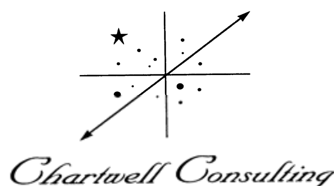


CHARTWELL REVIEW

July 2016 | SECOND QUARTER 2016 | Volume XXIII, Issue No.2

Unintended Consequences

Or, perhaps we should say Unexpected Consequences.

In one of the starkest examples of cutting off one's nose to spite one's face, late in the quarter British voters elected to exit the EU. The primary issues were the EU's open borders policy and its very high support payments system. Even so, with the other EU countries accounting for 50% of Britain's exports, limiting access to these markets is expected to pitch Britain into a recession, costing its citizens much more wealth than continued payments to Brussels.

OPEC has lowered its estimate of global economic growth this year to 3% from 3.1%, citing the Brexit vote's effect on European oil demand. An OPEC report says European oil demand "faces substantial downside risks ... as a result of uncertainties related to the region's economy, resulting from the UK referendum, among other challenges." Oil prices have dropped globally by over $10/barrel.

Late last year Congress enacted legislation enabling another round of accelerated deductions for business investment. In response, businesses have *reduced* fixed investment levels for three straight quarters, while ramping up dividends and stock buybacks to all-time levels. As a result of an 11% reduction in corporate tax receipts, Treasury reports the fiscal deficit through June is up 27% from the same period a year ago.

In December 2012, Japan announced plans for a new suite of policies to jolt Japan's stagnating economy out of its deflationary malaise ("Abenomics"), spurring growth, increasing inflation, and reducing the value of the Yen in order to improve global competitiveness. Since then, the Yen has depreciated by 12.5%, but GDP growth forecasts remain barely above 0%, and consumer prices have declined. It has aggressively extended the program this quarter.

The Zero Interest Rate Policy (ZIRP) is being replaced by NIRP in many places. This month, Germany became the first eurozone nation to issue a fresh 10-year bond at a negative yield. You don't receive interest on the bonds. You pay it.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	2Q 16	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	2.5	4.0	11.7	12.1	7.4
U.S. Top-cap Stocks	2.3	4.0	11.8	12.3	7.3
U.S. Mid-cap Stocks	3.2	0.6	10.8	10.9	8.1
U.S. Small-cap Stocks	3.8	(6.7)	7.1	8.4	6.2
Non-US Stocks (**EAFE**)	(1.5)	(10.2)	2.1	1.7	1.6
Non-US Stocks (**Emerg**)	0.7	(12.1)	(1.6)	(3.8)	3.5
3 mo. T-Bills	0.1	0.1	0.1	0.1	1.0
U.S. Aggregate Bonds	2.2	6.0	4.1	3.8	5.1
High Yield Bonds	5.9	1.7	4.2	5.7	7.4
Global Aggregate Bonds	2.9	8.9	2.8	1.8	4.4
Consumer Prices	*1.2*	*1.0*	*1.1*	*1.3*	*1.7*
Bloomberg Commodity	12.8	(13.3)	(10.6)	(10.8)	(5.6)
S&P Global REIT's	4.8	17.8	11.3	10.3	6.0
Global 65/35	*2.8*	*1.7*	*6.3*	*5.9*	*6.1*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	2Q 16	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	1.6	(0.3)	9.9	10.3	6.8
U.S. Mid-cap	2.2	(4.2)	8.4	8.7	7.0
U.S. Small-cap	2.9	(6.6)	6.7	8.0	6.4
International Lg. Cap	(1.1)	(9.6)	2.2	1.7	2.0
International Sm. Cap	(1.7)	(6.2)	4.9	4.3	4.5
Emerg. Mkt. Equity	2.6	(9.1)	(1.0)	(2.6)	3.6
Balanced/Hybrid	1.2	(4.2)	3.0	3.4	4.1
General Bond	2.3	4.9	3.8	3.8	5.3
High Yield Bond	4.3	(0.2)	3.0	4.7	6.3
Equity Hedge Index	1.6	(4.8)	3.1	2.3	3.0

*Annualized trailing returns for periods ending 6/30/16

Economies, Economics, Prices, and Policy

	6/2016	6/2015
CPI - All, trailing 1-year	1.0%	0.1%
CPI - headline, y-o-y	2.3%	1.8%
Real GDP Growth, 1-year *	1.2%	3.0%
Employment (000's)	151,097	148,722
Employment / Population %	59.6%	59.3%

** first estimate*

The government's first estimate of our **2nd quarter GDP growth** is quite disappointing. The American economy continues to expand, but at a very sluggish rate. From April to June, it is estimated to have grown at only a 1.2% annual rate, well below the 2.5% that economists had expected as recently as one month ago.

