Monthly Outlook: August, 2016: "Summer Doldrums…"

With ***scorching temperatures*** in this part of the world ("it is not the heat, it is the humility", said the famous Yankee catcher Yogi Berra) and no apparent end in sight to the heat, equity markets appear to be ***grinding higher in desultory fashion***, perhaps in consonance with the weather we have been having lately! While equity markets appear to be hitting new highs almost daily, we are more cautious. Ironically, the higher these markets get, the more skeptical we are of their longer term sustainability.

After a horrendous May jobs report, the ***labor market*** looks to be picking up some steam – albeit only for some sectors of the economy. The July jobs report looks good on the surface but as always, the devil is in the details. First, the good news: The US economy added a total 255,000 jobs in July. The biggest benefactors of the July jobs report were Professional & Business Services (+70k) and Leisure & Hospitality (+45k). Manufacturing (+9k), Construction (+14k), and Mining & Logging (-7k) continue to be the laggards.

Average hourly earnings posted a gain of 0.61% (m/m; y/y: 1.97%) while the average weekly hours increased slightly to 34.5 hours for the month. The politically sensitive unemployment rate fell one-tenth to 4.8% while the ***U-6 measure of unemployment*** (a more robust measure which also accounts for those working part time for economic reasons and are marginally attached to the labor force) actually rose one-tenth to 9.7%. The labor force participation rate also inched up a tenth to 62.8% - still a low number from historical standards.

The US Department of Commerce also reported that ***Second Quarter*** Gross Domestic Product (***GDP***) grew at a tepid 1.2% (seasonally adjusted annual rate) while First quarter's growth rate in GDP was revised downwards to a paltry 0.8% (also seasonally adjusted annual rate). Within the GDP report, consumer spending showed signs of growth (+4.2%) while both housing (-6.1%) and non-residential fixed investment (-2.3%) posted surprising declines. Inventories grew significantly during 1Q2016 while they declined a touch during 2Q2016.

Survey data including the Institute of Supply Management's Purchasing Managers Index imply some slowing in the manufacturing sector (52.6 in July versus 53.2 in June) as well as in the services (or non-manufacturing) sector (55.5 in July versus 56.5 in June). Many of the components of the two reports including new orders, supplier deliveries (a favorite indicator of Alan Greenspan's, we are told) do suggest some ***loss of momentum*** during July.

Globally, ***international trade*** appears to have hit a ***large speed bump*** with exports out of China, South Korea and Japan posting greater than expected declines. While a single month's decline does not a trend make, we are well aware that the severe loss of momentum in global trade (especially after the Brexit vote in late June) does have the potential to be a harbinger of slower growth around the globe.

News from the UK has been ***"quite damp"***, to coin a phrase. The Bank of England (BoE) did cut interest rates by 25bp (or 0.25%) earlier this month in an effort to boost confidence in the wake of the uncertainty surrounding the Brexit vote. The BoE did also increase its asset purchase target (quantitative easing) from a previous £ 375 Billion to £ 435 Billion. In an ironic development, the BoE had to suffer the ignominy of having a ***"failed" reverse auction*** – where market participants failed to tender sufficient longer dated Gilts (British Government bonds) to satisfy the asset purchase target.

In our opinion, this is quite a dangerous trend – as it suggests that market participants would rather see the Gilts they own be taken away from their hands by the BoE at much lower yields than those prevailing in the marketplace currently. In other words, the actions of the BoE (and the market's bizarre reaction) will ***undoubtedly put further downward pressure on yields in the UK and elsewhere.***

For example, the long dated Gilt (maturing in thirty years) was yielding 2.19% when trading closed on June 23rd (the date of the Brexit vote). Currently the same Gilt yields 1.25% - an astonishing drop in yields of almost 100bp in a mere seven weeks. Indeed, there have been many years where Gilt yields have not changed (neither increased nor decreased) by this amount over the history of the instrument. We suspect that yields are headed lower still – especially as central banks around the world continue to push the envelope on lowering traded interest rates.

The Bank of Japan (BoJ) for its part has also continued to expand the ***size of its balance sheet*** to a whopping 80% of total Japanese GDP to no avail (from an economic growth standpoint). The BoJ has the singular distinction of also owning significant proportions of Japanese ETFs both fixed income and equities as well – given the size of its balance sheet. Comparable ratios of the size of the balance sheet relative to the GDP are roughly a third (or 33%) for the European Central Bank and 24% for the Federal Reserve.

We are often asked the question – ***how and when does it all end?*** It is hard to say, as the world has not really experienced such coordinated policy action on this scale before and there isn't a laboratory that one can study the actions of a central bank or a group of central banks to ascertain the answer. The excess central bank liquidity is clearly having a ***"positive"*** impact on equity markets around the world (for now) and equity markets will likely be propelled higher as long as markets believe in the powers of central bank liquidity. As to the ***timing*** of when it all unravels, we can only quote Yogi Berra again: "It is difficult to make predictions, especially about the future".

Our worries about rising equity markets stem from an old-fashioned belief that ***fundamentals do eventually matter:*** 453 of the S&P500 companies (a little over 90% of the total) have reported earnings for 2Q2016 so far. The net share-weighted earnings change has been an eye-popping ***decline*** of -3.0%. In other words, earnings have posted a ***negative growth*** for 2Q2016 compared to 2Q2015. Also, this is the ***fifth consecutive quarter of earnings declines*** that these companies have posted (in aggregate) – and the equity market does not seem to care!

As we have pointed out in previous missives, we also feel that valuation multiples for the US equity market are a little stretched at this point – especially as the trailing multiple is now around ***20.5 times*** the past four quarters of actual earnings per share for the S&P500. While there is nothing that says the valuation multiples cannot go even higher, we do believe that near term caution appears to be prudent and warranted.

On the US political front, the great political theater called the ***national conventions*** were held in late July. With Donald Trump as the Republican nominee and Hillary Clinton as the Democratic nominee, the battle has been well and truly joined. We expect the ***campaign to be nasty*** and the Presidential debates to have a "Super bowl" type audience – even if a couple of the dates do clash with prime time National Football League games.

Despite much of the focus on the Presidential elections, the more important one from a regulatory standpoint might be control of the ***Senate and the House***. With more Republican Senators up for re-election, we do think that the Democrats could usurp control of the Senate – especially if their nominee has significant ***"coat tails".*** Given the size of the Republican majority in the House of Representatives currently, we do not envision a switch of leadership there, however. Nonetheless, it is still very ***early in the political season*** and much could change between now and election-day (November 8th).

In summary, the equity market's grind higher continues in ***relentless fashion*** (like the oppressive heat of the Texas Summer) despite obviously ***deteriorating fundamentals***. We do not want to give the impression that we are overly bearish on our outlook for financial markets – we are ***merely cautious in the near term*** (which explains the reason for having larger than usual cash balances in your portfolios). Over the longer term, we continue to believe that there are still plenty of opportunities to add value to your portfolios through a ***judicious admixture*** of asset allocation, style and theme distribution as well as manager and security selection.

This report was prepared by

Suresh Raghavan, CFA
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: **contactus@mbrfinancial.com**

Important Disclosures

MBR Financial is registered with the SEC as a Registered Investment Advisor. Registration as an investment advisor does not imply a certain level of skill or training.

Investing involves risk including the potential loss of principal. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values.

Past performance is not a guarantee of future results.

This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete.