MARKET AND ECONOMIC OUTLOOK

July 2016

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# Brexit Uncertainty and Opportunities, U.S. Election, and Evolving Health Care

The waning days of the second quarter of 2016 brought capital market participants a surprise in the form of the Brexit, Britain's momentous decision to leave the European Union (EU). We must acknowledge that the "leaves" outnumbering the "stays" in the U.K.'s referendum is not the result we, nor many political and economic analysts, expected. But the result ushers in a period of political, economic, and market uncertainty for the U.K., EU, and economies and markets worldwide. In addition, there are legitimate concerns with Brexit's domino effect, in which other countries may host similar "leave or stay" referendums. While only a couple of weeks ago it seemed inconceivable to consider the dissolution of the EU, that potential outcome is no longer so implausible. And yet, there are a few optimistic points worth considering:

- We see sell-offs in global risk assets as buying opportunities in the United States and Europe, where many world class companies with global franchises are domiciled.
- We acknowledge that there are likely to be negative consequences to the European economy. However, the U.K. only represents about 4 percent of global gross domestic product. So, by itself, a slowdown in the U.K. is not highly material to U.S.-based investors. A slowdown in the EU may also occur, as it was already at risk of recession. Accordingly, we expect the European Central Bank (ECB) to be very aggressive in its response in an effort to avoid a slowdown.
- Better investment opportunities occur when there is uncertainty and market volatility. Conversely, future returns are rarely attractive when markets have been strong, as they have already priced in a healthy economic outlook. While unnerving, market volatility is actually setting the table for better returns going forward. We'll use this environment to opportunistically rebalance portfolios back to targets.

The vote does not change our desire to remain globally diversified. However, it does reinforce our view on the importance of including other asset classes like high quality bonds and alternative investments (i.e., different from traditional stocks, bonds, or cash) in portfolios where appropriate. Exposure to these nontraditional assets can be highly beneficial to portfolios during market downturns as well as over the long term.

| Positives | Negatives |
|---|---|
| Employment is strong | Brexit creates cloud of uncertainty over U.K. and eurozone area economies and markets |
| Housing prices continue to firm | U.S. dollar continues to strengthen, hurting overseas earnings and exports |
| Light vehicle sales at all-time highs | U.S. stocks are no longer cheap, future return expectations are below historical averages |
| Energy costs, gasoline, natural gas prices falling | Geo-political concerns; specifically, terrorism |
| Low financing costs continue | Fear of Chinese slowdown, impact on global economy |
| Low inflation | |

While in hindsight it may seem that reducing equity exposure in portfolios would have been prudent in anticipation of Brexit, we must reiterate what we have said in previous issues of *Market and Economic Outlook*: that markets cannot be reliably timed. It is just as likely that the markets would have rallied upon a vote to stay. The only certain outcomes from attempting to time the market are additional transaction expenses, and tax consequences in taxable portfolios.

Furthermore, selling after the market is down is a surefire way to impair performance. Upon selling, the question then becomes when to get back in — which usually occurs after the market has moved up, exacerbating the impact of the volatility.

The U.K.'s decision to leave the EU brings long-lasting political and economic consequences. We fully agree with BlackRock's viewpoint that European leaders will be forced to focus on fending off domestic populist movements emboldened by the British exit, and on preventing the entire EU edifice from crumbling. Contentious debate is certain to be part of any trade deals and debt arrangements between EU participants. Our suspicion is that those who believed in leaving the EU for better trade terms are likely to be disappointed as policy makers have a strong incentive to make an example of the U.K. to dissuade others from following suit. Beyond trade, it seems fairly clear that immigration is at the center of the populist movement. Indeed, it is difficult to ignore the similarity of those movements with the political debate here in the United States.

### Brexit impact on the U.S. economy

We see minor impact on the U.S. economy. That said, it seems to us that the Federal Reserve will again be forced to defer any decision to raise short-term interest rates. In fact, the United States actually benefits from the uncertainty in Europe, becoming the clear safe harbor for investors domiciled elsewhere. A quick look at the pricing of U.S. Treasuries and many high-grade corporate bonds confirms the global appetite for our debt when equity markets are under stress. Though the Fed may want to raise rates in the future, the market is pushing Treasury yields to historic lows. We expect them to stay there for the foreseeable future.

Conversely, we expect the euro to become steadily weaker, which should help provide a modest positive economic offset to weakened lending and labor conditions in Europe.

