SMITH AFFILIATED CAPITAL

Third QUARTER 2016 INVESTMENT COMMENTARY

THE BREXIT SLOW SLIDE TO CRISIS

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The Sock Waves Generated by the Brexit Vote Amplifies Political and Economic Uncertainties and Sets the Stage for a Long Period of Financial Turbulence That Will Sustain Strong Safe-Haven Bid.

The Brexit vote on June 23rd exposed pre-existing vulnerabilities in the global economy and further threatens the solvency of major financial institutions in both developed and emerging market countries. It also adds another layer of uncertainty to the widespread anxiety that the highly disruptive political environment is already having on household and business confidence in the U.S. The U.S. stocks rebounded from the initial plunge following the Brexit vote, but the aftershocks will resurface once the emotional dust settles and continue to resonate in coming months. Meanwhile, the 10-year Treasury yield hit a record low on July 5, reflecting massive safe-haven bids as well as renewed growth concerns and deflationary fears that will intensify as the year progresses.

The Federal Reserve already took a step back in its normalization process prior to Brexit, but it will have more conviction in keeping rates unchanged for the balance of this year, and perhaps beyond, now that growth will remain even softer than perceived prior to the referendum. Indeed, markets are flirting with the idea that the Fed could cut rates in the face of a growing recession threat and the "un-anchoring" of inflationary expectations, which is already underway according to recent University of Michigan house-hold surveys. We don't subscribe to that view yet, if only because the Fed funds rate is just a tad above the zero bound, and the Fed is loath to enter into negative rate territory – something that prevails on more than $11 trillion of sovereign debt outside the U.S. and is causing unprecedented pain for financial institutions.

While the persistence of low rates in the U.S. is a tailwind, the post-Brexit ramifications for the dollar and weakening global demand for U.S. exports are notable growth headwinds. The economy's performance in the second quarter was much better than the first, thanks to seasonal quirks that pumped up consumer spending from a dismal winter reading; but the second quarter will be the high point for the year. There was little momentum prior to Brexit and the confidence-shattering uncertainty that will overhang the economy going forward will short-circuit the build-up of any traction. The U.S. is much more insulated than other economies and should weather the storm better than most. Yet it is not immune to the feedback from slower growth overseas, the uncertainty shock associated with possible political contagion that could eventually lead to the demise of the E.U. as we know it, and the financial turmoil that has only begun.

After Second-Quarter Rebound, Lackluster U.S. Growth Will Resume

Most tracking models peg the second-quarter growth rate at around 2.5 percent, which would be a substantial improvement over the 1.1 percent registered in the first quarter. However, that still leaves the average for the first half of the year at less than the 2 percent "normal" pace that is now the long-term trend for the U.S. economy. What's more, the second quarter was likely the high-water mark for the year. The rebound in consumer spending – the main growth driver—offset the setback in the first quarter when extreme financial turbulence sent households into hiding. Most of the pent-up demand from that period has now been satisfied.

Going into the second half of the year, the fundamentals driving consumer spending look to be sputtering. Job growth slowed dramatically in April and May, and future increases will fall far short of the 200 thousand monthly gains seen in recent years. Even with those gains, the job market has not fully healed. Contrary to Fed expectations, the long and steady period of job growth has still not pulled people back into the labor force, which in May retreated to the lowest share of the population since the late 1970's. Most of those dropouts simply lack the skills sought after by employers or are not motivated to return by prevailing wages. The 2.5 percent annual increase in hourly earnings so far this year is hardly a breakout from the 2-2.2 percent range over the previous five years and is well below the 3.5-4.0 percent typical of late stage expansions. With more than 6 million part-time workers desiring full time positions and the underemployment rate at 9.7 percent, there is still considerable slack in the labor force that will continue to restrain wage increases.

Nor is the economy receiving help outside of the consumer sector. The surge in the greenback following the Brexit vote is driving another nail in the coffin of exporters, who are already coping with weak global demand for their products. By making their goods more expensive via the stronger dollar, the task of competing in the global marketplace becomes even more daunting. This is just another blow to the beleaguered industrial sector that has struggled mightily over the past year, thanks to weak global conditions and to the severe cutback in the energy complex, where investment spending has plummeted. In the first quarter, real nonresidential outlays plunged by a 4.5 percent annual rate, the weakest reading since the Great Recession, slicing 0.6-percentage point from the economy's overall growth rate. That's a sizeable haircut for an economy that registered a skimpy 1.1 percent increase in GDP during the period.

