CAPITAL ASSET MANAGEMENT

Quarterly Commentary 2016 | Q2

Whenever you find yourself on the side of majority, it is time to pause and reflect.
-Mark Twain-

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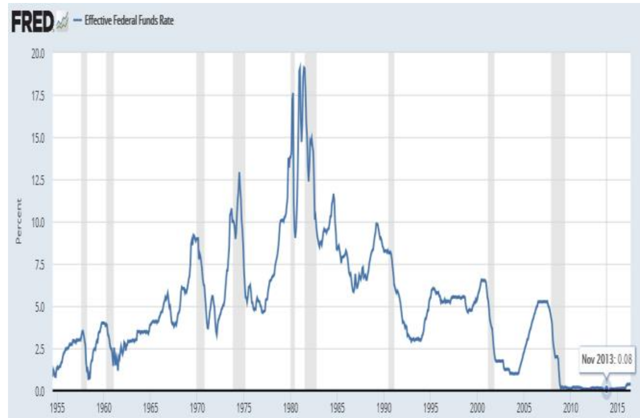
After an unusually rough start, equity markets have reached new highs in 2016, thanks in large part to Central Bankers around the world, who remain overwhelmingly committed to keeping interest rates "lower for longer".

The hurdles have been many. First, growth has been limited and in some sectors non-existent. Energy, which often signals future growth or decline, has been extremely volatile. Business investment has decreased. China, the world's second largest economy experienced a significant pull-back. British voters quite unexpectedly decided to pull out of the European Union, calling the long-term viability of the union into question. Yet despite these obstacles, equity valuations have continued to climb relatively unabated.

After Britain voted on June 23rd to withdraw from the union, investors were initially shocked and dismayed. A 5.34% sell-off in the S & P 500 ensued. But before the quarter closed, the index had regained 4.91% of its losses. The angst investors felt as trading got underway on the 24th had largely dissipated in the last days of the quarter. Given how much the market typically hates uncertainty, the rebound was somewhat unexpected and unprecedented.

Without extraordinary accommodation from Central Bankers around the world, such a bounce would likely not have happened. Easy money policies have mitigated some of the inherent risk associated with equity investments, as investors have come to rely on the continuation of such policy. By all indications, Central Bankers are prepared to oblige.

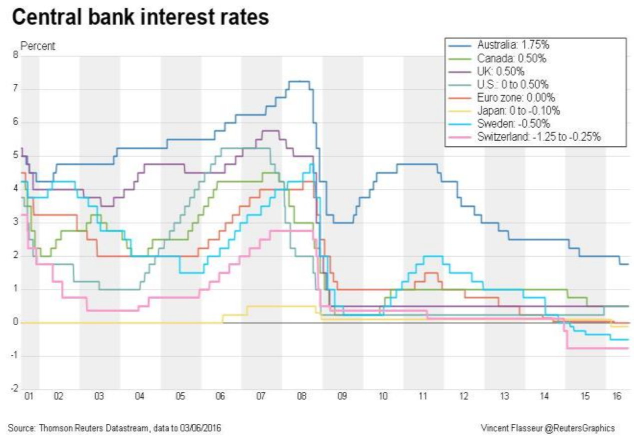


Many analysts feel that the world's bankers have little choice. To paraphrase one economist, when shocks, such as Brexit, threaten to curtail global growth, central banks must act as circuit-breaker to battle contagion. Low rates and quantitative easing are seen as perhaps the best tools to combat the destabilizing forces of political and economic upheaval.

Advancing their mandates

Although Central Banks are typically charged with taking actions to maintain full employment and price stability, most today do so with a keen eye on promoting market stability. They are quick to look for reasons to appease investors and avoid market turmoil.

Just days before the Brexit vote, the Federal Reserve refrained from raising rates at its June meeting, while the Bank of England suggested that a rate cut could be forthcoming at its next meeting. Throughout much of 2015, falling commodity prices and slowing growth in China provided cover for keeping rates low.



To be fair, equity markets do have a pronounced effect on the economy. Rising markets create a wealth effect and encourage confidence in the future, prompting consumers to spend and invest. In consumer driven economies, the psyche of the consumer is critical.

Additionally, healthy markets allow companies to raise capital needed for expansion. Strong valuations also support retirement plans, allowing for higher distributions in future years. Conversely, tumultuous markets have just the opposite effect, which is why Central Bankers strive to limit market volatility.

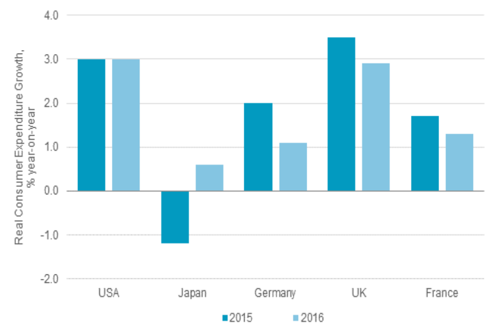
Maintaining well-functioning markets is a role the bankers have adopted and freely acknowledge. Mario Draghi, head of the European Central Bank, recently commented that the readiness of central banks to provide liquidity and an accommodative monetary policy, coupled with a robust regulatory and supervisory framework, have helped keep market stress contained.

