MARKET COMMENTARY & OUTLOOK

Second Quarter, 2016

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Eight years into a recovery from the worst economic environment since the Great Depression and all seems well. The US Equity market has reached record highs, household net worth has eclipsed the pre-recession peak by a wide margin, interest rates are low, inflation is in check, and the unemployment rate is at its lowest level since 2007. In an environment such as this, it is not surprising that consumer confidence is high and fear amongst investors, as measured by the VIX (the volatility index), is low. However despite these outward appearances and to a large degree because of them, we remain cautious.

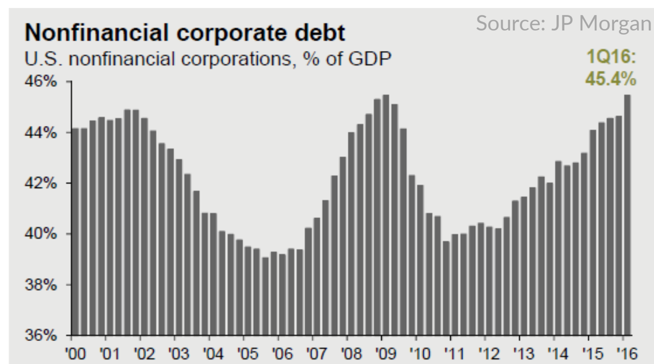
In our opinion, stock prices are high and they are being supported by non-operational activities that can not continue at their current pace. The S&P 500 has appreciated 47% since December 2012 while the revenues of those underlying companies have declined by 2%. As an example, over the last 12 months, the combination of corporate share repurchases and dividends paid to investors ("Investment Activities") for the average S&P 500 company exceeded free cash flow, meaning those companies were either using idle cash or borrowing money for these activities. The YTD performance for S&P 500 companies whose Investment Activities exceeded Free Cash Flow was 11.49% versus 6.58% for those that did not. Perhaps more interesting is the 1.76% return for companies who had positive Free Cash Flow but did not undertake any Investment Activities. It is also noteworthy that non-financial corporate debt, as a percent of GDP, is approaching the highs that presaged the last two bear markets.

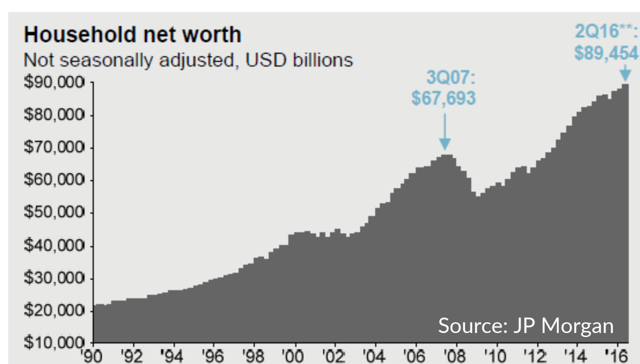
The Great Experiment of artificially low interest rates has failed to create the intended global economic growth. With German and Japanese debt offering negative interest rates and the US Treasury debt near all-time low rates, there is not much further rates can fall. Despite these unprecedented machinations, the recovery from the most recent recession is the shallowest in history. As mentioned above, what these low rates have been effective in doing is inflating asset prices for those fortunate enough to have assets, while penalizing savers and those living off of a fixed income. Simply, rates have been too low for too long. As we witnessed by investor reaction earlier this year, raising interest rates will result in declining asset prices. This, in turn, will cause those with assets to feel less wealthy, leading to reduced spending and increasing the possibility of a recession. Central banks have no easy exit from the position they are in and have a reduced capacity to react to future shocks to the financial system as they are all but out of bullets to fire.

