# MARKET COMMENTARY

SECOND QUARTER 2016

## Uncertainty Rings True

### In the aftermath of the Great Recession, uncertainty was an environmental staple. The second quarter of 2016 is no exception.

How many times have we heard the phrase "We are in uncharted territory," never mind the wide divergence of opinions on whether or not the next economic black swan is about to reveal itself? Undoubtedly, this has weighed on the animal spirits of business owners and investors alike. While we have yet to meet a "certain" time period, a review of the United States Economic Policy Uncertainty Index, which attempts to measure the relative level of environmental uncertainty, helps paint a picture of the past and provides a canvas for our future economic and market outlook.

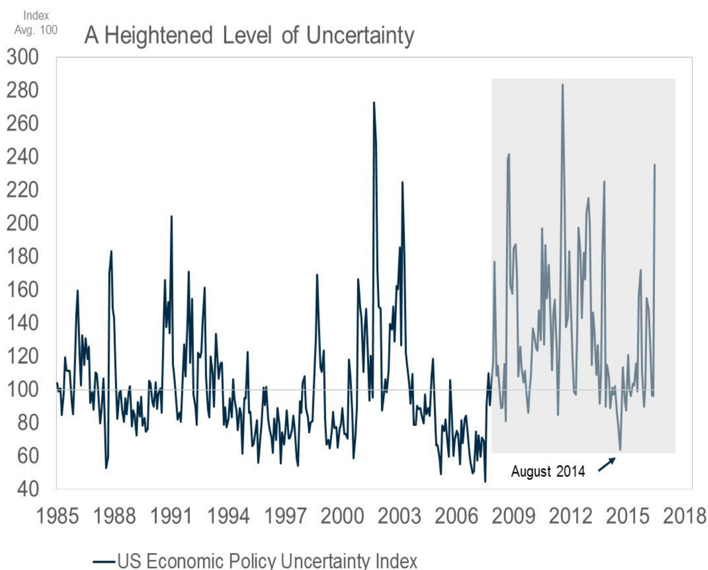


Chart #0045
Source: Baker Bloom & Davis, Bloomberg L.P., Northwestern Mutual Wealth Management Company

To combat the scar tissue left from the economic crisis, monetary policy was aggressively employed to help propel the U.S. economy forward. By August 2014, "uncertainty" in the U.S. had fallen to a post-recession low and the U.S. economy was gathering strength. A "healing" U.S. consumer was beginning to awaken and was poised to join forces with a manufacturing sector that was humming. Just then the U.S. economy was hit by two negative short-term "shocks": plummeting oil prices and a rapidly rising U.S. dollar. These shocks pushed inflation lower and stoked deflationary fears, they shuttered manufacturing vigor and led to a slowing U.S. economy, and finally corporate profits faltered and flattened U.S. investor confidence.

The early part of the second quarter of 2016 brought relief as the stabilization in oil and the U.S. dollar helped U.S. manufacturing regather momentum and pushed inflation higher and corporate profits to recover. Most importantly, consumers, who had saved their oil surplus initially, began expressing heightened confidence in their financial conditions and were beginning to open their pocketbooks. In other words, for the first time since the Great Recession it appeared as if the U.S. economy was going to have two engines operating.

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As a result, uncertainty was falling, only to see the quarter end with a new "shock" to contemplate when the United Kingdom would vote to leave the European Union (Brexit). Indeed, the aforementioned uncertainty index closed the month at its sixth highest level in its 31-year history.

## What's the Price of Safety?

In the aftermath of Brexit, we saw stocks in the S&P 500 sell off sharply but quickly recovered most of their losses in the U.S. as equity investors seemingly shrugged off any potential risks. However, in a bit of a contradiction, 10-year U.S. Treasury yields became a perceived safe haven for investors. Indeed, the 10-year treasury term premium, a fancy way of saying how much compensation investors demand for the interest rate risk of buying a 10-year treasury versus buying and continually rolling shorter-term treasuries over 10 years, fell to a record 55-year low of -0.6087. In other words, contrary to the textbook teachings of demanding (positive) extra compensation for the higher level of forecast uncertainty when buying a 10-year security versus one much shorter, investors now view the longer-term security as a safer bet.

The question remains: What is the root cause of this U.S. Treasury yield plunge? Is it truly fear induced or is it a less sinister reality that there is a ton of money from global central bank easing that needs to find a home and has pushed over $10 trillion in bonds around the globe into negative territory? The answer is likely as simple as what, if anything, breaks in the aftermath of Brexit.

## Our Forecast — Near and Far

In the shorter term we do not currently believe that Brexit will cause a global economic debacle or U.S. recession. Certainly, the heightened level of uncertainty could serve as a headwind to overall global growth, which will have a feedback loop effect on U.S. growth. However, we remain relatively constructive about the U.S. economy given the above analysis of the U.S. consumer and healing manufacturing sector. Importantly, the U.S. "financial plumbing" is in much better shape than it was prior to 2008. Indeed, we're reminded that the 33 largest U.S. banks recently passed their annual Federal Reserve stress tests. Among other conditions, these banks' capital adequacy was tested against the following conditions: a 6.25% decline in U.S. economic growth, a 5% point increase in the unemployment and a 50% drop in equity prices. Each and every one of them passed.

In the intermediate to longer term it is important to contemplate the "symptoms" that helped lead to the Brexit vote. The root cause appears to be society's growing impatience with slower economic growth. Globalization and increased world trade has become the scapegoat for those assigning blame to slow growth and inequality. Much like the 1970s, it appears that this environment is highly conducive to a future bout of protectionism and populism as countries retreat inward and "take care of their own."

Against this backdrop, fiscal policymakers (elected government officials) will likely attempt to "do more" to help monetary policy quicken the pace of economic growth. This is especially true in the eurozone, where there will be a push for faster economic growth to help keep the bloc together. Ironically, while many worry about the possibility of deflationary forces stemming from the Brexit vote, we must contemplate that the above stew finally leads to rising costs and wages, which ultimately pushes global inflation higher.

## The Bottom Line

While it may be tempting for some to join the herd and run for the perceived safety of fixed income, we continue to recommend overall broad portfolio diversification. Many look at low bond yields and conclude that it must be the case that the equity markets are whistling past the graveyard, perhaps it's time to contemplate that bond markets are the ones with puckered lips and are priced for a deflationary certainty that we believe is unlikely. We also note that a review of history reveals that after spikes in the aforementioned U.S. Economic Policy Uncertainty Index, more often than not future 12-month equity returns are higher than average.

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Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The United States Economic Policy Uncertainty Index measures market-related economic uncertainty through an analysis of news articles containing terms in three categories pertaining to the econo-my, uncertainty and the stock market.



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