So while the vote to leave the European Union has created uncertainty and unsettling volatility, we view it as an opportunity to rebalance portfolios. The impact on the EU is likely to be significant, but its impact on the U.S. economy and capital markets is not likely to be wide reaching or much more than temporary to domestic investors.

### Uncertain Fed and strong dollar roil capital markets

Beyond Brexit, the second quarter was marked by a fascinating set of cross currents that made navigating the capital markets quite tricky for investors around the world. One example was the outlook as to when the Fed would raise interest rates. The Fed made what were widely perceived as "dovish" comments in April, indicating that it would likely not raise rates any time soon. In May, however, the Fed turned noticeably "hawkish," indicating that it may raise rates soon, on the heels of positive economic data releases, including better-than-expected manufacturing indicators, encouraging retail and home sales data, and improved consumer sentiment. The interplay of the Fed's extraordinary monetary policies and the perception of how and when to change them continues to be a fast-moving and difficult-to-predict challenge for investors.

Other cross currents included the continued strengthening of the U.S. dollar. While this is a boon for our clients planning European vacations, a too-strong dollar creates some havoc in the global economy and hurts our domestic exporters. The International Monetary Fund (IMF) recently stated that the U.S. dollar is already 10 – 20 percent higher than economic conditions warrant, and Brexit-related concerns may only exacerbate this issue. In markets outside the U.S., concerns regarding China's slowing economy caused some turmoil in emerging market stocks, while economic growth data (manufacturing and inflation) in the U.K. and Europe, though positive, were less robust than analyst expectations.

In U.S. stocks, the large company S&P 500 index posted a nearly 2.5 percent gain for the second quarter, leaving the year-to-date gain at 3.8 percent. Small company stocks, as measured by the Russell 2000 index, moved into positive territory for the year (2.2 percent year-to-date) after returning 3.8 percent for the quarter. International developing market stocks (the MSCI EAFE index), again owing partially to Brexit, posted a loss of 1.5 percent for the quarter, and are now down nearly 4.5 percent for 2016. Emerging market stocks were volatile during the second quarter, but finished with a slight gain of 0.7 percent and are up a healthy 6.4 percent for the year.

In fixed income markets, government bond yields fell dramatically toward the end of the quarter, with the bellwether 10-year U.S. Treasury note closing at under a 1.5 percent yield. The broad U.S. bond market, as measured by Barclays Aggregate Bond index, posted a 2.2 percent gain during the quarter and now stands at 5.3 percent year-to-date.

## Choosing municipal bonds for fixed income

With our low interest rate environment showing few signs of subsiding, investors are likely to remain keen for the tax-advantaged income of municipal bonds (also known as munis). An allocation to municipal bonds, where appropriate, can improve a portfolio's efficiency and provide reliable income.

The after-tax benefits of municipal bonds have long made them an attractive asset class for high net worth investors. At the end of the quarter, the yield for the 10-year, AAA-rated municipal bond index stood at 1.34 percent. Perhaps this is not a number that jumps off the page, but consider that the tax-equivalent yield for an investor in the highest federal marginal tax bracket (39.6 percent) is 2.22 percent. If that same investor resides in a state with a 7 percent tax rate, the tax-equivalent yield jumps to 2.39 percent. When you note that the federally taxable 10-year U.S. Treasury note stood at 1.45 percent, the after-tax advantage of high quality municipal bonds is obvious.

Another potential advantage of municipal bonds is lower portfolio volatility. Historically, munis have exhibited lower volatility than most fixed income categories and for the trailing one-year period ended March 31, 2016, they were significantly less volatile than even U.S. Treasuries. Munies also tend to be less sensitive to the Fed's gyrations on interest rates changes, and their default rate is quite low. BlackRock reports that for the 10-year period ending 2015, only 0.24 percent of municipal bond issues defaulted, compared with more than 11 percent of corporate bonds.

Muni bonds can also provide a portfolio with a ballast-against-equity risk. They have exhibited a negative correlation to the S&P 500, meaning their prices tend to move in the opposite direction of stocks. An analysis done by BlackRock showed that in the 11 months since 2011 in which U.S. stocks had a negative return, munis were up 0.8 percent on average, which was even a higher total return than provided by taxable bonds.

