Investment Management of Virginia

Investment Viewpoint

July, 2016

Overview

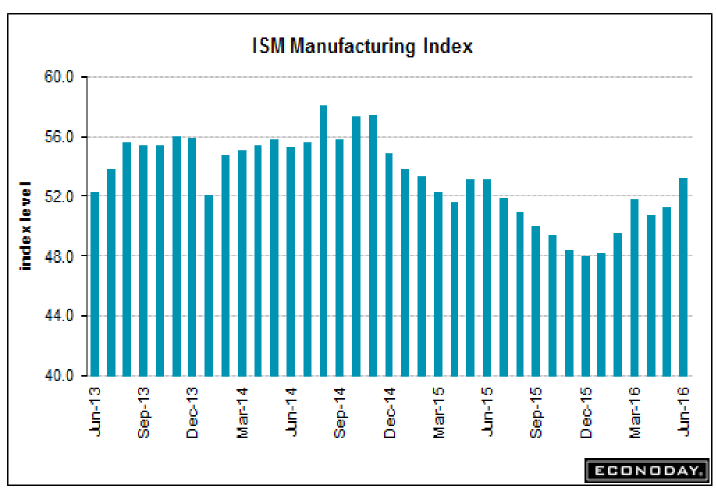
Early in 2016, activity in the financial markets reflected fears about declining Chinese economic conditions, tightening on the part of the U.S. Federal Reserve, mounting evidence of global deflation, and rising risks of a recession. Oil prices also fell dramatically, which placed downward pressure on credit markets, the banking system, and broader equity markets.

Heading into June, animal spirits and some data had improved: the Chinese economy and the value of the U.S. dollar appeared stable; oil prices had rebounded from $26 per barrel to the $40-$50 range; the U.S. economy reflected modest growth with jobless claims nearing 26-year lows; and the Federal Reserve had reiterated its dovish stance on U.S. interest rates in advance of the “Brexit” vote (the referendum in the U.K. on whether or not to remain in the European Union). U.S. equity markets had risen for three consecutive months and were positive on a year-to-date basis.

Late in June, the U.K.’s populace – in a 52% to 48% vote, with 70% turnout – surprised the pollsters and opted for “Leave”, creating much uncertainty. Low worldwide interest rates plunged even further. Germany’s 10-year Treasury Bund traded at a negative rate for the first time in its history. The U.S. 10-year Treasury yield touched 1.44%, having ended 2015 at 2.27%.

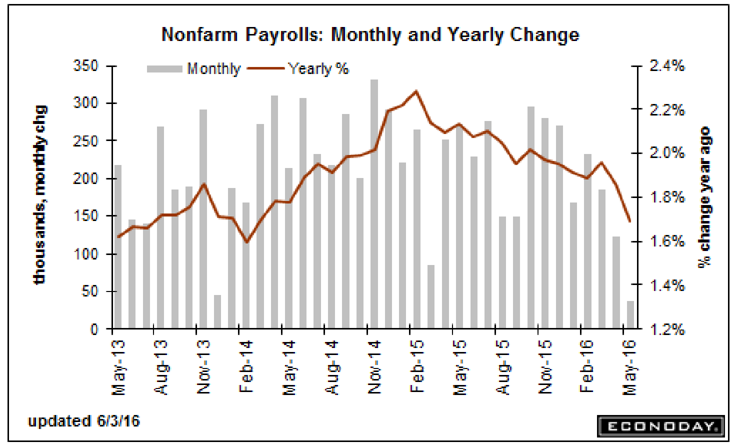
Despite the “Brexit” surprise, the U.S. equity markets – after a tough couple of days – continued to climb the wall of worry into quarter-end, with value and dividend stocks leading the way. As of June 30th, the S&P 500 Total Return (“TR”) Index had gained 2.46% for the quarter (and 3.84% YTD); the Dow Jones Industrial Average had advanced 2.07% (and 4.31% YTD); the S&P MidCap 400 TR Index was up 3.99% (and 7.93% YTD); and the S&P SmallCap 600 TR Index had risen 3.48% (and 6.23% YTD). Leading sectors included Telecommunication Services, Utilities, Energy, and Consumer Staples, each with double-digit gains on the year. Financials, Information Technology, Health Care, and Consumer Discretionary lagged. The markets effectively have treaded water for much of the last two years, setting new highs in May of 2015, followed by two 10+% corrections. Aggregate earnings have also remained flat over this timeframe but show signs of basing.

