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Stolper Asset Management

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Portfolio Comments For the Quarter Ending June 30, 2016

By mid-June, with the first half of the year almost behind us, the pervading economic and political themes that have been driving investment market performances for some time appeared fairly entrenched for the foreseeable near future. That was until the British populace presented the world with a black swan on June 23rd in the form of an unanticipated 'leave' decision in the nation's referendum on its continued European Union membership. The outcome of the Brexit vote, as it was dubbed, left in its immediate wake significant turmoil and power vacuums that reverberated worldwide. As the ancient Chinese philosopher Confucius cautioned: "A man who does not plan long ahead will find trouble right at his door." In this case, the door was No. 10 Downing Street, the soon-to-be-former abode of British Prime Minister David Cameron.

If there is one thing the financial markets aren't a fan of, it's uncertainty, which the Brexit decision delivered in seismic doses. In a knee-jerk reaction, and reflecting the fact that a remain outcome had practically been priced in, the immediate fall out was spectacular. The British pound plummeted to its lowest level against the U.S. dollar since the mid-1980's and global stock markets lost a record \$3 trillion in the two trading days following the vote results. The unwinding of positions and a revaluation of allocations as investors flocked to implement 'risk-off' strategies, were the major loss drivers. Bargain hunting, alongside an ebbing of the panic, has since resulted in significant recouping and stabilization for many asset classes.

The U.S. equity markets were not immune, with the benchmark S&P 500 recording its third worst two-day drop ever in value terms following the vote with a \$1 trillion loss. This certainly put a dent in both the S&P 500's and the Dow Jones Industrial Average's (DJIA) choppy accents from their February year-to-date lows, although the subsequent final days' rebound resulted in a positive second quarter and as well as solid first half gains. The S&P 500 closed on June 30th at 2,099, representing a return of 2.46% for the second quarter, and 3.85% for the first six months of 2016. The Dow Jones Industrial Average (DJIA) ended June at 17,930 for a return of 2.07% in the past three months and 4.32% for the year to date.

It might seem reasonable to assume that a referendum result, regardless of the outcome, would have imparted some clarity regarding future effects, but the reality is that this unprecedented decision by a

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major economy that has been part of the EU for over four decades has left those in charge scrambling to come up with a plan, let alone begin to implement one. Starting with what we do know, David Cameron, British Prime Minister since 2010 and the leader of the incumbent Conservative Party, promptly resigned having failed to secure a win for the 'stay' camp. His party will vote on a replacement in September. Britain's EU commissioner also relinquished his post and the nation's opposition Labour Party is in disarray following a slew of top resignations and a vote of no confidence in its leader, Jeremy Corbyn. Although the current Parliament still has close to four years of its five-year term to run, the U.K. may find itself going to the polls for a general election in the near future as a means of voicing how the majority of the nation want the situation to play out.

The mechanisms for implementing the split are also known, in theory. To proceed, Britain must invoke Article 50 of the Lisbon treaty, at which time the other 27 member countries have two years to reach a majority agreement on the terms of Britain's exit. Concurrently, Britain can negotiate its new trade relationship with the EU. Given the U.K. leadership vacuum, such an invocation is months, if not longer, away. In broad terms, the two post-Brexit frameworks available to negotiate around are a Norway-style model with membership of the European Economic Area (which would involve budget contributions and continued free movement of people in return for access to the EU market) or complete separation. Given that the rest of the EU buys almost half of Britain's exports it's hard to envisage how either of these models offers a clear path to fulfil the dual 'leave' campaigners' promises of a thriving economy *and* immigration control. Also, given the flipside - that only 7% of other EU members' exports are bought by Britain - it difficult to see

why Brussels will be clamoring to pander to a U.K. only interested in securing special trading status.

The vote was relatively close, with the 'leave' camp securing victory by a 52% to 48% margin. Lines were drawn by age, wealth and geography with Scotland, Northern Ireland and London all voting to stay. Already polls show that the Scottish are now in favor of a repeat independence referendum to secede from the U.K. By voting to end EU membership the electoral majority were expressing opposition towards unchecked immigration and dissatisfaction with imposed regulations, inclusion in a weak euro-zone economy, bloated budgets and the hordes of faceless Eurocrats whom they had no say in electing. Among these issues, immigration was the strongest trigger and "anti-establishment" was the general rallying theme.

Voting for and achieving a desired outcome, however, are not as closely related as many hope. For a start, Britain has a large 7% current account deficit, which must be financed from abroad. While a weaker British pound (spurred by the perception that Britain will now appeal less to foreign investment) could boost exports, the cost of imports such as oil will rise, worsening the deficit in the short term. Higher inflation will also result from the weakened pound, which could lead to higher wages, offsetting the devaluation benefit for businesses, or wages will stagnate and standards of living will fall. In the meantime, major investment decisions have been put on hold and companies have raised the possibility of moving jobs to Europe. 10-year U.K. gilt yields dipped below 1% for the first time ever, reflecting an investor rush towards a safe harbor and the expectation that short-term interest rates are going to fall. Concurrently, German 10-year bond yields briefly dropped to a record low of minus 0.15%.

In addition, the U.K. was stripped of its AAA credit rating by Standard & Poor's. This confluence of factors is leading some analysts to forecast an imminent British recession.

