WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

July 2016

Making a positive impact on as many lives as I can.

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In This Issue

WHAT'S AHEAD FOR THE U.K. AND EUROPE?

KEY TAKEAWAYS

- Following its vote to the leave, the U.K. will need to enter negotiations with the EU regarding the terms of the exit.
- The terms regarding movement of people across borders and the trade relationship will be the focus of the negotiations.
- In addition to political uncertainty in the U.K., there are several other political events across Europe in 2016-2017 that we'll be watching.

Following the United Kingdom's (U.K.) decision to leave the European Union (EU) in a referendum held on June 23, 2016, there are still many questions regarding the future of the U.K.'s relationship with the EU and other impacts throughout Europe. The ruling Conservative Party of the U.K will begin to formally elect a new leader early this week (July 4-8, 2016) to replace outgoing Prime Minister David Cameron. Cameron announced his intention to resign as Prime Minister on June 24, 2016, a day after the U.K. voted to leave the EU. The fallout from the vote will have many implications for the U.K.'s place in Europe and Europe itself as the politics of "Brexit" reverberate around the continent. Cameron was the leader of the "remain" camp in the U.K., and has said that the next Prime Minister should be the one to negotiate the terms of the U.K.'s separation from the EU after 40 years of membership. Nearly two weeks after the vote, the U.K. government has not yet officially notified the EU (by triggering Article 50 of the Treaty of Lisbon) that it intends to leave.

It's also possible that the U.K. may not end up leaving the EU at all. After all, the June 23 vote was a referendum that took place outside of the constitutional process in the U.K. and is not binding on the government. The market may be anticipating some sort of face-saving deal between the parties, where U.K. politicians can be seen as following the will of the people (mainly, restricting the flow of immigrants in the U.K., but also restoring some of the sovereignty the U.K. has lost in the past 40 years), while still allowing trade between the parties on essentially the same terms as it is conducted currently. Though possible, such a relationship will be difficult to achieve.

One sticking point may be movement of people across borders. The EU is founded on the "four freedoms":

- Free movement of goods.
- Free movement of services
- Free movement of persons (and citizenship), including free movement of workers
- Free movement of capital

At the meeting of European leaders that ended last Wednesday, June 29, a number of elected officials, including German Prime Minister Angela Merkel, reiterated the importance of all four freedoms, or pillars, of the EU. Given that immigration was one of the major issues in the Brexit referendum campaign, this makes it hard to find an acceptable compromise. However, given the importance of the trading relationship between the parties, there is great economic incentive to find some way out of this position.

Political Chaos in the U.K.

As we and many other observers expected, the U.K.'s vote to leave the EU has caused nothing less than political chaos in the U.K. The current Prime Minister, David Cameron, announced his resignation the day after the referendum. The leader of the largest opposition party in Parliament (Jeremy Corbyn, leader of the Labour Party) held and lost a no confidence vote by the members of his own party in the week after the referendum. As of Tuesday, July 5, 2016, his status as Labour leader is tenuous, at best. Over the weekend of July 2-4, 2016, Nigel Farage, leader of the far right U.K. Independence Party (UKIP), who strongly advocated for "leave," also resigned, adding to the chaos.

If and when the U.K. government triggers Article 50, it would begin the process of negotiating the U.K.'s exit from the EU. Markets are realizing that trade between the U.K. and the EU is not going to cease as a result of this vote. What will be negotiated is not whether there will be trade, but on what terms this trade will take place. Some have referred to the concept of a "Brexit Lite," whereby the U.K. would be able to gain access to European markets, but without having to accept the regulatory system that many in the U.K. believe is too restrictive, a message that was clearly sent by the leave voters on June 23.

By leaving the EU, the U.K. would lose its vote in the European Parliament, which makes the rules governing the "four freedoms" noted earlier. Currently, Norway, Iceland, Lichtenstein, and all 28 members of the EU (see the infographic) are members of the European Free Trade Association. All 31 countries have access to the single market of the EU, and are bound by the four freedoms. The freedom of movement of people is likely to be the major sticking point for the U.K. and the EU as they negotiate, using the other three freedoms (goods, services, and capital) as bargaining chips.

