



2016 Q2 MARKET RECAP

To Brexit or not to Brexit?

Coming off tumultuous start to the year, the second quarter was a whole lot about nothing; at least as far as the market indexes were concerned. The stock markets around the world rallied into the end of the June to post slight gains, while the All-Country World Index was up just a fraction. Most European markets were down considerably with UK and Germany faring the worst (in dollar terms). The Japanese market (Nikkei 225) also was down over 7% for the 2nd quarter. With the 10 year Treasury falling, we saw bond prices go up and the Barclays Aggregate bond index posting a gain of about 2% for the quarter. Commodity indexes posted large gains for the quarter mostly on the back of precious metals, in a sign that gold has bottomed after a 3+ year bear market for the metal. Our portfolios did well last quarter, as our overweight to Fixed Income and US Large Cap Value stocks not only cushioned the downside volatility, but also outperformed to the upside. We continue to be pretty conservative going into the 3rd quarter, with a continued overweight to Fixed Income and adding to our Alternative assets, which is very similar to how the model would have been positioned in 2007. With all the things that can go wrong, we are more in the mode of capital preservation rather than growth mode at this point.

Aside from what happened in the markets, there were a couple other things that happened in the quarter of note. The most important was the UK vote on whether to leave the European Union (EU). If you followed the “betting parlors” in London, the bet was that UK would remain in the EU. When you looked at the data underneath the headlines, you saw that there were 7 bets (leave) to every 1 bet (remain), but because of how the odds makers work, an outsized bet on the remain side could swamp the leave votes, thus skewing the odds toward remain. So what does that mean for us here in the US? Potentially not much, as the UK is less than 10% of our GDP, so a slowdown in their economy would likely have a very small impact on our overall economy. But wait, maybe there are other things to consider in regards to this decision. First off, the UK government could decide they don’t want to get out of the EU, although that might cause problems with their electorate. Second, if they

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do follow through with the “Brexit” there might be other countries that may want to follow suit. If that were to happen there would likely be unknown fallout, depending on the country in question. Third and this is a comment on global discontent, stick with me for a minute on this. The middle class, not just in the United States, but around the industrialized world are starting to realize that politicians and the “establishment” aren’t really working to solve their problems. You see that with the “Brexit” vote, the US Presidential election, and other countries in Europe. High debt levels, low to no growth, stagnant wages and no good choices for the future. Here in the states, whether you are for Bernie Sanders or Donald Trump, either is a vote against the “establishment” and for change. The middle class around the world is feeling like they are being left out and the establishment would like to keep themselves in their positions of power and money that they have grown accustomed to. On a side note, for those who are or will be receiving Social Security, congratulations, you are getting a 0.2% increase in your benefits. Of course, the increase in Social Security is supposed to represent the increase in cost of living for those that depend on that money. Do you think that accurately reflects increased cost of living? My guess is no.

The second thing that happened last quarter was the amount of “negative interest” government bonds there are in the world today. Wait a minute, what’s a negative interest bond? Normally you would put money in a bank and receive some interest in exchange for the use of your money, it’s called the ‘fractional reserve’ system. You put \$1 with the bank and they loan out 90 cents, keeping the “fractional” amount in reserve. Makes sense, right? Now, instead of receiving some interest on the money that you deposit, the bank is charging you for the privilege of having money in their bank. Truth is, they get charged for holding their reserves with the central bank (and pass along that charge). Like we’ve been talking about for years, the world is deeply in debt with many countries over 200% of annual GDP (Gross Domestic Product). In order to fund that debt, they issue more debt through printing money. Before I get too deep in the woods, let’s just say that nobody I know would solve a debt problem by borrowing more money. At some point that money will need to be paid back or a default will happen. Until that point, the central banks around the world print more money and sell more bonds (and buy them back with the money they just printed). So at the end of May 2016, according to FITCH, there were \$9.9 Trillion worth of negative interest

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rate bonds in the world. Bad, right? In the month of June alone, that number skyrocketed to \$11.7 Trillion, and increase of 12.5% from the end of May. That is telling us that an investor (individual, institution or government) would rather lose money than put the money anywhere else. As I've been saying, we are likely to see how much "pain" investors would put up with before they decide to do something different with their money. Until then interest rates on savings, checking, money market and short term bonds are likely to be basically zero, and when accounting for inflation will be negative. Side note: There are currently no negative yielding bonds in the United States, but I would say don't get too comfortable with that, as Janet Yellen (the head of the Federal Reserve) recently asked banks to stress test their balance sheets for negative interest rates. That's probably not something you ask unless you believe there's a chance it could happen.

We are still very bullish for the long-term, given technology changes that include solving horrible medical afflictions, artificial intelligence, virtual reality, robotics, 3D printing, cloud computing, the internet of things and the list could go on. All this to improve the world's standard of living but we do have a few issues to work through first.

As always, we encourage you to call or email if you wish to have a longer discussion surrounding these, or any topics and we look forward to speaking to you. If you have friends or family that you would like to pass this along to, please do.

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