

Last quarter: **S&P** ↑1.9% **DJI** ↑1.4% **NASDAQ** ↓0.6% **10Y Treas** 1.5% **OIL** ↑ \$48.33 **EURO** ↑ \$1.11 **YEN** ↑ ¥103

Stability, Better Sentiment and Improving Conditions Limit Brexit Contagion

Global markets have been resilient in the aftermath of UK's vote to leave the European Union due to stable economic data, better EU political sentiment and improving financial conditions.

Forward looking European indicators such as the purchasing manager's indices for manufacturing and services are above pre-Brexit levels.

Despite warnings of potentially severe economic consequences of Brexit, the IMF kept their global economic forecast about the same in an update after the vote.

Though analyst's earnings estimate dipped after the vote, they remain at higher levels than earlier this year signaling, prospects will continue to rise.

2016 TACTICAL CONCERNS

- Declining Wall Street earnings turn around
- Pace of Fed rate hikes
- Long term shape of US political landscape
- Fallout from global geopolitical issues

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Sir John Templeton, 1912-2008

The political threat of a EU breakdown maybe more significant than the economic fallout.

Theresa May's quick win in the UK prime minister succession removes uncertainty and places her in good position to forge a constructive relationship with the EU, mitigating business investment and hiring risks.

Support for the EU has been surging in the polls of Germany, Denmark and Ireland while Finland and France have rejected 'leave' referendums.

For the Brexit shock to lead to a crisis in Europe, financial conditions would likely need to deteriorate sharply, as in 2008 and 2011, which is not happening.

Not only have global stocks recovered all their Brexit-related losses, Bloomberg's Euro Financial Conditions Index now exceeds its pre-Brexit level.

Even the plunging pound sterling, which now is 10% lower than pre-Brexit levels, holds a silver lining for UK exports by making them more price competitive and boosting UK tourism.

The implication from the behavior of global markets is the short term damage was less than expected and the prospects for European recovery are much brighter.

For US investors, the European threat has been eliminated to the lightly exposed US economy and gives the Fed one less reason to hold back a rate hike by the end of the year.

With a turnaround in weak US earnings driven down by soft energy prices expected, a Fed hike may indicate the recovery still has legs.

SCM feels the Brexit chapter has not changed the investment environment materially enough to force a change in its fully invested policy.



UK's Brexit vote took global markets by surprise

Markets Handled Brexit Curveball with Aplomb and Climbed to New Heights

Equity and commodity markets celebrated the surprise Brexit vote with alarming volatility, but snapped back to reach new highs by the end of the quarter. All this in spite of four quarters of receding corporate profits.

The Dow Jones Industrial Average was up 1.4% while the S&P was up 1.9% in the second quarter. For the first half of 2016, the Dow Jones Industrial Average was up 2.9% and the S&P 500 up 2.7%.

Small caps were up even more in the quarter with Russell 2000 clocking an impressive 3.4% but the tech laden Nasdaq was off 0.6%. For the first half of 2016, the Russell 2000 was up 1.4% while the Nasdaq sunk 3.3%. The mixed result for small caps means the rally favored less risky blue chips.

The ten year Treasury finished near record low yields at 1.49% while crude oil settled in at \$48.33/

barrel and gold ended at \$1,318/oz. Gold was up 24% and crude oil up even more at 31%.

The dollar bought 103 yen which has soared 14% YTD while the euro cost \$1.11 which was also 2.2% higher against the dollar. The UK pound closed at \$1.33 down 11% YTD. Through the first half the euro climbed 2.3% and the yen was up 17%. The UK pound was off almost 10%.

The results indicate the Brexit downdraft was not sustainable. Markets showed resilience fueled by central bank backstopping. SCM feels equities won't be climbing much higher without improvement in corporate earnings.

Industrial Sector Review and Outlook

The Brexit market plunge caught the market off-guard though it recovered nicely, It left more questions than answers with resolution a few quarters out.

Business in Europe will not come to a complete stop and the exposure of US firms appears limited.

It's too early to make sector changes so investors should stay diversified. Any realignment depends on the political decisions of UK and EU policymakers which are impossible to predict.