Household spending was the economy's bright spot, rising at an annualized rate of 4.2 percent, but the gain was overshadowed by the poor showing in other sectors of the economy. As Figure 3 attests, the quarter was the third consecutive period in which the economy advanced at less than a 2% rate, the weakest stretch in four years.

The abrupt fall-off in homebuilding caught analysts off guard, but it came after a series of double-digit gains in late 2014 and 2015. And with mortgage rates very low and home prices still rising in many parts of the country, the residential real estate sector is expected to contribute to growth again in the coming quarters.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	2Q '16	1Q '16	4Q '15	3Q '15
Real GDP Growth	1.2	0.8	0.9	2.0
Nominal GDP Growth	3.5	1.3	1.8	3.2
Final Sales	2.1	1.2	1.8	3.3
Personal Spending	4.2	1.6	2.3	2.7
Private Investment	(9.7)	(3.3)	(2.3)	2.0
- Fixed, Businesses	*(2.2)*	*(3.4)*	*(3.3)*	*3.9*
- Fixed, Residential	*(6.8)*	*7.8*	*11.5*	*12.6*
*- Chg. In Inventories (**$bn**)*	*($13)*	*$42*	*$63*	*$77*
Export growth	1.4	(0.7)	(2.7)	(2.8)
Import growth	(0.4)	(0.6)	0.7	1.1
Government Spending	(0.9)	1.6	1.0	1.9

Many market strategists expect final Q2 GDP growth will be marked up a little. And, the second half of 2016 is forecast to see 2-2.5% annualized growth. Lower than previous estimates, yet twice as robust as the past year.

Non-farm payroll growth stunned to the upside in June, but was weaker for the full quarter. The private sector added just 442,000 jobs in Q2, compared to 628,000 in the first quarter.

As a result, the Employment/Population ratio dropped slightly. The household survey data reflected a *decline* of 223,000 jobs in the quarter. Nonetheless, over 2.4 million payroll jobs have been created during the past year.

After employment growth, stable prices (low inflation rates), are the Fed's second mandated responsibility -

- **"Headline" CPI** was once again up every month this quarter, ultimately rising 1.2% (up 0.7% in Q1). The index rose only 1.0% during the past year.
- **Core CPI** (ex-food & energy) rose 0.6% during the second quarter (+1.0% in Q1), and is up 2.3% over the past year. This is its highest level in over 4 years.
- The **Producer Price Index** for final demand goods and services rose 1.1% during the past quarter, but by just 0.3% during the past year. PPI final demand, ex-food & energy, has risen 1.2% the past year.

Wage growth continues to be mediocre, but positive. In nominal terms, median weekly earnings of the nation's 111.2 million full-time wage and salary workers were $824 in the second quarter (not seasonally adjusted). This was 2.9% higher than a year earlier, compared with the rise of 1.0% in overall consumer prices.

Personal spending rose 0.8% in the quarter, and increased 3.6% the past year. With personal incomes rising by less, the savings rate has dipped down to 5.3%.

Industrial production activity once again disappointed in the second quarter, falling at an annual rate of 1.0%. This was the third consecutive quarterly decline. Industrial production in June was 0.7% below year earlier levels. At just +0.6%, annualized capacity growth has been constrained by low energy and mining capex.

Painting a dim picture of the world economy, the International Monetary Fund this month trimmed its **global growth** forecast a full percentage point, to 3.1%, and called for "immediate action to reduce the increasing risk of recession." They typified global growth as weak and fragile, being held back by unfavorable productivity trends, the legacy of high private and sovereign debt, persistent costs associated with high unemployment and weak government policy responses.

The U.K.'s vote to leave the EU is seen to have altered the global growth projection due to a substantial increase in economic and political uncertainty. Accounting for almost 18% of EU GDP, Britain's departure is expected to have painful consequences for the rest of Europe and severe ones for Britain.

