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Update on Current Market Conditions

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The stock and bond market's performance in the second quarter of the year should leave no doubt that the markets know much more about the condition of the underlying economy than the US Federal Reserve apparently does. Over the course of just the first half of the year we have seen Fed policy makers vacillate from raising interest rates, to not raising, to wanting to raise, to now not raising. Confused? So were most investors as well as their financial advisers. Much of the volatility that we have witnessed during the year so far is simply portfolio managers trying to ascertain what the central bank's policy outlook really was. Through it all the market was able to realize and price in what was actually taking place. Our previous prediction of the US economy gathering strength into the second half of the year is proving correct. Our stock market, whose current prices reflect the expected economic and earnings environment six to nine months into the future, has been moving higher in anticipation of that earnings and revenue recovery. In many ways the actions of world's central banks remain the biggest risk to the markets as any policy error on their part, as we just saw last December, would again have significant negative consequences.

Even with our markets now making new all-time highs, a number of key sectors remain well below their previous historic highs. Despite their substantial dividend yields, the telecommunications group is still 46% below its highs last seen way back in 1999. Far from being overvalued, the technology sector is still down 26% from its early 2000 highs. More understandable is the financial group which is off by 39% from their pre financial crisis highs of 2007 and the same can be seen with the energy sector now trading 31% off their 2014 all-time highs due to the recent fall in crude oil prices. Compared to the previous market highs back in May 2015 some key economic inputs have changed. US Treasury 10 year bond yields have fallen from 2.25% to 1.50% and the price of a barrel of oil has declined from \$59 to \$45. Both of these factors should continue to stimulate growth and reassure consumers and businesses alike. There are several sectors that I feel still offer clients that compelling combination of growth and value. In healthcare, the large cap pharmaceuticals have strong growth and rich dividends. In the industrial and manufacturing sector several names still trade at near recessionary values and any increase in overall economic growth will give them a dramatic jump in earnings. Another

sector that has seen tremendous losses is in retail. While stores that have substantial exposure to apparel sales have seen the greatest share price declines, we are observing growing strength in home furnishings and home improvement. The energy and financial sectors, which we were avid buyers of in the first quarter, have recovered much of their earlier losses and are now relatively fairly valued. The markets are making new highs, not because of a sudden realization of robust economic health, but because stocks are simply becoming more expensive. The underlying cause for this increase in valuation and the corresponding expansion of the market's price to earnings ratio, is the continuing decline in long term interest rates. Historically, when inflation is low the quality of corporations earnings are considered to be higher and more valuable as they are not artificially enhanced by inflation. Actual organic growth trumps the artificial growth of inflationary pricing increases and therefore investors are willing to pay more for it.

While many individual investors have had their financial advisers hold substantial cash reserves, institutional investment managers have to be in the market continuously as they are compelled to meet certain pension and insurance obligations. The monthly inflows into these funds are enormous and significant as it has helped keep a floor under the market and has also helped move it higher. This type of forced buying carries its own unique set of risks. Even as the market hits new record highs, the average pension fund remains about 24% short of the amount required to fulfill their benefit liabilities. Not only are these pension funds underfunded, but the way they calculate future returns are also unrealistically optimistic. Corporate and public pension plans are also held to different accounting standards. If they were treated equally, according to American Enterprise Institute, the state and local yearly contributions would have to double to make up the shortfalls. This lack of necessary funding has dangerous consequences as these underfunded pension funds are compelled to invest in increasingly risky asset classes such as hedge funds, futures and commodity trading and complex financial derivatives.

After experiencing declines over the last nine months, corporate earnings should begin to recover in the third quarter. Current estimates for this quarter predict S&P 500 earnings to increase by 1.3% and revenues to grow by 2.3%. As previously stated in my last letter, the absence of additional Fed rate hikes has not only taken the risks of a US recession off the table, but it will also allow economic growth to strengthen. Signs of growth are already showing up in healthy gains in retail sales, increasing consumer confidence and improving job creation. If the governments of the major advanced economies decide to shift from their current monetary stimulus stance, such as what we have seen with currency devaluations and quantitative easing, to a fiscal stimulus policy, equity prices will head even higher. As with every investment, you the investor, have to be adequately compensated for the potential risk you are willing to take on. The high quality dividend paying multinational corporations will provide the best risk reward ratio to capture future domestic and overseas growth all the while getting a reliable stream of income far exceeding the returns on interest bearing US government treasury bonds.

