The Cobblestone Advisor

Investment Brief

COBBLESTONE CAPITAL ADVISORS

July 25, 2016

A Sizzling Summer

There is an old Wall Street quip suggesting that investors "sell in May and go away" - as in, go away to the Hamptons, the favored retreat of the Wall Street swells who coined the saying. The adage springs from the belief that stocks struggle more and earn less during the stretch from June through September, and it tends to be true.

So far this summer, however, with stocks surging to new highs, the market seems to be charting a different course. Worries over China's debt-impaired economy have been left behind, as have been the more recent fears over "Brexit." The move higher has not been unwarranted; the 17% surge since February has been driven by two key factors: interest rates are at historic lows and economic data has turned for the better. The adjacent chart of Citigroup's Economic Surprise Index tells the story: data has gone from surprisingly bad to surprisingly good.

In short, economists and analysts have been too cautious. Last Fall we noted that falling inflation and interest rates in 2015 would provide a dual tailwind to the economy in 2016. And earlier this year, we relied on our recession probability monitor to conclude that the steep sell-off in stocks was unwarranted. Today, the same inputs are giving largely the same signal: odds of a recession are low, and economic momentum is likely to carry the expansion well into 2017, or beyond.

The fact that the expansion is poised to carry on for quite some time, however, does not automatically mean that equity returns will be robust; although the economic outlook remains good, the financial market outlook is beginning to shift. A key difference between this summer and last is that stocks (and stock valuations) are a bit higher, interest rates are a lot lower, and inflation has quietly begun to accelerate. The move higher in inflation has received little attention, but bears watching. Over the past year, core CPI has risen by a modest 0.5% to its current level of

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Total Return Ending 6/30/2016				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	**0.99%**	**1.23%**	**-3.70%**	**6.00%**	**5.36%**	**4.25%**
Russell 3000 Stock Index	2.63%	3.62%	2.12%	11.07%	11.55%	7.37%
S&P 500 Stock Index	**2.46%**	**3.84%**	**3.96%**	**11.59%**	**12.05%**	**7.40%**
Russell 2000 (Small Cap Stocks)	3.79%	2.22%	-6.68%	7.05%	8.32%	6.17%
MSCI EAFE (International Stocks)	**-1.46%**	**-4.42%**	**-10.09%**	**2.05%**	**1.67%**	**1.57%**
MSCI EMF (Emerging Markets)	0.66%	6.41%	-11.97%	-1.56%	-3.77%	3.53%
Barclays US Aggregate Index	**2.21%**	**5.31%**	**5.95%**	**4.04%**	**3.75%**	**5.12%**
FTSE NAREIT All Equity REITs	7.41%	13.68%	23.42%	13.24%	12.47%	7.42%

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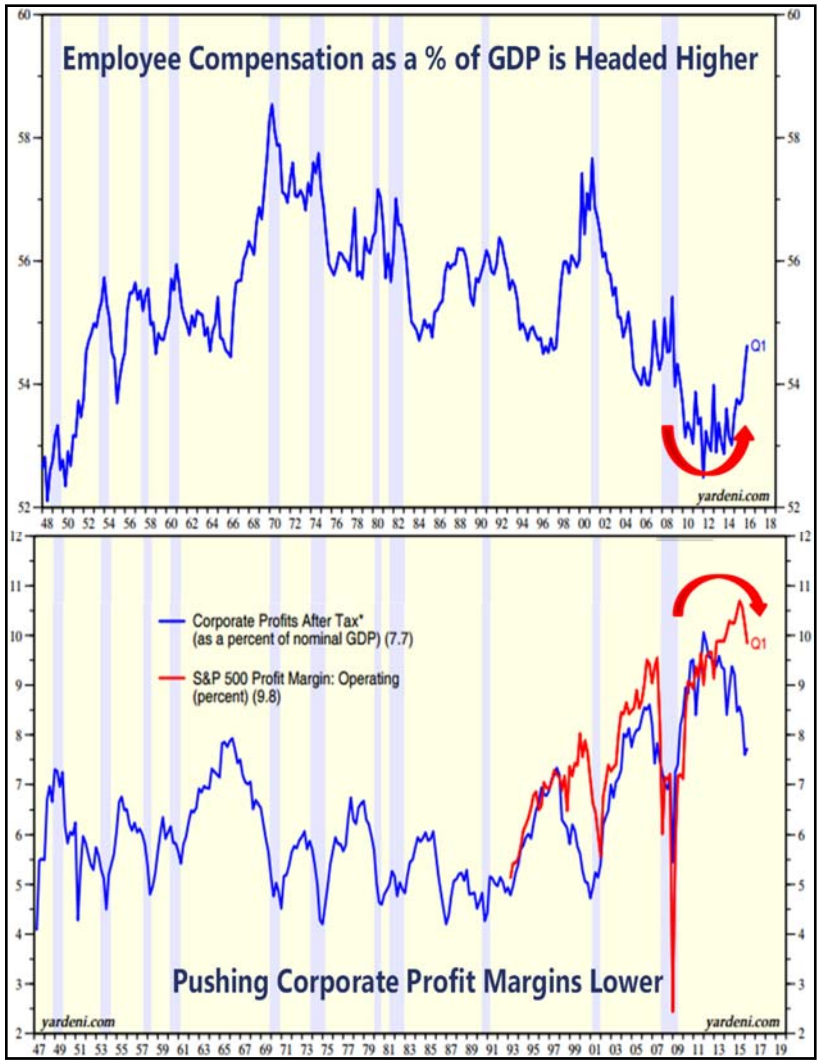
2.23%. But with unemployment at a low 4.7% and likely to decline further, we expect wage pressures to gradually foster even more inflation. Inflation erodes the value of fixed coupon investments, a risk that seems underappreciated today as investors worldwide clamor for long-dated bonds. This brings to mind a lesser known Wall Street saying that "more money has been lost chasing yield than at the point of a gun." Although the prospects for a rapid surge in inflation and interest rates today seem remote to most observers, caution in the bond market is warranted nonetheless; investors should not expect fixed income returns to exceed current yields to maturity.



As seen in the adjacent charts, tighter labor markets are already leading to an increase in compensation levels for employees. And while rising wages are great news for consumers and for consumer confidence, they aren't for corporate profits. So, again, the health of the economy and the prospect for continued expansion is not uniformly good news from an investment perspective; rising wage pressures lead to lower profit margins, a headwind that lowers returns in the absence of surging enthusiasm (higher valuations) or an acceleration in growth. We are not expecting a significant and sustained decline in stocks until the next, reasonably far-off recession. But headwinds are mounting and, as a result, we are beginning to adopt a modestly more cautious/less bullish perspective.

Beyond the subtle shift in inflation, the gradually building pressure on profit margins, and the slightly elevated state of current valuations, there is another less-tangible factor that clouds the outlook for financial markets. Beleaguered voters both here and abroad are making it clear that their disaffection is much stronger than previously appreciated. The Brexit referendum and the successes of both Donald Trump and Bernie Sanders highlight the degree to which anti-immigration, anti-trade, and anti-business platforms have gained traction. While it is too early to determine whether these platforms become policies, it isn't too early to acknowledge that they likely would lower the return on capital.

With the expansion poised to press higher for at least another year or so, stocks should enjoy further gains. But, increasingly, the tailwind of economic growth will be met with headwinds that dampen returns. Rather than heading to the Hamptons, we'll be looking for opportunities and making judicious portfolio adjustments to navigate the environment ahead.