INVESTMENT OUTLOOK
THIRD QUARTER 2016

Second Quarter Review

		Total Returns	
	Close 6/30/16	2nd Quarter	2016 Year-to-Date
Standard & Poor's 500 Index	**2061**	**+2.46%**	**+3.84%**
Dow Jones Industrial Average	**17,929**	**+1.38%**	**+2.90%**
NASDAQ Composite Index	**4867**	**-0.23%**	**-2.66%**
Dow Jones Global (ex U.S.)	**205**	**-1.50%**	**-2.45%**
Barclays Aggregate Bond Index (BNDS)	**59**	**+2.12%**	**+5.25%**

Politics to the Fore for Now

Financial experts are more accustomed to analyzing economic trends, interest rates, and corporate earnings than evaluating the ramifications of elections. However, when an event like the Brexit vote lands like a stink bomb on financial markets, investors are forced to shift their attention to a changing political landscape. Unfortunately, we are left with more questions than answers regarding what happens next in Europe. Do Scotland and Northern Ireland break from the United Kingdom in order to stay in the EU? Who will succeed Prime Minister Cameron and how will the negotiations between England and the EU go? Will countries such as the Netherlands schedule their own referenda? All of these possibilities will be floated during the summer. Then in the fall we have the U.S. elections followed by elections in France and Germany next year. In short, there is no shortage of political uncertainty.

Stocks and currencies reacted sharply to the Brexit voting results in part due to the ongoing fragility of the European economy. Europe has not fully recovered economically from the recession of 2008. When you add in the terrorist activity and refugee problem, it is easy to see why Europe is on pins and needles. The immediate selloff in the markets reflected concerns that a weaker UK would cause the Eurozone to slip back into recession territory. We think Europe will avoid a recession scenario as long as there are no other shocks to the system, such as problems with European banks.

The political uncertainty in Europe, and to some extent in the U.S., will now take precedence over the critically important issue of how to accelerate global growth. It is hard to imagine that there will be any new, effective, coordinated efforts by Europe and the U.S. in the near term to stimulate growth other than through low interest rates. Financial market saviors, such as central banks, are now on the outside looking in at the current rise of populist and nationalist emotions and agendas. The benefits of low interest rates are nearly exhausted, and from a political perspective they obviously have little influence on an anti-immigrant electorate. Political gridlock and uncertainty stymies changes in fiscal policy and will remain a psychological cloud for financial markets.

Investors Will Soon Refocus on Earnings and Interest Rates

Although politics should remain in the headlines into the fall, investors will ultimately return to the task of evaluating earnings and dividends and how they measure up to returns on cash and bonds. However, the question is, which earnings? There has been a rising chorus of criticism over the past year about the way U.S. companies are reporting earnings. Without getting into the arcane world of accounting, the majority of companies report earnings in two ways -- including all costs and excluding self-selected costs (e.g. stock options, restructuring costs, currency effects). Over time, more and more companies have been deemphasizing earnings which include all costs (GAAP earnings -- earnings according to generally acceptable accounting procedures) and emphasizing earnings excluding selected costs (so called non-GAAP earnings). Fewer than 6% of the S&P 500 exclusively used GAAP earnings last year compared to 25% ten years ago and over 40% twenty years ago. In May, the SEC finally said enough is enough and wants the lower GAAP earnings numbers displayed as prominently as the higher non-GAAP numbers.

Is this distinction really important? Well, increasingly so. In 2015, non-GAAP earnings were 44% higher than GAAP earnings. This is quite a difference. Investment professionals look at both earnings numbers and decide for themselves which numbers most accurately reflect real earnings. Some investors believe that since earnings are subject to such wide interpretation that the proof of the pudding is in dividend payments, not two different earnings reports.

Dividends Reign Supreme in Low Rate, Low Growth Environment

In an environment with declining bond yields due to slow economic growth, investors have sought out companies with high dividends. The best performing sector of the U.S. market this year is utilities, well known for competitive dividend yields, not growth potential. The utility sector of the S&P 500 has posted a 20% plus return so far in 2016. Many other companies, outside of utilities, have also done well because they have yields in excess of Treasury bond yields. Companies such as Johnson & Johnson, Philip Morris, McDonalds, Wal-Mart, Kraft, 3M Company, and General Mills have all been market leaders with competitive current yields and a history of dividend increases. Johnson & Johnson's dividend yield is higher than the yield on their bonds. And, Johnson & Johnson has raised their dividend 44 years in a row. Johnson & Johnson is up 18% this year. Apparently, investors like the yield and the historical trend of higher annual payouts at JNJ.

The global economic recovery from the deep recession of 2008 continues to be sluggish and a source of frustration for voters. Interest rates are lower than one year ago, but earnings by any definition are lower as well. Once again the U.S. central bank looks like they are unlikely to raise short term rates any time soon. The U.S. stock market has made very little progress over the past two years. Last year the market was up only 1.4%, including dividends. This year has been much of the same, +3.84% through June. The last time the market advanced two years in a row by only single digits was 1947-1948. The following year was up over 18%. We offer that up as a ray of hope.

Speaking of headline news:

We are happy to announce that Owen Gilmore has joined our firm as a Research Associate. Owen recently graduated from New York University's Leonard N. Stern School of Business, where he earned an MBA with distinction. He was a member of the Stern Investment Management & Research Society. Owen received his undergraduate degree from Colby College, where he majored in Economics and Mathematical Science. He is a Chartered Financial Analyst, and has prior work experience as a bond trader. He currently is a Red Sox fan.

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