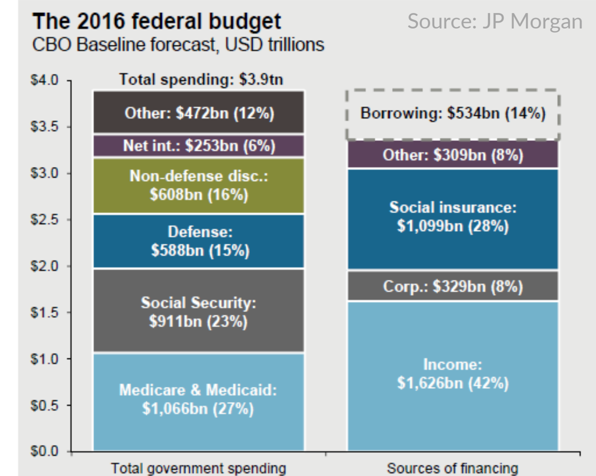
Largely ignored are the longer term implications of an aging population, which is the root cause of many of today's economic challenges. The aging demographic not only impacts consumption, as older consumers shift consumption patterns and amounts, but it strains limited government resources as a larger and larger percentage of the population draws from social benefits rather than contributing to them. As shown in Exhibit D, Social Security and Medicare payments now comprise 50% of the federal budget and exceed the social insurance deposits from current worker paychecks by nearly $1 Billion. In this country, the longer we wait to address this problem, the more painful the solution will become. This is a global problem as the world's five largest economies are faced with aging demographics.

While not an exhaustive list of our concerns, those mentioned above form the foundation. As noteworthy as the issues themselves is the lack of attention they seem to be attracting. It is often said that ignorance is bliss. However, while ignoring these very real challenges may make one feel better and more confident, that confidence has little basis in fact. If history has taught us anything, it is that confidence can quickly morph into over-confidence and that, in turn, leads to complacency. In these environments where asset valuations are stretched and complacency and confidence dominate the emotional landscape, we remain cautious.

On the following pages we provide commentary on the economy and the major financial markets.







Commentary

- US economic data has shown signs of improvement. Real GDP was reported at 1.1% for the 1st quarter; up from 0.6% a year ago. Forecasts for 2nd quarter GDP, using the Federal Reserve of Atlanta's GDPNow forecast[a] registered 2.7% a of the end of June.

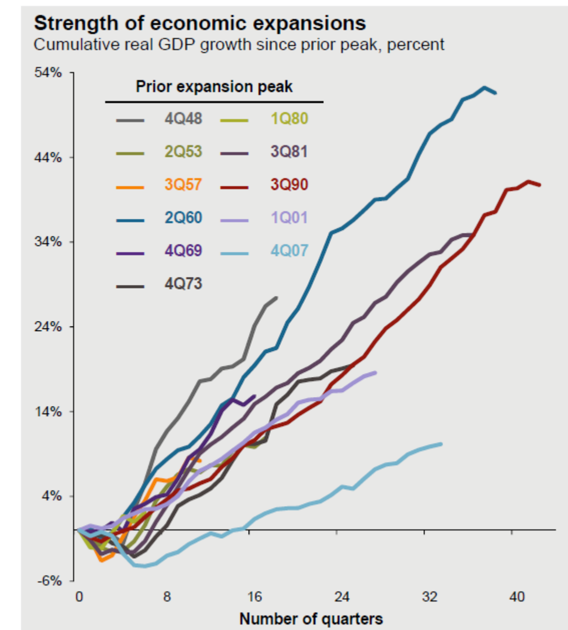
- Employment data for June eased concerns that the labor market was losing steam. Within that report was a significant drop in the number of people working part-time for economic reasons and an uptick in the labor force participation rate; likely a result of part-time employees transitioning to full-time roles. Therefore, while the unemployment rate increased to 4.9%, it did so for the right reasons, as the increase in the labor force outstripped the 67,000 gain in unemployment. Real personal income growth, while down from the year prior, remains solid.

- From a manufacturing perspective, the ISM composite index, which includes manufacturing and non-manufacturing, rose to 56.1. A reading greater than 50 signifies expansion, again allaying fears of an impending US recession.

- Despite the positive news, this economic expansion remains lackluster by historic standards. As seen in the chart to the right, despite the monetary stimulus of the Federal Reserve and international counterparts, the current economic expansion is the shallowest expansion since 1948. It is also noteworthy that this expansion is the fourth, and soon to be the third, longest expansion on record.

(a) The Atlanta Federal Reserve's GDPNow forecast is a unofficial model that mimics the Bureau of Economic Analysis' methods for calculating GDP. Unlike the official GDP report, GDPNow provides updated estimates intra quarter.

