Third Quarter Outlook 2016

I|S|G
INVESTMENT SECURITY GROUP, INC.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"I am describing the outlook that I see as most likely, but based on many years of making economic projections, I can assure you that any specific projection I write down will turn out to be wrong, perhaps markedly so."

Janet Yellen

Mid-Year Outlook 2016

The big story towards the end of the first half was Britain's unexpected decision to exit the European Union (aka, "Brexit). This took the investment community by surprise and the initial reaction was a plummeting of global stock markets. The S&P 500 fell by 3.6% while European indexes like the FTSE 100 (London index) fell 8.7%. Markets rebounded, however, and when the dust settled U.S. stocks were up 3.8% (S&P 500) for the first half while foreign stocks (MSCI World ex USA) lagged once again with a -2.6% showing. Bonds benefited from the stock market turbulence and a drop in rates as investors fled to "safe haven" investments, ending the first half up slightly over 5% (Barclays U.S. Aggregate Bond).

U.S. Stock Markets/Economy

According to Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, the U.S. economy continues to move like a **SLUG**- with **S**low, **L**umbering, **U**nstable, **G**rowth. Metrics which track the economy's health seem to take two steps forward, then one back. This stop/start pattern looks to continue for the immediate future and along with the economic, financial, and political uncertainties associated with Brexit, the Federal Reserve is likely to take their time raising rates. There are risks associated with this policy as the Fed could get behind the curve if economic growth and/or wage growth triggers a spike in inflation. On the flipside, slower rate hike cycles historically have been rewarded by stronger stock market returns relative to faster cycles. Potential stumbling blocks for stocks, however, are slightly elevated valuations and weak corporate earnings growth (corporate earnings growth has actually been contracting over the last year). Low interest rates and inflation are supportive of higher-than-median stock price values, but investor patience will wear thin if earnings growth doesn't move into positive territory. Contracting profit margins and a stronger dollar- which makes our goods and services less globally competitive -could restrict an earnings growth recovery in the near term. Therefore, our current U.S. stock exposure remains unchanged from prior quarters at a slightly underweight exposure (relative to traditional allocation models). We aim to increase exposure back to normal levels…but only when given a better buying opportunity and/or if earnings growth looks to pick up significantly from current levels. Given slightly elevated valuations, the earnings contraction, and uncertainties associated with Fed policy, Brexit, and the upcoming presidential election, we are likely to experience a range bound market for a while with bouts of volatility along the way.

Foreign Stock Markets/Economy

Global economic growth remains slow and the uncertainties around the impact of Brexit look to keep financial markets tentative and volatile following a brief recovery from the initial sell-off after the announcement. Some near-term economic pain is likely in the Eurozone as trade agreements between the U.K. and Europe get re-negotiated but the political uncertainties may weigh equally on the financial markets. Many are saying that Brexit reflects growing global frustrations against established leaders who are sitting on their hands while global monetary experiments are failing to effectively fuel wage and job growth in the real economy and instead are benefitting the wealthy. A Credit Suisse study of 46 countries found that before 2007, "wealth inequality" was on the rise in 12 countries: after 2007, that

News Notes:

Annual Client Event

Please mark your calendars for our upcoming client lunch event, to be held at the **Hyatt Regency DTC** on **Friday, September 16th.** Along with ISG's investment outlook, Peter Nakada from Stone Ridge Asset Management will share insights on some of their unique investment strategies. More information to come.

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number jumped to 35, from China and India to Italy and Britain. This concern, along with frustrations about slower growth and immigration issues, could lead to anti-establishment parties in other countries holding similar referendums on EU membership. Scotland is likely to hold another referendum on leaving the U.K. to remain in the EU and upcoming referendums in Italy in October and the polling on the upcoming 2017 French and German elections may offer more clarity on whether political risk continues to rise or begins to recede.

In another "hotspot", China , fears of a rapid drop in economic growth- as policymakers steer their economy from one driven by cheap exports and infrastructure buildup to consumer-driven growth has roiled global markets over the last year. Our research, however, suggests China's economy is slowing but not crashing. China's consumers are experiencing rapid income growth and sharp rises in retail spending are serving as a buffer to a slowdown in exports. Additionally, China's government has the policy flexibility to turn on the stimulus switch via infrastructure spending, like it did in early 2016.

In sum, we are reviewing our foreign stock allocations in light of the recent developments in Europe and continued uncertainties around China's growth outlook. While stock valuations in places like Europe are more attractive than their U.S. counterparts, we need to assess whether this lower valuation compensates us for the higher risk environment following Brexit. It may take time for the aftershock to fully work through the economic, financial, and political systems in the U.K. and Europe. Additionally, there are questions about how slower growth in Europe will affect China given that Europe is China's largest customer.

Bond returns: Where to from here?

Bond returns this year have defied most analysts' prognostications with most bond categories recording impressive gains for the first half. Typically, these various types of bonds do not perform well at the same time. Government and investment grade bonds tend to do well when economic growth is slowing or when there is a flight to safe haven assets following a market disruption, while riskier bond categories like high yield and emerging market bonds do well when the economy and stock markets are in an upswing. Presently, our strategies are skewed towards higher quality bonds as risks may be increasing somewhat as the impact of Brexit plays out and U.S. investors fret over the upcoming presidential election. In addition, with much of the world's bonds bearing negative yields, demand for higher quality U.S. bonds should remain firm which should serve to support or increase prices (and lower yields) for these type bonds during the second half of the year. Looking out longer term, we are likely transitioning to an extended period of lower bond returns once interest rates begin to rise as it becomes more difficult for bond managers to perform in such environments (ie. the "bond math" catches up to you given the gravitational pull of very low starting bond yields in determining your total return as a bond investor). Identifying reliable alternate bond strategies that can perform well in a rising rate environment without sacrificing too much of bond's inherent ballast qualities continues to be a focal point in our weekly investment committee meetings.

Closing Comments

Investing has been difficult of late. (The price of the S&P 500 is up less than 2% since May of 2015). With no asset classes around the world selling on the cheap, low yielding bond markets, uncertain end games to unprecedented global monetary policies, and social unrest building around growing income inequality and inept political leadership to name a few, we suspect things are not going to get any easier in the near term. Increased market volatility will also likely challenge investors' convictions and emotions as well. Times like these can be dangerous ones because as investors lose patience they start swinging at bad pitches and costly mistakes are frequently made.

From our end, we believe remaining patient and disciplined and having the flexibility and expertise to invest across a broad opportunity set will be important attributes for navigating the next three to five years. Our use of reinsurance bonds and private real estate serve as notable examples here. From our clients' perspective, it is critical to do an honest self-assessment to understand your temperament, risk tolerance, and objectives, and to invest in a portfolio that is managed in a manner that is consistent with those attributes *before* market volatility strikes rather than in the heat of it, when emotions are likely to cloud judgment and lead to poor decision-making. Investing is part of a process, not a one-off decision, toward achieving your long-term financial goals. Remaining focused on the long-term objective is key, as is maintaining a consistent investment discipline to guide your decisions over time.