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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

"Brexit", the term coined to describe the recent British vote to leave the European Union, surprised the markets last Friday causing a sharp sell-off in stocks and a rally in Treasury Bonds. While clearly disconcerting for a few days, how should investors view this development? Where are the risks? While no one can be sure of the future, the last part of this *Outlook &Trends* issue discusses our opinions on both the outlook for Brexit and how it fits within the prevailing global trends.

The Economy

Not much has changed economy-wise since we last wrote. First quarter GDP was still weak. The growth rate came in at 1.1%. Current estimates are looking up a bit for the second quarter, but are still not near "lift-off" velocity. The Federal Reserve describes growth as "modest" in most regions. The leading economic index, a gauge of future growth, reads the same as it did six months ago. Likewise, the trend in corporate profits remains weak, dropping at a -4% annual rate. S&P 500 companies' operating earnings / per share, a popular measure of stock market value, dropped by -11.6% between March 2015 and 2016. Although the Fed has tried its best, it is difficult to support a bull market with these fundamentals.

Officially, the unemployment rate dropped further to a new low for this cycle of 4.7%. The broader U-6 measure, including the discouraged and under-employed, remains stubbornly high at 9.7%. Unemployment is a lagging indicator, however. It is more an indication of where the economy has been, rather than where it will be. The good news for homeowners is that home prices have increased by 3.2% over the year for the US as a whole. Unfortunately for those of us in the Northeast, prices have declined a bit. Another bright spot is that families have retained a much more manageable debt burden than prevailed in 2008. If a recession were to occur, families would be better positioned to handle the stress today.

The Markets

Jim Paulson's characterization of a bunny market that hops around a lot, but does not go anywhere, is still on point. The S&P 500 is just about where it was a year ago at the end of June in 2015. That performance is not bad though, given the 11% decline in earnings. Although there are always ups and downs, rabbit-like volatility is more noticeable when the general trend is flat like today. The decoupling with fundamental reality is a product of the Federal Reserve's "accommodation" policies.

Valuations remain high, but the third quarter of an election year is typically one of the strongest periods. The Federal Reserve has clearly backed off their intention to raise interest rates for now, suggesting that their earlier intentions, which spooked the markets in December and January, are no longer in the immediate plan, and their economic/market support efforts may continue longer. Mere support and actual price growth are two different things though, suggesting that for now there may be limited upside potential, while the downside risk continues to grow. A number of pundits are questioning whether the Fed is losing (or has lost) its credibility, and whether it has sufficient "tools" to continue its market-supporting policies. Eventually we will see what kind of suit the emperor is wearing.

Brexit

The popular vote to withdraw the United Kingdom from the European Union is primarily a political one rather than financial. However, the vote was no doubt influenced by the financial structure of the EU and will also have financial reverberations – certainly in Britain, and perhaps beyond. We are the first to acknowledge that we are not political advisors and our crystal ball is no clearer than others', but, as investors, we must at least try to construct a concept of the issues involved and how they might affect us.

The EU was created to foster greater harmony among the countries in Europe. For a continent that has been at war for centuries, it is reasoned that countries that are dependent on each other are less likely to fight. Whether that is true or not, we will let others and time decide (as we consider the US's and other civil wars). The countries of Europe have different cultures, origins, and different needs. If the EU experiment is successful in creating "one big happy family", there will still be members of the family with inherent differences. To succeed it would seem that the family must be flexible to accommodate the differences of the individuals, rather than imposing a central, top-down structure on all.

A family can do reasonably well with few complaints when everyone is happy. Unhappiness (particularly economic) is likely to cause strains and threaten the structure. Since the eurozone growth has been slowing since the "Great Recession" of 2008, the European Central Bank followed the Fed's initiative and has been delivering their own form of QE, driving interest rates negative. Like in the US, its success has been limited. The approach has supported the economy by essentially borrowing future growth to shore up the present. At some point this has to end. The question will be whether the EU leadership (and the Fed) can hold out until conditions improve, create a "soft landing", and escape from the debt they are building, or will other members vote with their feet like Britain.

The untangling of relationships can take time and have unforeseen consequences, especially if the foundation that the relationships are built upon is fragile. The immediate financial impact of the Brexit is likely to be an adjustment of currency exchange rates, which will change the profitability of global investments and business arrangements. As these are unwound, they may (or may not) have a snowballing effect, not unlike the mortgage derivative mess we experienced in 2008. The global economy is too broad and too complex to see all the latent forces that can appear when it is bounced out of equilibrium. To the extent, however, that Fed and ECB policies have created a fragile global structure, held together by their version of "chewing gum and bailing wire", the effect is likely to be more rapid and extend farther.

In our view, it is not the Brexit per se that is a concern. At some point, sooner or later, there could be a Brexit-like trigger that begins the process of reversion to normal valuations for US markets. We do not necessarily view this as a negative occurrence though. We view it as an opportunity to be released from the low-growth, suspended animation state that we are currently in, a reduction of risk, and providing a reset to a healthier and more vigorous economy and a return to normal asset growth rates, albeit from lower levels.

From a financial planning perspective, it is important to make sure that you do not disregard potential risk, just because it is not visible today. Make sure that your risk exposure is calibrated to your financial needs and the time you have before you will need to use your funds. Also be sure you will be comfortable maintaining your strategy, if the stock and bond markets were to return to historically average levels or less. If you are satisfied that you are properly prepared and positioned, Brexit or other market shocks need not be a concern. You will be able be able to recognize and take advantage of future opportunities as they arise, regardless of whether they occur as a continuation of the current slow trend or a sharper revaluation.

If you would like help looking into your financial future, evaluating your risks, managing your investments, or planning to manage your income effectively, please call or e-mail. We invite you to visit our website www.linnardfinancial.com.

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