AUGUSTINE
ASSET MANAGEMENT

July 2016

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It's All Relative

MARKET SUMMARY

Equities

S&P 500	2099
Price / Earnings	19.4x
Dividend Yield	2.2%

US Treasury

2 Year Yield	0.6%
10 Year Yield	1.5%
30 Year Yield	2.3%

US Corporate Spreads

Investment Grade	1.6%
Speculative Grade	6.7%

Volatility

CBOE Market Volatility	15.6

US Economic Figures

Real GDP Growth (1Q16)	1.1%
Unemployment	4.9%
Inflation (Core CPI Y/Y)	2.2%
Fed Funds Rate	0.50%
3 Month LIBOR	0.65%

Commodities

Oil (Brent Crude)	$49.68
Natural Gas	$2.92
Copper ($/lb.)	$2.19
Gold ($/oz.)	$1,322

Foreign Exchange

Euro	$/€	1.11
Japanese Yen	¥/$	103
Chinese Yuan	元/$	6.67

Market summary data as of:
June 30th, 2016

2016 has thus far been a tepid but positive environment for investors. Stocks globally (MSCI All-Country World Index) and domestically (S&P 500 Index) have produced modest gains, returning respectively 1.2% and 3.8% since the beginning of the year. Bonds have fared better, with the domestic benchmark (Barclays Capital US Aggregate Index) returning 5.3%.

Given the economic and earnings backdrop of the last six months, that's a good outcome that has "over achieved" versus fundamentals.

The domestic economy remains in "muddle" mode. According to forecasters at the Atlanta and New York Federal Reserve Banks, second quarter US growth could be 2.1% to 2.4%, following just 1.1% in the first quarter. Initial expectations for the full year have been marked down from 2.5% to 1.9%. Growth in a global context is better, reflecting the inclusion of faster-growing emerging markets. Yet consensus expectations for this year's global growth have also fallen, from 3.3% at the beginning of the year to 3.0% today.

With lower economic forecasts, the outlook for corporate earnings has moderated. Earnings are now expected to be roughly flat for the year both globally and in the US. Based on consensus expectations, the current 2Q earnings season will be the fifth consecutive quarter to show declining year-on-year earnings for US companies.

Rising financial asset prices in the context of lowered economic expectations and no earnings growth are a historically odd combination. But the market's resiliency versus challenging fundamentals remains abetted by central bank actions to prop up financial asset prices in hope that economic growth will follow.

We've chronicled in these pages the incursion by central banks into financial markets through their asset purchase programs. While the US program is "holding steady", Europe and Japan have recently become more aggressive and have expanded their

purchases beyond government bonds to include corporate debt and even stocks. From $4.0 trillion in 2008, central banks in the US, Europe, and Japan now hold $12.1 trillion of securities.

Exhibit 1: Central Banks Now Very Large Holders of Government Debt

	USA		Eurozone		Japan	
	Holdings $ Billions	% of Economy	Holdings € Billions	% of Economy	Holdings ¥ Billions	% of Economy
June 2008	893	6%	1,463	17%	101,420	20%
June 2016	4,466	25%	3,131	33%	432,759	86%

A positive "wealth effect" on the economy that former Fed chairman Bernanke cited as a reason to inflate financial asset prices is debatable. Renowned economists Karl Case, Robert Shiller, and John Quig found "at best weak evidence" of such effect. The impact on interest rates appears much clearer. Central bank purchases of government bonds have effectively cornered the market for such securities, resulting in record-high bond prices and commensurately lower yields. This year has seen yields plummet globally to the point where over $13 trillion of global government bonds trade at a negative yield.