Apart from the potential long-term portfolio benefits, municipal bonds appear to be well-positioned in terms of supply/demand and sentiment perspective. According to Nuveen Asset Management, the new supply of muni issues hitting the market has been easily absorbed for investors. Demand remains strong, with the flow of investment dollars into munis for the first quarter of 2016 being nearly double that of 2015.

## A look at health care, an industry in transition

The American health care system is an undeniably vital industry and an enduring bright spot in our economy. But like the global economy in the wake of the Brexit vote, it is undergoing tremendous change. It is also an industry beset by many challenges — regulatory, legal, political, and technological, to name a few.

| Health Care Industry Statistics | |
|---|---|
| Annual revenue total | $1.668 trillion |
| Number of health care companies in the United States | 784,626 |
| Number of health care company employees in the United States | 16.79 million |
| Average health care company employee salary | $39,400 |

*Source: U.S. Census Bureau, Statistic Brain Research Institute, March 2016*

**Mike Slavik**
**Chief Industry Officer, Health Care**

According to Mike Slavik, CLA's chief industry officer for health care, there is an important evolution happening in the industry that he describes as a shift in provider payment focus from volume to value. It is a move from being paid for the volume of services delivered to being paid based on the *quality and cost* — or value — of services provided.

An important facet of the volume-to-value shift can be seen in health care billing and payment practices. Under the current system, each provider is typically paid a separate fee for every service provided, as is historically customary for governmental and many commercial payers. Health care reform initiatives are changing this practice. Rather than getting paid for each specific service provided, health care providers are paid under a global payment model or budget. They are asked to manage the total cost and care for their patients, and are rewarded financially for providing better quality services and/or outcomes of the care delivered. These new payment models and their incentives are disrupting the health care delivery system as success is dependent upon the ability of providers to communicate, collaborate, share information, and coordinate care across the spectrum of health care providers. While this new collaboration among providers is positive for patients, it is much more challenging for providers to predict and manage their revenue and bottom line.

"This shift leaves organizations with an important question," Slavik says. "How are we going to manage capital during this shift from volume to value and the transformation of our care delivery models?"

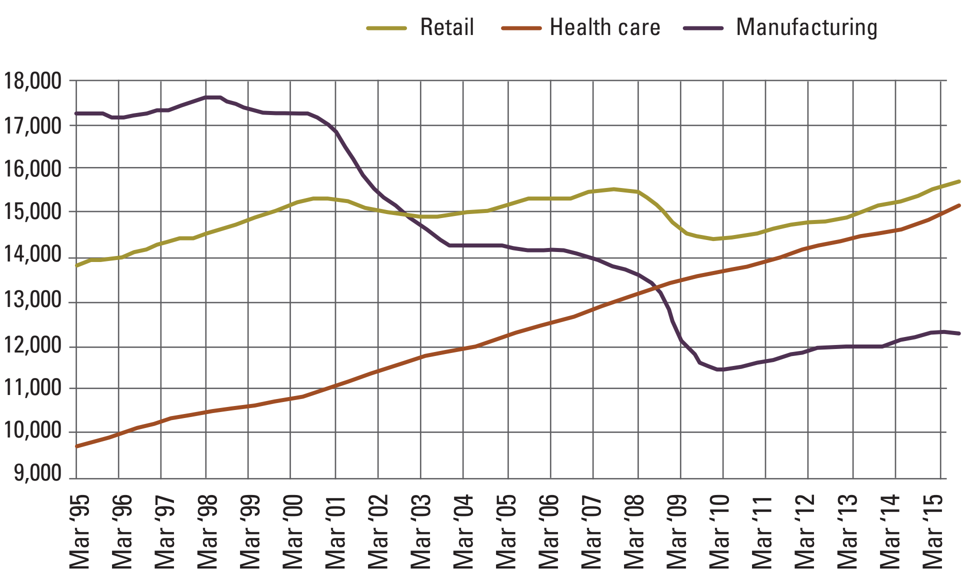
Perhaps the good thing in the midst of these capital management challenges is the amount of capital available to the health care marketplace right now, and the many institutional investors that are aggressively seeking opportunities. Demographics play a role here, too, as investors seek to take advantage of the fact that 10,000 people in the U.S. will turn 65 every day until 2050.

