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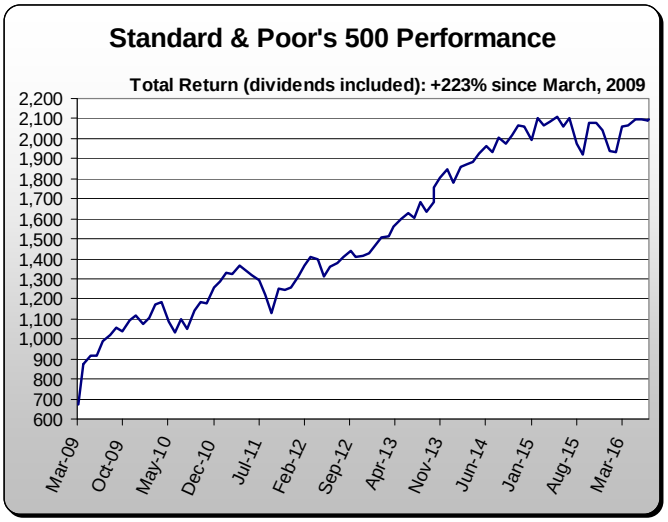
INVESTMENT COMMENTARY

Summer, 2016

—Russell B. Dow, J.D.
Private Account Portfolio Manager



Now, it's all about interest rates.

Dear Client:

Brexit was not supposed to happen... according to the experts. Regardless, after Great Britain shocked the markets with its vote to leave the E.U., media-anointed authorities then assured us that prolonged "uncertainty" would keep the markets riled and that a sell-off was inevitable. At least they were accurate with their second assessment—disregarding that their prediction was for a sell-off already underway.

For those who judiciously avoid the news: The market debacle was a brief two-day affair, dropping -5.8% from peak to trough. Fortunately, doomsdays are more often feared than actually lived. A week later, stocks fully recovered.

That is not to say that Brexit and the sorry state of the E.U. don't have consequences. But their implications differ vastly by country and investment. Some will be stressed, others will benefit. The Saturday after the vote, I was returning from Hungary. On the way to the airport, I passed a line of apparent retirees stretching down the road outside a bank, hoping presumably to make withdrawals. That is not mere stress. That is distress. Yet back in the U.S., the knock-on effect looks to be almost sanguine.

From our vantage point:

U.S. Dollar & Inflation: The dollar soared against other currencies. Effectively, then, Brexit means that our imports now cost less. That, in turn, should help mitigate the rate of inflation increases over the near term.

Interest Rates: A lowered outlook for an acceleration in the rate of inflation over the short-term probably means that the Federal Reserve will not raise interest rates in the immediate future. Following Brexit, rates plunged to record low levels: The U.S. 30-year bond yield dropped to an unprecedented 2.1% percent, while the benchmark 10-year yield is now just 1.4%.

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How low are record lows?

Factor in the Fed's 2% inflation target, and the U.S. government can borrow $1,000 for a negligible $1 per year. We consumers are not left out of the free-money party. Mortgage rates are down again. Subtract out both inflation and the home mortgage interest tax deduction, and homebuyers can borrow at essentially no cost.

That is fuel for the U.S. economy, stimulating demand by putting more money into consumers' pockets, and cutting financing costs for businesses.

Low borrowing costs are, also, an incentive for corporations to continue with debt-financed stock buyback programs. Such buybacks are often maligned in the media because they are expenditures that do not add jobs in the weak economy. True, they are not what we would like to see optimally. But, for shareholders, buybacks concentrate ownership, and hence earnings, among fewer investors.

Flight to Quality: During times of stress (and distress), money seeks safe havens.

Where does the international financier invest prudently today?

- *Probably not in Europe*, which is suffering from the afore-mentioned Brexit, the risk of similar defections from the trading bloc, and negative interest rates;

- *Probably not in the Asian emerging markets*, which are suffering from bloated amounts of dollar-denominated debt (which now will be even harder for them to repay because of the dollar's appreciation);

- *Probably not in the Middle East*, which is suffering from a collapse in oil prices and a growing inability to afford its pervasive social welfare system;

- *Russia, ditto*;

- *Probably not Latin America,* which is suffering from a panoply of maladies.

The U.S. wins, then, if only by default—and even if one were unenthused by our political landscape. As overseas investors seek safety, they may well help keep upward pressure on U.S. stock prices.

Asset Class Risk: There is no risk-free way to store wealth. But some strategies seem to hold far more peril than others.

<u>*Cash*</u>: Earning the current 0% interest rate with the Federal Reserve targeting a 2% inflation rate means that $100,000 would be worth, in inflation-adjusted terms, $82,000 in 10 years. That scenario is subject to change. But, with Brexit, current prospects have changed only for the worse.

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Bonds: 1% to 2.3% are the current rates for high-quality government bonds; about 2.5% to 4% for high-quality corporate bonds. Factor in taxes and projected inflation, and any residual for investor profit is miniscule, at best.

A caveat: to earn the "lofty" higher interest rates in those ranges, an investor would need to tie his money up for 30 years. That creates enormous downside interest rate and inflation risks.

It is not surprising, then, that current headlines read:

- *Cantillon: just when will bond 'supernova' explode?*
- *Bond market is in an 'epic bubble of colossal proportions,' says Boockvar*

In short, bonds seem to hold the risk of a ticking time bomb.

Common Stocks: Stocks are no panacea. U.S. economic growth appears to be slowing from an already tepid pace. Analysts project 2016 GDP to grow by about 1.8%, down from 2.4% in 2015.*

Nonetheless, that would be forward momentum and not a recession.

As I've written before, stocks still appear to be the "least bad" option for a slow-growth, low-interest-rate economy.

The potential advantage of stocks: When the economy recovers, shareholders stand to gain. If the economy stumbles into a recession, the Fed may, once again, be tempted to open the floodgates of cash and force even lower interest rates. That could help to dampen downside risk.

* * * * *

So, if your portfolio is primarily dominated by U.S. stocks, as we recommend; and if those stocks primarily carry high-quality S&P A-ratings, as we recommend, then we might take comfort that these are the kinds of investments many investors worldwide probably wish they owned. Such a portfolio is, at least, better than standing in line at a bank of questionable solvency.

Thank you, and we wish you a most enjoyable summer.

Most sincerely,

Russell

Russell B. Dow, J.D.
President & Senior Portfolio Manager

*http://www.kiplinger.com/article/business/T019-C000-S010-gdp-growth-rate-and-forecast.html