Colorado Capital
MANAGEMENT

# Quarterly Market Update

Second Quarter
Volume 17, Issue 3
July 2016

## Inside This Issue:



## Key Data Points:

- **GDP rose 1.1% in Q1**
- **Unemployment fell to 4.9%**
- **Large-Cap stocks rose 2.5% in Q2**
- **Small and Mid-Cap stocks rose almost 4% in Q2**
- **10-yr Treasury yield fell to 1.4%**

## ECONOMIC UPDATE

During the second quarter, economic growth reports from the U.S. and around the world came in mixed, with slow but steady levels of expansion in the U.S. and Europe, a lower absolute level of growth in China, and flat to negative growth in Japan. While the results were not uniformly strong, reflecting somewhat divergent patterns around the world, they were positive enough to counter the global recession fears that prompted a market pullback at the start of the year.

### IMPORTANCE OF THE CONSUMER

The threat of a global recession was also diminished somewhat by a bounce back in commodity prices, helping many countries and companies which rely on energy exports, and by the persistence of low (and in some cases negative) interest rates.

The consumer has benefited from these trends because energy costs are still relatively low, resulting in cheaper fuel prices, while low interest rates reduce borrowing costs for homes, cars, and other consumer products and services.

Strength from the U.S. consumer was particularly evident this quarter, with monthly consumer spending reports for both April and May showing solid gains. Even if spending slows somewhat in June, second quarter consumption is on track to reach 4.4%, a ten-year peak according to *Barron's* economist Gene Epstein. This higher consumer spending can be attributed to the aforementioned lower energy costs and interest rates as well as wage and income growth related to the improving U.S. job market.

*(Continued on page 2, **Economy...**)*

## MARKET UPDATE

After a relatively calm start in April and May, the second quarter ended with great drama in the financial markets. Political uncertainty surrounding the June 23 referendum in the U.K. led to higher volatility in June, with the surprise vote by Britain to leave the Euro Zone contributing to a sharp pull-back in many stock, bond and currency markets that had risen in anticipation of a different outcome.

In spite of the stock market sell-off, returns for major U.S. stock indexes ended the quarter up over 2%, while developed foreign stock indexes were down less than 2%. Bonds generated positive returns thanks to a flight to safety as well as another decline in interest rates, and real estate and commodities delivered solid gains.

### FLIGHT TO SAFETY AND LOWER RATES BOOST BONDS

In the course of the late quarter sell-off following the Brexit vote, we witnessed a rather typical flight to safety as many investors sold risk assets (stocks and currencies of the U.K. and many European countries) and moved into the perceived safety of Treasury bonds, gold, and the U.S. dollar. This resulted in higher prices for these safe haven assets, particularly bonds, which have continued to perform well even as stocks have rebounded.

Yields on U.S. bonds are now at record lows, as the 10 Year Treasury finished the quarter at 1.5% and fell further during the first week of July to 1.4%. These already paltry yields turn negative after factoring in inflation, as shown by the real yields of -.75% in the chart on page 3. Despite this, investor demand for U.S. Treasury's continues, driving prices higher.

Many investors in the U.S. and around the world continue to invest in U.S. Treasuries in spite of their historically low yield since they are more attractive than the large number of foreign bonds offering negative yields ($11.7 trillion in value according to *Barron's**). In addition, the downside protection Treasury bonds offer in uncertain times is and always has been a great reason to own these safe haven assets.

**Source: Barron's. July 4, 2016.*

*(Continued on page 3, **Investing…**)*

# ECONOMIC UPDATE...

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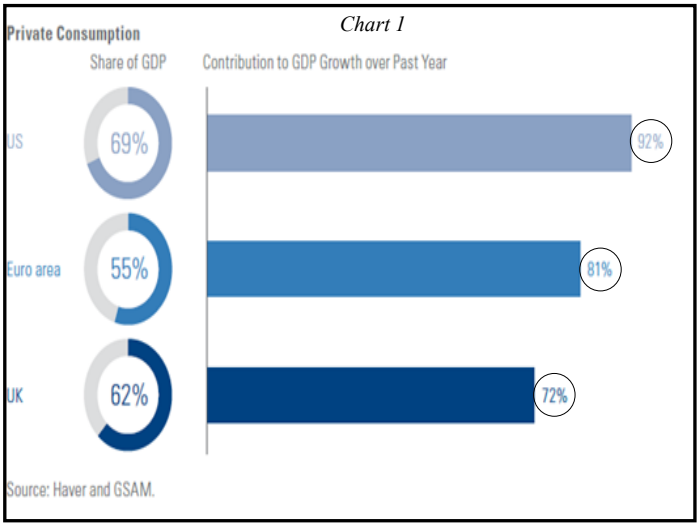
As the U.S. has benefited greatly from higher levels of household consumption, we have also seen consumer spending increase in the U.K. and the Euro area. The chart below from Goldman Sachs indicates just how much private consumption contributed to GDP growth in the U.S., the Euro area, and the United Kingdom over the last year. It also shows that consumption makes up a large percentage of GDP (up to 69% for the U.S.)