The IMF modestly reduced its forecast for 2016 US economic growth to 2.2%, saying the effects of Britain's decision to leave the EU will be negligible. Recent increases in the dollar have been less than feared, the stock markets have recovered, and a rush to Treasuries has lowered yields and financing costs.

Copyright @2016 Chartwell Consulting (USA) LLC All rights reserved.

Investors Search for Yield

The path of policy rates globally looks lower and flatter compared to the outlook this time last year. Expectations fell in Europe and Japan this quarter, as the ECB and BoJ addressed slow growth and low inflation by implementing lower rates. The UK faces massive uncertainty after voting to leave the EU, which should lead to a rate cut from the Bank of England rather than the relatively steep pace of tightening expected last year. And the US Fed has struggled to raise rates since December despite a tighter labor market and generally improving economic data. The low rate environment continues on for longer than expected, which has helped fixed income returns.

Sovereign interest rates once again fell 10-40bps in most developed countries during the quarter, including the U.S. The bellwether 10-year US Treasury yield dropped 30bps to 1.49% by quarter's end, and then slipped to a record low close below 1.37% during the first few days of July (it has since rebounded to 1.54%). The 5-year Treasury yield dropped to 0.71%. It has declined over one percent since the beginning of 2016. The 30-year's yield declined to 2.31%, and then hit a record low of 2.14% in early July.

Abroad, we can see in Figue 6 that three bellwhether developed countries, Germany, Japan, and Switzerland (Sweden and Denmark, too) have seen the yields on their 10-year bonds dip solidly into negative territory. It's estimated that 40% of sovereign debt trade at negative yields-to-maturity. Perhaps the most surprising market is the UK, where the 10-year traded at a yield of only 1.13% at quarter's end, more than 1.4% lower than one year ago.

Rallying government bond prices pushed investment grade Global Aggregate Bond's quarterly return to 2.9%, and 2.5% on a $-hedged basis. Year-to-date return is 9.0% (5.9% $-hedged). Global Credit bonds reflect slightly higher y-t-d returns, at 6.7% $-hedged.

Higher yielding US$ Emerging Market bonds, which are 50% investment grade, enjoyed a very strong quarter, returning 6.0%. EM($) bonds have advanced 12.3% in 2016. EM (local currency) bonds are up 14.3% this year.

Per Figure 4, the top-performing primary US fixed income sectors during the 2nd quarter were Long Credit (+6.8%) and Long Treasuries (+6.4%), with the former benefitting from narrowing credit spreads. During the past twelve months, Long Treasuries have returned 19.3%! Only US REIT's (+22.9%) have done better.

All Credit Bond sectors benefitted from notable price appreciation and declining spreads during the quarter. Those with higher starting yields benefitted the most. Top-performing corporate bonds were the small and high risk CCC-rated sector, up 11.8%. B-rated bonds returned 4.8%. Among investment grade sectors, BBB's advanced 4.3%. The lowest returning primary bond sectors were the low yield and low duration 1-3yr Government/Credit, Asset-Backed, and Mortgage-backed sectors.

Figure 4: Primary Bond Sector Returns (%)

Index	2Q '16	1 Year	3 Years	5 Years
US Aggregate Bond index	2.2	6.0	4.1	3.8
US Gov't/Credit: 1-3 Yrs.	0.5	1.3	1.0	0.1
US Treasury: Long	6.4	19.3	10.5	10.3
US Inflation-Linked	1.8	4.6	2.5	2.8
Mortgage-Backed (MBS)	1.1	4.3	3.7	3.0
CMBS	2.2	6.1	4.2	4.6
Asset-Backed (ABS)	0.9	1.1	1.4	1.5
Inv. Grade Credit, 1-10yr	2.2	5.1	4.1	4.2
Inv. Grade Credit, 10+yr	6.8	13.6	8.6	8.4
US High Yield Credit	5.9	1.7	4.2	5.7
Municipal Bonds	2.6	7.7	5.6	5.3
Global Aggregate, ($ hdgd)	2.9	8.9	2.8	1.8
Global Credit, ($ hdgd)	3.3	6.3	5.2	5.5
Emerg. Mkts Bonds (US$)	6.0	12.3	7.1	6.4