The Persistent Capital Spending Drag Will Continue

Meanwhile, the drag from weak business investment persists with no end in sight. On the same day as the vote and buried by the Brexit news, the Commerce Department released its latest tally of capital spending and the reading was anything but hopeful. Shipments of nondefense capital goods excluding aircraft – a proxy for business equipment spending – fell by 0.5 percent in May, reversing most of April's 0.6 percent promising increase. That lowers the average for April and May below the first quarter average in nominal dollars, suggesting that capital spending in the second quarter will be a drag on growth for the third consecutive quarter.

The near-term outlook for capital spending is not much brighter. New orders for these same capital goods fell by 0.7 percent in May, following a 0.4 percent decline in April. Only once in the past eight months have bookings increased – a slight 0.3 percent uptick in March – leaving the total 3.6% below the year-earlier level. The downward trend in this series is as startling as it is atypical. Ordinarily, capital spending picks up momentum in the later stages of an economic upturn. This lagging pattern is understandable. Early on in a recovery, businesses tend to be stuck with a good deal of excess capacity left over from the recession. Hence, the incentive to expand capital budgets remains limited as current output requirements can readily be accommodated with existing plant and equipment.

Depending on the strength of the post-recession rebound, operating rates eventually reach the point that spurs new spending to expand capacity, lest companies risk losing sales to competitors. As recoveries advance and the job market tightens, labor costs are driven up, reinforcing the incentive to invest in productivity-enhancing equipment and software. But as we all know, this has not been your typical recovery. Since the upturn began precisely seven years ago, the economy never gained sustainable momentum. The 2.2 percent average growth rate has been about half the normal pace seen in past post-war recoveries. Hence, the rebound in industrial output from the steepest contraction in 2007-09 since the end of World War II was equally unimpressive. Fully seven years since the recovery's start, capacity utilization in May remains more than five percentage points below its long-term average. At the same time, labor costs have hardly put pressure on businesses to invest in labor saving equipment. Indeed, the availability of cheap labor throughout most of the recovery has had just the opposite effect, spurring companies to substitute labor for capital, even as productivity suffered in the process

Fed Policy On Hold

There will come a time that the Fed pulls the rate-hiking trigger again. But from our lens, the tightening cycle has already run most of its course. Although the quarter-point increase in the funds rate last December highlighted the process, the tightening actually began in 2014 when the Fed first tapered then ended its quantitative easing program and put the markets on notice that a series of rate increases was in the offering. According to the Federal Reserve Bank of Atlanta, the growth-retarding impact of those moves, which jump-started the upward trend in the dollar, equals a 300 basis point increase in a so-called "shadow" federal funds rate.

As noted, we don't think the Brexit aftershocks will derail the U.S. recovery, if only because of the relatively minor influence exports have on total domestic activity. But the risks of a recession are certainly not trivial and could well escalate under certain conditions. Keep in mind that the dollar's strength does more than just impede exports. About 50 percent of revenues of U.S. corporations are derived from overseas operations, which translates into fewer dollars when the greenback appreciates. As it is, profits have been under pressure for several quarters as the combination of weak productivity and lackluster demand has driven up unit costs amid constrained pricing power.

Needless to say, the profit squeeze reinforces the disincentive to increase capital spending, which in turn further retards productivity growth. But it also diminishes hiring incentives, as companies redouble cost-cutting measures. The prospect of slower jobs growth as the economy struggles to grow at an already diminished 2 percent pace will further impede the Fed's efforts to meet its long-elusive 2 percent inflation target. Until recently, the Fed has given short-shrift to receding market-based inflation measures, preferring to focus on household expectations as more critical influences on actual inflation. Unfortunately the long-held view that household inflation expectations remain "well anchored" is being torn asunder. According to the latest University of Michigan reading, household inflation expectations over the next five years fell to 2.3 percent in May, the lowest level in the survey's history.

Weak U.S. Economy Vulnerable to the Proliferation of Global Shocks

The widespread acceptance of 2 percent growth as the new normal would be tolerable if it could be sustained on a consistent basis over time. But over the past five years, the upturn has not strung together more than two consecutive quarters of 2 percent growth, and is the only postwar recovery that has suffered two quarterly contractions in GDP. Simply put, the economy's growth engine can downshift to stall speed at any time, which makes it highly vulnerable to external shocks that might emerge during one of those episodes.

In a tranquil world, these episodic setbacks would not be overly concerning to financial markets and policy makers. But the global economy is anything but tranquil. The Brexit vote has the potential to ignite a number of shocks that could lead to extreme market turmoil. First and foremost is the possible political contagion associated with the explosion of populist sentiment across the E.U. that leads to the disintegration of the Eurozone and triggers a wave of sovereign and banking defaults. Indeed, the cost of credit default swaps against major European banks has jumped by more than 30 percent since the Brexit vote, with nonperforming loans accounting for more than 20 percent of total loans at Italian banks. Banks in Spain, Portugal, and Greece are also under extreme duress. Even Deutsche Bank, a major bank in Germany, which is the bulwark of stability, failed the Fed's latest stress test and is considered by the IMF to be a major source of systemic risks.

Aside from bank runs that could well occur as depositors lose confidence in their banks, the high level of nonperforming loans and inadequate bank capital, particularly in the peripheral EU nations, will lead to a further tightening of credit conditions. This will retard growth even more and push foreign central banks to expand their bond buying programs. Whether or not a a full-blown banking crisis rocks the financial markets, investors throughout the world will be seeking out safe havens to guard against the unintended consequences that the expanded push into QE by foreign central banks as well as their efforts to impose even deeper negative yields will have on financial institutions.

While we don't see a recession on the near-term horizon for the U.S. economy, the flattening of the yield curve, with Treasury yields at all-time lows, points to a heightened recession risk. To be sure, the flattening is more a function of a flight to quality into U.S. Treasuries than to a deteriorating domestic environment. But the fundamentals underpinning the U.S. economy are clearly not sufficiently strong to dismiss recession prospects out of hand, particularly if anxiety associated with the volatile political campaign upends consumer and business confidence. As was the case last year, quality bonds in the U.S. continue to outperform stocks and other risk assets. Despite record-low rates, that outperformance should persist over the foreseeable future.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.11	0.39	0.35	0.08	0.14
2-Yr. Note	0.65	0.74	0.58	0.82	0.72
5-Yr. Note	1.65	1.22	1.00	2.96	2.53
10-Yr. Note	2.35	1.78	1.47	4.79	3.06
30-Yr. Note	3.12	2.62	2.29	8.93	0.40

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.28	2.67	2.10	4.42	11.56
ML G.O. 22+ Index	3.14	2.52	2.08	5.19	13.23

Equities	Levels			US $ Terms (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
S&P 500	2,063.11	2,059.74	2,098.86	2.45	3.98
DJIA	17,619.51	17,658.00	17,929.99	2.06	4.50
NIKKEI (Tokyo)	20,235.73	16,759.00	15,575.92	-6.95	-21.57

Commodities	US $			Percent Change (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,172.42	1,234.00	1,322.20	7.15	12.78
CRB Future Com. Pr. Index*	227.17	170.52	193.43	13.44	-14.85
West Texas Intermediate Crude ($ per bbl)	59.47	38.34	48.33	26.06	-18.73

Currencies	Levels			Percent Change (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
Yen	122.50	112.57	103.20	8.32	15.76
Sterling	1.57	1.44	1.33	-7.31	-15.28
Euro	1.11	1.13	1.11	-2.41	-0.37

Foreign Bond Markets	Levels			US $ Total Return (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	-0.04	-0.28	-0.32	N/A	N/A
ML German 10-Yr.+ Bond Index	1.35	0.58	0.14	7.37	21.34
3-Mo. LIBOR Yen Fixing (3)	0.10	-0.01	-0.02	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.98	0.29	0.00	6.32	21.69

Source: Bloomberg Financial Data
Notes: 1) 6/30/2015 thru 3/31/2016 2) 6/30/2015 thru 6/30/2016

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index