Slavik says merger and acquisition activity is likely to continue as providers look to position themselves in the evolving health care landscape. This is likely to entail both horizontal and vertical integration, and will also likely include other consolidators such as private equity groups and real estate investment trusts (REITs). In fact, REITs are building portfolios of health care entities (skilled nursing providers, specialty physician practices, for example), further enticing investors chasing those fields.

In addition, the aging demographic is attracting other organizations to enter the health care field. Interest in health care is expanding as seen by developers who previously focused on the hospitality industry are developing assisted or independent living communities and Fortune 100 companies are developing health care related products and services.

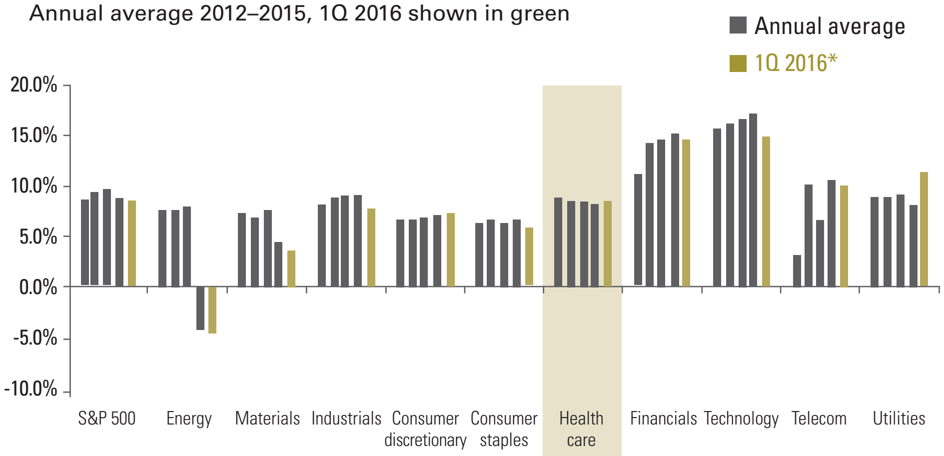
**Health Care Sector Job Growth, 1995 – 2015**

Total jobs by sector (000s)




*Source: Bureau of Labor Statistics*

## S&P 500 Operating Profit Margins by Sector




*Sources: FactSet, J.P. Morgan Asset Management, Bureau of Economic Analysis, Standard & Poor's.*

** 1Q16 profit margin estimates are Standard & Poor's consensus analyst expectations, based on actual revenue and earnings for the 98 percent of Standard & Poor's companies that have reported and estimates for the remaining 2 percent of companies.*

Guide to the Markets — *U.S. data are as of June 30, 2016.*

"They are positioning themselves as disrupters within the industry as they look to benefit from the aging population and the redesign of the health care delivery model," Slavik says. He adds that we are also witnessing a tsunami of emerging technologies in the health care field. One example: Google is developing a contact lens that not only corrects your vision, but also measures blood glucose levels. These emerging technologies have the potential to improve care, and Slavik believes they may also become investment opportunities.

## Health Care Weight in the S&P 500

| | Financials | Technology | Health Care | Industrials | Energy | Consumer Discretionary | Consumer Staples | Telecom | Utilities | Materials | S&P 500 Index | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **S&P weight** | 15.7% | 19.8% | 14.7% | 10.2% | 7.4% | 12.3% | 10.6% | 2.9% | 3.6% | 2.8% | 100% | |
| **2Q 2016** | 2.1 | -2.8 | 6.3 | 1.4 | 11.6 | -0.9 | 4.6 | 7.1 | 6.8 | 3.7 | 2.5 | Return (%) |
| **YTD** | -3.0 | -0.3 | 0.4 | 6.5 | 16.1 | 0.7 | 10.5 | 24.8 | 23.4 | 7.5 | 3.8 | Return (%) |
| **Since market peak** (October 2007) | -23.3 | 88.6 | 134.8 | 58.1 | 7.1 | 139.2 | 149.9 | 58.1 | 80.8 | 31.4 | 62.2 | Return (%) |
| **Since market low** (March 2009) | 318.9 | 295.1 | 278.5 | 334.6 | 96.1 | 453.7 | 250.5 | 202.0 | 216.4 | 213.0 | 262.4 | Return (%) |

