



Episode 38

A Market Review of the Second Quarter of 2016, and an Outlook for the Rest of the Year

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Financial market volatility continued during the second quarter primarily driven by the surprising outcome to the U.K. Brexit vote. For the quarter, the S&P 500 gained 2.46 percent, bringing the year-to-date return to 3.84 percent. Smaller stocks, as measured by the Russell 2000 Index, managed to break into positive territory for the year-to-date with a return of 2.22 percent. The NASDAQ Composite Index, however, continued to struggle with a decline of 2.66 percent. Higher yielding stocks continued to perform the best with the S&P utilities and telecom sectors up approximately 20 percent year to date, their best start since at least 1990. Emerging market stocks, as measured by the MSCI Emerging Markets Index, increased only slightly in the quarter, up 0.81 percent, but they are still up 6.67 percent for the year.

Bonds, as measured by the Barclays U.S. Aggregate Bond Index, had another strong quarter, returning 2.21 percent, bringing the year-to-date total to 5.31 percent. Credit-sensitive areas continued to perform well with emerging-market debt, as measured by the JPMorgan Emerging Markets Bond Index Global, returning 11.55 percent and high-yield bonds returned 9.74 percent for the year. California muni bonds, as measured by the Barclays California Municipal Bond Index, performed well and are up 4.33 percent for the year. At the risk of sounding very repetitive, the 10-year U.S. Treasury note fell once again during the quarter from 1.77 percent down to 1.47 percent.

Many of the trends we witnessed in the first quarter continued into the second quarter. Investors lowered their expectations for global growth rates slightly, at least in the short term, driven by the Brexit vote causing global yields to decline once again. (For more details on our thoughts and implications for Brexit, please listen to our podcast released on June 27 available on kayne.com or iTunes). The yield curve has continued to flatten which essentially throws into question just how much flexibility the Fed really has to “normalize” interest rates at the short end of the curve.

In response to the potential economic uncertainty created by the Brexit vote, any further interest-rate increases will be very modest at best. It has become increasingly clear that we are in a steady, but slow, global growth environment and this is causing the Fed to reassess what “normal” really means for monetary policy today. Many countries (Switzerland, Germany, France, and Japan to name a few) already have negative interest rates which continue to make our paltry interest rates look attractive for foreign investment. Central banks need help from fiscal policies around the globe in the way of pro-growth initiatives and structural labor and corporate tax reforms in order to stimulate better growth globally.

Our forecast, however, for 2016 remains unchanged. We believe the domestic economy will grow at a very modest rate in the range of 1.5 to 2.5 percent and corporate earnings growth will grow in the mid-single digit range. Our confidence is growing that oil has finally bottomed because domestic shale producers and major international oil companies have announced dramatic reductions in capital spending on the order of 40 to 70 percent. These supply reductions combined with natural depletion rates will ultimately reduce excess supply. Importantly, stability in the price of oil and the U.S. dollar will help stabilize reported profits for companies in the S&P 500. Stability is needed in oil and the dollar in order for equity markets to generate returns in line with earnings growth. We continue to believe that equity returns for the S&P 500 will be in the five to seven percent range for the year as long as energy prices remain fairly stable. Despite these fairly modest overall equity returns, there continues to be significant dispersion among sectors. Sectors close to or in a recession over the last two years (such as oil and gas, manufacturers who export, industrial companies, and many railroads) continue to



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show some stability this quarter, but they have yet to materially improve. Given this environment over the last two years, stock selection has become paramount and, subsequently, many of our investment strategies are performing very well on a relative and absolute basis. As always, we will attempt to use this sector volatility to our clients' advantage.

Investors are finding it increasingly difficult to capture yield and continue to bid up higher yielding sectors as fixed-income yields shrink. Additionally, two-thirds of the S&P 500 now yields more than a 10-year bond. Lower interest rates have continued to pressure banks' net interest margins in the U.S. and particularly in Europe.

As we have experienced thus far this year, it is likely to continue to be a volatile year for financial markets. Repercussions from the Brexit vote and our own presidential elections are likely to cause continued market volatility over the next six months. However, we remain steadfast in our high-quality orientation as we have done through good and bad times over the last three decades. We thank you for your continued trust and confidence and would welcome any questions you may have.

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