Strength and Length Of Expansions



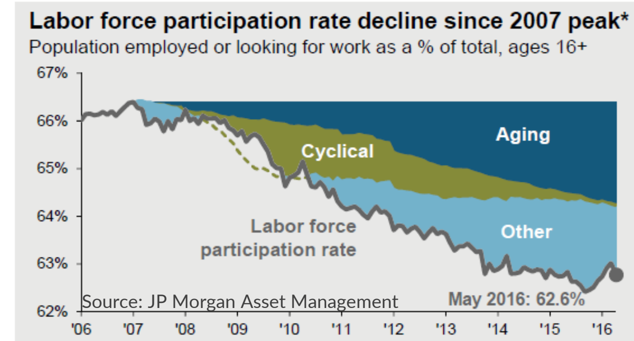
Source: NBER, BEA, JP Morgan Asset Management

Economic Statistics

	Current	One Year Ago
Real GDP Growth (Yr. over Yr.)	1.07%	0.64%
Unemployment Rate	4.90%	5.30%
Labor Force Participation Rate	62.70%	62.60%
Core CPI (Year Over Year)	2.24%	1.72%
Real Personal Income Growth (YoY)	3.07%	4.37%
10 Year Treasury Rate	1.49%	2.35%

Chart Of The Qtr. - Declining Labor Force Participation Rate

The chart below depicts the declining labor force participation rate since the beginning of the Great Recession and attempts to attribute the decline to primary causes. The aging effect on the labor force participation rate is the estimated number of people who are no longer employed or looking for work because they are retired. The cyclical effect is the estimated number of people who lose their jobs and stop looking for work or do not look for work due to economic conditions. Other represents the drop in labor force participation from the prior expansion peak that cannot be explained by age or cyclical effects. Estimates for reason of decline in labor force participation rate are made by J.P. Morgan Asset Management.



Source: JP Morgan Asset Management

US Equity Market

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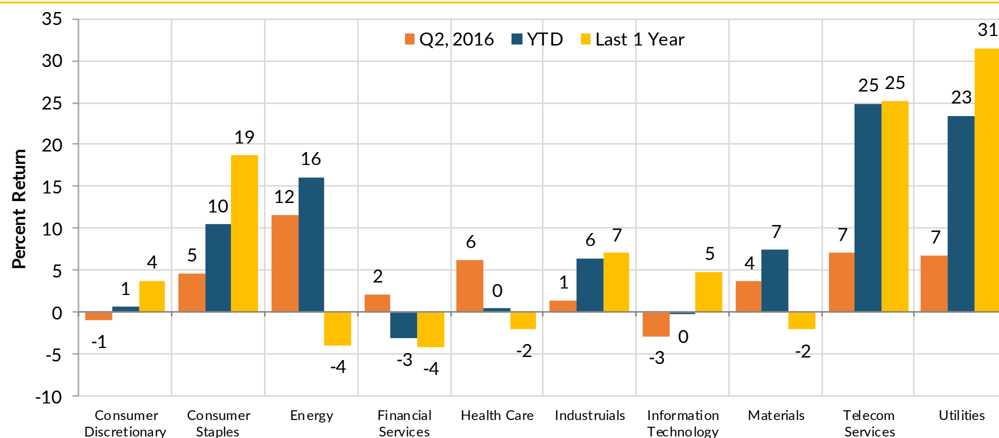
Commentary

- Returns in the second quarter were well distributed, unlike the past five quarters, where a select number of stocks had a disproportionate impact on market returns.
- With the exception of micro cap stocks (market capitalization below $300 Million), there was little difference in return amongst capitalization ranges.
- The median stock in the Russell 3000 index returned 2.67% for the quarter while the capitalization weighted index returned 2.6%. On an equal weighted basis, the Russell 3000 returned 4% for the quarter.
- Energy and healthcare stocks contributed the most (7 of the top 10 contributors were from these sectors) to the performance of the S&P 500 while the three largest holdings in the S&P 500, Apple, Microsoft and Alphabet, were the largest detractors. Apple was the largest detractor from performance (-.40% contribution to the S&P 500), returning -11.75% for the quarter.
- Higher quality stocks continued to outperform lower quality stocks. Stocks with a financial health grade of A have returned nearly 9% year to date, while stocks with a grade of D have returned -9%, an 18% differential.
- The biggest winners YTD are stocks that have bond-like qualities. Investors are stretching for yield. Utility and Telecom stocks have been rewarded. The valuations of these sectors are stretched and prospective earnings growth is very low. Not surprisingly, dividend yield was a significant contributing factor during the quarter. S&P 500 companies in the top quartile of dividend yield, returned, on average, 5.91% while the bottom quartile returned 0.29%. For the YTD period, four of the top five contributors to S&P 500 performance (Exxon, AT&T, Johnson & Johnson, Verizon, and Chevron) were in the top quartile of dividend yield. The top quartile, as a group, returned 13% while the bottom quartile returned -3%.

S&P 500 Sector Performance

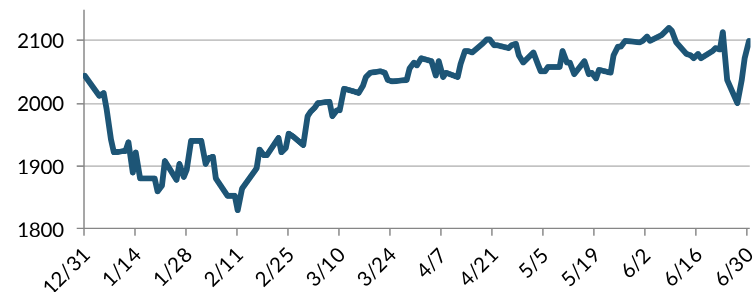


Major Market Averages

	Q2, 2016	YTD	Trailing 1 Year
Russell 3000	2.6%	3.6%	2.1%
FTSE RAFI 3000	3.3%	5.2%	2.0%
Russell 3000 Equal Weighted	4.0%	3.4%	-6.0%
S&P 500	2.5%	3.8%	4.0%
Russell Mid Cap	3.2%	5.5%	0.6%
Russell 2000	3.8%	2.2%	-6.7%

Data Source: Morningstar

S&P 500 Price Movement



Russell 3000 Style & Cap Summary

	Mo.	Qtr	Value		Core		Growth	
Large	Apr		2.10%		0.54%		-0.91%	
	May	Q2	1.55%	4.58%	1.75%	2.54%	1.94%	0.61%
	Jun		0.86%		0.23%		-0.39%	
Mid	Apr		2.15%		1.06%		-0.06%	
	May	Q2	1.64%	4.77%	1.64%	3.18%	1.64%	1.56%
	Jun		0.91%		0.46%		-0.02%	
Small	Apr		2.12%		1.57%		1.00%	
	May	Q2	1.83%	4.31%	2.25%	3.79%	2.69%	3.24%
	Jun		0.30%		-0.06%		-0.46%	

US Equity Market

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Dividend Yield (S&P 500)	Weights %	Return %	Contribution to Return %
Dividend Yield [0.00 - 1.00)	22.7%	0.29%	0.07%
Dividend Yield [1.00 - 2.13)	25.0%	0.22%	0.05%
Dividend Yield [2.13 - 2.91)	26.7%	3.02%	0.81%
Dividend Yield [2.91 - 46.99]	25.6%	5.91%	1.51%
Attribution Total	100.0%	2.44%	2.44%

Market Capitalization (R 3000)	Weights %	Return %	Contribution to Return %
Market Cap 5 Buckets [5972 - 529557]	86.4%	2.67%	2.32%
Market Cap 5 Buckets [2036 - 5972)	8.3%	2.48%	0.21%
Market Cap 5 Buckets [844 - 2036)	3.1%	1.68%	0.05%
Market Cap 5 Buckets [318 - 844)	1.1%	1.05%	0.01%
Market Cap 5 Buckets [0 - 318)	0.3%	-7.15%	-0.02%
Unclassified	0.4%	11.02%	0.02%
Total	**100.0%**	**2.59%**	**2.59%**

Credit Quality (S&P 500)	Weights %	Return %	Contribution to Return %
A	41.6%	3.91%	1.62%
B	37.6%	2.43%	0.92%
C	17.4%	-1.15%	-0.20%
D	3.2%	2.78%	0.08%
F	0.0%	0.00%	0.00%
Unclassified	0.2%	7.35%	0.01%
Total	**100.0%**	**2.44%**	**2.44%**