Figure 5: Primary US$ Bond Yields

	Jun-16	Mar-16	Dec-15	Jun-15	*1-Year Change*
US Treasuries	(%)	(%)	(%)	(%)	*(%)*
3-month	0.26	0.21	0.16	0.01	*0.25*
2-year	0.59	0.74	1.06	0.64	*(0.05)*
5-year	0.71	1.22	1.77	1.63	*(0.92)*
10-year	1.49	1.78	2.25	2.33	*(0.84)*
30-year	2.31	2.62	3.01	3.10	*(0.79)*
BarCap Aggregate	1.91	2.16	2.59	2.39	*(0.48)*
BBB Credit	3.42	3.86	4.34	3.96	*(0.54)*
AA Credit	2.01	2.22	2.63	2.34	*(0.33)*
Agency MBS	2.07	2.35	2.34	2.78	*(0.71)*
Emerging Mkts ($)	5.37	5.87	6.39	5.81	*(0.44)*
US High Yield	7.27	8.18	8.75	6.94	*0.33*
UST30yr - UST2yr	1.72	1.88	1.95	2.46	*(0.10)*

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Jun-16	Mar-16	Dec-15	Jun-15	*1-Year Change*
United States	1.49	1.78	2.25	2.33	*(0.84)*
Germany	**(0.12)**	0.16	0.64	0.83	*(0.95)*
Switzerland	**(0.50)**	**(0.39)**	**(0.07)**	0.11	*(0.61)*
Britain	1.13	1.54	1.99	2.55	*(1.42)*
Poland	2.93	2.86	2.92	3.31	*(0.38)*
Italy	1.30	1.22	1.63	2.25	*(0.95)*
Spain	1.33	1.44	1.85	2.35	*(1.02)*
Greece (new bonds)	8.19	8.77	8.34	15.12	*(6.93)*
China (5 year)	2.70	2.55	2.67	3.24	*(0.54)*
Japan	**(0.19)**	**(0.09)**	0.28	0.45	*(0.64)*
Australia	1.99	2.50	2.75	3.01	*(1.02)*
Russia	8.39	9.09	9.52	10.85	*(2.46)*
Brazil	12.15	13.67	16.41	12.68	*(0.53)*
India	7.44	7.49	7.76	7.82	*(0.38)*

Copyright @2016 Chartwell Consulting (USA) LLC All rights reserved.

T.I.N.A. *

It was shaping up to be a quiet and above average quarter. Through 6/23, the S&P was up 2.6% plus dividends. Then "the vote" happened and US stocks took a 5.3% nosedive in two days. Eighty-four days of boredom, followed by two days of terror. A nifty three-day 4.9% rally ensued after US investors re-assessed Brexit, and large-cap stocks ended the quarter up 2.5%.

Mid-cap stock portfolios did well in the quarter, up 3.2%, but only if they were value-biased. Small-cap stocks did even better, advancing 3.8%, but this was not close to making up for the first quarter. Small-caps remain in the stealth bear market they entered in February.

Figure 7: U.S. Equity Market - Size/Style Returns

	2Q '16	Trailing 1-yr	3-yrs	5-yrs
Growth				
Large Cap	0.2	5.2	14.2	13.4
Mid Cap	1.6	(2.1)	10.5	10.0
Small Cap	3.2	(10.8)	7.7	8.5
Value				
Large Cap	4.5	2.7	9.4	11.2
Mid Cap	4.8	3.2	11.0	11.7
Small Cap	4.3	(2.6)	6.4	8.1

Size/style performance ranged quite tightly, from a high of 4.8% for mid-cap value to a low of 0.2% for large growth. Per Figure 7, longer-term returns still favor large growth stocks. However, the past year's reversal has decidedly favored mid- and small-cap value portfolios over growth.