Key Political Events in the U.K. & Europe Through 2017

The leadership vote for the head of the Conservative party that begins this week in the U.K. is likely only the beginning of a series of political events in the U.K. and across Europe that markets will be keeping close tabs on over the rest of this year and into 2017:

- Another election in the U.K. In essence, this will be to ratify the referendum results and may occur as soon as later this year, although one isn't required until 2020 (five years after the general election in 2015).
- The political situation in Scotland. The electorate voted by a wide margin to remain in the U.K. in the September 18, 2014 referendum; Scotland's political leadership wants to hold another referendum to leave the U.K. and rejoin the EU.
- Referendum in Italy. The Italian government will hold a referendum on constitutional reforms in Italy in October 2016. The results may lead to the resignation of the Italian government and further bolster anti-EU sentiment in that country.
- Political uncertainty in Spain. Spain's economy is the fourth largest in an EU without the U.K., and has held two elections in the past seven months (including one just three days after the referendum in the U.K.). Although centrist, pro Europe parties picked up seats in the June election, the ruling center-right party did not win a majority in Spain's 350 seat parliament, leaving political uncertainty high.
- Elections in Germany, France, and the Netherlands in 2017. In an EU without the U.K., these countries rank first, second, and fifth, respectively, in the size of their economies. Each will hold a parliamentary election in 2017, and although Germany remains fully committed to the EU, there are sizable political entities in both France and the Netherlands that are generally opposed granting the EU more power at the expense of national governments. The rise of these anti-EU political movements in recent years makes the EU's negotiation with the U.K. over its exit crucial; the EU leadership wants to make sure that the terms are onerous enough politically and economically to send a message to any of the remaining 27 nations who may be thinking about leaving the EU.

The European Landscape

The EU is defined as the 28 nations within Europe that share a single market, but not a single currency, government, or central bank. The Eurozone is the collective name for the 19 of those nations that currently use the euro as their currency, and the European Central Bank (ECB) serves as the central bank for these countries. This group includes (in order of size of their respective economies):

- Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, Finland, Portugal, Ireland, Slovakia, Luxembourg, Slovenia, Lithuania, Latvia, Estonia, Cyprus, and Malta.

The 9 nations that are members of the EU, but do not use the euro or the ECB (again, arranged by the size of their economies) are:

- The United Kingdom, Sweden, Poland, Denmark, the Czech Republic, Romania, Hungary, Bulgaria, and Croatia.

Although sharing some of the economic and trade linkages with the 19 nations that use the euro and the ECB, each of these 9 nations has its own currency and central bank.

To make matters even more confusing, Switzerland, Norway, Iceland, and tiny Lichtenstein are also European nations with sizable economies, but are not members of the Eurozone (19 nations) or the EU (28 nations) and also have their own currencies and central banks. These nations share many of the "four freedoms" of the EU, but don't have a say in the European Parliament to make any of the rules governing the movement of goods, services, capital, or people.

The nearby infographic puts the population, size, and indebtedness of the EU, Eurozone, U.K., and U.S. in perspective. It also shows that exports are a much bigger part of the economies of the Eurozone and EU than either the U.S. or U.K., which may help to influence the coming Brexit negotiations between the EU and the U.K. The U.S. runs an overall trade deficit with the EU and the Eurozone, but runs a large trade surplus on the service side, or what we like to call good old American know-how. We export far more financial, legal, education, and travel services to the EU than we import, and we send the EU far more intellectual property, entertainment, and TV broadcast rights than we import. Our large trade surplus on good old American know-how is likely to persist regardless of the outcome of Brexit, aided by the fact that the U.S. spends 40% more (as a share of GDP) on research and development than the EU, and nearly 75% more than the U.K.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for your clients. All performance referenced is historical and is no guarantee of future results. Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Weekly Market Commentary | Week of July 5, 2016

KEY TAKEAWAYS

- The earnings recession will likely continue with second quarter results, which will begin to be reported this week.
- Better times may lie ahead: U.S. economic growth has started to pick up, the drags from the U.S. dollar and oil are starting to abate, and Brexit appears unlikely to hurt U.S. companies much.
- We continue to expect a second half earnings rebound to drive further stock market gains in the second half of 2016.

Q2 2016 EARNINGS PREVIEW: BETTER TIMES AHEAD?

The earnings recession will likely continue with second quarter results, which will begin with a small handful of companies reporting this week (July 5-8, 2016). The Thomson-tracked consensus estimate for S&P 500 earnings per share (EPS) is calling for a 4% year-over-year drop, which would mark the fourth consecutive quarterly decline (by FactSet's count the streak would reach five). Perhaps the best thing to say about this streak, the longest since 2008, is that the drop will likely confirm that the 5% year-over-year decline in the first quarter of 2016 marked a trough.

But signs are pointing to better times ahead. U.S. economic growth has picked up in the second quarter of 2016 based on available economic data. Despite the U.S. dollar rally following the Brexit news on June 23, 2016, we expect the dollar to turn from a headwind to tailwind in the second quarter of 2016. Higher oil prices should lead to a smaller (but still large) decline in energy sector profits. And we do not expect the Brexit news to have a meaningful impact on results.

This week we preview the upcoming earnings season and update our thinking on the prospects for an earnings rebound in the second half of 2016.