Top Contributors	Weight	Return	Contribution
Amazon.com Inc	1.41%	20.55%	0.26%
Exxon Mobil Corp	2.00%	13.09%	0.25%
Johnson & Johnson	1.69%	12.90%	0.21%
Pfizer Inc	1.08%	19.87%	0.20%
AT&T Inc	1.33%	11.68%	0.16%
Chevron Corp	1.04%	11.05%	0.11%
Bristol-Myers Squibb Company	0.64%	15.74%	0.09%
Medtronic PLC	0.61%	15.69%	0.09%
Merck & Co Inc	0.84%	9.78%	0.08%
Altria Group Inc	0.68%	11.01%	0.08%

Top Detractors	Weight	Return	Contribution
Apple Inc	3.09%	-11.75%	-0.40%
Microsoft Corp	2.30%	-6.69%	-0.16%
Alphabet Inc A	1.20%	-7.78%	-0.10%
Alphabet Inc C	1.19%	-7.09%	-0.09%
Allergan PLC	0.52%	-13.78%	-0.08%
Gilead Sciences Inc	0.67%	-8.68%	-0.06%
Delta Air Lines Inc	0.19%	-24.93%	-0.05%
CVS Health Corp	0.61%	-7.32%	-0.05%
Nike Inc B	0.44%	-9.94%	-0.05%
American Airlines Group Inc	0.12%	-30.77%	-0.04%

Data Source: Morningstar

US Equity Market Valuations

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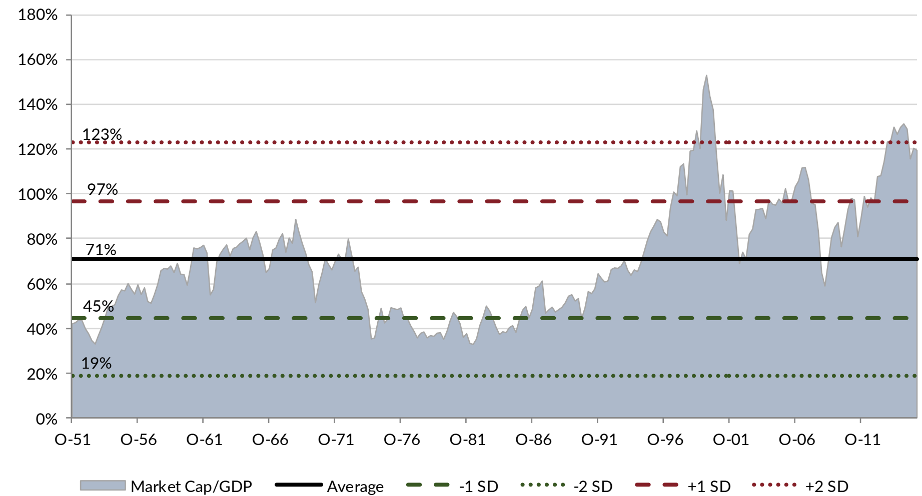
- US stock valuations remain our primary concern. At 1.88, the Price/Sales ratio on the S&P 500 is more than 1 standard deviation above its average since 1990. Using this analytic, the S&P 500 has been more expensive only 16% in that time frame.
- Since the end of 2012, when the market approximated fair valuation, the S&P 500 has returned 47.2%, approximately 12% per year. Over that same period of time, the revenues of the companies in the S&P 500 declined by 2%. This relationship is hard to explain at a fundamental level. At some point, the price level of the S&P 500 will need to be supported by growth in company revenue. Sans revenue growth, the price of stocks will either correct to a more appropriate level or they will remain flat for an extended period of time as fundamentals slowly catch up lost ground.
- Another measure of market valuation is the Buffett indicator which compares the market value of equities to Gross Domestic Product. Using data gathered since 1951, the current market is one of the most expensive markets over the last 65 years, again rivaled only by the tech bubble on 2000.
- It is important to recognize that valuation is not a good predictor of market corrections and markets can remain overvalued for extended periods of time; especially with the level of central bank intervention we are witnessing. Valuations are helpful in estimating the future return potential for stocks which we believe will be well below historic averages.

