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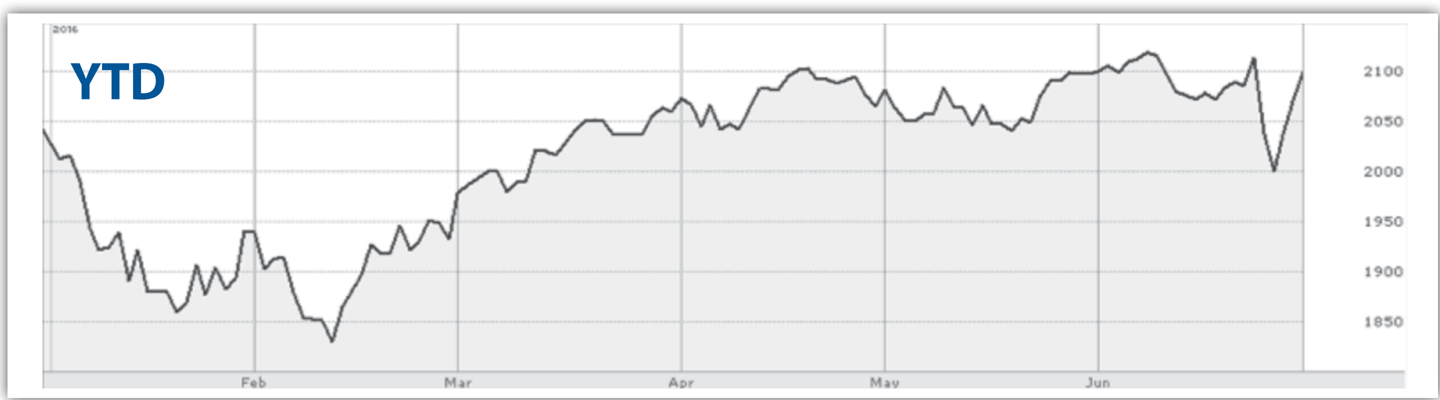
Second Quarter 2016 Review

Brexit was all the news in the second quarter of 2016. The British voted to leave the European Union, sending the world's stock markets into a tailspin. The S&P 500 shook off the Brexit fears and quickly recovered most of the post-Brexit losses, finishing the quarter up 1.90%, as seen in the chart below. Remarkably, the FTSE 100 (British Index) reversed its two day tumble and finished the quarter higher than where it was prior to the Brexit vote, up 5.41% for the quarter. Other European indexes didn't fare as well. The German DAX fell 5.05%, the French CAC 40 dropped 3.71%, and the Spanish IBEX 35 lost 6.32% of its value in the second quarter. Fear and uncertainty spread to other large country indexes, like Japan's Nikkei Index and China's Shanghai Index which lost 7.92% and 1.69% of their value respectively.

Source: TD Ameritrade

The S&P 500's ability to shrug off Brexit fears pushed the broad index up 2.69% for the year, as seen below. Unfortunately, every country that makes up the regional Europe ex U.K. Index finished the first half of the year down. The best performing countries were Belgium and Norway which were only down 3.78% and 3.98% respectively. Other countries weren't as lucky. Germany and France, the two largest economies on mainland Europe were down 11.99% and 8.33% for the first half of the year. The worst performing countries were Ireland, down 16.39%, and Italy, down 24.67%.



Source: TD Ameritrade

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Here are some highlights and interesting facts for the second quarter in the markets:

- The S&P Goldman Sachs Commodity Index (GSCI) finished the quarter up 15.65%.
- Gold futures rose 7.06% for the quarter.
- Bonds outperformed stocks, with long-term treasuries reaping a 6.44% return for the quarter. The Barclay's Aggregate Bond Index was up 2.21%.
- Domestic stocks outperformed international stocks. The MSCI EAFE Index lost 0.74% of its value for the quarter, dragging it down to -7.71% for the year.
- Based on Russell indices, value outperformed growth at all three cap tiers for the quarter and year-to-date.
- Best performing sectors were energy, telecom, and utilities, up 11.6%, 7.1%, and 6.8% respectively.
- Worst performing sectors were information technology, consumer discretionary, and industrials. Information technology and consumer discretionary were down 2.8% and 0.9% respectively. Industrials were up 1.4%.
- The All Country World Index (ACWI) was up 0.50% for the quarter but remains down 1.52% for the year, in local currency. The best performing regions (in local currency) were the United Kingdom, up 5.41%, and Canada, up 3.19%. Worst performing regions (in local currency) were Europe ex. United Kingdom, down 2.83%, and Japan, down 7.92%.

Second Half Outlook – What Might Influence the Markets?

The second half of 2016 is lining up to be as exciting as the first half of the year. What will influence the markets to go up or down during the second half of 2016?

Politics

The U.S. presidential election is starting to heat up between Hillary Clinton and Donald Trump. Both political parties have their national conventions in July. The Republican Party will hold its national convention July 18 - 21 in Cleveland, Ohio. The Democratic National Convention will be held in Philadelphia July 25 - 28. The presidential election will certainly influence the markets as each candidate picks a vice-presidential running mate and clarifies their political platform.

Price of Oil

West Texas Intermediate (WTI) oil prices tumbled almost 30% to start the year, trading as low as $26.05 on February 11th. This price movement was an influence on the stock market's 10% decline to start the year. WTI prices finished the 2nd quarter at $48.33, up slightly over 30% for the year. This rebound has influenced all commodity prices and impacted inflation rates. We don't see WTI oil prices returning to $100+ range, which was last seen in 2014, any time soon, but rather see WTI prices trade ranged near current levels. According to JP Morgan, oil inventories in the United States have gone up approximately 15% since 2014, to over 1.2 billion barrels of oil. The number of active rigs has dropped over 75% as a result of low oil prices. This means that as oil goes up in price, investors will dump their reserves and oil companies will bring their rigs back online. Both of these things will suppress oil prices from making a quick recovery.

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The Fed

According to the CME Group's 30-day fed fund future prices, there is no chance of the Federal Reserve moving rates in their July meeting, and a 32.4% chance that they will make some rate hike before the end of the year. Janet Yellen has made it clear that the Fed wants to normalize rates at 3.5% as soon as possible. Their original date was by the end of 2018. This seems aggressive, given our current economic environment. If the global economic environment stabilizes, you will see the Fed start making their move towards resetting this valuable lever.

The Dollar

The strength in the U.S. dollar over the past few years has impacted corporate earnings, as U.S. products have become more expensive to consumers abroad. The euro to dollar ratio began to drop (meaning the euro was losing value to the dollar) in March of 2014. It declined from 1.388 dollar to 1 euro to 1.086 dollar to 1 euro at the end of last year. The euro has stopped its free fall and as of June 30th was trading 1.106 dollar to 1 euro.

This is not the case with most other major economic regions. The British pound has dropped over 10% since the Brexit vote. The Japanese yen has dropped almost 15% to the dollar during the first half of the year, and the Chinese yuan has dipped 2.32% during the same time period.

The 10-Year Treasury

As you might remember, there is an inverted relationship between bond prices and yield. The 10-year treasury's yield has dropped from 3% at the end of 2013 to 1.49% on June 30, 2016 as worldwide investors have sought higher yielding, safe, dollar denominated investments. Demand for U.S. treasuries is due to the low and negative interest rate environment found in several of the world's largest economies.

Nominal and Real 10-Year Treasury Yields

Source: BLS, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for June 2016, where real yields are calculated by subtracting out May 2016 year-over-year core inflation.
Guide to the Markets – U.S. Data are as of June 30, 2016.

