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AAFMAA Wealth Management & Trust LLC

MARKET OUTLOOK

JUNE 2016

Citizens of the U.K. shocked financial markets around the world by walking in to their voting booths and with a shout of “I’m mad as hell and I’m not going to take this anymore,” voted 52% to 48% to leave the European Union (EU).

Technically, the referendum was not legally binding on the U.K. government. Only if the British prime minister invokes Article 50 of the EU’s governing treaty — an irreversible action — will the U.K. have two years to negotiate terms for a new relationship with the EU. If they do not reach an agreement, the U.K. will be out anyway.

EU and U.K. negotiators face a challenge to strike a good balance in its terms with the U.K. If the terms are too favorable, it could start a domino effect with other EU nations wishing to leave including France (Frexit?), Greece (Grexit?) or Italy (Quitaly?). If they are to too harsh, it could result in a collapse of trade — almost half of U.K. exports go to the EU.

U.S. markets declined 6% in two days on the news, but that was minor compared to international markets, which plunged up to 10%. As we have repeatedly told our clients, ignore short-term events — what we call “noise” — and concentrate on long-term goals. This event was no different. Within a few days, U.S. markets turned around and climbed 6%, virtually erasing the entire deficit.

Why did the market reverse itself? Could it be that U.S. exports to the U.K. account for less than 0.7% of GDP or that even the EU as a whole only accounts for 2% of GDP? Maybe investors came to their senses and realized that for an economy the size of the U.S., this was a non-event. More importantly, domestic drivers of U.S. growth are still positive, although not spectacular — our “slow growth” scenario remains intact. While you should not act on short-term events, you can expect another knee jerk reaction when the U.K. invokes Article 50.

Investors are growing increasingly frustrated with the market and rightly so. Returns have been subpar. The S&P 500 currently sits roughly where it was at the end of 2014. With equity markets in performance purgatory, some investors have been tempted to reach for yield via long-term maturity bonds. We advise otherwise. With 10 year Treasuries currently yielding 1.4% and 30 year Treasuries at 2.1%, this segment of the bond market looks like a bubble that will end badly. Why are yields so low? A flight to quality from international investors. , The political uncertainty and negative interest rates in Europe are making U.S. fixed assets especially appealing to those investors. Instead, we recommend intermediate maturity corporate debt and higher quality non-investment grade bonds for the fixed income portion of your portfolio as a more appropriate mix.

What are we doing with our clients' portfolios? As we have mentioned numerous times in the past, ignore the noise, concentrate on the long term, and watch the "investment traffic lights":

- **Federal Reserve Bank policies** (tightening=red; loosening=green)
- **Market valuation** (high=red; low=green)
- **Investor psychology** (greed=red; fear=green)

When we boil down our market components to these three indicators, we find the Fed maintaining an accommodative monetary policy (green), market valuations at reasonable levels given the current interest rate environment (green but turning yellow) and the typical individual investor terrified of the market (green).

What should you do to navigate the volatility of this market and achieve investment success? Here's our advice:

1. Have an investment strategy that matches your goals and risk tolerance. You should determine the correct strategic asset allocation that matches both your time horizon and your ability to tolerate price fluctuations. Most people have goals that span years or even decades, and the longer that period of time, the more aggressively you can allocate your portfolio. However, if you panic every time the market has a down draft, you should not choose an aggressive allocation. Both time and tolerance must match to be a successful long term investor.

2. Diversify your portfolio. No one knows what areas of the market (large, mid, small) or what style (value, core, growth) or what sector (health care, technology, utilities, etc.) will out-perform or under-perform each year. At AAFMAA Wealth Management & Trust we over-weight certain areas based on historical valuation parameters, but we never make big investment bets.

3. Don't forget the world. There are around 7 billion people in the world, 95% of whom are not American. Businesses and investors outside the U.S. generate a large and growing share of global economic activity. Your portfolio should have an exposure to this area. International equity valuations are very compelling right now for patient investors.

4. Manage your portfolio. Long term investment success does not come from a select and forget strategy. Although market timing does not work, disciplined rebalancing does. AAFMAA Wealth Management & Trust rebalances on a percentage basis rather than a periodic basis. History demonstrates that percentage rebalancing adds value over time.

Executing these four pieces of advice might seem complex, but AAFMAA Wealth Management & Trust can help. As a regulated and chartered trust company, we hold the highest level of a fiduciary duty and care for our clients. Talk with your account administrator, relationship manager and investment officer to make sure they are calibrating your investment risk correctly for your situation, because proper risk assessment will better enable you to stay the course through all types of markets.

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