PRIVATE CAPITAL MANAGEMENT
A Subsidiary of GUARANTY BANK AND TRUST

P: 303.370.0055
F: 303.370.0066

pcm-inc.com

250 Steele Street | Suite 350 | Denver, CO 80206

Second Quarter 2016

"It's never paid to bet against America."
- *Warren Buffett*

The first six months of the year has been full of uncertainty and surprises for investors. Following the stock market correction in January and February due to fears about a continued economic slowdown in China, U.S. stocks roared back by the end of March. Stocks continued to climb the wall of worry until Thursday, June 22nd when Britain shocked the world by voting to leave the European Union. This unanticipated historic decision led to a knee jerk reaction by many investors, and stocks sold off globally the following two days. But, as cooler heads prevailed, U.S. stocks recovered much of their value by the end of June and actually delivered positive returns during the second quarter. In this quarter's commentary, we provide some perspective on how the markets have been doing over the last 17 months, our thoughts on why bonds still matter, and the situation in Britain.

Muddling Through

Investors seem to have a general sense of uncertainty and nervousness about the global economy, the U.S. Presidential elections, the situation in Europe, and global terrorism. In fact, a poll from last year showed that 64% of Americans felt the economy was still in a recession (which ended 7 years ago!).[1] Election polls show that many Americans are dissatisfied with their choice of Presidential candidates, and we regularly hear concern about how one candidate or another may impact the country. All of this uncertainty has led to a low growth environment for investors over the last 17 months. The chart below shows the S&P 500 large U.S. company index has been relatively flat since November 2014.

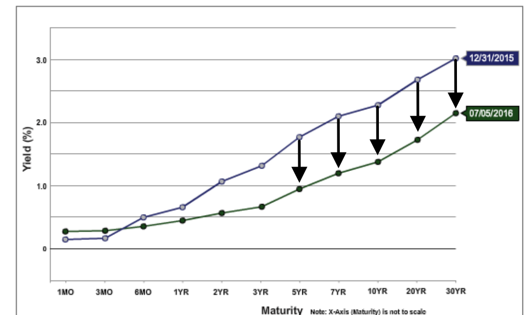
Below is a list of factors that Deutsche Bank Chief International Economist, Torsten Slok, Ph.D., believes are all positive indications that the U.S. economy is not headed for a recession.[2]

- Weekly jobless claims are at the lowest level in decades.
- The unemployment rate and weekly continuing jobless claims are near decade lows with no signs of a recent increase.
- There are a record number of job openings, and wages are rising.
- The number of people available per job opening is below the 2006-2007 level, and it's taking an average of 29 days to fill a vacant job, which is up from 23 days in 2006.
- Weekly data for bank lending continues to grow at about 8%.
- The Conference Board Leading Economic Index is at the highest level since 2007.
- The Institute for Supply Management's June non-manufacturing (services sector) index came in at 56.5%, up from 52.9% in May (readings above 50 are designed to signal economic expansion).
- Payrolls increased 287,000 in June, the most in eight months.

There is a lot of negative news dominating the headlines, but the recent economic data continues to show resiliency in the U.S.

Yields Fall as Uncertainty Rises

One point of continued interest for our Investment Committee is the ever changing slope of the U.S. Treasury Yield Curve, which is a plot of the yields on various maturities of Treasury bonds. As we explored in our 3Q15 Commentary, the yield curve is positively sloped with long-term rates higher than short-term rates in a normal economic environment. This is logical because borrowers pay a higher interest rate for a 10-year loan versus a 2-year loan. But, the yield curve has historically inverted (short-term rates higher than long-term rates) prior to every recession since the 1960's. The yield curve is still positively sloped, but it has been flattening since 12/31/15 as shown in the chart to the right from the U.S. Treasury as of 7/5/16.



The chart below from the Federal Reserve Bank of St. Louis shows the yield differential between the 10-year and the 2-year Treasury (blue line) and past recessions (grey bars) going all the way back to 1976. Again, recessions have occurred historically after the spread (blue line) dips below zero – the yield curve inverts. There are two points worth noting about

recent changes in the yield curve. The yield curve has been flattening as evidenced by the declining yield spread between the 2 and 10 year Treasuries, but importantly the yield curve is <u>not</u>

inverted. So, even though the yield on the 10-year Treasury reached an all-time low of 1.38% on July 5th, this historical recession indicator is still not flashing an alert. But, this begs the question: If the U.S. economic data is still resilient, why is the yield curve flattening? To answer this question, we believe U.S. investors will need to understand what is happening with global interest rates. The table below contains the yields on various government bonds from seven major countries around the world. Please note that the negative yields are not a typo!