*Sources: Bureau of Labor Statistics, FactSet, J.P. Morgan Asset Management*

*Information, Financial, and Business Services = Information, financial activities, and professional and business services; Manufacturing, Trade, and Transportation = Manufacturing, trade, transportation, and utilities; Leisure, Hospitality, and Other Services = Leisure, hospitality, and other services; Education and Health Services = Education and health services; Mining and Construction = Natural resources mining and construction; Government = Government. Aging effect on the labor force participation rate is the estimate number of people who are no longer employed or looking for work because they are retired. Cyclical effect is the estimated number of people who lose their jobs and stop looking for work or do not look for work because of economic conditions. Other represents the drop in labor force participation from the prior expansion peak that cannot be explained by age or cyclical effects. Estimates for reason of decline in labor force participation rate are made by J.P. Morgan Asset Management.*

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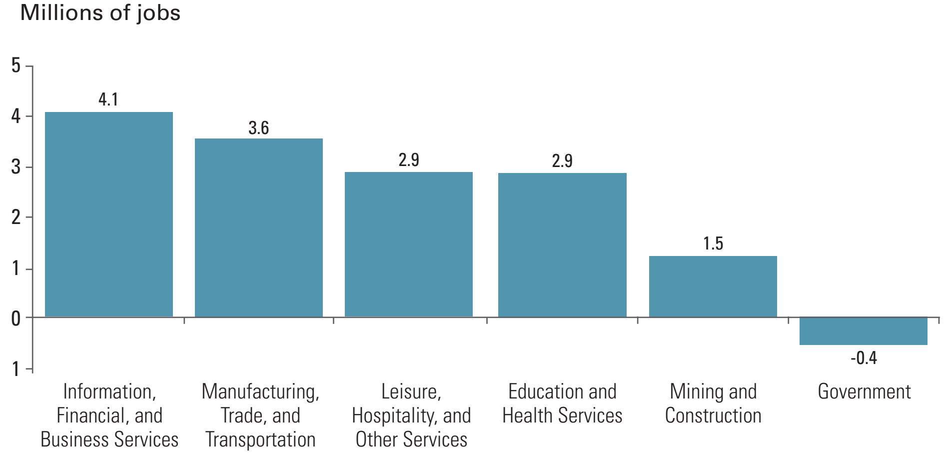
## Net Job Creation Since February 2010




*Sources: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management*

*All calculations are cumulative total return, not annualized, including dividends for the state period. Since market peak represents period 10/9/07 – 6/30/16. Since market low represents period 3/9/09 – 6/30/16. Correlation to Treasury yields are trailing two-year monthly correlations between S&P 500 sector price returns and 10-year Treasury yield movements. Forward P/E ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Trailing P/E ratios are bottom-up values defined as month-end price divided by the last 12 months of available reported earnings. Historical data can change as new information becomes available. Note that P/E ratios for the S&P 500 may differ from estimates elsewhere due to the use of a bottom-up calculation of constituent earnings (as described) rather than a top-down calculation. This methodology is used to allow proper comparison of sector level data to broad index level data. Dividend yield is calculated as the next 12-month consensus dividend divided by the most recent price. Beta calculations are based on 10-years of monthly price returns for the S&P 500 and its sub-indices. Betas are calculated on a monthly frequency over the past 10 years. Past performance is not indicative of future returns.*

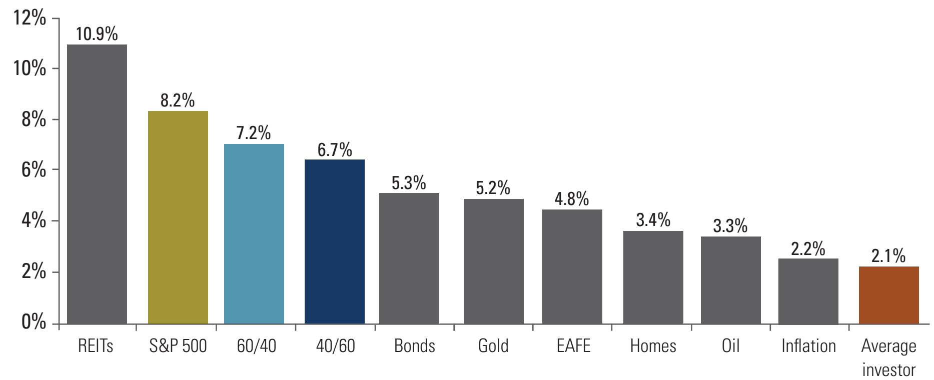
Guide to the Markets — *U.S. data are as of June 30, 2016.*

### Final thought: Don't let the election derail your investment strategy

The presidential primary season provided much made-for-TV entertainment but little intrigue regarding who the eventual nominees were likely to be. With each party's convention looming this summer, voters' gaze will now turn toward the big day in November, when we choose the 45th president of the United States. The ensuing campaign is likely to be caustic in tone and emotions will surely run high on both sides. Whenever this happens, whether due to market volatility or contentious elections, investors may be prone to making decisions that work against their long-term best interest.