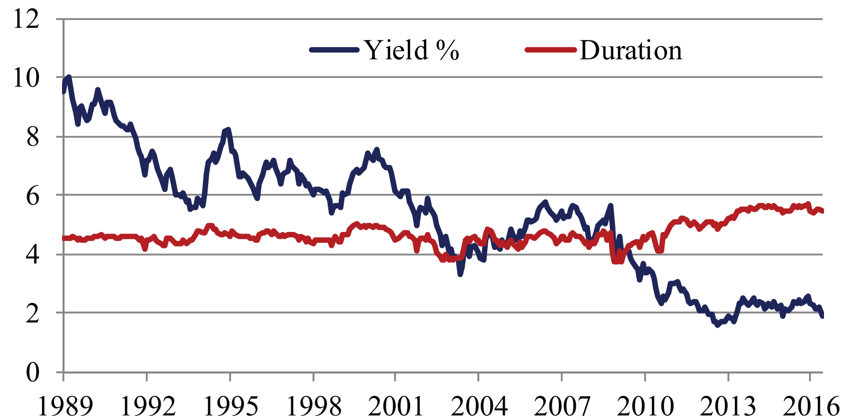
Exhibit 2: A Large Portion of Government Debt at Negative Yield

	Yield to Maturity %				
	2 Years	5 Years	7 Years	10 Years	30 Years
USA	0.58	1.00	1.28	1.47	2.28
Japan	-0.30	-0.31	-0.32	-0.22	0.14
Italy	-0.11	0.29	0.67	1.26	2.27
France	-0.55	-0.36	-0.20	0.18	0.91
Germany	-0.66	-0.57	-0.46	-0.13	0.38
UK	0.10	0.35	0.65	0.87	1.69

If negative bond yields, with guaranteed losses if held to maturity, sound aberrant to you, you're not alone. Its palliative, immediate effect of higher asset prices and easier service of debt comes with the challenge that such conditions can't persist in a normally functioning economy.

Moreover, it likely has a negative effect on long-term economic growth. Negative interest rates are toxic for financial institutions, pensions, and anyone favoring low-risk investments. Unusually cheap financing rates are driving a misallocation of resources, leading companies to acquire competitors and repurchase their own shares rather than compete and make productive capital investments.

For investors, low rates make investing more challenging, with lower returns and higher risk. The bond market's benchmark index currently yields 1.9% with a duration (sensitivity to interest rates) of 5.5. That means index investors could lose almost three years of returns if yields rise by just 1%. It’s a much different proposition compared with historical norm.



Most equity investors have taken a positive view of low rates, claiming that perpetually low rates should justify a price/earnings multiple for stocks well above its historical average. Versus cash and bonds, they've even created a catch phrase – TINA – "there is no alternative". That bullish case for equities relies on stock's relative valuation and yield versus bonds and cash and the belief that central banks will suppress yields indefinitely.

That view takes the point too far for two reasons. While lower interest rates theoretically mean that future corporate earnings are worth more today (hence the higher valuation for the same earnings), it's possible that low rates stem partially from expectations that high debt levels, aging demographics and lower gains in productivity will constrain the economy and cause earnings to grow more slowly in the future (less earnings). Meanwhile, low rates would need to remain for decades, a stretch considering the experimental nature of central bank policy and the eventual strengthening effect of tighter labor markets on inflation.

For now, the "lower for longer" view on yields is driving the market. Six months ago, investors heard guidance from the Fed that short-term rates would soon rise by 1%, with four quarter-point increases during 2016. Those plans have been shelved, and a dovish turn in Fed rhetoric has led investors to expect no further increases until 2018.

Outlook & Strategy

Since our last quarterly update, economic data suggest the economy is tracking in line with our modest growth, non-recessionary, projection. As in recent years, the second quarter has shown an improvement from the very weak start of the year, with measures of industrial production, services, and employment ticking up in June.

We remain defensively positioned across client portfolios, but slightly less so versus three months ago. Cash levels remain above "fully invested" levels but are lower after purchases of several cyclically-oriented and yield-producing stocks that trade at attractive valuations.

With both stocks and bonds markets trading at historically high valuations, we remain mindful that blanket market exposure presents a lower-than-normal reward versus risk proposition. As such, we believe quality stocks that are trading at or below their historical norms present better prospects with lower risk than the market averages.

Global diversification, which normally helps control portfolio risk, appears the most attractive in recent years. Relative performance and valuation suggests investors will be rewarded by this non-consensus position.