Government Bond Yields as of 7/5/16 from Bloomberg			
Country	**2-Year**	**5-Year**	**10-Year**
United States	**0.55%**	**0.94%**	**1.38%**
Canada	0.49%	0.54%	0.99%
United Kingdom	0.11%	0.33%	0.77%
Japan	-0.33%	-0.35%	-0.25%
France	-0.61%	-0.41%	0.13%
Germany	-0.68%	-0.61%	-0.19%
Switzerland	-1.15%	-1.05%	-0.65%

In a global investing world, it's not hard to see why there is demand for U.S. Treasuries despite their record low yields. It is truly a case of being the cleanest dirty shirt, or the "least worst" option. Additionally, the U.S. Dollar continues to be the world's reserve currency. During times of geopolitical and economic uncertainty, investors still flock to the safety and stability of U.S. Treasuries. We believe traders continue to buy other government bonds at such low yields because they expect additional monetary easing may be in the works from some foreign central banks. This may come in the form of Quantitative Easing (QE) bond buying programs much like the U.S. did in response to the financial crisis in 2008. Under this premise, some bond traders are following the greater fool theory where they are buying low, or even negative, yielding bonds in hopes to sell them back to a central bank (the greater fool) for a higher price later. We prefer, however, to invest diversified portfolios of bonds that our clients can own for the long term. With the increased level of uncertainty following the Brexit announcement, investor expectations of future rates increases by the Federal Reserve have declined. Our team continues to monitor global interest rates and the evolving shape of the U.S. yield curve.

Some Facts about Brexit

On Thursday, June 23rd, roughly 30 million people in the United Kingdom (UK) (72% voter turnout) voted on a historic referendum to advise their government whether or not they should stay or leave the European Union (EU). In a surprising turnout, the vote to "leave" won by 52% to 48%. It's important to keep in mind that the formal process to exit the EU has a two year time limit, so this is not something that will happen overnight. However, the British Pound has been tumbling in value and it is now widely expected that the UK economy will fall into recession. Below is a list of facts about U.S. financial exposure to the United Kingdom that should bring perspective to investors who are concerned about this situation:

- Of $1.5 trillion in total U.S. exports, only $56 billion went to the UK. This is less than 4% of U.S. exports and 0.4% of U.S. GDP.[3]
- Only 3% of total U.S. bank assets are exposed to British entities.[3]
- Just 1.8% ($1.3 trillion) of the $70 trillion Americans have on their household balance sheets is invested in British securities, which are unlikely to go to zero.[3]
- FactSet estimates that the aggregate revenue exposure of the S&P 500 to the UK is just 2.9%, and it is also unlikely to go to zero.[3]

The direct financial exposure to the UK is manageable, but investors are still nervous about the uncertainty that lies ahead and how it could impact broader Europe.

Navigating Uncertain Times

Famed investor Peter Lynch once said, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections." Everyone fears losing money on an investment. That is just human nature. But, abandoning long term investment planning because of the news headline of the day can be just as detrimental as the next stock market correction. It is important to recognize that stock market movements cannot be predicted consistently in advance, and that investors do not get the benefit of hindsight when making investment decisions. So, we believe investors should hold a diversified asset allocation that allows them to stay the course while the markets gyrate around them, and use a disciplined asset allocation rebalancing process to take advantage of short term dislocations in the markets that may create investment opportunity.

Thank you

During times of geopolitical, economic and market uncertainty, we remain committed to serving the needs of our clients by staying disciplined and focused. We would like to express our appreciation for being able to work with each of our clients. *–The PCM Team*

By the numbers…

Index	**Close**	**2nd Quarter**	**Year-to-Date**
S&P 500	2098	+2.5%	+3.8%
Dow Jones Industrial Average	17,929	+2.1%	+4.3%
Russell 2000	2862	+3.8%	+2.2%
MSCI EAFE	1608	-1.5%	-4.4%
MSCI Emerging Markets	834	+0.7%	+6.4%
Barclay's US Aggregate Bond	-	+2.2%	+5.3%
Bloomberg Commodity	88	+12.8%	+13.3%

Data provided by Morningstar as of 6/30/2016

1 Blanton, Dana. "Fox News Poll: 64 Percent Say U.S. Still in Recession, Yet 58 Percent Optimistic about Economy." *Fox News*. Fox News, 25 Jan. 2015. Web. 05 July 2016.
2 Slock, Torsten, Ph.D. "DB: The US Economy Is Not about to Enter a Recession." 13 June 2016. E-mail.
3 Ro, Sam. "These 4 Charts Show What the US's Exposure to the UK Actually Looks like." *Yahoo Finance*. Yahoo, 26 June 2016. Web. 05 July 2016.

Disclosures: Investment Products: Not FDIC Insured – No Bank Guarantee – May Lose Value - Not insured by any federal government agency
Private Capital Management, LLC (PCM) is a wholly owned subsidiary of Guaranty Bank and Trust. Opinions and information presented have been obtained or derived from sources we believe to be reliable, but we cannot guarantee their completeness or accuracy. Opinions represent PCM's judgment as of the date of the report and are subject to change without notice. This material is for general information only and is not suitable for all investors. It is not soliciting any action from any particular investor. This presentation is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this presentation may be unsuitable for some investors depending on their specific financial position and investment objectives. Private Capital Management and/or its personnel may trade for their own accounts, be on the opposite side of customer orders, and have positions in securities related to issues mentioned in this presentation. Investing in foreign securities presents certain risk that may not be present in domestic securities. Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses. PCM does not provide tax or legal advice. Please consult appropriate tax or legal advisors to determine how this information may apply to your own situation. The indices and benchmarks mentioned for comparison purposes are unmanaged. You cannot purchase an index. S&P 500 Index is an unmanaged capitalization weighted index of 500 stocks. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. The Russell 1000 Index is a large-cap stock market index of the largest 1,000 stocks in the Russell 3000 Index. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets consisting of 21 emerging market country indices. The Barclay's U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Bloomberg Commodity Index is an index composed of the futures contracts on 19 physical commodities. Additional information is available upon request. Dated: 7/8/2016