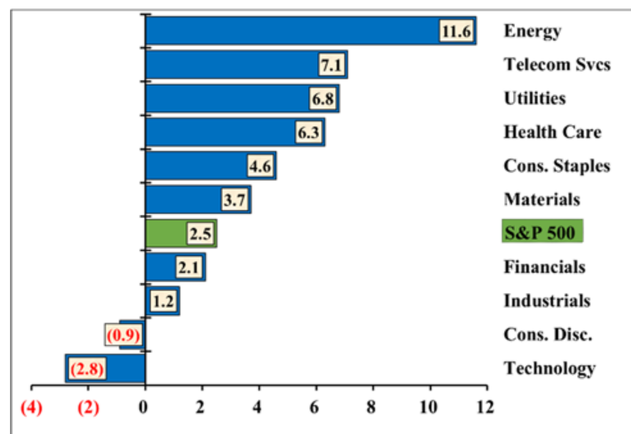
The performance range across sectors was relatively wide. Energy stocks outperformed handily (haven't said that for a long while). Large/mid-cap stocks of the sector are up 15.5% in 2016, led by drillers and exploration companies. The large integrated firms also did well and have returned 18% this year. Refining and marketing ("downstream") stocks have lost 19%.

Telephone and utility companies, collectively accounting for only 6% of the Russell 3000, remained market darlings. Year-to-date, these sectors have each returned a rather amazing 24%. Electric utilities have accounted for the majority of gains. Unfortunately, many active managers entered the year underweight these two sectors.

Technology and consumer discretionary stocks were the only negative sectors of the quarter. It was red ink across nearly all tech industries, except semiconductors. By market cap, the largest consumer discretionary industry is internet retail. These stocks returned 11% in the quarter, led by Amazon (+20.5%), but are flat for 2016.

The top five positive contributors to large-cap returns in the quarter were Amazon, AT&T (again), ExxonMobil (again), J&J, and Pfizer. All returned double-digit gains. The four largest detractors were Apple, Microsoft, Alphabet (Google), and Allergan.

Figure 8: US Sector Returns – 2nd Quarter 2016



Among the risk factors that are prime determinants of return, the following stood out in the quarter –

- Quality (high operating margins and high ROE) was a large negative performance factor in the quarter, which is a major reversal from the past year;
- High historical and projected earnings growth were big negatives, and have been the past year;
- Low volatility and risk (beta) were positive factors, and have been significantly over the past year;
- High dividend yield was a positive factor, as it has been for most of the past two years;
- Another value factor, low P/E, was a negative.

Figure 9: One-year Trailing P/E Ratios – June 2016

	Value	Blend	Growth
US Large	16.9	19.5	22.8
US Mid	19.7	22.2	26.2
US Small	18.2	23.6	33.5
EAFE		15.8	
Emerg. Mkts		13.8	

* There Is No Alternative

Copyright @2016 Chartwell Consulting (USA) LLC All rights reserved.

The British are Leaving!

The British are Leaving!

Global equity markets capped off a volatile quarter with the Brexit vote on June 23rd, which approved a ballot measure for the UK to leave the European Union. For two days after the referendum global markets sold-off sharply, but experienced a strong "Brexit bounce" the final days of the quarter to erase *most* losses. Developed markets (MSCI EAFE) finished the quarter down -1.5%. Emerging markets posted a modest gain of 0.7%. MSCI All Country World ex-US index dropped -1.1%.

In Dollar terms, Europe ex-UK was the weakest performing region, falling -3.5%, driven by the market's sharp sell-off after the Brexit vote. Sterling plunged to levels last seen in the 1980's, as the BOE is expected to begin quantitative easing to help support the British economy. While the UK market dropped -3.5% for the month of June (-0.7% for the quarter), other EU countries fell further on uncertainty over what would happen with the first exit by a member country. Germany and France each fell -5.7% in June (-5.6% and -4.3%, respectively for the quarter). Smaller EU members, Ireland, Italy, Spain dropped even further (-8% to -10%).

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 6/30/16	2Q '16	1-Yr	2Q '16	1-Yr
World ex-USA	**(1.1)**	**(9.8)**	**(0.4)**	**(9.6)**
- MSCI Growth	*0.1*	*(5.3)*	*0.6*	*(5.3)*
- MSCI Value	*(2.2)*	*(14.4)*	*(1.3)*	*(13.9)*
- Europe ex-UK	(3.5)	(10.8)	(1.1)	(9.6)
- Pacific, ex-Japan	0.7	(6.8)	2.6	(5.0)
- Japan	1.0	(8.9)	(7.8)	(23.7)
- United Kingdom	(0.7)	(12.1)	6.7	3.4
Int'l Small Cap	**(1.3)**	**(3.4)**	**(1.6)**	**(4.6)**
Emerging Mkts	**0.7**	**(12.1)**	**0.7**	**(7.7)**
- EM Asia	*0.3*	*(12.2)*	*1.0*	*(9.8)*
- EM Europe	*(3.9)*	*(11.9)*	*(4.0)*	*(5.1)*
- EM Lat Amer	*5.3*	*(7.6)*	*2.1*	*(0.2)*
- EM BRIC	*3.1*	*(16.5)*	*1.6*	*(14.3)*