The Buffet Indicator

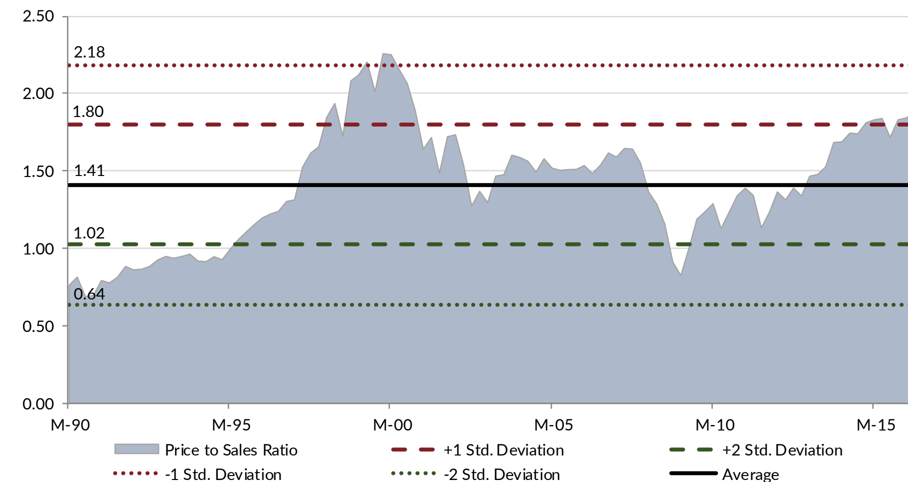
The Buffet indicator, made popular by Warren Buffett, compares the market cap of the US equity market to US Gross Domestic Product. The numerator for the equation is the Market Value of Equities Outstanding as reported by the Federal Reserve. The denominator is Nominal Quarterly GDP.

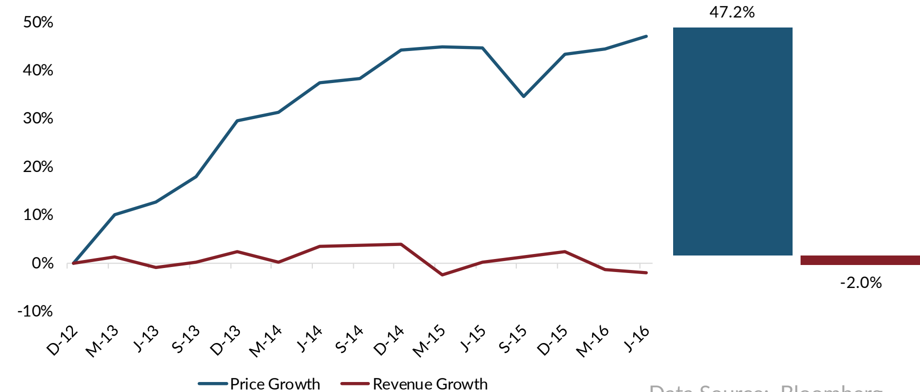


Data Source: Bloomberg

Price to Sales (Revenue)

The Price/Sales analysis compares the price being paid for stocks to their revenue. The numerator of the equation is the latest price of the S&P 500 while the denominator is the revenue of the constituent companies. The chart below right shows the current Price/Sales ratio relative to its historic level. The chart compares the return of the S&P 500 to the revenue growth of the constituent companies since December 31, 2012. It is our belief that US stocks reached fair valuation at the end of 2012, effectively recovering from the Great Recession of 2008.





Data Source: Bloomberg

International Equity

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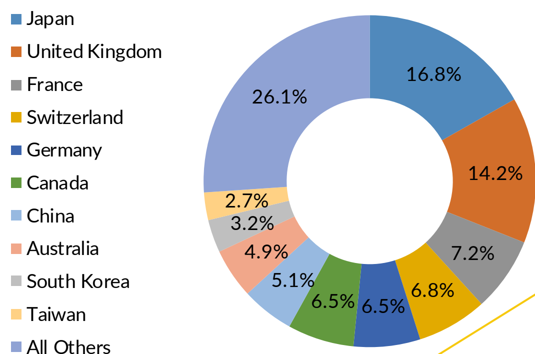
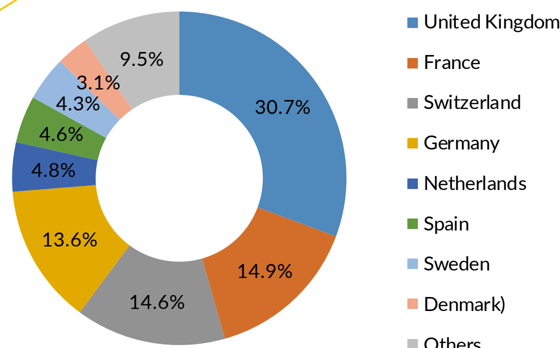
Commentary