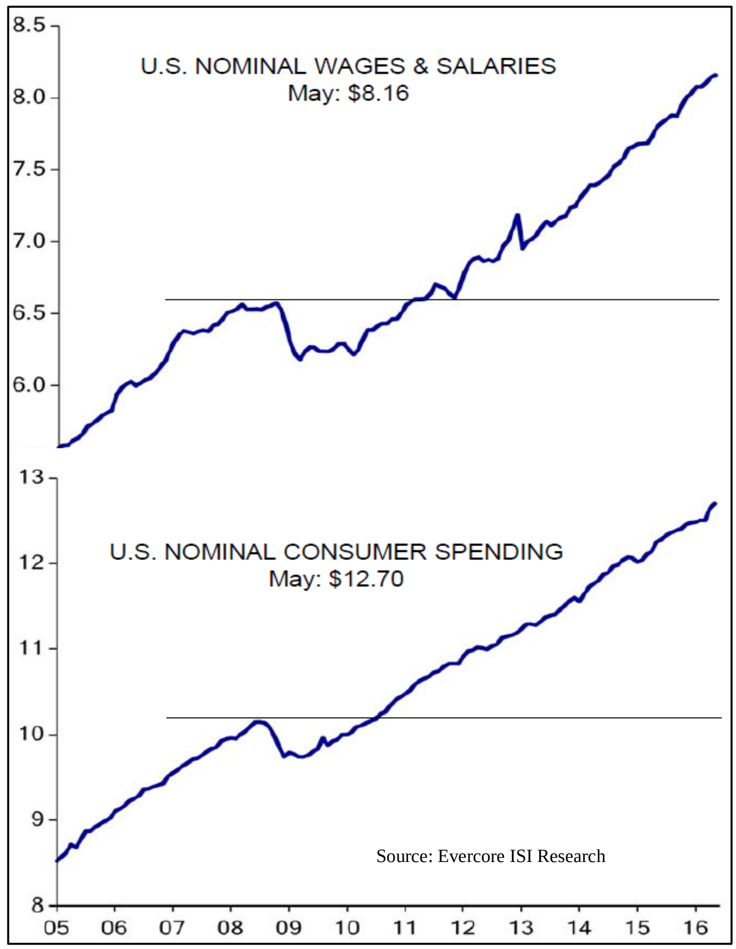
Looking ahead, negative interest rates abroad, low productivity and rising unit labor costs here at home, along with the weakest extended period of U.S. GDP since the end of World War II remain concerns. On a positive note, China’s GDP growth appears to be stabilizing, with 6.7% year-over-year growth reported in its most recent quarter; Japan’s corresponding figure improved to an annualized rate of 0.1%; and growth in the Eurozone advanced 1.7%. Post-Brexit, we would expect the latter to slow by 0.3%-0.5%, leaving full-year growth in excess of 1.0%. In the U.S., first quarter GDP grew at a better than expected 1.1% annualized rate. A healthy consumer has been the key driver of recent U.S. growth; and while business spending has weakened, manufacturing has shown signs of stabilizing and possibly turning up. May’s ISM Manufacturing Index reflected an especially encouraging reading of 53.2, indicating expansion and demonstrating solid new order growth. In the post WWII era, the U.S. has never fallen into a recession while the ISM Manufacturing Index signaled expansion.



