The Intelligent Investor—June 2016

Quick Market Update:

Investors did not exactly "sell in May and go away" – the S&P 500 gained 1.53% last month. Oil prices settled into a sweet spot of sorts; they were high enough to soothe analysts, but not so high as to portend gas price spikes for consumers. Fundamental indicators pointed to an economy leaving its first-quarter doldrums behind; the real estate market looked especially hot. Hiring moderated, but retail sales, personal spending, and inflation picked up. It was enough to stir questions about an interest rate hike, and certain Federal Reserve officials publicly entertained that possibility.

Summer's Hot Issues

On May 21, 2015, the S&P 500 Index closed at 2,130.82, an all-time closing high for this broad measure of 500 large U.S. companies (St. Louis Federal Reserve).
In the year since, it has failed to recapture that level. On April 20 of this year, we finished at 2,102.40 and we closed out May at 2,096.96, but there hasn't been a new high in over a year (St. Louis Federal Reserve). It's not uncommon for the major indexes to go through periods where gains are elusive or we experience unwanted volatility. That leads us to the next question, "Why have the bulls seemingly been taking an extended nap?"

Napping Bulls

1. S&P 500 profits have declined for three straight quarters (*Thomson Reuters*).
2. Major turbulence in the oil industry has rippled through manufacturing, which has also hampered profits.
3. The stronger dollar has hurt earnings of U.S. multinationals, because sales incurred overseas must be translated back into the stronger dollar.
4. A lackluster U.S. economy is a headwind to revenue and profit growth.
5. Lingering worries about global economic growth hamper overall sentiment.
6. There is election year uncertainty.

On the Flipside

1. The earnings recession is expected to run its course during the current quarter (Thomson Reuters).
2. Oil prices are well off the lows, which loosens the tight screws around the industry.
3. The dollar has stabilized.
4. Leading indicators are not pointing to a recession.

There's not much positive to say about the global economy. As far as the election, we'll leave that to the political pundits.

Table 1: Key Index Returns

	MTD %	YTD %	3-year* %
Dow Jones Industrial Average	+0.1	+2.1	+5.6
NASDAQ Composite	+3.6	-1.2	+12.7
S&P 500 Index	+1.5	+2.6	+8.7
Russell 2000 Index	+2.1	+1.7	+5.5
MSCI World ex-USA**	-1.7	-1.6	-1.0
MSCI Emerging Markets**	-3.9	+1.7	-7.2

Source: Wall Street Journal, MSCI.com
MTD returns: April 29, 2016-May 31, 2016
YTD returns: December 31, 2015-May 31, 2016
*Annualized
**USD

Summertime Blues: Brexit

At this juncture, let's take a look ahead and spend some time on a couple of issues that have the potential to create short-term volatility in stocks. This won't be all-inclusive, but hits on the high points. The first is the potential "Brexit," the possibility that Britain will choose to exit the 28-nation European Union (E.U.) in a June 23 yes-or-no referendum. The 28-nation E.U. is a political and economic alliance that allows member countries to benefit from free trade at the expense of ceding some political authority. Most economists see problems in the short term for Britain if anti-E.U. forces prevail, but those same forces believe the removal of burdensome regulations would benefit the nation.

The OECD said at the top of the month that a Brexit “would trigger negative economic effects on the U.K., other European countries, and the rest of the world.”
But St. Louis Federal Reserve President James Bullard took a much more sanguine view last month, noting if the U.K. decides to leave, “the next day nothing happens” and the country will enter into departure negotiations that are bound to go “very slowly” (Bloomberg).

One potential unknown: Will London lose its status as a banking center? Or would British-based firms depart? Again, this has the potential to damage Britain’s economy. The U.K.’s economy is much more important to Europe than Greece, and we may see added uncertainty if the election appears to be too close to call in the run-up to voting. While a number of polls in May placed the “remain” camp in a reasonable lead, two Guardian/ICM polls at the end of last month suggested those who want to exit the EU have taken a slight lead.

Nevertheless, we all know the imperfect nature of polls, and campaigning will continue. Whatever happens, a vote to leave would spike heightened uncertainty that could easily produce short-term volatility for U.S. stocks.

Summertime Blues: The Fed

While the Fed is taking a very slow approach to raising interest rates, several Federal Reserve officials, including Fed Chief Janet Yellen, are seriously eyeing another rate hike this summer. In remarks made in late May, Yellen noted it would be appropriate for the Fed to gradually lift the fed funds rate, with an increase “probably in the coming months (*Wall Street Journal*).” Currently, odds do not favor a hike in June (CME Group), but July is definitely a possibility. But let’s take a longer view. Historically, data from the St. Louis Federal Reserve suggests that, by itself, higher interest rates do not lead to bear markets (recessions do). But a second rate hike by the Fed has the potential to create short-term volatility for investors.

Market Tailwinds

While there are short-term risks, there are also tailwinds that are supporting stocks. Yes, corporate profits have been weak lately, but analysts are cautiously forecasting a return to growth by the third quarter (*Thomson Reuters*). Much will depend on the recent strength in oil prices, stability in the dollar, and continued economic growth at home.

Next, recent economic data have been encouraging. In last month's letter, I delved into some of the problems with seasonality in the quarterly GDP report. GDP, or gross domestic product, is the broadest measure of the economy. Recall that over the last 25 years, we've witnessed a statistically significant drag on first quarter growth (San Francisco Federal Reserve). Not surprisingly, Q2 is bouncing along at a faster pace than Q1 (Atlanta Federal Reserve).

At best, we're seeing an encouraging though cautious acceleration in the economy. At a minimum, it strongly suggests the economy isn't set to stall. On a more practical matter for investors, it creates a tailwind for corporate profits.

Meanwhile, even if the Fed goes through with another rate hike this summer, interest rates will remain near historic lows. Undoubtedly, low interest rates have been a challenge for savers who rely on income, but low rates are supportive of stocks when the economy is expanding.

Bottom Line

We cannot control the stock market, interest rates, or the economy. Clearly, these variables are outside our control. What we do control is the investment plan. So we encourage you to adhere to the one we've agreed upon, unless you've experienced a change in circumstances that means we need to adjust the plan.

When stocks are galloping ahead, some clients begin asking about a more aggressive exposure to equities. On the flipside, when shares are down, some want to take a more conservative stance. This was especially true in 2009, when we experienced the worst economic slump since the Great Depression. While bear markets are difficult, they are an inevitable part of the investment landscape. But always remember, storms end and rainbows follow.

We hope you've found this review to be educational and helpful. As we always emphasize, it is our job to assist you. If you have any questions or would like to discuss any matters, please feel free to give us or any of member of our team a call.

Thank you very much for the trust and confidence you've placed in our team at MBL Advisors.

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