Reasons for optimism

But to ascribe the ascent in domestic equities solely to monetary accommodation would be unfair. While growth remains slow, there are many signs that the health of the consumer and therefore, the economy, is improving.

Non-farm payrolls increased by 287,000 in June, however, May was a disappointment. Over the quarter, job gains averaged 147,000 per month. With the tightening of the labor market, personal incomes are also edging higher.

CONSUMER EXPENDITURE GROWTH IN THE FIVE LARGEST DEVELOPED MARKETS: 2015 AND 2016



Source: Euromonitor International from national statistics/Eurostat/UN/OECD

With increases in income have come increases in consumption. In April, consumer spending advanced at the fastest pace in nearly seven years. Then in June, retail sales rose 0.6%, surprising most economists. Consumer spending may be even more robust, though, than sales data would indicate. According to Moody's Analytics, because prices on many products, such as furniture, electronics, and certain imports have actually fallen, real consumer spending may be growing faster than what is implied.

Lending is also increasing. While bank earnings have been restrained by low interest rates, bank loans are actually up. Consumers and businesses are starting to spend, indicating a sense of confidence in the future.

Another bright spot for the economy is the resurgence in household formation. Last year, the number of new households increased by 1.3 million, continuing an upward trend that began a year earlier. Demographers now feel that household formation has reached a turning point.

The increase in new households is stimulating demand for new housing. In 2015, the number of new "non-replacement" housing starts was approximately 710,000. This figure is far below the annual long-term average of 1.4 million, indicating that housing has significant room to grow. Housing is now seen as a tailwind for the economy, particularly considering all the economic sectors which stand to benefit from its continued growth.

Signs of a Ripple Effect

U.S. wages, a key to home buying, are on the rise	+2.5%
Construction employment at highest levels since 2008	6.6 million
Housing is helping to lift U.S. industrials	61% of industries report expansion

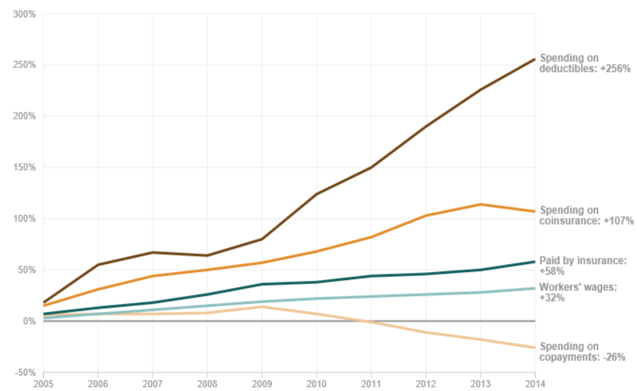
Reasons for concern

Still one does not have to look very far for signs of economic weakness. As valuations have risen, a sense of angst has lingered, giving investors, analysts and economists reason for pause.

While job growth has been largely steady, the quality of employment for many workforce participants has declined, not improved. Since the recession ended in 2009, a significant number of those who have found employment have done so by accepting positions that pay less than they were making in a previous job. These individuals and families continue to struggle financially and find themselves often unable to save for future needs and obligations.

Average Deductible Spending Nearly Tripled From 2004-2014

Cumulative increases and decreases in average healthcare costs and amounts paid by insurance

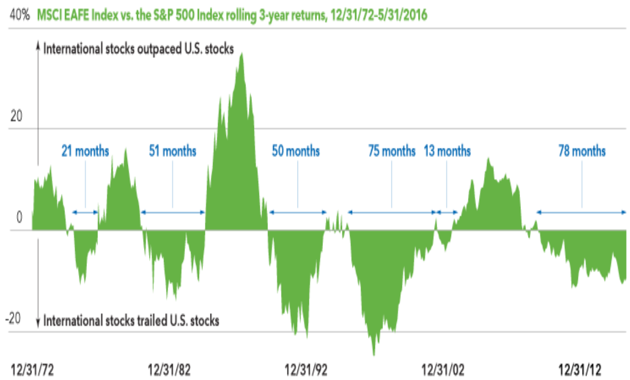


Source: *Peterson-Kaiser Health System Tracker*

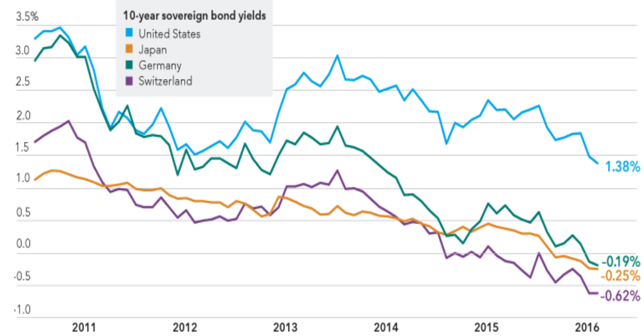
Often compounding their stress is the rising cost of healthcare. Even for those who are able to save, healthcare costs remain a drain. For a significant number of consumers, healthcare premiums and associated costs are rising faster than income. When the increasing costs are coupled with frequently declining benefits, a particularly bleak dichotomy begins to emerge.