Economic Trends

- The June 3rd Nonfarm Payrolls report delivered a big negative surprise; 38,000 new jobs were created; 158,000 had been expected. At the same time, the unemployment rate dropped to 4.7% from 5.0%. The data appear mixed.
- As of July 1st, Evercore ISI's (EVRISI) company surveys were on track for their highest level in three months with widespread advances in autos, airlines, trucking, credit card companies, bank loans, and homebuilders.
- Nominal wages and salaries rose 4.6% year/year in May, perhaps explaining the 3.7% increase in nominal consumer spending. Simultaneously, over the past year, the savings rate increased from 4.8% to 5.3%. Consumer incomes, spending, and balance sheets generally appear healthy.
- While the consumer has supported recent U.S. GDP growth, now estimated to be 3.0% for the second quarter, business investment and private non-residential construction have lagged until recently. May's ISM Manufacturing Index reading (53.2) reflected expansion and solid new order growth. Recent increases in the North American oil & gas rig count and total railcar loadings (ex-petroleum) were encouraging signs as well. As can be seen in the bottom chart, the Chicago Business Barometer Index has also turned up recently.
- Numerous early indications of rising pricing pressure have surfaced, including higher wages, low unemployment, and month/month increases in import and export prices (1.4% and 1.1%, respectively, in May). Collectively, these trends are signaling support for stable/rising commodity prices.

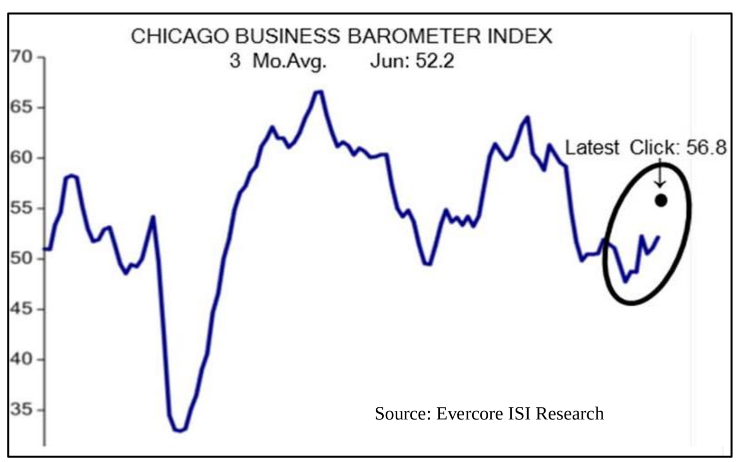




Source: Evercore ISI Research

Financial Conditions/Monetary Trends

- Following the 0.25% interest rate increase in December and a "proceed cautiously" statement with no increase in March, the Federal Open Market Committee voted unanimously (and dovishly) in June to hold the Federal Funds rate at 0.25%-0.50%.
- Of the five conditions Chair Yellen cited in March as necessary, all but one or two were "in place" or moving in the right direction in June:
  - The dollar appeared to have stabilized, which should help manufacturing, commodity prices, and earnings in general.
  - The housing sector has continued to advance.
  - Inflation seemed to be firming with rising wages, rising import/export prices, and a core PCE Price Index of 1.6%.
- Clearly, the uncertainty associated with foreign economies and their financial markets stood in the way of what the Fed wants to do (raise rates/normalize).



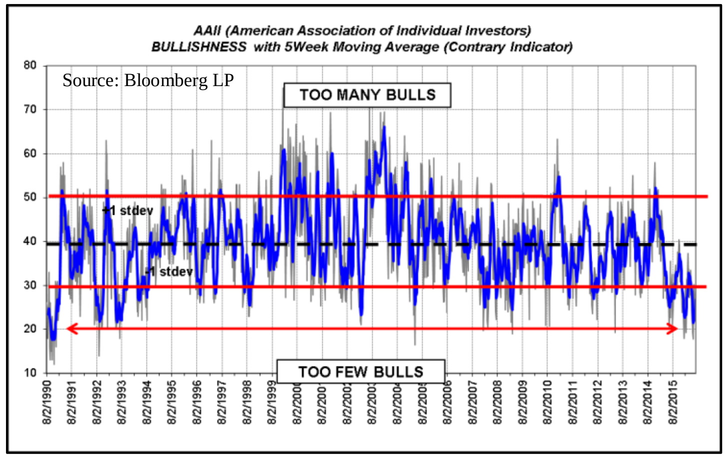
Source: Evercore ISI Research

Sentiment Indicators/Market Trends

- "Sentiment" is often a contrary indicator, with excessive fear signaling over-sold market conditions and excessive euphoria reflecting over-bought market conditions.
- For the last several years and until recently, overall investor sentiment measures have remained somewhat complacent. Sharp corrections in late 2015 and early 2016 did, however, signal intensifying levels of fear and panic. A more

significant turn came on the surprising Brexit "Leave" vote in late June.