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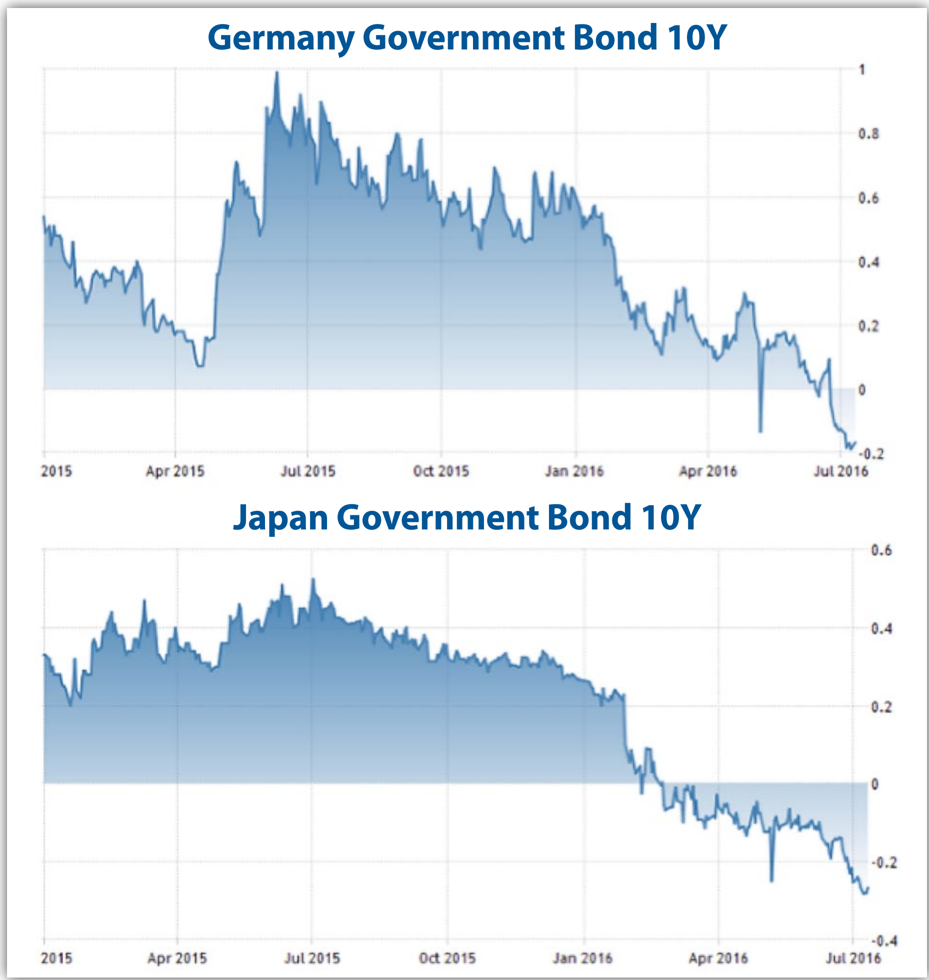
As you can see from the graphs below, the 10-year German bond and the 10-year Japanese bond have negative yields. China's 10-year bond is yielding 2.82%, the United Kingdom's 10-year bond is yielding 0.76% and France's 10-year bond is yielding 0.13%. Obviously negative rates are unprecedented. These other rates are unusually low, too.

Bonds pose significant risks to unaware investors. There are a couple of things that investors should realize before investing. First, while the current yield of the 10-year treasury is 1.49%, the nominal yield for the 10-year treasury is -0.75%. This means that inflation rates are higher than the current yield an investor will receive. In other words, if inflation remains at its current 2.24% rate an investor would lose 0.75% of their buying power every year. The second thing that an investor should be aware is that 10-year treasury yields will most likely normalize. If an investor bought a 1.5% 10-year treasury they would lose 12.80% if bond rates normalized back to 3%. There could be further losses if the Federal Reserve pushes to normalize fed fund rates.



Source: tradingeconomics.com

Brexit

We have written a lot about Brexit before the vote and right after the results were announced. I will not be rewriting what is in these two articles. As I write this article a little over a week after the quarter end, it was announced that Theresa May will become the next Prime Minister of the United Kingdom. She will take office on July 13th. She has made it very clear that there will be no revote or back door reentry into the EU. She will file Article 50 of the Lisbon Treaty and begin the official British exit of the EU. The British exit from the EU comes with many unknowns (as discussed in our prior articles). We will be evaluating the impacts as they become clearer over time.

