THE DANA VIEWPOINT

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Divorce British Style

Perhaps some of you remember two romantic comedies from the 1960's – Divorce Italian Style and Divorce American Style. Both establish that marriage is better and worth saving. Fifty years later Britain votes for a divorce from the European Union (EU). The EU was formed after the end of World War II as a way to prevent further conflicts between the countries of Europe. A good concept and one drawn from the playbook of the formation of the United States. Each country would be like a state with open borders, a common currency, and sort of a democracy. Britain joined but kept their own currency (first sign of trouble). Then came the financial crisis of 2007-2008 and many countries struggled economically. The Greek economy was hit the hardest and the EU has tried everything to repair their debt problem. Other countries had and are still having economic problems. Then came turmoil in the Middle East resulting in millions of people losing their homes and fleeing areas ravaged by war. With Europe being right next door (the distance from Turkey to the Greek island of Lesvos is about five miles by water), Greece was the logical destination. One of us here at Dana spent time in Lesvos earlier this year on a humanitarian mission. The scope of the refugee problem is vast, with no easy solutions. This further added to the EU's economic problems. The European Central Bank (ECB) is trying its best to prop up the economy with their own version of quantitative easing. Not only are they buying sovereign bonds, but they have added corporate bonds to their shopping list. Can you imagine a government subsidizing a corporation? Yields on ten year government bonds in Germany and elsewhere have turned negative so if you buy a German bond, you will receive less in interest and principal payments than you paid for the bond. This is also happening in Switzerland, the Netherlands, and Japan. The Wall Street Journal says that one third of all bonds globally have negative yields.

Now, amidst all this chaos Britain voted to exit the EU. Voters seemed to be keying on the open borders issue more than economic issues. Britain is the fifth largest economy in the world, and they are doing fine. However, voters did not like all the immigrants flooding into their country. Heightened fears of potential terrorist activities coupled with long brewing resentment concerning entitlement benefits led to the fissure. So in the recent UK referendum, they decided to divorce and voted themselves out of the EU. Initial investor reaction was that the EU would collapse without Britain. Upon further review (2 days later) investors decided, no - the EU will be OK. Well, the EU is not OK with, or without Britain. They have massive debt problems, struggling economies and an immigration problem. It's too soon to tell if these problems can be overcome, but you have to wonder how long the German citizens will allow their government to carry the bulk of the

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EU's problems on their back. Who is next in divorce court? Add rising terrorist activities and this past weekend's attempted military coup in Turkey, people across Europe are questioning open door policies.

Now, you would think all this chaos would be bad for stock and bond markets around the world. Think again. At this point, who has the strongest economy (on a relative basis) in the free world? If you said the United States, you would be correct. Sometimes too much data gets in the way of clear thinking. The Fed is obviously confused and Janet Yellen has said so. Sometimes it's as simple as there are more buyers than sellers. The worse the news gets in Europe and Japan, the better our stock market looks (our bond market too if you are buying for capital appreciation and some yield). FactSet shows the average yield on the S&P 500 is 2.1%, with one out of five stocks in the index paying a dividend over 3%. Investors have continued to search for yield and have focused on stocks paying solid dividends especially in the utility and telecom sectors. Both sectors have performed very well year-to-date and are now trading at valuations well above their long-term average. We are now at all-time highs in the Dow and S&P 500 indexes and while overall valuations are not unreasonable, there are certain stocks and sectors that look historically expensive and should be carefully researched before purchasing, something passive index funds do not do.

Another month, another jobs report – this time it was good news. The Labor Department reported that the private sector created 287,000 new jobs in June, close to the magic 300,000 number. The unemployment rate jumped from 4.7% to 4.9%. You can take that as a positive as it indicates that more people entered the job market. The employee participation rate ticked up to 62.7% and wages increased slightly. Definitely a solid month, but growth remains slow as we continue to push the wealth effect started under Fed head Bernanke.

"Toto, I have a feeling we're not in Kansas anymore". Just as Dorothy recognized that things didn't look the same, investors are having the same feeling about the stock and bond markets. Generally a good jobs report would push yields up and bond prices down as sellers of bonds anticipate the Fed raising interest rates. Not in this investment environment. Here investors are more concerned about the safety of their money and have deemed U.S. Treasuries to be a safe haven in the storm prevailing throughout the rest of the world. Could bond investors push our yields into negative territory? Doesn't seem likely, but now the precedent has been set in other countries.

Random Thought for July 2016: Time is that quality of nature which keeps events from happening all at once. Lately it doesn't seem to be working.

-Anonymous

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