- The total put-to-call ratio surged to the 3rd standard deviation level, statistically representing only a 2.1% probability. In other words, extreme panic (over-sold) levels were reached.
- Neither the VIX nor the VXO volatility indexes signaled absolute extreme levels, but both measures of volatility nearly doubled from their prior readings.
- Most intriguing was the American Association of Individual Investors (AAII) Bull/Bear survey. Bullishness dropped to lows not seen since the early 1990s with the worst five-week level since the invasion of Kuwait, by Iran, in August of 1990.
- These readings recovered somewhat into quarter-end, along with the market.



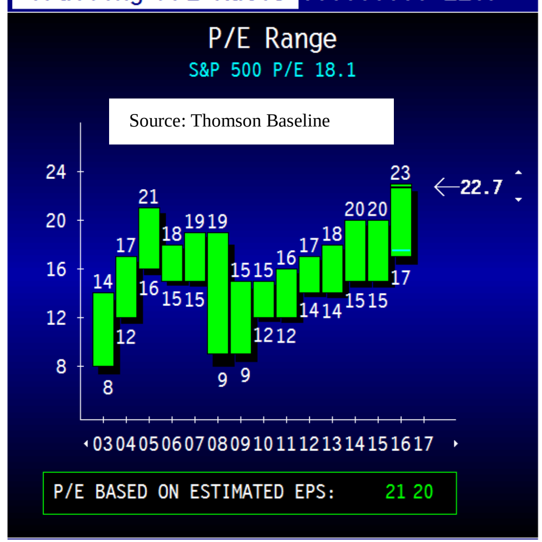
S&P500 (BTTM-UP EST) 7/01/16
(SPXB) 2102.95
Earnings Per Share - % change
Latest Qtr (Mar 16) ....down 7 %

%Y Earnings Per Share
Next Expected EPS Date: Aug 17

	2011	2012	2013	2014	2015	2016	2017
Mar	23.76	25.71	26.67	28.15	28.61	26.66	31.16
Jun	25.53	26.00	27.05	30.20	30.02	28.56	32.92
Sep	25.68	26.11	27.94	30.69	30.28	30.62	34.73
Dec	24.92	26.76	29.00	29.63	29.32	32.03	34.21
Yr.	99.88	104.58	110.67	118.67	118.23	117.58	133.74
Yr. to Yr.	5 %	6 %	7 %	0 %	-1 %	14 %	

Source: Thomson Baseline

DOW JONES UTILITY AV 7/01/16
(UTIL) 715.97
Trailing P/E Ratio 22.7



Equity Market Valuations & Earnings

- Assuming that S&P 500 earnings finish 2016 "as estimated," calendar year operating earnings will have been flat for three consecutive years, 2014-2016. Oil prices started their collapse in the summer of 2014 and represent the largest drag on S&P 500 profits. Ex-Energy, however, earnings growth expectations for 2016 stand at 7%-8%. Overall earnings growth, including Energy, is expected to accelerate in the back half of 2016 and into 2017.
- Stabilizing currency exchange rates, higher oil prices, and slow and steady macroeconomic growth are the factors that support estimated forward earnings improvements. At quarter-end, these legs of the stool appeared to remain intact.
- As for the impacts of Brexit, only 1%-2% of U.S. sales come from the U.K.; 49% of U.S. sales originate from outside the U.S. (Standard & Poors).
- With respect to valuations, price metrics generally hovered at the high-end of their long-term ranges at quarter-end, with those of some "defensives" reaching extremes. For example, according to Standard & Poors, the price-to-earnings ratio on utilities traded at a 34% premium relative to the S&P 500 Index, as measured over a twenty year interval. Looking ahead, some defensives may not be as defensive as before!
- Nevertheless, in what is expected to remain a low-yield/low-return environment, the dividend yield on the S&P 500 Index may prove to be supportive; at approximately 2.0%, it remained significantly higher than the yield of the U.S. 10-year Treasury at June 30th.
- Further multiple expansions appear unlikely in the near-term, since investors are nervous and many economies are growing at just above stall speed. Future equity market advances likely will require improved confidence and earnings growth.

For more information about Investment Management of Virginia, visit: http://www.imva.net

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