Emotionally-driven investment decisions, which may feel satisfying and correct when we make them, are often disastrous. One way this might be illustrated is with the chart below. Based on a study done by Dalbar, which looked at the results of thousands of investors' accounts over a 20-year period, it shows how the 'average investor' realized returns far below those returns provided by stocks, bonds, and diversified portfolios. How did this happen? The average investor will be emotionally driven to chase returns by buying assets that have already surged, and also grow despondent and sell assets at low prices during downturns.

## 20-year Annualized Returns by Asset Class (1996 – 2015)




*Sources: J.P. Morgan Asset Management, Barclays, FactSet, Standard & Poor's, Dalbar Inc.*

*Indexes used are as follows: REITs: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy ounce, Inflation: CPI. 60/40: A balanced portfolio with 60 percent invested in S&P Index and 40 percent invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and period ending 12/31/15 to match Dalbar's most recent analysis.*

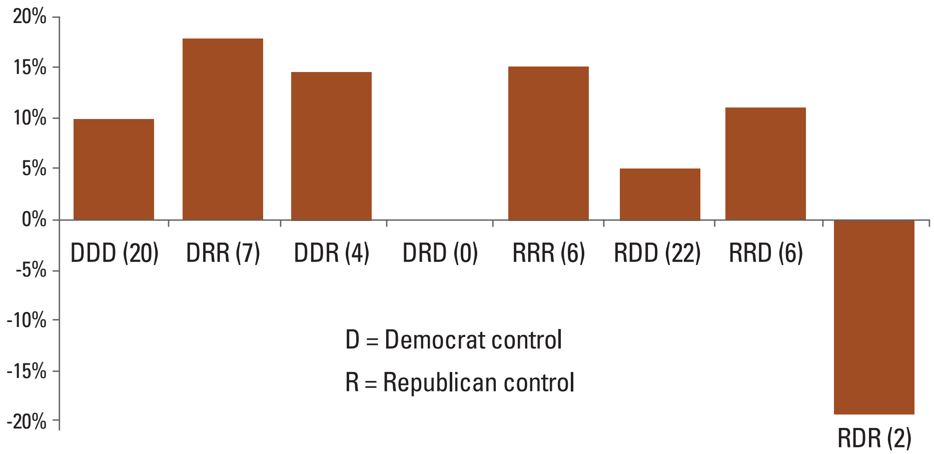
Guide to the Markets — *U.S. data are as of June 30, 2016.*

With regard to presidential and congressional politics, it is best to not make any dramatic investment decisions based on how your candidates fare. An objective review of stock market performance over the last 65+ years, as delineated by which party controls the presidency, Senate, and House of Representatives, does not clearly indicate that market results favor one particular party. It may also illustrate how economic and capital market performance is driven be many forces, large and small, global and domestic, that elected officials may not be able to control.

There are many important issues at stake in this year's election. Of course, we all should exercise our right to vote and passionately support our candidates, but it's better to maintain an established, long-term investment strategy than to make changes based on who wins.

**Annual Market Returns by Political Party Control***

Parties listed as President/Senate/House, number of years, 1949 – 2015




*Sources: U.S. House of Representatives, U.S. Senate, Gallup Inc., FactSet, Standard & Poor's, Bureau of Economic Analysis, J.P. Morgan Asset Management.*

*In roll call votes where the majority in one party voted the opposite way to the majority in the other. Data compiled by Professors Keith T. Poole and Howard Rosenthal, available at www.voteview.com. Data on voting records are not yet available for the 114th Congress.*

**Stock market returns are price returns and do not include dividends. Average annual returns are calculated using year-end to year-end numbers for the S&P 500. During the calendar year of 2001 the Senate changed party control three times. It is counted as being under Democratic Party control for the entire year because Democrats held the chamber for most of the year.*

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CliftonLarsonAllen Wealth Advisors, LLC
Investment Committee
connect@CLAconnect.com



 