According to a recent study by Goldman Sachs, dividends will play an even greater role in determining an investor's future total return. Using the S&P 500 index as its benchmark, they anticipate over the next ten years share price appreciation will account for 54% and dividends for the remaining 46% of the indices' total return. Having a portion of a portfolio's equity allocation that trades at a lower valuation than the broad market while still paying a higher than average dividend yield remains, for many investors, the most astute way to achieve long term growth and generate income simultaneously.

The global decline in interest rates and the effect that this has had on income dependent investors remains widespread and pervasive. As of today, we now see 94% of the world's sovereign debt trading with yields below 2%. Of that amount nearly \$14 trillion dollars pay a negative yield which are interest rates of less than zero. How low have interest rates gone? Historically, looking at debt issued by all governments, average interest rates globally are, according to renowned bond manager Bill Gross, now at 500 year lows. This has resulted in an almost frantic search for higher returns with investors and their advisers trying to justify the increasing degree of risk that they know come with those higher yields. One of the reasons the shares of so many dividend paying stocks continue to climb is this ever growing need of investors searching for a reliable stream of income.

There is another force at work here that is either being overlooked or not fully recognized. Along with the search for growth and income, there is an increasing desire to find and buy competency. Governments are spending money they don't have, adding to already enormous outstanding debts. Central banks continue to pursue policies designed to devalue their currencies, by printing money in to manipulate their country's bond markets. Political gridlock that can't or is unable to agree on any coherent fiscal legislation. What investor would want any of these organizations running any business let alone buy the debt that they want to sell you. If the US government were a corporation would you invest in the shares of that company? Of course we all would like to say yes, but why should you? Not when you could invest in companies like an AT&T, Pfizer, Intel or any one of over a hundred extremely well run global corporate giants. These firms are run by the very best and most competent financial minds we have. They are accountable to you, the shareholder, every three months when they release their most recent earnings, not by an election held every four years where promises made are no longer remembered. Add in the lower tax rate on qualified dividend income, and these stocks are even more appealing to all but the most risk adverse investors. So for the rest of the year, our stock selection process will continue to remain the same. Beginning always with a top down sector valuation analysis, which allows us to find where value and growth are best represented in the market. Using fundamental analysis, which is the study of earnings, revenues and underlying financials, allows us to identify which stocks best reflect our risk and reward profile. The final step is the application of technical analysis, the study of price, volume and trading history, which tells us when the best time is to buy that particular stock.

Yes, risks do remain. Especially given the current lofty market valuations and any possible changes in monetary policy. I share the view of many economists that there are few remaining fiscal and monetary tools left for the US government to use in dealing with any future crisis. With short term interest rates still near zero and long term rates just recently making all time historic lows, the Federal Reserve reminds me of a gunfighter from the Old West standing in the middle of the street that doesn't realize he has no bullets left. The same can be said for the ability of the rest of the government to borrow additional funds to pursue any further attempts to stimulate the economy. Already high levels of public debt and growing budget deficits make any further spending politically unacceptable. One concern that remains is that any further interest rate hike will cause the US dollar to rise in value versus other currencies. In many ways, a strengthening dollar is in effect an additional monetary policy tightening as it makes our exports and commodities less competitive as well as the reducing the value of the international sales of US companies.

At home and abroad, dramatic changes taking place in the political landscape will present investors with another set of risks that we will have to account for. For example, global stock markets sold off dramatically after the British people voted to leave the European Union. Stocks traded on the London exchange took the brunt of the selloff but in many ways it was uncalled for. The weaker British currency only makes that country's corporations all that more competitive globally as only 21% of their revenues come from within their home country. Despite their ongoing political drama, European stocks trade at a substantial discount, by 20% to 25%, in valuation when compared to our domestic equities. At the same time, they offer dividends on average 40% higher. By comparison, non-US based corporate income streams are valued significantly cheaper than those here at home, making investment opportunities abroad quite compelling.

On the fixed income side of your portfolio there are a number of ways to diversify your bond portfolio away from the low yielding and artificially manipulated US treasury market. Clients that have a municipal bond allocation have done very well over the last six months with a combination of unrealized capital gains as well as substantial tax free income. All bonds are not the same, while US government bonds are considered by many to be overvalued, investment grade corporate and foreign bonds and municipal bonds issued by your state are excellent alternatives that we can use to diversify the income allocation of your portfolio. Complacency, and a belief in the longevity of the status quo is a subtle but very real threat to every portfolio. It is also equally true that however compelling any single stock or sector may be when viewed in isolation, the health of the overall economic landscape must remain a key component of any investment decision. Therefore, as your portfolio manager, I am fully aware of my responsibility to anticipate and navigate the numerous crosscurrents that still lie ahead. Every risk to the downside will eventually create its own potential reward and when those opportunities are acted upon decisively, they will ultimately allow us to achieve your individual investment objectives.