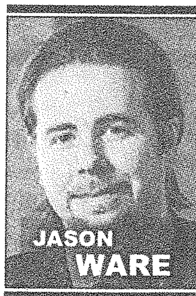
Market Matters

Market surveillance: 'Flat' was the new 'up' for second quarter

In the second quarter, global stock markets continued along with choppy trade and much uncertainty. For U.S. equities, neither a clear trend nor sense of direction for the market was evident, primarily due to challenged aggregate earnings growth and macroeconomic concerns.



For now, flat is the new up and volatility remains a defining feature. Despite that backdrop, the first half of the year did see advances in less-appealing sectors in the equity market, like beaten down, left-for-dead energy and materials companies with dubious fundamentals; industrials acutely exposed to weak global growth and a strong dollar; and expensive "safe havens/bond proxies" like utilities and telecoms.

These money flows reflected both Wall Street's hopeful narrative on oil prices and investor dollars flowing into dividend stocks as investors searched for higher yield and lower volatility. Higher-quality growth companies were left out in the cold. Indeed, stocks with the best fundamentals — rationally priced companies with growing sales, earnings and cash flows in technology, health care and pharmaceuticals and consumer discretionary sectors — have been largely ignored by investors so far in 2016. This doesn't make much sense to us. We strongly believe that staying the course by investing in strong businesses pays off over the long run as opposed to chasing fast-moving Wall Street fads.

On the American economy, Janet Yellen in her recent semi-annual testimony to Congress stated that the risk of an imminent U.S. recession "is low." We agree. After a weak first quarter GDP report (+1.1 percent), underlying data has improved. Job growth — despite the unexpectedly low 38,000 job adds in May — is persistent, total consumer spending continues to expand at a solid clip, and general confidence is holding up.

Additionally, savings rates are high, household debt servicing ratios are low and net worth is at record levels. Banks are well-capitalized (perhaps as healthy as they've ever been), as determined by the Fed's annual financial reviews, and businesses in general are not acting recklessly.

Meanwhile, inflation is low and the large U.S. services sector continues its expansion. Together, these features suggest a continued moderate economic expansion here in the U.S.

Overseas, China continues its long-wave economic pivot from primarily an export-driven economy to a firmer consumption-based one. We continue to be neither exuberantly bullish nor overly bearish on Chinese economic data. In Japan, bold experiments continue on the policy front in order to resuscitate their moribund economy. Over in Europe, Mario Draghi continues with his four-year-old mantra of "doing whatever it takes" with his European Central Bank policy to keep their economy's head above water.

The 800-pound gorilla overhanging the markets at the end of the quarter was the U.K.'s June 23 referendum on whether or not to leave the European Union. As we briefly mentioned in last quarter's letter, this vote was sure to capture the market's attention as the date drew nearer. In a surprise to nearly everyone, citizens in the U.K. voted by a slim margin to strike out on their own — separating themselves from the EU bloc.

Financial markets went haywire in the immediate aftermath and in the ensuing weeks all manner of pundits, prognosticators and politicians have attempted to divine exactly what this "Brexit" means for the U.K., Europe, the global economy and financial markets. The reality, however, is that nobody truly knows how this will play out. With that said, our current take is that while "Brexit" has increased short-term market volatility and may even slow economic growth in the U.K. as businesses and consumers pause a bit to assess conditions, we think there is little reason to believe this event will cause a global recession. Rather, we surmise that while an extra dose of caution may be warranted for the time being, this process will likely move slowly over many years and policymakers are likely to forge a new framework that minimizes economic pain. In other words, the world goes on.

All told, we continue to expect growth in world output to march along at a modest pace over the balance of this year. When we add up the pluses and minuses, we remain cautiously optimistic on stocks and continue our efforts to find high-quality investments.

Markets ebb and flow, but finding and owning a slice of first-rate companies endures over time.

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