period of 72 hours until staging a powerful recovery. This window of opportunity was precisely what we as contrarian investors had anticipated, and we were quite busy in those final days of the quarter putting cash to work.

Only time will tell if the volatility from Brexit is truly a distant memory, but as we enter the second half of a rather dramatic year, here are three predictions that will likely drive asset prices in the short and medium term.

1. NEGATIVE RATES WILL BECOME MORE NEGATIVE

An investment purchased with a negative yield is guaranteed to lose an investor money if held to maturity. In effect, the buyer is paying the bond issuer for the privilege of loaning it money, which is analogous to paying interest on money loaned to a friend.

Furthermore, banks pay depositors to supply them with money in the same manner a clothing company pays a supplier for cotton. What's amazing about a negative interest rate is that it's synonymous to a supplier paying a clothing company to use its cotton.

The concept of a negative interest rate is one that would be considered unthinkable just a few years ago. Yet today, over 25% of all outstanding government debt, totaling over $8 trillion, now offer a negative yield. This phenomenon is causing financial textbooks to be rewritten.

Imagine a world where a bank charged you to hold your money. A bank is supposed to pay customers for deposits, pool it all together, and then loan it out at a higher rate in the form of mortgages, car loans, company lines of credit, etc. Charging depositors is completely backwards.

Banks have yet to take it as far as to charge customers in such a manner, but there those who are already preparing for this very scenario to materialize. The chart below is courtesy of Deutsche Bank Research and shows the amount of money spent on fire-proof safes in Japan. According to the dotted arrow on the right, sales have recently surged to levels not seen since the financial crisis.

Any minute that cash is not in a bank is a minute that it risks getting stolen, burned, ripped, or misplaced. That risk is far too high for most, yet a sizeable number of Japanese citizens seem to think that this risk is lower than the risk of having to pay a bank to keep their money safe. Say hello to one of the perverse outcomes from Japan's current monetary policy.

Japan is not alone. Sweden, Denmark, Switzerland, the European Central Bank (ECB), and other smaller central banks are using negative interest rates as an attempt to kick-start their economies. These strategies most likely will not work, but that won't stop these governments from pushing deeper into negative territory because politics won't allow them to do otherwise.

The obvious next question is how the world will look after a few years of living with negative rates. I wish I had an answer, but nobody knows how this story will end just yet. However, I do expect any negative externalities from these perplexing monetary policy decisions to be contained within their respective borders.

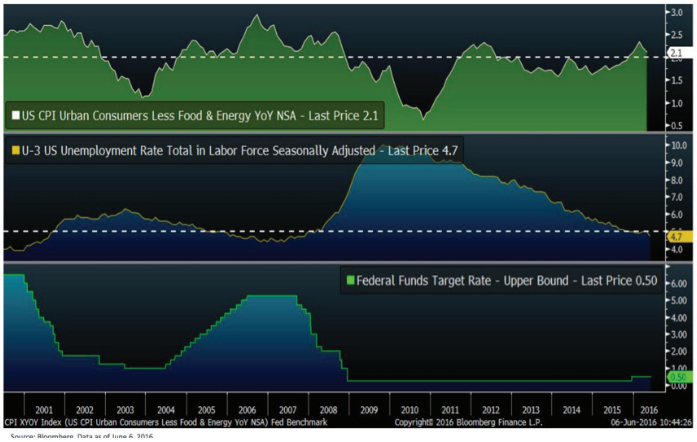
Back home, the odds that the Fed follows suit is microscopic, and the U.S. may even benefit as foreign investors flock to our financial markets to escape these negative interest rate policies (NIRP) and drive up demand for dollar-denominated assets even further.

The net result of negative rates becoming more negative has confirmed our decision to maintain a strong "home bias" in our asset allocation, which means that we remain heavily overweight the U.S. and underweight in the regions currently experimenting with NIRP.

2. THE FED WILL CONTINUE TO DODGE TOUGH DECISIONS

When the Fed began their third round of government bond buying, also known as Quantitative Easing (QE), they communicated a dual mandate to the world. The first goal was to lower unemployment, and the second was to revive inflation to a level conducive to sustainable economic growth.

The chart below shows these two metrics on top of the current Fed Funds Target Rate, which is their primary tool to control interest rates.



The Consumer Price Index, which is a measure of inflation, is right around the Fed's intended target of 2 percent, and the unemployment rate has fallen to near all-time lows. Yet despite clearly meeting their mandate, The Fed has only moved its rate target one time (slight bump up in the green line on the lower right side of the bottom chart).

Over the past six months since this first interest rate hike in a decade, the Fed has consistently stated that the economy continues to improve and that their economic forecast remains intact. However, during this same time period, the Fed has not only refused to raise interest rates, but they have actually lowered their interest rate forecast each step along the way.

This decision is perplexing. If raising interest rates is predicated upon an improving economy, and our economy continues to improve in the eyes of the Fed, then why lower projections for interest rates?

The only logical answer to this question is if some other data are being incorporated into the decision, and the reality of the world we live in today is that the Fed can always find an excuse to keep rates low. A few months ago, it was China and oil prices. Today, they can point to Brexit. Tomorrow, who knows?

The Fed's inability to stick to a plan is doing nothing more than ensuring that the path to higher interest rates is only going to take longer than initially expected. The net effect will be lower returns for longer, but the upside is that Fed policy should continue to support asset prices and mitigate recession risk.

Said another way, those investors who are doing everything right by staying diversified are probably going to have to wait even longer before expected returns on stocks and bonds rise up to levels that consistently beat inflation.

3. THE U.S. PRESIDENTIAL ELECTION WILL FUEL VOLATILITY

Let's face it. We are entering the final months of arguably the most contentious presidential election in our nation's history, and things could get weird. Markets despise uncertainty, so investors should, at the very minimum, prepare themselves for a more volatile second half to the year.

We are in the process of formulating an investment plan for each outcome as time goes on and we learn more about the specifics of each candidate's platform. Once the winner is announced, and only then, we will execute the appropriate plan based on who will become our next President.

What we will not do is jump the gun and place bets on who will win. Fundamental investors are risk managers, not risk takers, so placing a bet on who wins is akin to gambling. We also won't go to cash and simply wait until it's all over because we are not market timers (predicting the moment when market volatility will spike and then subsequently rebound requires one to get lucky twice).

That being said, I hope I am wrong on all three of these predictions. I hope that negative interest rate policies disappear, I would be thrilled to see the Fed raise rates by 0.50% by year-end, and although volatility creates opportunity, I would prefer to see our investors sleep better at night rather than worry about who will lead our country over the next four years.

Right or wrong, the fact remains that our economy continues to grow slowly, stock prices are fairly valued, and the risk of a recession remains low. Within this context, we look forward to a profitable second half of the year, and thank you for your continued support.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
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