Review & *Outlook*

SECOND QUARTER 2016

WAYCROSS
INVESTMENT MANAGEMENT COMPANY
119 N. Commercial St., Ste. 191 ▪ PO Box 1618 ▪ Bellingham, WA 98227
P: 360.671.0148 ▪ P: 800.292.8794 ▪ F: 360.671.8936

Review

During the second quarter of 2016, the S&P 500 index moved in a fairly tight range: about 1.9% on either side of the mid-point. Within the index, however, sector returns varied widely, most notably energy (which was up) and consumer discretionary (which was down). At the end of the quarter, Great Britain voted to leave the European Union, and we found ourselves in yet another storm. The unexpected Brexit outcome created significant uncertainty in the markets, resulting in a sharp plunge of over 5% in the S&P 500 index, and much larger declines in foreign indices. The financial sector, banking in particular, was hit especially hard by this decline. However, the decline was followed by a fairly significant rebound, leaving the S&P 500 with a total return of 2.46% for the second quarter of 2016.

In June, we also passed through another cycle of great speculation as to whether the Federal Reserve would raise interest rates. Predictions of a rate hike in June were suspended due to an unusually poor jobs report early in the month. For most of the quarter, the 10-year treasury rate was solidly above 1.7%, and looked to be moving higher; in late April it reached a high of 1.93%. Subsequent to the June jobs report, rates started to decline, and have taken another significant move downwards following the Brexit vote, reaching 1.46% on June 27th. The Brexit vote has also pushed the expectation for a possible interest rate hike well into 2017. The Federal Reserve raised interest rates one quarter percent in December 2015, with the view that key measures within the US economy were improving. At that time, the 10-year Treasury rate was 2.30%. With negative interest rates on offer by other governments around the globe, there is likely to be continued downward pressure on US treasury rates maintaining the 10-year yield well below 2%.

Outlook

The US economy continues to grow slowly, with projections of global growth for 2017 revised downward as a result of Brexit. Still, there is no compelling outlook for a U.S. recession on the near-term horizon. NABE (National Association for Business Economics) revised their 2016 annualized growth rate from 2.2% in March to 1.8%. While this number is perhaps uncomfortably close to zero, and has sparked some commentary including the word "recession", it is our view that a recession in the very near term is unlikely.

> *"Any current or prospective business model relying on seamless access for the UK to EU markets, and/or access to world markets through EU trade agreements is now being reevaluated."*

With several elections coming up in major European countries and the fall election in the US, it will be interesting to see how governments respond to increasing calls by economists and others for active fiscal action (government spending on infrastructure, for example) to boost the economy. Pundits and policy makers are coming to the view that central bank monetary policy is becoming increasingly ineffective and engaged fiscal spending may be the only path to more vigorous global growth.

In Focus

"Darlin' you got to let me know;
Should I stay or should I go?"
– The Clash

Last week the United Kingdom (UK) surprised the world and voted to leave the European Economic Union (EU). Curiously, at about the time referendum results were becoming clear,

the UK's Google Analytics revealed a spike in the query, "What is the EU?" In the coming months, we will all come to a deeper understanding of both the question and the answer.
As we write this quarterly newsletter, the "Brexit" vote is still fresh, unexpected, complex, and dynamic. There are hundreds, if not thousands, of cogs and gears in the global economy that will be affected in one way or another. Our job is to try to filter out the noise and identify the major relevant themes that may impact our management duties.

With respect to financial markets, the single comment you will hear over and over again is that Brexit has caused "uncertainty". The problem with uncertainty is that it is very difficult to manage around because the range of potential outcomes may be vast and the associated hazards unknowable. In the broader markets, uncertainty tends to create volatility in risk assets, paralysis in decision making, and causes investors to seek solutions akin to hiding under a rock (rushing into US treasuries or Japanese Yen, for example).

Market Index Performance Data: Total Return (%)[1]

Index	As of 6/30/2016 Q2 2016	Trailing 12 Months
S&P 500 Index	2.46%	3.84%
Barclay's Capital Intermediate-Term U.S. Government/Credit	1.43%[2]	4.33%
Barclay's Capital U.S. Treasury 1-3 Years	0.60%[2]	1.31%

Unfortunately for the UK, and perhaps to a lesser extent the EU, this means a reduction in investment, and consequently lower levels of economic growth in the coming years. Any current or prospective business model relying on seamless access for the UK to EU markets, and/or access to world markets through EU trade agreements is now being reevaluated.

