July 22, 2016

Q2 2016 Commentary: Moving quickly beyond Brexit…

For all the hullabaloo the Brexit vote caused in June, it ultimately made little difference to US equity prices. The initial shock that triggered a two-day market retreat was followed by a swift three-day recovery. In fact, by July 11th, the S&P 500 had gone on to make new all-time highs. That's what's known on Wall Street as climbing a wall of worry. For the second quarter the S&P 500 gained 2.46% as prospects for interest rate hikes dimmed. Following the trend around the world, interest rates in the US slid further. As a result, the bond prices rallied and the aggregate bond market advanced 2.2%.

If Brexit is going to be a train wreck, it is going to be a slow motion train wreck. It will take years for the process to play out. If I had to, I would bet that the peak of Brexit's impact on the market has already passed. Because Brexit will change the economic and political landscape over an extended period, it will have little impact on our current investment outlook. Mario Draghi, President of the European Central Bank, estimates that Great Britain leaving the EU will slow European economic growth by just 0.5% over three years. The immediate fallout from Britain's vote to leave the EU is the renewed strength in the dollar and lower long-term interest rates. The dollar has surged against the pound and strengthened against most currencies. A strong dollar could slow earnings growth just as it did in 2015 and perhaps delay the resumption of earnings growth necessary to move the stock market higher in the second half of the year.

The 10-year US Treasury yield fell to an all-time low of 1.36% earlier in July. At the beginning of the year, the Fed was expected to bump short-term rates higher by as many as four times. Now, there is doubt that there will be any rate hikes in 2016. The prospect of stable, or even lower interest rates removes a major concern for investors and has been immediately beneficial to stock prices as the shock from the Brexit vote fades. We expect further pressure for lower rates going forward. With rates in Japan and Germany in negative territory and many other sovereign rates around the world well below those of the US, investors will want to own US debt. Strong demand will keep long-term rates very low for the foreseeable future.

Last August and again in February we experienced fairly rapid 10% corrections in the stock market. Both times we used the opportunity to acquire strong companies at attractive prices. During broad market corrections, selling is indiscriminate and all stocks go "on sale". Finding high quality stocks at discount prices becomes easier. However, the circumstances are different when the stock market is making new highs and valuations rise. In this environment, uncovering investment opportunities requires more focus. Company specific issues trigger selling in a stock that creates a discount to long-term value. Many companies stumble in their execution of short term operations and shortsighted investors dump their stock. However, temporary problems do not impair long-term prospects. More often than not, it is these situations that we rely upon for our investment ideas.

There is no doubt that unusually low interest rates have supported a higher market valuation. In addition, US stocks are considered by many to be the best investment alternative right now. Given low rates and positive sentiment, we can expect higher valuations to persist. The stock market may be hitting new highs and stocks are no longer cheap, but it does not mean we need to be defensive. We will always be wary, but good investment opportunities are still available.