RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

SECOND QUARTER 2016 MARKET COMMENTARY
July 2016

STATE OF THE MARKETS

Equities rebounded from their February lows in the second quarter, with the S&P 500 and Dow finishing up 2% for the quarter and approaching all-time highs. ***Due in part to strong performance in the energy and materials sectors, the RDM Capital composite of value-equity oriented accounts more than doubled the S&P 500 and Dow indices, rising 4.5% for the quarter.***

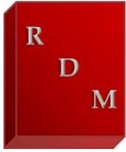
A main cause of the equity rebound in the second quarter was rising crude oil prices. Crude fell as low as $25 per barrel in February, a stunning decline considering crude was over $100 not long ago. Some market participants panicked, interpreting falling oil prices as indicative of weakening demand from China and other emerging markets and a possible global recession in the near term. However, the price of crude recovered throughout the second quarter as a result of a leveling of production, supply disruptions and strong demand, ultimately breaking the psychologically important $50 price level. While crude prices pulled back slightly at the end of the quarter, the recovery alleviated concerns of an imminent global recession.

As the quarter came to a close, the U.K.'s "Brexit" vote to leave the European Union temporarily shattered the relative calm in the market. The market had drastically underestimated the odds that the U.K. would vote to leave the E.U., which caused many short-term traders to scramble to change their positions. Over the next two trading sessions after the June 23rd vote, the Dow Jones declined almost 900 points, making it the biggest two day drop since August of 2015. More economically sensitive sectors, like financial and energy stocks, were especially hard hit.

We do not underestimate the political impact of the Brexit vote, especially if the populist politics and anti-E.U. sentiment that led to the Brexit vote spread to other E.U. countries. However, the immediate reaction to the Brexit decision clearly was overdone: the U.K. will not formally leave the E.U. for months, if not years; the U.K. could reverse or temper its Brexit decision when the U.K.'s new leadership takes power; and in the absence of a contagion to the rest of the E.U., any negative economic impact will be mostly confined to the U.K. As a result, the market reversed course and recovered almost all of its losses by the end of the quarter. We explore the implications of Brexit in more detail below.

While equities returns continued to frustrate bulls and bears in the second quarter, there remain few profitable alternatives outside of equities. In particular, stocks are relatively cheap compared to fixed income investments, which continue to hold expensive levels due to the persistently accommodative Federal Reserve. After another very dovish statement on the path of interest rates, the Fed appears unlikely to significantly raise rates in 2016 and may only make one 0.25% rate hike towards the end of the year. Indeed, the Fed continues to adjust the projected path of interest rates lower into 2017 and 2018 as well. Uncertainty abroad has given the Fed some pause, as did the May unemployment report that signaled especially weak job creation that month.

As we have stated in the past, it is our view that the Fed will not take aggressive action on the rate front in the near term because of its fear of derailing a historically sluggish economic recovery. The market weakness after the Brexit vote will only extend the Fed's interest rate path. Thus, we expect the Fed to proceed cautiously with at most just one 0.25% rate hike in December, as in 2015, if the Fed takes any action at all in 2016.



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Heading into the second half of 2016, we expect investor attention to remain focused on developments with the Federal Reserve and international economies, as well as the upcoming U.S. presidential election. After party conventions take place in the third quarter, we expect the candidates' rhetoric to heighten and the ramifications of policy positions to be examined by investors in more exacting detail. With the rise of populist and nationalist positions in the U.S., as well as internationally, we expect some market volatility if it appears that free trade may be restricted or increased tax and regulatory scrutiny may be placed on U.S. businesses under the next administration.

The U.K. Referendum to Exit the European Union Casts a Pall over Markets

The U.K.'s membership in the E.U. has always been a reluctant one. The U.K. never adopted the Euro as its own currency and maintained its own central bank, the Bank of England. In recent years, disaffected nationalist segments of the population have argued against the nation remaining a member in the E.U. In their minds, the benefits of independence and isolation outweighed the benefits of free trade and coordinated governance across Europe. Conservative Prime Minister David Cameron had become increasingly unpopular among this segment of the U.K. populace. Therefore, he put to a national referendum whether the U.K. should remain as a member of the E.U. Leading up to the vote, the British were evenly split over whether to leave the E.U., with most of England in favor of leaving and most of Scotland and Northern Ireland in favor of remaining. On June 23rd, voters in the U.K. voted to leave the E.U., causing markets to plummet and Cameron to resign.