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We are very pleased to announce that Polaris Greystone was listed in the Financial Times top 300 registered investment advisers in the country for the second year in a row. Financial Advisor magazine also recently listed Polaris Greystone Financial Group as the 206 largest registered investment adviser in the country and the 4th fastest large registered investment adviser in the country.* We are very proud of these distinctions but realize that we would not be in this position were it not for the trust that you have placed with us. We strive every day to balance the risk of investing during uncertain times with the opportunity and growth needed by most investors to accomplish their long-term financial goals. We will continue to tactically manage your portfolio using clinical technical and fundamental research.

Client Service News

At Polaris Greystone Financial Group, we strive for continuous improvement in our service offerings to you. Your feedback and suggestions are genuinely appreciated and help us identify how we can better serve you. To that end, I'm excited to announce a new quarterly report format that will give you access to all the relevant information more quickly and easily. We hope you enjoy this new format, and we welcome your comments.

Also, in order to ensure timely processing of all check deposits, please mail your checks directly to the custodian of your accounts. Here are some guidelines to follow:

For accounts held at TD Ameritrade

- Checks must be made payable to TD Ameritrade Clearing or to the exact account title
- The account number must be indicated clearly in the memo line
- **For US mail, please send your checks to:**
  TD Ameritrade Institutional
  PO Box 919094
  San Diego, CA 92191
- **For overnight delivery, please send your checks to:**
  TD Ameritrade Institutional
  5010 Wateridge Vista Drive
  San Diego, CA 92121

For accounts held at Schwab

- The account owner's name and Schwab account number must be included in the payable line
- **For US mail, please send your checks to:**
  Charles Schwab & Co., Inc.
  P.O. Box 982603
  El Paso, TX 79998-2603
- **For overnight delivery, please send your checks to:**
  Charles Schwab & Co., Inc.
  1945 Northwestern Drive
  El Paso, TX 79912-1108

If you need additional guidelines for check acceptance, please don't hesitate to give us a call.

In addition, please let us know if there have been any changes to your financial situation or investment objectives or if you wish to discuss changes to the management of your account.

We always look forward to hearing from you.

Sincerely,

Jeffrey J. Powell
Managing Partner

*The 2016 Financial Times 300 Top Registered Investment Advisors is an independent listing produced by the Financial Times (June, 2016). The FT 300 is based on data gathered from RIA firms, regulatory disclosures, and the FT's research. As identified by the FT, the listing reflected each practice's performance in six primary areas, including assets under management, asset growth, compliance record, years in existence, credentials and accessibility. Inclusion in the FT 300 is based on the criteria cited, is not representative of any client or group of client's experience, is not an endorsement of any of the advisors mentioned, and is not indicative of Polaris Greystone's future performance. Neither the RIA firms nor their employees pay a fee to The Financial Times in exchange for inclusion in the FT 300. The full report can be found on the Financial Times website: http://www.ft.com/intl/cms/s/2/37bd6974-31b9-11e6-ad39-3fee5ffe5b5b.html

To be eligible for Financial Advisor magazine's ranking, firms must be independent registered investment advisors (RIAs) who file their own Form ADV with the Securities and Exchange Commission and provide financial planning and related services to individual clients. Neither the firms nor their employees pay a fee to Financial Advisor in exchange for inclusion in FA Magazine's Registered Investment Advisor (RIA) Survey & Ranking. Inclusion on the list is not representative of any client or group of client's experience, is not an endorsement of any of the advisors mentioned and is not indicative of Polaris Greystone's future performance. To see the complete list of FA Magazine's Top RIA Survey, please visit their website at: http://www.fa-mag.com/userfiles/2016_FA_Issues/July_2016/RIA_Files/jul_fa_RIA2016_Top50_1.pdf