Brexit effects on Financials relative to interest rates, currency exchange rates, stock prices, and market volatility will likely be more material to earnings than problems caused by relocating operations out of the UK to the EU.

The Tech sector is slightly undervalued and we continue to see opportunities in smartphone related vendors. When the chips are down, bet on capital equipment firms.

Brexit fears have pushed down most European Telecom stocks which is an overreaction. Telecom is somewhat immune to geopolitical changes and Brexit has little effect on cross-border voice/data traffic.

Utilities kept its foot on the gas during the second quarter. The spread between U.S. utilities' 3.6% average dividend yield and 1.6% 10-year U.S. Treasuries suggests utilities have a long way to run.

Consumer Discretionary, Consumer Staples, Energy, Healthcare, Industrials and Materials are expected to match market pace.

S&P 500 Weights

Sector	Wgt %	YTD%
Cons Cyclical	12	1
Cons Staples	11	11
Energy	7	14
Financial	16	-5
Health Care	15	1
Industrials	10	6
Technology	20	-1
Materials	3	6
Telecom	3	27
Utilities	3	24

Data Source: Standard & Poor's as of 7/5/16

US Economic Forecast Survey Highlights

SCM's *Quarterly Consensus Survey*, conducted at the beginning of the third quarter, saw real GDP forecast consensus slide further to 2.2 percent for 2016 and 2.3 for 2017. The continued below average GDP growth is disappointing but chances of recession are still low due to strong consumer spending and solid labor markets.

Industrial production is expected to rise 0.1 percent in 2016 and 2.0 percent in 2017. Capacity utilization estimates trended slightly lower to 76.2 percent for 2016 and 76.7 percent for 2017, not helpful to capital spending on Tech products.

US Forecast Consensus (%)

Series	2015*	2016	2017
GDP	2.4	2.2	2.3
CPI	.2	1.3	2.2
Profits	-.7	2.5	1.7
	*actual		

Sources: Federal Reserve, BMO Capital, Congressional Budget Office, Wells Fargo, and PNC Bank

Positive housing trends remain in place. Starts are set at 1.2 million units for 2016, and may rise to 1.3 million units in 2017. Unemployment rate forecasts held steady at 4.8 percent in 2016 and should be 4.6 percent in 2017, giving a boost to the recovering housing market and, along with plummeting gas prices, buoying auto sales.

Inflation expectations remain low, held down by soft energy prices and restrained global demand. Below average money supply turnover should keep a lid on prices near term. Continued easy monetary policy is contingent on low inflation. Only one or two interest rate hikes are expected in 2016.

CPI estimates dipped to 1.3 percent for 2016 and 2.2 percent for 2017. Other indices, such as GDP Price Deflator and Personal Consumption Expenditures (PCE), show a similar path, trending toward continued moderate inflation.

The yield curve will elevate but retain a flat shape in 2016, with T-bill rates rising to 0.5 percent and 1.1 percent in 2017. Ten-year Treasury yield expectations are 2.0 percent in 2016 and 2.4 percent in 2017.

Check out SCM's remodeled website stuffed with new features including a Blog and new published data at www.simpsoncapital.com.

"You pay a very high price in the stock market for a cheery consensus."

Warren Buffett, 1930-

Simpson Capital Management Investment Policy

Simpson Capital Management (SCM) provides investment management and consulting services for personal and institutional client portfolios.

Strategic asset allocations for portfolios are determined by continued assessment of client needs and market conditions. Needs, such as risk and return requirements, are monitored to customize investment guidelines for each portfolio.

SCM uses a macroeconomic or 'top down' approach. The firm prepares forecasts of the future market environment and employs a proprietary market valuation model underpinned by expected returns.

With a growth approach, equities are selected based on management quality, expected market growth and market leadership.

Emphasis is placed on Mid-cap companies for return and Large-cap companies for stability.



David Simpson, CFA
President, Simpson Capital

Portfolios are balanced relative to S&P500 index sector weights. Lesser positions of small-cap and international issues are also held.

Fixed income securities including money market instruments are selected relative to client needs based on credit quality and interest rate sensitivity.

For a more detailed look at SCM's investment philosophy, visit the Our Approach section on our website at www.simpsoncapital.com.