In *local currency* terms, the Pacific region was the weakest sector, but the strongest after currency effects are considered. Japanese stocks sank amid a strengthening yen (which appreciated 10% versus the US dollar) and a sluggish economy. The BOJ's mid-June decision to keep its monetary stimulus plan steady caused an equity sell-off while pushing the yen to its highest level versus the dollar in two years. The Japanese stock market dropped -7.8% for the quarter in Yen terms, but rose 1% in US Dollar terms.

Australian equities rose, led by the recovery of metals and mining companies. The Reserve Bank of Australia lowered its cash rate to an all-time low of 1.75%, weakening the Aussie dollar by 3%. New Zealand was once again the top performing developed markets country, rising 5.9% for the quarter.

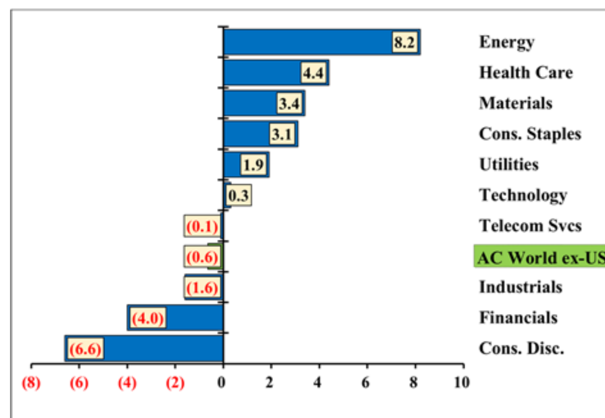
Emerging markets rallied broadly on expectations that the US Federal Reserve Bank would pause its monetary tightening policy and spur the demand for risk assets. The ongoing recovery of commodities has also contributed to the emerging markets rally year to date.

Latin America led the way, advancing 5.3%. Brazil jumped 14% for the quarter, despite the country's ongoing corruption scandal. The Brazilian real climbed 11% versus the US dollar. Mexican stocks fell -7%, as the government trimmed its 2016 growth projections due to lower oil prices and sluggish manufacturing exports. The peso declined 7% versus the US dollar.

Asian markets finished the quarter with a modest gain of 0.3%. Chinese stocks finished the quarter flat. Indian ones rose 3.7%, as positive corporate earnings reflected that economy's high (7.9%) growth rate. The Indonesian market rose 5%, following another policy rate cut.

Emerging Europe was the regional market laggard, declining -3.9%, on sharp declines in Greece (-14%) and Poland (-17.5%). Russian stocks marched higher (4%) despite a weak economy, helped by a 26% increase in the price of Brent crude oil.

Figure 11: Ex-USA Sector Returns (2nd Qtr 2016)



Economically sensitive sectors fared worse than defensive sectors. Consumer discretionary stocks dropped -6.6% and financial stocks fell -4% amid fears the UK banks may lose access to the EU common market and concerns over a broad recession in Europe. Energy stocks were once again top performers, gaining 8%, as oil prices rose during the quarter. Healthcare, materials, utilities and consumer staples sectors also advanced 2%-4%, as investors sought out defensive, dividend-paying stocks.

Copyright @2016 Chartwell Consulting (USA) LLC All rights reserved.

