Argent FINANCIAL GROUP, INC

The World, the U.S. and the Markets

Overview

- The U.S. economy is in divergence from the economies of Europe and China.
- Europe is growing more slowly than the U.S. and now faces the added stress of the British exit from the EU.
- China continues to slow and is now beset by institutionally driven over-capacity.
- The U.S. consumer should keep the U.S. economy moving in a positive direction.
- The markets were shaken by the news of the "Brexit" vote, but were not crushed. Volatility should continue at a high level.
- Stocks are not cheap, but are also not wildly overpriced.
- Bond yields are extremely low and long dated fixed income asset prices are particularly vulnerable to potential increases in interest rates.
- Cash equivalents provide stable value, but little or no yield.
- The stock market shows resiliency, bouncing back from stressful events like the "Brexit" vote. It may be the most attractive of the investment choices. However, we recommend employing cash and short to intermediate term bonds to dampen volatility.

There once was a time when all we needed to know about the economy occurred within the confines of our national borders. Then, the free world was rebuilding itself from the devastation of World War II and the U.S. was the building supply company, bank, grocery store and general merchandiser to the world. There was no U.S. trade deficit. That was over fifty years ago and the global economy has changed dramatically. The U.S. is no longer the sole driver of economic growth, not because it has stopped growing, but because the rest of the world has recovered from the war, developed and learned how to compete. Today, the three largest world economies are the European Union, the U.S. and China, in that order. Over the last forty or so years, the domestic U.S. economy has become increasingly linked to the economies of its trading partners, both overseas and across borders. Despite the entangling nature of this process and the inevitable economic correlations that occur on a global basis, there are always divergences. The major divergence that exists today is between the U.S. economy and the rest of the world. While the U.S. economy appears to be somewhat healthy (despite a looming debt burden and entitlement liabilities, we do have low unemployment and positive GDP growth), the economies of both China and Europe face serious stress.

The news from Europe that the United Kingdom has voted to leave the European Union is a particularly distressing development in a region that has already experienced its share of challenges. Although GDP in Europe has been increasing for over three years, it has been at a slower pace than that of the U.S. and has required the European Central Bank to maintain interest rates at even lower levels (zero to negative) than has the U.S. Federal Reserve. Most of the growth has come from Germany and France while Greece, Italy and many of the peripheral members of the EU have been languishing in recessions. Terrorism and the flood of migrants from Syria and Africa have strained the budgets of many of the weaker nations, many of whom were already weakened by the raft of austerity measures imposed by budget hawks in Brussels. The news that the U.K. is giving up on the EU has a profound psychological effect on the continent and the world. The actual exit cannot occur for at least two years and there are many negotiations that must occur before anything becomes final. But, since one interpretation of economics is mass psychology expressed through markets, the "Brexit" vote itself may be enough to depress global and European growth.

On the other side of the world, China's GDP has grown almost eightfold -- about 9% a year -- over the last twenty-five years. Nevertheless, the People's Republic of China is now facing some of the paradoxes inherent in that almost oxymoronic state, a planned capitalist economy. In allowing some decentralization in its provinces, the central committee emboldened and monetarily encouraged local bureaucrats to develop infrastructure and products for China's bright new future. This effectively created thousands of "capitalist roaders" without a market discipline to moderate their acquisitive instincts. The first result of this ill-conceived program was over production of housing, transportation, municipal services, infrastructure, capital goods, consumer products and debt. This, of course, led to the dumping of consumer products and capital goods on international markets. The next result has been high unemployment, intolerable in a worker's paradise, and a restive population. A rebellion is highly unlikely, but there will continue to be corruption trials and other assignments of blame. In short, China's growth rate will not return to 9% anytime soon and appears to be headed south of 6%. This retrenchment will continue to place downward pressure on the economies of the developed and developing world.

Unlike the U.S. of yesteryear, the domestic economy is not totally immune to these international stresses. Although the U.S. has run a trade deficit for most of the recent past, close to 50% of S&P 500 earnings come from non U.S. sources. Weakness in foreign demand and the relative strength of the dollar during the current period of international stress have taken a toll on corporate income statements. Though declines in corporate profits have no direct impact on GDP, declines in the international sales of large U.S. corporations do have a negative impact on capital expenditures, a component of GDP, and on hiring. Capital expenditures by non-energy companies have remained weak throughout the current business expansion. And payroll employment has recently slowed to an increase of only 38,000 in May from an average increase of 155,000 in the prior two months. Labor productivity -- output per hours worked -- is strongly influenced by corporate expenditures on more efficient capital equipment; in the first quarter of 2016 -- the most recent report -- productivity declined by .6%. It remains to be seen if the decline in payroll employment and productivity is only a statistical blip, a sign of an aging expansion or the result of an absence of capital investment due to corporate timidity. We prefer to believe in the latter explanation, but the current expansion is a little long in the tooth (eight years) and well past the time when corporations normally would ramp up capital expenditures. If the economies of Europe and China deteriorate and drift into recessions, it would increase the odds that the U.S. might experience a similar fate. We don't believe that this will happen, at least not in 2016, even with the fear-inducing issues in Europe and China. The main reason for our optimism is the consumer.

