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From Our Chief Investment Officer
The Populist Wave

The analogy of a crashing wave seems fitting to describe the events of the 2nd quarter. The Federal Reserve has been trying to support the economy for years on a raft of easy monetary policy. Just as the economy was showing signs that the need for that raft was slowly dissipating, a wave of populist politics has crashed over them.
As a result, the Fed is now holding on to that raft tighter, with the market now expecting a next-to-zero percent chance of a rate hike in 2016 and a much-less-than-fifty percent chance of any rate hikes in 2017. As a result, interest rates are back near all-time lows, with the 10-year U.S. Treasury closing out the quarter at 1.5%.

The specific wave that markets are dealing with is “Brexit”—Britain’s decision to leave the European Union (by a vote of 52 to 48%). This was an unexpected result—betting sites going into the vote viewed “Leave” as a 20% probability—and the markets showed their surprise over the next two days of trading. The pound fell by 11%; European equities fell by double-digits; and even U.S. equities experienced a 5% drop. Given the uncertainty, this could cause a recessionary event in the U.K. and put pressures on continental Europe. But there’s a long timeline involved here, which should help moderate its overall impacts.

Once Britain formally declares its intention to leave, a two-year negotiation period ensues, with the markets hoping both sides can renegotiate an economic relationship that is minimally disruptive to the global economy. Indeed, after the initial knee-jerk reaction, global equity markets rebounded sharply, with U.S. equities ending the quarter less than 1% below the level going into the “Brexit” vote. But it is the indirect impacts the markets believe the Fed is watching. Most prominent is the dollar, where the Fed will likely feel the need to offset “flight to safety”-driven dollar strength through extended monetary accommodation.

Given the late-quarter volatility, it may surprise some to find out that, excluding developed ex-U.S. equities, all major asset classes finished the quarter up, pushing further into positive territory for the year. Interest rate-sensitive asset classes performed well, including: high yield, listed infrastructure, REITS and investment grade fixed income; while those asset classes that benefit from easy monetary policy performed best, including natural resources and gold. So far, the markets have survived the populist waves, but more may be on the way (U.S. elections in four months). With the water still rough, it will likely be awhile before the Fed no longer needs that raft.
Financial Market Review

Interest Rates

The yield curve flattened during the quarter as the markets lowered expectations for growth, inflation and Fed rate hikes in the wake of “Brexit.” The markets now view any rate hikes during the rest of 2016 as very unlikely, pricing in only a 10% chance of a rate hike by the Fed’s December meeting. At present, a rate hike throughout 2017 is also viewed as improbable (less than 50% currently). Yields on 10-year U.S. Treasuries are now back under 1.5%, flirting with the all-time lows reached in 2012. Current rates may seem low, but are an absolute bargain compared to Japan and Germany, where yields on 10-year debt ended the quarter at -0.22% and -0.13%, respectively.

Credit Spreads

Credit spreads were very well behaved during the height of the “Brexit”-induced market volatility. High yield spreads pushed up by only 0.6%—far less than the 1.7% increase witnessed at the beginning of the year over China hard landing concerns. Overall spreads reached 6.2%, vs. 7.3% at the height of the recent energy price weakness; 8.1% when U.S. debt was downgraded by S&P in 2012; 18.1% during the financial crisis; and 10.1% in the aftermath of the dot-com bubble. Over the full quarter, spreads fell modestly for both high yield and investment grade issues; this combined with falling rates, led to quarterly gains of 2.2% and 5.5%, respectively.
**Equities**

Equity prices took another roller coaster ride during the 2nd quarter but all regions—with the exception of developed ex-U.S. equities—ended the quarter in positive territory with global equities gaining 1.2%. The biggest drop of this roller coaster ride was in response to “Brexit;” global equities fell by nearly 7% over two days before rallying over 5% to end out the quarter. U.S. equities performed best in the quarter, returning 2.6%. Emerging market equities also ended in positive territory with a 0.8% return, after being down as much as 6% earlier in May (due to concerns over a Fed rate hike). Developed ex-U.S. equities were not quite able to overcome the drop, falling 0.8%.

**Real Assets**

Real assets of all stripes continued their upward march in the second quarter, extending their gains from Q1. Natural resources were the best performer, their 8.7% gain attributed to tightening supply/demand dynamics and expectations for extended accommodative monetary policy. Global listed infrastructure and REITs were up 5.0% and 3.6%, respectively, as falling interest rates benefited these interest rate-sensitive asset classes. All three asset classes materially outperformed the global equities (which returned 1.2%), and have served as a nice complement to traditional stock and bond exposure in a period of increased volatility.
From Our Chief Investment Officer

Dear Valued Clients,

In light of the ever changing global economic landscape and recent market volatility, we remain committed to preserving our clients’ assets while promoting growth. We continue to stress the importance of a sound investment strategy through a diversified mix of assets. We feel the best way to dampen volatility in this uncertain period of time is to embrace high-quality assets, such as U.S. government bonds and AAA-rated mortgage-backed securities. This is a strategy that we implemented earlier in the year as we felt the higher relative yield and “safe haven” status of these assets would increase demand and return. We also increased our allocation to Large Cap U.S. equities because investors would seek out fundamentally sound and undervalued stocks domiciled in a stable country, especially after a market correction or a “shock” to the system, such as the “Brexit.”

Lastly, our desire to reduce correlation in client portfolios is highlighted by our allocation to alternative assets, such as Real Estate Investment Trusts (REITs), commodities, global infrastructure and energy storage and transportation. While the main benefit of including alternatives in the portfolio is to counter the price movements of traditional assets, such as stocks and bonds, the returns from this asset class on overall portfolio returns can be dramatic. The recent action by global central banks to stimulate economic growth through low and even negative interest rates has created a large demand for yield, so interest rate sensitive assets, such as REITs, infrastructure and MLP’s have some of the highest returns of any asset class. In addition, the recent weakness in the U.S. dollar has also enhanced commodity demand and total return.

In summary, while we favor an overweight position to U.S. equities and high-quality bonds, our philosophy to diversify our clients’ assets over a myriad of investment classes remains the most prudent method to managing risk and return over an economic cycle. In this regard, we remain committed to our allocation in developed international equities and emerging markets, which is currently outperforming the S&P 500 year-to-date. Although developed international is struggling due to the slowdown in the Eurozone, we will look to add to our current positions when growth stabilizes. We also stand by our high yield bond exposure, as the global search for yield will continue to increase demand for this asset class, along with higher yielding alternatives.

We appreciate the confidence you have in us and are here to answer any questions you might have.

Until next quarter,

Jeffrey McDonald
Chief Investment Officer

At Enterprise Wealth Management, our mission is to help clients achieve their financial goals by providing professional money management, extensive resources, and independent, objective advice that you can trust. Enterprise Wealth Management was established in 1992 and manages $650 million in client assets. Our clients are successful executives, professionals, entrepreneurs, non-profit organizations, private foundations, and retirees who desire a financial partnership that can provide access to investment opportunities and alternative strategies.

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