CONSIDER THE SOURCE

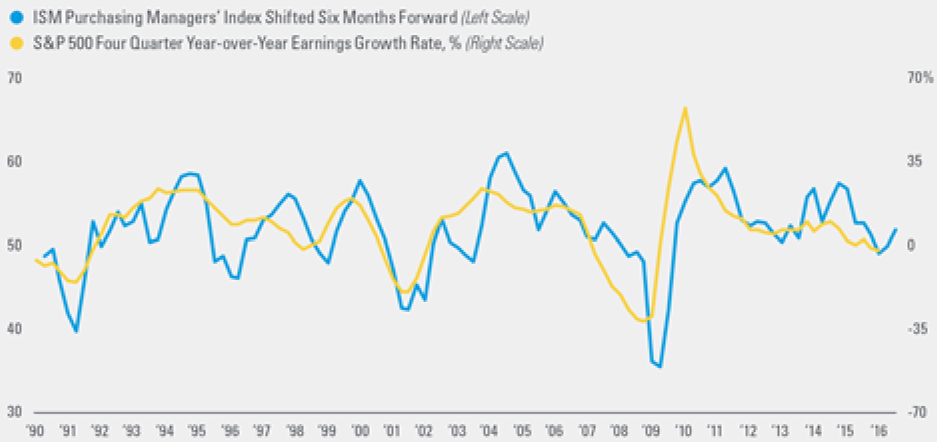
Different sources such as FactSet, Bloomberg, Standard & Poor's, and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

BETTER U.S. ECONOMIC PICTURE

U.S. corporate profits are closely tied to manufacturing activity and capital spending. Accordingly, earnings have historically been well correlated with the Institute for Supply Management's (ISM) Manufacturing Index, a survey of purchasing managers' future spending plans. As a result, the strong and better than expected ISM Index of 53.2 for June (reported July 1), the fourth straight reading above 50 and second straight month of improvement, is a positive signal [Figure 1].

We expect another bounce back in second quarter gross domestic product (GDP), to perhaps 3.0% or more, despite the weak May 2016 jobs report and weakness in Europe, and see capital spending beginning to pick up following the nearly two-year oil-driven slump, despite heightened political uncertainty.

1 KEY EARNINGS INDICATOR STARTING TO POINT HIGHER



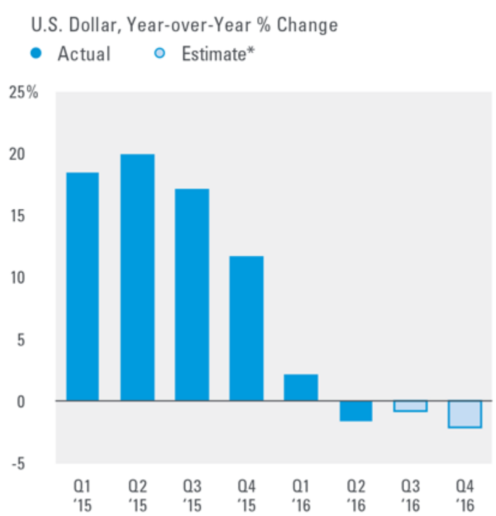
Source: LPL Research, Haver Analytics, Thomson Reuters, FactSet 07/01/16

Indexes referenced are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

FADING DRAG #1: U.S. DOLLAR

We expect the earnings drag on foreign profits from a stronger U.S. dollar to dissipate during the second quarter of 2016 despite the latest Brexit-driven rally. Even with the 3% jump since the Brexit news on June 23, 2016, the dollar has weakened considerably since December 2015, as expectations for Federal Reserve (Fed) rate hikes in 2016 have been pared back--to the point where no hikes are being fully priced into federal funds futures markets in 2016 or 2017. The average dollar index level in the second quarter of 2016 was 1.7% below that of the same quarter a year ago, providing a tailwind for earnings. And should the dollar remain where it is for the rest of 2016, currency would be a tailwind for the second half of the year as well, after representing a drag of as much as 20% on foreign profits during the second quarter of 2015
[Figure 2].

2 U.S. DOLLAR DRAG ABATING



Source: LPL Research, FactSet 07/01/16

*Changes for Q3 and Q4 are based on the assumption that the U.S. dollar stays at its 07/01/16 level of 95.64 for the rest of the year.