Given the impending Brexit, who would want to invest new money in the UK if the freedom of movement of goods and services and labor to other EU countries is restricted? Imagine if Texas suddenly voted to become its own country (a "Texit"?). It would become more difficult for goods, services, and labor to move freely between Texas and the remaining states. This probably wouldn't be so good for the economy of Texas. If you, an investor, wanted easy access to the American market, there would be many better options than Texas, and you could be sure that all the remaining states would compete hard for your business.

Presently, there are a number of questions that still need answers. Will significant parts of the London financial sector move to the EU? Will other countries leave the EU? Will Scotland and/or Northern Ireland leave the UK to join the EU? And if that were to happen, would it be an amiable split, or a protracted, painful process? And, finally, will the UK actually leave the EU, or will they hold a new vote and decide to stay?

The answers (or lack thereof) to these questions are most immediately expressed in the currency markets and government bond markets. The British pound has dropped to thirty-year lows, and continues to drop as we write this newsletter. The Euro is falling with respect to the dollar. Billions of dollars are flowing into government bonds and assets of currencies considered "safe", notably the Japanese Yen and the US Dollar. But this rush to invest in US dollars is driving down bond yields. The US ten-year treasury yield moved down to 1.47% on June 28th, a near record low this century.

The uncertainty is also shaping the equity markets. A strong US dollar can have negative impacts on the earnings results of large multinational companies. As we observed last year, after foreign revenues are translated into US dollars, earnings growth for US companies can take a hit. This can in turn put downward pressure on the underlying stocks.

With lower interest rates for the longer term looking likely, the financial industry has been hit especially hard. Bank earnings increase with a larger spread between short and long-term interest rates, but uncertainty has reduced this long-short spread. And banks in the UK and Europe hold a large amount of debt. Declines in earnings for these banks will make it harder for them to manage certain loans, further reducing profits. Moreover, European and UK growth is already so low that it would not take much of a shock to push them into a recession. Many people are already wondering if Brexit will cause a recession in the UK, in particular.

> *"One complaint about gold has always been that there are storage costs and no interest paid. With negative interest rates, gold has started to look more appealing."*

With all the uncertainty, investors are showing a preference for investments they perceive as safe, like government bonds or gold. Gold is being regarded as a safety currency because many government bonds are now paying negative interest rates. One complaint about gold has always been that there are storage costs and no interest paid. With negative interest rates, gold has started to look more appealing. Gold is also drawing in those concerned about central banks repeatedly being left to solve economic problems by printing more money.

In the best case scenario, it looks like it might take three years or more to negotiate all the new trade rules between the UK and the rest of the world, where existing trade is governed through treaties signed by the EU. Between now and then, we will see a lot of uncertainty, and a lot of investment diverted from the UK in favor of the EU. This will be bad for the UK, and the pound will suffer. Imported goods will become more expensive in the UK. Real estate will likely be challenged, especially commercial space in the financial districts of London. However, tourism could be a bright spot (with the UK "on sale"), but will not make up for losses elsewhere.

Our long-term view is that this recent Brexit-induced stock market fall in the US is another passing storm, much like the plunge in most equities as the price of oil hit its lows earlier this year. The Brexit will have impact on the earnings of some companies, but certainly not all. To the extent that companies are paying strong dividends based on quality earnings, money should begin to return from under the mattress and should flow back into equities.

While we believe the Brexit turmoil will be prolonged, we think the markets will start to look past it as a likely path forward emerges, even if it is a multi-stage process. The remaining EU countries have a strong incentive to generate signals of solidarity, and even start to make active plans for deeper integration of the EU economic and political institutions.

Experience from past market shocks shows that any rebound can be unpredictable in timing, and sharp in nature ("V" shaped). The first week post Brexit is somewhat consistent with this, although while equity markets, in general, rebounded quickly, certain sectors remained under pressure, including the British pound, many airlines, and equities tied to the internal British economy. Our view is to largely remain invested, and not attempt to time any rebound. Prior to the Brexit we did make a few changes with potential volatility in Europe in mind, namely selling the European Small Cap mutual fund and buying a position in gold for accounts that hold global and alternative allocations, respectively. We also have cash in accounts for new positions that we feel are reasonably priced, perhaps turning this bit of crisis into an opportunity.

1. S&P 500 Data: http://us.spindices.com/indices/equity/sp-500. Barclay's Index Data: https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices.
2. The Barclay's Index Data reported is for the month of June 2016 only. Quarterly data is not provided by Barclay's.