Exhibit 4: Global Diversification Presents Better Value than Domestic-Only

	US Stocks		International Stocks	
	Price/Earnings	Price/Cash Flow	Price/Earnings	Price/Cash Flow
Current	19.1	13.2	15.1	10.1
15 Year Avg.	16.5	10.7	14.3	9.2
Premium	16%	23%	6%	10%

The yield premium offered by corporate bonds over treasuries continues to be a prudent risk to take in a non-recessionary environment, and our fixed income strategies remain focused on that portion of the market. With 10-year government bonds yielding less than core inflation, we've positioned fixed income portfolios with shorter than benchmark maturities.

Meanwhile, we continue to believe substantial holdings in assets that have lower volatility and correlation to general market risk, such as cash, gold, and high-yielding preferred stock help control risk while preserving purchasing power should the economic and market dynamic surprise to the downside.

As the remainder of the year unfolds, we'll continue to make portfolio adjustments as the fundamental picture suggests. We're watching economic data for confirmation that the current, historically mature, cycle remains in growth. And we'll monitor the so-called "reaction function" of central banks to the evolving economic and market landscape. If the Fed is as "data dependent" as they claim, they and investors may soon contend with the upward effect that tighter labor markets may have on inflation. With unemployment and core inflation already at the Fed's targets, there is a real possibility that "low rates forever" currently serving as accepted market wisdom may need revision.

Finally, we expect political change will have over time an increased effect on the economy and markets. The recent referendum that may result in the UK leaving the European Union is an example of the societal and political strain most developed countries face as a consequence of slow growth, high debt levels, and demographic headwinds. Electorates are rejecting the status quo in favor of populist, anti-trade political alternatives in hope of restoring conditions to a more favorable time. Recent trends suggest we need to expect the unexpected.

We hope this review of the economy, capital markets, and investment strategy helps inform you on how we're investing your assets to achieve prudent risk-adjusted returns. Please contact us if you would like to discuss the outlook for capital markets and the investments of your portfolio. We would welcome your call.

Best regards!

Jeffrey E. Bernardo   Neil J. Sullivan   Frederick M. Blum   Austen P. Cornell   Milena D. Spasova

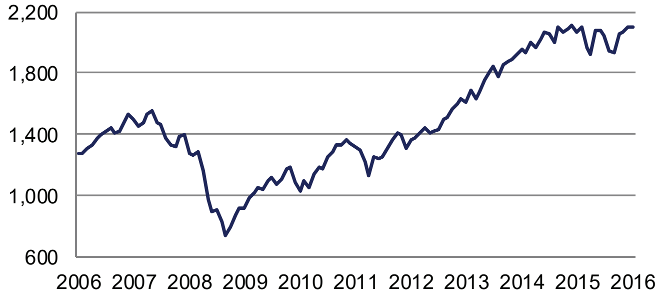


Chart 1: S&P 500 Index
2,200
1,800
1,400
1,000
600
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

Chart 6: US Unemployment Rate %
11
10
9
8
7
6
5
4
3
2
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

Chart 2: US Treasury 10 Year Yield %
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

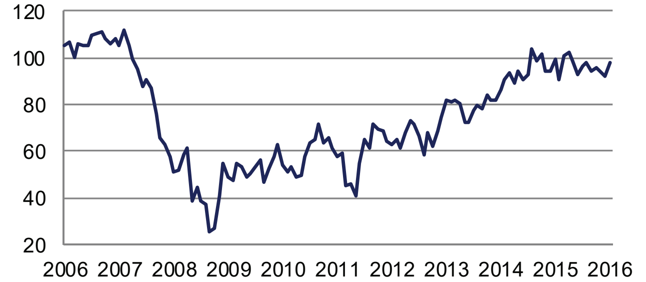


Chart 7: US Consumer Confidence Index
120
100
80
60
40
20
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