- Foreign stock returns were mixed for the quarter. Emerging market stocks were modestly positive while developed market stocks were negative.
- A strengthening dollar weighed heavily on returns in the quarter. Seven of the ten largest countries in the MSCI All Country World Index ex USA. ("ACWI ex,. US"), were impacted negatively by a strong dollar.
- The decision of the UK to leave the European Union ("Brexit") sent shockwaves through the markets in late June. While the equity prices recovered much of the lost ground by quarter end, the real impact of Brexit has yet to be recognized. As seen below, the UK represents the second largest country in the ACWI ex. US and the largest country in the MSCI Europe Index, where it is larger than France and Switzerland combined. Undoubtedly this decision will have a significant impact on the quarters to come, although what that impact will be is conjecture at this point. For a more detailed analysis on Brexit, please reference (http://www.lamcoadvisory.com/london-fog-the-impact-of-brexit-on-your-investments/. We will be posting updates on our position as new information becomes available.

MSCI ACWI Ex. USA – Country Weight



MSCI Europe – Country Weight



Data Source: Morningstar

Major Market Averages

	Q2, 2016	YTD	Trailing 1 Year
MSCI EAFE	-1.2%	-4.0%	-9.7%
MSCI EAFE Value	-2.4%	-6.2%	-14.9%
MSCI EAFE Growth	0.0%	-1.9%	-4.4%
MSCI EM	0.8%	6.6%	-11.7%
MSCI ACWI Ex. USA.	-0.4%	-0.7%	-9.8%

Regional & Country Performance

	Local	USD	Impact Of US Dollar [a]
MSCI ACWI Ex USA	0.14%	-0.40%	-0.54%
MSCI Europe Ex UK	-0.55%	-2.97%	-2.42%
MSCI Pacific Ex Japan	2.68%	0.70%	-1.99%
MSCI Japan	-7.78%	1.03%	8.81%
MSCI United Kingdom	6.74%	-0.72%	-7.46%
MSCI France	-1.05%	-3.53%	-2.48%
MSCI Switzerland	4.24%	2.47%	-1.77%
MSCI Germany	-2.53%	-4.98%	-2.45%
MSCI Canada	4.03%	3.61%	-0.42%
MSCI China	0.31%	0.28%	-0.03%
MSCI India	5.72%	3.72%	-1.99%
MSCI Brazil	3.00%	13.94%	10.94%
MSCI Russia	0.46%	4.19%	3.73%

Assumes Gross Reinvestment Of Dividends

Data Source: Morningstar

(a) Impact of Dollar: A strengthening dollar (represented as a negative return) has a negative impact on foreign returns as those returns are converted from foreign currency to US dollars. A weakening currency (represented by a positive return) has the opposite effect.

