TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development in Q 2

Global market reactions were initially severe, but generally orderly to the Brexit referendum on June 23. The pound had dropped 13% to the dollar since the vote, while demand has strengthened for safe haven assets such as U.S. Treasuries. Global stock markets have, however, largely recovered with the S&P 500 Index surging 9.4% to an all-time high on August 5, when the realization set in that Brexit was not a systemic risk and there would be no immediate damaging effects on global economies. As a result of the strong recovery the market in general seems overvalued. With continuous sluggish economic growth expected globally, lower corporate earnings, valuations well above historic norms, the stock market is likely to continue to be mainly driven by "no alternatives to stocks".

Bond Market Development in Q 2

Despite Brexit and its likely longer impact on European economic growth, global currencies, and Federal Reserve policies, risky assets had a strong quarter. High-yield bonds were up 5.4% for the year despite the continued distress in the energy, metals and mining sectors. Interest –rate risk was also a winner when the Fed did not raise short-term rates in May and negative yields were becoming increasingly prevalent abroad. Long-term bond categories were up 12.43% YTD through June 28, outperforming all other fixed-income categories. Investment-grade corporate bonds, which had come under pressure during 2014 and into 2015, faired particularly well (+7.02%). Considering that U.S. Treasury bonds are some of the last sovereign bonds in the developed markets to trade at a positive yield, dollar-denominated fixed-income securities present value to foreign investors. In addition, with deposit rates negative in the European Union, over time the U.S. dollar is likely to continue to appreciate against the euro. As interest rates fall, corporate bonds have become increasingly more attractive on a relative value basis. With underlying interest rates as low as they are, the extra return provided by the credit spread on corporate bonds above the underlying benchmark Treasury bond has become an increasingly larger portion of total return. The European Central Bank confirmed its intention to maintain its EUR 80 billion monthly asset-purchase plan until at least March 2017. A significant amount of the Euro 640 billion of new money created is likely to be reinvested in the fixed-income markets. Not only does this asset-purchase program increase demand for fixed-income securities by creating new money that must be reinvested, but it also reduces the amount of outstanding supply, which exacerbates the market impact.

Federal Reserve Bank Policy Outlook

Low interest rates are historically reflecting low nominal GDP growth (NGDP). NGDP is currently close to 3% which would suggest the yield on a 10-year T-bond to be around 4.25% and the historical relationship to the fed funds rate to be closer to 2.755 than 1.50%. Short term rates are hovering around zero by design with the Fed's balance sheet bloated relative to the pre-crisis norm, a scarce supply of bonds due to both lower deficits and slower accumulation of credit by households, regulatory changes in the wake of the financial crisis and an aging population. The longer-term nature of these circumstances are likely to provide ongoing pressure on yields. Furthermore, over $10 trillion (40 countries) of Sovereign debt currently trades with negative nominal yields (Bloomberg data). With an interest rate differential of 1.6% between German 10-year bonds (-0.013%) and U.S. (1.58%) increased demand for U.S. bonds keeps interest rates at an artificially low level. We expect that interest rates are likely to increase in 2017, but given the surreal state of global bond markets the potential is limited in our opinion.

U.S. Economy

The US economy expanded less than forecast by 1.2% p.a. after 0.8% in Q 1, as the massive 1.2% subtraction for inventories due to lighter global demand could not be offset by robust consumption. Private investment, which includes residential and business spending dropped 3.2% in Q 2. Household consumption, which accounts for 70% of the economy grew 4.2% p.a. after 1.6% in Q 1. Inflation stood at 1.7% (ex food and

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energy) after 2.1% in Q1. As inventory data are very seasonal and historically usually have no impact on GDP over the course of a full year, it is fair to expect a stronger trend in GDP growth in the second half when inventories start to adjust. Representing 70% of GDP, consumption is a key driver of GDP growth. Not only is it important from a calculation standpoint, but it also helps drive some of the other GDP categories. Furthermore, YOY, as well as sequential growth in consumption, seems to continue, which should also help the economy.

Corporate Earnings

Since the significant net margins decline in Q1 ‘16, they recovered in Q2 ‘16 in the S&P 500 to 11% ex-energy and 10% ex-energy and financials, both close to record highs. We think margins over 10% should be sustainable through the rest of the year. Cash flow from operations do not cover outlays from plant upgrades to acquisitions. Therefore, debt-funded share buybacks to reward shareholders have increased by 8% in the last 12 months amid low interest rates and have been on a steady rise since 2001. Debt to total assets of non-financial companies in the S&P 500 has increased to 32%. The influence of corporate buybacks on share performance is likely to wane when interest rates start to rise.

TN Outlook

This has been a year of contradictions, with the market's best performing sectors coming from opposite ends of the risk spectrum. The drop in interest rates explains half of the year's best performing sectors: utilities, telecoms, REITs and consumer staples on the defensive side and energy and basic materials on the cyclical side can be attributed to a rebound in commodity prices, in particular oil. The best opportunities going forward in our opinion will be among out-of-favor financial-services, consumer cyclical, healthcare stocks and technology. Furthermore, on August 31st real estate will be elevated from an industry within the finance sector to its own sector within the S&P 500 Index. REITs have historically provided liquid and diversified property exposure, attractive dividend yields, and competitive long-term rates of total return. Lastly, the defensive sectors are likely to continue to do well. Consumer staples and utilities historically have soundly beaten the S&P 500 during the 12 months after their forward P/Es were above their historical averages relative to the market.

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