Given the challenges many consumers continue to face, it is somewhat easy to understand why confidence remains fragile. While consumer spending is on the rise, the uptick is partly attributable to low gas prices and low interest rates. Both factors have created something of a windfall for some consumers. Whether the spending trend will continue may hinge on whether consumers feel confident in their continued financial and personal well-being.

U.S. Equities Have Outpaced International Markets Since the Financial Crisis



With Sovereign Yields Below or Near Zero Elsewhere, the U.S. Is a Relative High-Rate Haven



Source: FactSet. Yields are as of July 5, 2016.

Given those requirements, it is important to remember that terrorism and geopolitical risks remain high. Mass casualties periodically dominate the 24-hour news cycle. The recent military coup in Turkey prompted the yield on the 10-year Treasury to plummet, as risk-adverse investors sought a safer haven. As the coup drew to a relatively muted close and order was restored over the weekend, the yield rebounded on Monday as investors opted for less-risk-adverse positions.

The path forward is far from certain.

Our take

We are obviously pleased to see the advance in equity valuations. The upward trend has created new wealth for some and restored wealth for others.

While much of this increase is due to extraordinary monetary accommodation from Central Bankers around the world, fundamental economic improvement in various sectors has supported the advance. Moreover, the Central Bankers seem to have no intention of reversing course anytime soon. If anything, many, including the Fed, seem to be growing more cautious.

The prospect of rate increases yet this year seems to be declining. Rates may well remain low for years to come. The Fed's rationale may rest on the fact that interest rates in the U.S. are still high, when compared with those of other developed nations. The key takeaway may be that our economy is still considerably stronger than other sovereign economies around the globe. Approximately 86% of government bonds issued by developed countries are yielding less than U.S. Treasuries.

The low rate environment will continue to be a boon for equities. Low rates lower the bar that companies must meet to satisfy investors. Additionally, low rates curtail bond yields. Investors seeking yield, who would typically prefer to find it in the fixed income markets, are today often forced to find it in equity markets instead. The net result—an increased demand for equities.

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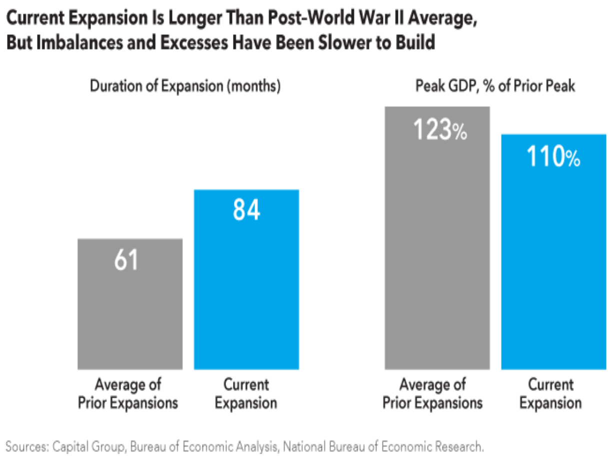

While we remain optimistic, we are also cautious, as markets reach new heights. The S & P 500 PE Ratio as of the Friday, July 22, 2016 close, stood at 25.16, well above the mean of 15.60. As equities become more fully valued, there is less opportunity for sustained fundamental growth. From the perspective of a value investor, there are few opportunities to purchase at a discount.

In sum, we believe that investors should remain true to their objectives, risk tolerance and time horizon. Although the recent uptick in valuations can be alluring, it is important to remember that these gains are fueled in large part by ultra-low interest rates, due to a sluggish pattern of global economic growth.

Central Bankers hope that such extraordinary accommodation is temporary and that eventually the support can be withdrawn, at a point where both economies and markets are strong enough to stand on their own. Today, that support has been in place for almost nine years. It is difficult to imagine when it will end.

What is important to remember is that market conditions are transitory; the environment is always subject to change. Ultimately, the best investment plan is the one that works for you despite prevailing headwinds or tailwinds. No investor should ever accept a level of risk that is neither fully understood nor justified, based on his or her reasons for investing and the time frame identified for realizing those objectives.

If you have questions about your portfolio or would like to discuss any recent developments which may alter your investment approach, we would welcome a call. We are available to discuss any concerns you may have at your request.

As always, we remain grateful for the opportunity to be of service.

Sincerely,
Capital Asset Management, Inc.

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