Fixed Income

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Commentary

- The US Treasury yield curve continued to flatten. Since the end of 2013, the yield on the 30 year treasury bond has declined 1.68% (3.97% to 2.29%) while the yield on the 3 month treasury increased by .19% (.07% to .26%). The spread between the 30 year and 3 month treasury declined from 3.9% to 2.02% over the same period. During the quarter, subsequent to the Brexit vote, the 10 year treasury note traded at an all time low of 1.385% (Source: Tradeweb Data).
- Despite the low absolute, US Treasury bond yields remain attractive when compared to the yield offered by other high quality sovereign credits. Yields on bonds offered by Germany and Japan are negative, meaning investors are paying that government to hold their cash. Concerns about that caused a fight to safety, further compressing yields at the end of the quarter. Bloomberg data, passed along by Bianco Research, shows that 36% of the $35.07 trillion of all sovereign global debt, yielded less than zero as of June 30. (Source: Peter Foley, Bloomberg).
- This is not to say that US Treasury bonds represent a value. To the contrary, we believe them to be one of the significantly overvalued.
- The goal of Central Bank intervention across the globe has been lower yields in the hopes it would stimulate economic activity. Unfortunately, lower yields have not had the desired effect. US GDP has averaged 2.1% since the end of the Great Recession, far below historic recoveries.
- We believe today's artificially low rates are having the opposite effect; negatively impacting retirees who live off of a fixed income, savers who are seeking safe return in excess of inflation, and lending activity by disincentivizing banks from lending. With a narrowing spread between the rate at which banks borrow (short rate) and lend (longer rates), there is less incentive for them to make new loans.
- Not only have loose monetary policies not had the desired economic impact, there are concerns that low rates are artificially raising the asset prices, fostering an environment for asset bubbles.

Major Market Averages

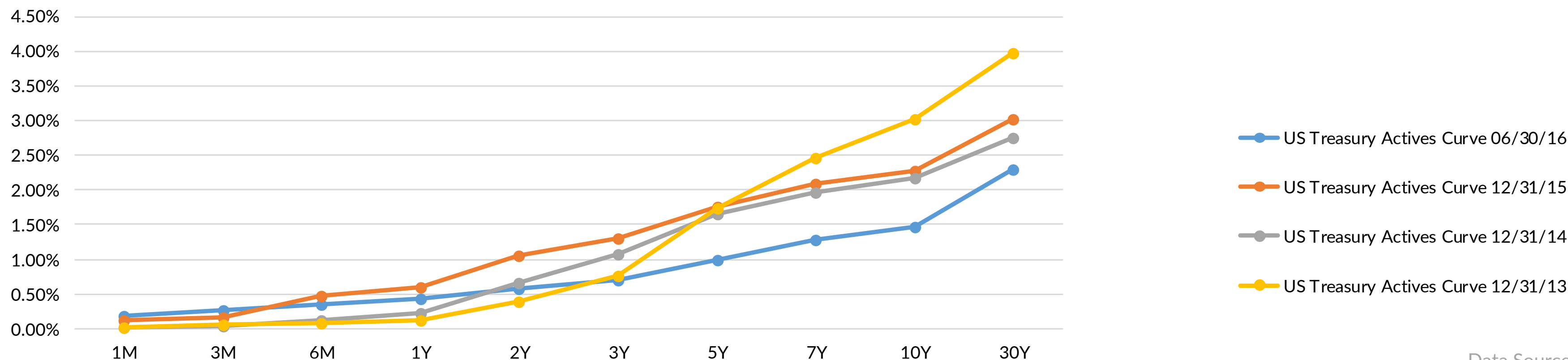
Major Market Averages	Q2	YTD	Trailing 1 Year
BofAML US Treasury Bill 3 Mon	0.07%	0.15%	0.19%
Barclays US Govt/Credit 1-3 Yr	0.67%	1.65%	1.59%
Barclays US Govt Interm	0.46%	0.94%	1.44%
Barclays US Govt/Credit Interm	1.24%	3.55%	3.93%
Barclays US Agg Interm	1.59%	4.07%	4.33%
Barclays US Govt/Credit	1.44%	3.78%	4.36%
Barclays US Agg Bond	2.67%	6.23%	6.70%
Barclays US Treasury US TIPS	2.21%	5.31%	6.00%
Barclays High Yield Corporate	1.71%	6.24%	4.35%
Barclays Municipal	5.52%	9.06%	1.62%
Barclays Municipal 7 Yr 6-8	2.61%	4.33%	7.65%

Credit Quality

Credit Quality	Q2	YTD	Trailing 1 Year
BofAML US Corporate AAA	3.30%	7.87%	10.44%
BofAML US Corporate AA	2.67%	6.45%	7.79%
BofAML US Corporate A	2.94%	6.69%	7.83%
BofAML US Corps BBB	4.27%	8.72%	6.82%
BofAML US High Yield BB	4.03%	7.89%	4.36%

Data Source: Morningstar

Yield Curve Movement



Data Source: Bloomberg

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