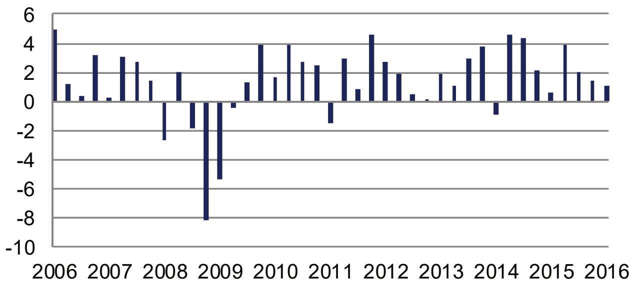


Chart 3: US Annualized GDP Growth %
6
4
2
0
-2
-4
-6
-8
-10
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

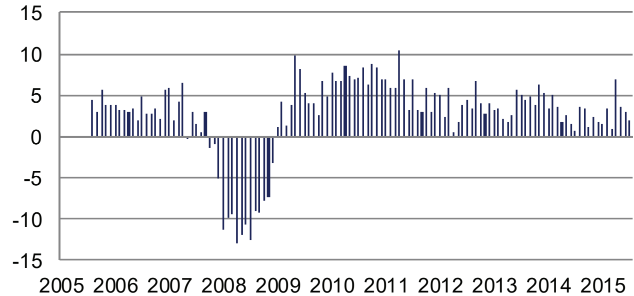


Chart 8: US Retail Sales Growth %
15
10
5
0
-5
-10
-15
2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015

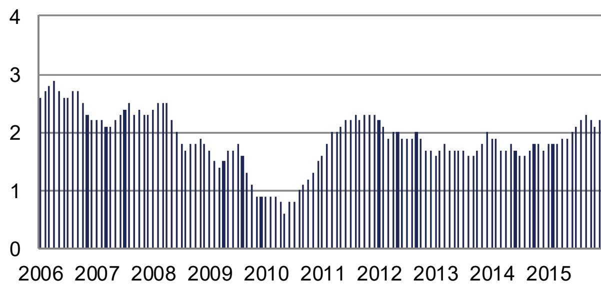


Chart 4: US Core Consumer Price Index %
4
3
2
1
0
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015

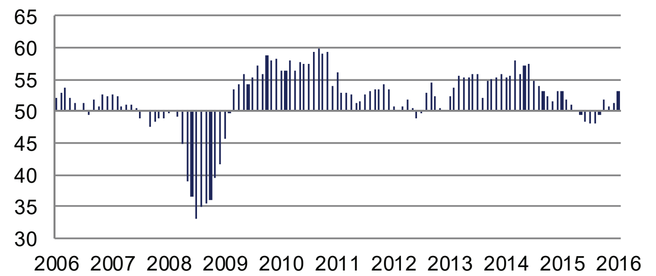


Chart 9: US ISM Manufacturing Index
65
60
55
50
45
40
35
30
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

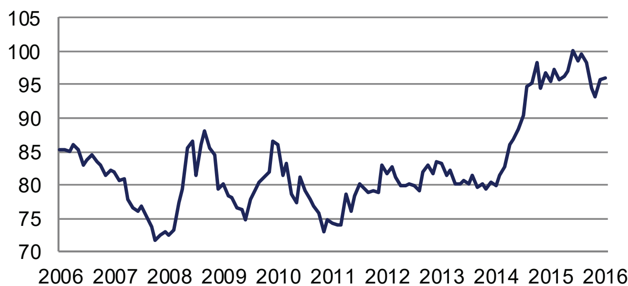


Chart 5: Trade-Weighted US Dollar Index
105
100
95
90
85
80
75
70
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

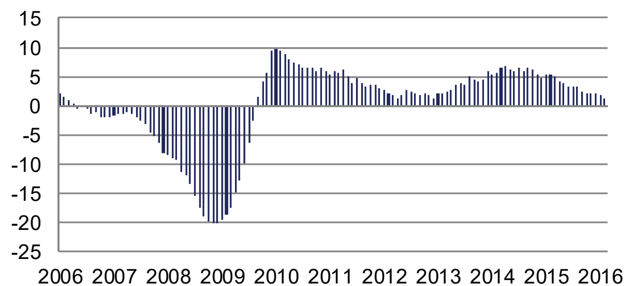


Chart 10: Conference Board Leading Index
15
10
5
0
-5
-10
-15
-20
-25
2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016