Despite the benefits to the U.S. of improving foreign trade and the negatives associated with a shrinkage in international transactions, the U.S. is not an export driven economy. More than two-thirds of the U.S. economy comes from consumer spending, and the consumer is doing well: unemployment is below 5%, payroll employment continues to improve (despite a disappointing May number), salaries are finally growing, housing starts are averaging over 1100 per month, gasoline prices are almost 40% below where they were five years ago, interest rates continue to favor the borrower, retail sales remain strong and inflation is still quiescent. In the spirit of "it's an ill wind that blows no good", the "Brexit"-induced global angst has created some benefits: the Fed is likely to postpone again an interest rate hike and dollar strength has lowered prices on imported goods. The U.S. has its issues – an aging population, exploding national debt due to out-of-control retirement benefits – and the payroll employment numbers will bear watching, but as long as the consumer remains optimistic, economic troubles overseas should not derail the progress of the domestic economy.

In the financial markets, the news of the British vote hit like a bombshell. Despite warnings that the vote would be close, most investors believed that the British people would never do something so un-British as to jump off a cliff without considering the consequences. The vote was probably prompted by immigration concerns and fears of vanishing British sovereignty, but the result was a clear negative for those who support globalization and the expansion of world trade. On the day the results came in (Friday, 6/24), the S&P 500 dropped 3.6% and yields on U.S. Treasuries dropped to the lower levels of their recent ranges. The damage continued on the second day of trading (Monday, 6/27), but by the third day Tuesday (6/28), the markets began to recover. Despite all the excitement, trading remained orderly and there were few glitches in computerized systems. It was the worst one day decline since last August, but only brought us even with the previous week’s close. It certainly didn't compare with some of the more horrific declines of the last ten years. And it was definitely not a "crash". Nevertheless, dramatic market events usually produce aftershocks for days and weeks following the first impact: we expect to see heightened market volatility well into July.

It is difficult to muster great enthusiasm for any investment market as we approach the dog days of summer. Stocks, while not wildly expensive on a valuation basis, certainly aren't cheap. Price/earnings multiples are high relative to the averages over the last ten years, but not when compared with the averages over the last sixty years. They certainly are discounting more earnings growth than is justified based on recent history: corporate profits have declined for each of the last four reported quarters and analysts’ expectations are for a decline in the quarter just ending (Q2, 2016). Dividend yields look very attractive when compared with the yields on ten year bonds, but most things do.

Bond yields are at absurdly low levels everywhere but in the higher risk categories. Despite our inclination to believe that interest rates will never rise again, we know they will. When they do, bond prices will plummet for even the highest rated bonds. (We should note, however, that if interest rates increase because of quickening economic activity, lower rated credits (junk bonds) may increase, instead of decline, in price.)

And what can we say about cash? As low as yields are on bonds, they're even lower on cash equivalent securities. Central banks everywhere have pushed yields to zero and beyond in order to curtail savings and stimulate borrowing and spending. American investors can take some comfort in the knowledge that at least dollar denominated cash investments are yielding above zero.

It's possible to make an argument that stocks, particularly U.S. stocks, are the most attractive investments among the three traditional asset classes. Despite all the clear evidence of stress and weakness across the globe, U.S. equities have generally held onto their somewhat elevated prices. Even the "Brexit" vote was not enough to shatter the optimism of investors, though it did cause many to doubt. There's an old saying on Wall Street that one shouldn't fight the tape. If it has any meaning, it is that the market has a better sense of where the future lies than pundits and opinion makers. We would agree that the market is prescient, but we also know that it's not infallible. Investors who remain fully invested in stocks will likely be rewarded with higher prices and better returns over the long run, but they will also experience a good bit of volatility and the fear that they might be wrong. Within the allocation guidelines that are appropriate for our clients' long term goals, we recommend maintaining a meaningful equity position, but we also advocate a healthy dose of volatility dampening investments: cash equivalents and short to intermediate term fixed income securities. The weeks ahead could produce more fireworks than just those on the Fourth of July.

For more information about the commentary found in this newsletter, please contact a member of the investment committee.

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