Impact on the U.K. & Europe

The U.K.'s Brexit comes at a fragile stage for the global economy and still could have negative implications on the U.K. and Europe, despite the market's bounce back in the second quarter:

1. While the U.K. never adopted the Euro as its currency, a departure from the E.U. threatens to weaken the pound and further strengthen the dollar at a time when Fed monetary tightening and European monetary stimulus had already pushed the Euro and other European currencies lower and the dollar higher. This dynamic could destabilize currency markets as well as throw central bank stimulus efforts off of a fragile pedestal. As we have seen over the past week, we expect to continue to see investors and savers rotate their funds out of the pound and Euro and into the relative safe haven of the U.S. dollar and Japanese yen.

2. The possibility of a nation as large and influential as the U.K. – the E.U.'s strongest growing major economy – leaving the E.U. projects weakness in the members' overall commitment to the E.U. The possibility remains that disgruntled citizens in other large E.U. nations, such as Spain, Portugal, the Netherlands and Italy, could be emboldened to pursue a similar course of action by pressuring their leaders for a voter referendum, eventually leading to the collapse of the E.U. While some European leaders have come out strongly to emphasize their commitment to the E.U. in the wake of the Brexit vote, we expect to see continued pressure on them to re-assess the benefits of E.U. membership.

3. A U.K. departure from the E.U. could have grave implications for free trade for the British economy by weakening the nation's hand in trade with the E.U. and other non-E.U. nations. Ironically, those voters angry over the economic state of affairs in the U.K. could end up

suffering the most if multinational corporations move jobs to other now more prominent locations in Europe and, relatedly, economic growth suffers in U.K. more so than the rest of the global economy.

Impact on the U.S.

While the departure of the U.K. from the E.U. may have direct negative impacts on the U.K. and Europe as a whole, its impact on the U.S. economy is more attenuated. The most significant ways the Brexit decision could impact the U.S. are as follows:

1. It is increasingly unlikely that the Fed will move to raise interest rates in 2016 given the Brexit vote and uncertainty in Europe. The Fed will not act aggressively in the face of global economic uncertainty and could even cut rates to counteract some of the strength of the dollar in the wake of the plummeting Euro and pound.

2. The global economy will continue to muddle through an extended period of uncertainty and political stalemate as the future of the E.U. is periodically threatened and managed through various political and economic crises. The Brexit could take up to 2 years to sort out, which would cause enough uncertainty on its own, assuming no other European crises emerge. Since uncertainty is always a negative for financial markets, this may have some dampening effect on growth in the global economy, which will also affect the U.S. economy and corporate earnings.

3. The E.U. also may become a weaker trade partner for the U.S. The U.K. is the U.S.'s seventh largest trading partner, representing only about 3 percent of total U.S. trade. However, the E.U. is currently the largest trade partner of the U.S. and weakness there ultimately affects demand for U.S. goods and services on the international stage.

Impact on Investment Portfolios

In the near term, equity markets will likely remain volatile due to the aftershocks of the Brexit vote, particularly in Europe. The S&P 500 has traded around the 2,050 level since hitting its all-time high over a year ago, seldom trading below 2,000 or over 2,100. Global economic uncertainty and slow growth has played a major role in this stagnation. However, investors are left with few long-term attractive options outside of equities. Thanks to the impact of massive central bank monetary easing, global government bonds like U.S. Treasuries are near rock-bottom yields with some nations experiencing negative interest rates on their government bonds. For savers near retirement, the impact of low rates has been profound.

Our view is that high quality U.S. large-cap equities should play a major role for most investors' portfolios. We plan to continue this emphasis with a particular bias towards sectors that present currently compelling value, such as financials and energy stocks. We also will continue to diversify investments for those clients that prefer less volatility or have a need for income. The challenge at the moment is that high investment-grade corporate bonds and treasuries do not produce the requisite interest yield to satisfy the income needs of many investors. Thus, for income-oriented investors, we will continue to look for opportunities in other income producing investments, such as preferred stock and utilities. We also will maintain a healthy cash balance to smooth market volatility and provide ammunition for attractive opportunities.