Back Page Perspectives

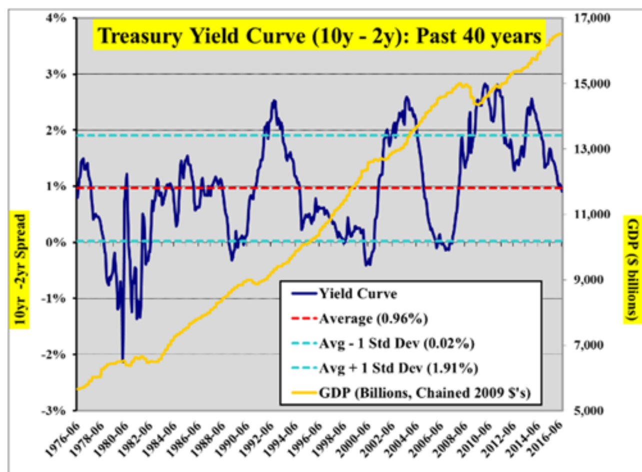
There has been some discussion recently about the flatness of the US yield curve, given the steep decline in long-term rates. The 10-year Treasury yield has dropped by 1.5% since December 2013, while at the same time the 2-year's yield has risen by 50bps. This is not idle chit-chat.

As Figure 12 reflects, *every* time the 10yr-2yr curve has gone negative during the past 40 years, we've experienced a breakdown in GDP (a recession). With current GDP growing at less than 2% annually, the feeling is that we just can't afford this added burden right now.

By comparing historical Treasury yield spreads to GDP growth, we see in Figure 12 that distinct flattening, and especially *inversion* (short-term rates > long-term rates), of the yield curve has resulted in economic contraction. The rationale for this is as follows: in an environment of both restrictive monetary and fiscal policy (increased short-term interest rates along with increased taxes and/or decreased gov't spending), expectations for economic output are low. Conversely, when monetary and fiscal policy are more stimulative, the yield curve is steep and economic expectations are higher.

The good news is that, at least for now, we're not close to the inversion point. In fact, the curve was almost exactly at the 40-year average as the second quarter ended. But, if the recent flattening continues, eventually reaching inversion, the U.S. may be looking at another period of economic contraction, as in 1980, 1982, 1991, 2001, and 2008-2009, where all downturns occurred after inversions of the yield curve.

Figure 12: Treasury Yield Curve v. GDP Growth



Last quarter we observed the only domestic fixed income sector with any real yield "juice" was high yield bonds. They were trading at an option adjusted spread of 7.05% as of first quarter's end, 2% above their 20-year average, and down from over 9% in February. Many others noticed this and price appreciation pushed high yield spreads down to 5.94% by the end of June.

Despite the furious rally in credit since February, BBB, high yield, and Emerging Markets bonds are the only major US$ fixed income sectors trading at yields above the S&P 500's dividend yield.

Unfortunately, there's really no free lunch in bonds. The contra to higher yields is higher default risk. The trailing 12-month junk-bond default rate hit a 6-year high in June at 4.9%, says Fitch Ratings, highlighting the ongoing pain from the oil patch. Energy companies defaulted on $28.8 billion of debt the first half of this year, for a 15% sector default rate. Morgan Stanley puts the current default rate at 6.6%. But HY prices have risen nevertheless, more than reversing their post-Brexit decline. New high-yield issuance topped $20 billion in June for a 4th-straight month, pushing the first-half total to $116 billion. In 2015, $251 billion of such debt was sold.

As policy rates across three major central banks fall even further from current levels, they promise to constrain long-term sovereign yields to "lower for longer." Blackrock estimates that over 40% of developed market bonds now trade at negative yields, led by Japan. As this continues, look for investors to continue the global search for higher yielding assets.

Which brings us to a closing observation. Sovereign and highest quality credit bond yields leave precious little cushion against the risk of rising growth or inflation. Even in the US, real yields are more negative than since 1980. Highest quality bonds are now as risky as stocks. **If interest rates rise/fall by 1%, then** -

- The price impact on a 10-year Treasury bond would be *-8.7%* / *+9.7%*.
- The price impact on a 30-year Treasury bond would be *-19.2%* / *+25.3%*.
- Even the investment grade corporate sector would see a swing of *-6.9%* / *+8.0%*.

Low yields still make sense in a world where interest rates continue to fall in many countries, central banks are gobbling up an increasing share of new issuance, and investors - after seven years of an equity bull market, are more worried about return *of* capital than return *on* capital. But, for the rest of us, overweighting stocks, real assets, and liquidity seems like a logical strategic reaction to the lowest interest rates, ever.

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA

Copyright @2016 Chartwell Consulting (USA) LLC All rights reserved.