In the midst of this current turmoil and an atmosphere of partial voter remorse, rumblings are afoot that Article 50 may never be invoked. There is talk of a swift, second identical referendum, or that Parliament could essentially veto the result, both options seeming rather farcical in a democracy. A third option, whereby the new Premier negotiates revised terms in the form of an associate-type membership with the EU, with immigration rules featuring prominently, and puts the agreement to a national vote could be plausible. It wouldn't even be such a departure from the pre-vote status quo given that Britain already doesn't participate in the EU's single currency or the Schengen passport-free zone. The lure for the other EU members of continuing to include the U.K. in their club on revised terms lies in Britain's budget contributions alongside their diplomatic, economic and military clout as well as maintaining at least some preferred status for being accepted into the U.K. labor market.

In any case, it's safe to say that the lofty powers-that-be in the EU have lost touch with the general citizenship, and not just in Britain. Resentment bubbles in the weak Italian and Greek economies, which balk against dictated austerity, the French complain of the EU being too liberal, and traditional cultures in Eastern Europe are at odds with imposed cosmopolitan values. Worryingly, right-wing isolationist and protectionist factions across Europe lauded the vote result, latching onto the xenophobic undertones they read into it. At the extreme, the whole euro zone is a wave of populist votes away from disintegrating.

The immediate financial ramifications felt in the U.S. were the aforementioned marked dip in equity markets both at home and abroad, coupled with a strengthening of the dollar, notably against the British pound and the euro, and a significant fall in Treasury bond yields, with the 10-year dipping below 1.5%. Mirroring the reaction in Britain, the fall in rates reflected the opinion that the Federal Reserve will suspend any plan to raise rates for the time being. If Britain truly does go it alone, the U.S. will eventually have to negotiate a new trade agreement with the U.K., although, despite British leaders' often heady opinion of their status, it will unlikely be at the top of the next President's agenda.

The reality is that Britain accounts for only 3.9% of the world's output, so any domestic U.K. economic woes won't cast the same pall that comparable crises in the U.S. or China would. That said, the American recovery has been prolonged, but anemic, and China is still under a mountain of debt, so anything that puts a dent in European growth, including a slowdown in the consumerist British economy certainly isn't a welcome event. The European bank could step in to buy bonds to alleviate the effects of anxious investor behavior, but it can't prop up underlying weak growth.

Weak growth at home has also cast a pervasive cautiousness over the markets and the macro investment landscape in general, masking the fact that the current U.S. economic expansion is the fourth-largest since World War II. Unemployment remains low at 4.7% (down from 10% in late 2009) and wages are climbing, alongside rising retail and home sales in April and May. However, job growth numbers in May unexpectedly slowed, and economic output is only forecast to grow by 2% in 2016, markedly below the average of 3.4% experienced from 1950 to 2007. These figures alone would likely

have put a brake on immediate Fed interest rate hikes, even without the Brexit bombshell. Inflation has stayed low, recently contained by low oil prices, although core inflation, excluding oil and food prices, has been inching toward the Fed's 2% annual target.

Coming into second quarter reporting season, both revenues and earnings for the S&P 500 companies continue to be under pressure, when measured on average. The estimated earnings decline, year on year, for the S&P 500 for Q2 2016 is -5.2%. This figure is significantly less (-2.8%) for companies that derive more than 50% of sales inside the U.S., and markedly greater for those generating less than 50% of sales inside the U.S. (-9.0%). These numbers emphasize the relative strength of the American economy compared to many foreign jurisdictions as well as the continuing strength of the dollar. The Energy sector continues to be the largest contributor to declines, with Telecom and Consumer Discretionary leading the sectors that are expected to report the highest earnings growth. Many companies continue to employ methods to return value to shareholders at a time when cash piles are high, borrowing is cheap and large scale investment opportunities aren't always sufficiently compelling: according to the S&P Dow Jones Indices, for the 12 months ended March 2016, S&P 500 companies spent a record \$589.4 billion on share buy backs. For the same 12-month period, buybacks and dividends combined were an all-time high of \$974.6 billion.

Political news is squarely focused on the November Presidential elections, with Donald Trump and Hillary Clinton now the presumptive

nominees for the Republican and Democratic parties respectively ahead of the Parties' conventions in July. The economy, immigration, social issues and the war on terror all continue to feature prominently in campaign rhetoric. Gun control was starkly brought to the forefront earlier this month with the tragic murder by shooting of 49 people at a gay nightclub in Orlando, Florida. It was the worst mass shooting in modern America and was perpetrated by a 29-year-old Afghan-American, who dedicated the evil act to the Islamic State, before being shot dead by police. "Lone wolf" crimes on such a scale highlight the near-impossible task facing law enforcement agencies attempting to identify and apprehend individual perpetrators before they attack.

It's been an eventful end to the quarter with developments that will cause ramifications for some time to come. As the month closes, other stories are unfolding including investors in Puerto Rico's debt-burdened economy facing the risk of default on some of the island's \$70 billion in debt despite U.S. government intervention. At times like these, we return again to Warren Buffet's oft-quoted mantra: "Be fearful when others are greedy and greedy when others are fearful". As it relates to our investment philosophy at Stolper Asset Management, when markets are uniformly suppressed due to a pervasive uncertainty surrounding the future, the opportunity to acquire quality at a discount is often enhanced. We continue to relentlessly seek and focus on quality both in our investment decisions and in our business. We wish you an enjoyable summer whether at home or on travels and, as always, thank you for your trust and confidence.

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