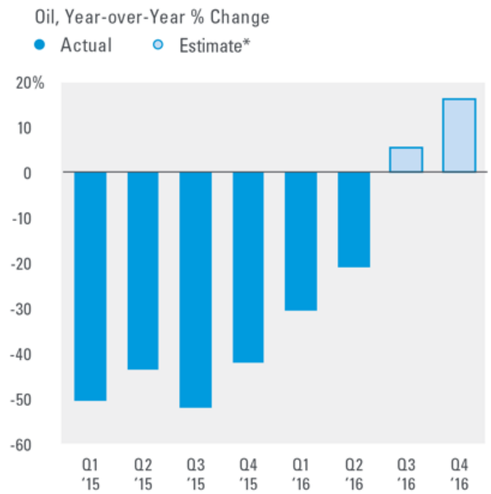
Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Past performance is no guarantee of future results.

FADING DRAG #2: OIL

The drag on earnings from the energy downturn has been even bigger than the dollar drag over recent quarters. The sector posted a small loss in the first quarter of 2016, registering a 105.7% year-over-year earnings decline, which trimmed about 5 percentage points off of overall S&P 500 profits. Low oil prices will still likely lead to energy sector profit declines in the second and third quarters of 2016 based on consensus estimates. Oil prices averaged 21% less in the second quarter of 2016 than in the second quarter of 2015. However, should oil prices stay at current levels, the commodity would show a year-over-year price gain in the third quarter of 2016 [Figure 3] and position the sector to potentially produce double-digit earnings gains in the fourth quarter.

3 OIL PRICE PRESSURES BEGINNING TO EASE



Source: LPL Research, FactSet 07/01/16

*Changes for Q3 and Q4 are based on the assumption that oil prices stay at their 07/01/16 level of 48.99 for the rest of the year.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, disease, and regulatory developments.

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BREXIT IMPLICATIONS

Broadly, we expect Brexit to have limited impact on earnings. S&P 500 companies overall have minimal exposure to the U.K. (estimated less than 5%, according to FactSet). Although some companies will surely use Brexit as an excuse for falling short of estimates, overall, we do not expect political and economic uncertainty in the U.K. to have much impact on U.S. company profits.

Brexit has had some negative impact on corporate profits through the stronger dollar and tighter financial conditions. The financials sector is perhaps most impacted given its sensitivity to interest rates, which remain near post-Great Recession lows; the 10-year Treasury yield closed at 1.46% on July 1 and dipped below 1.40% intra-day on July 5. One way Brexit has not yet negatively impacted earnings is commodity prices; the Bloomberg Commodity Index is actually up since the Brexit news despite dollar strength.

ALL ABOUT GUIDANCE

It's always about guidance as stocks trade more on expectations for future quarters than on results for a quarter that ended. Since the Great Recession, earnings estimates for the next 12-months have typically fallen 2-3% during earnings season. During first quarter 2016 earnings season, the estimate reduction was at the low end of that range--an encouraging sign. We believe we will see a similar result this quarter for several reasons:

- Better growth. We continue to see 2-2.5% GDP growth for the second half of the year despite stalled overseas growth, the Brexit-related tightening of financial conditions (via the stronger U.S. dollar), which we expect to be short-lived, and U.S. election uncertainty that will be with us for the next several months. This growth pace is supportive of a return to high-single-digit earnings gains by year-end.
- Easing drags of the dollar and oil. The significant drop in earnings estimates early this year was largely due to weak oil prices and the strong dollar. Even with the post-Brexit dollar rally, these drags are easing considerably and increase the chances that companies are able to at least maintain their outlooks through year-end and into 2017.
- Favorable pre-announcements. The ratio of companies pre-announcing negative results relative to

those pre-announcing positive results (2.3) has been more favorable during the second quarter 2016 than in the prior quarter (3.8) and the year-ago quarter (4.3). The ratio is also better than the 20-year average of 2.7.
- Estimates held up well late in the quarter even post-Brexit. Estimates for the second quarter of 2016 and the next year held up very well in June 2016, even following the June 23, 2016 Brexit vote, after which many economists reduced their European and U.K. economic growth forecasts and currencies experienced extreme volatility. Consensus estimates, which have fallen less than 0.2% since the vote, are calling for a 10% increase in S&P 500 EPS over the next four quarters, so we would view a number near this or slightly lower after earnings season is over as a positive surprise.

These factors suggest that high-single-digit earnings gains in the fourth quarter of 2016 are potentially achievable (consistent with consensus estimates), in our opinion, and can help support modest stock market gains in the second half of 2016.

CONCLUSION

The earnings recession will likely continue with second quarter results. Although the decline is likely to be smaller than the first quarter's and suggest a trough is in, there will not be much good to say about the results. But better times may lie ahead. U.S. economic growth has started to pick up, the drags from the U.S. dollar and oil are starting to abate, Brexit appears unlikely to hurt U.S. companies all that much, and we generally expect guidance to be pretty good. We continue to expect a second half earnings rebound to drive further stock market gains in the second half of 2016.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management. Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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