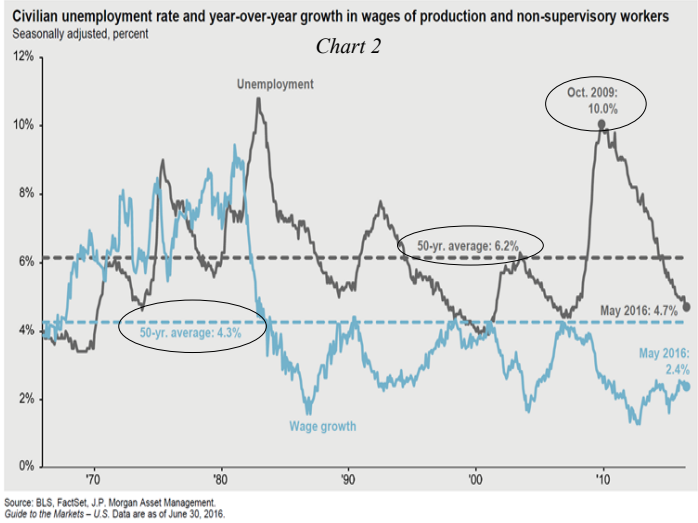

While the U.K. and the Euro area are at different stages in the economic cycle from the U.S., and the recent Brexit vote brings added uncertainty to U.K. economic growth, the fate of the consumer and continued private consumption should nonetheless be a key determinant of growth for years to come.

## JOBS GROWTH ALSO POWERS U.S.

A few other key elements of the U.S. economy continued to show strength this quarter, including the housing market, which was helped by continued low mortgage rates, and the job market, which showed continued strength.

While April and May employment reports were more moderate, the June payroll report was strong, with U.S. employers adding 287,000 jobs for the month in various sectors. The overall level of unemployment was reported at 4.9%, near all-time lows. This is down from levels as high as 10% in October of 2009 and is still below the 50-year unemployment average of 6.2% (see black line in following chart)

Wage growth of 2.6% for June also signaled an improving employment situation, although it is still somewhat low relative to long term averages of 4.3%. As the rest of 2016 unfolds, we would hope to see further wage growth contribute to the slow but steady economic expansion that has characterized the U.S. economy so far this year.




## POLITICS

The uneven state of the global economic cycle has affected market sentiment much of this year, contributing to mixed results in stock markets and low to negative bond yields around the world. More recently, however, we have seen politics take center stage with the unexpected vote by the U.K. to leave the Euro Zone.

Political uncertainty stemming from the Brexit vote roiled currency and stock markets around the world in the two days following the referendum. Fears of how the U.K and Euro Zone countries might weather such a split created renewed fears of economic distress and global recession.

While political and economic implications remain uncertain, particularly for the U.K., the sell-off proved to be relatively brief, with many indexes recovering their losses in the five days after the sharp pull-back. Clearer heads seemed to prevail as many investors recognized that nothing has fundamentally changed and global markets should keep functioning regardless of how and when Brexit actually occurs. The confusion and lack of clarity in the U.K. may in fact serve as a cautionary tale for other nations considering leaving the EU.

Whatever the outcome, the Brexit vote illustrated the critical role politics can play in financial markets and economies. The upcoming U.S. presidential election, which may be particularly dramatic, is likely to continue the trend of politics affecting the markets. While uncertainty around the election creates the risk of more volatility and potential downside for stocks over shorter periods, over longer periods it should not have a major impact on stock market returns.

The following analysis from Goldman Sachs shows that over the last 60 years, there has been a weak relationship between election outcomes and market performance, with less than 5% of the returns of the S&P 500 affected by which political party wins the presidency and control of Congress. (see last page for chart)

*Source (Chart1): Goldman Sachs Market Know How. July 2016.*
*Source (Chart2): JP Morgan Guide to the Markets. July 2016.*

# MARKET UPDATE…

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Government bonds performed well for the quarter once again thanks to these trends, as did municipal bonds and Treasury Inflation Protected Securities (TIPS), all of which rose close to 2%. They generated even better results for the first half of the year, gaining between 4% and 6% and outperforming many stock market indexes in the U.S. and around the world. High yield bonds performed even better, rising over 5% for the quarter and 9% for the year to date period.


Source: BLS, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for June 2016, where real yields are calculated by subtracting out May 2016 year-over-year core inflation.
*Guide to the Markets – U.S.* Data are as of June 30, 2016.

## STOCKS REBOUND & APPROACH RECORD HIGHS

The broad S&P 500 Index finished the quarter up 2.5%, with a large portion of the gains coming in the last week as the index rebounded over 5% from the Brexit-induced sell-off. Among the winners were value focused stocks, which continued a comeback that began in the first quarter, and small and mid-cap stocks, which outperformed larger cap names. Additionally, stocks from higher yielding sectors including utilities, energy, and consumer staples were strong as investors sought alternative sources of income in a low yielding bond environment.

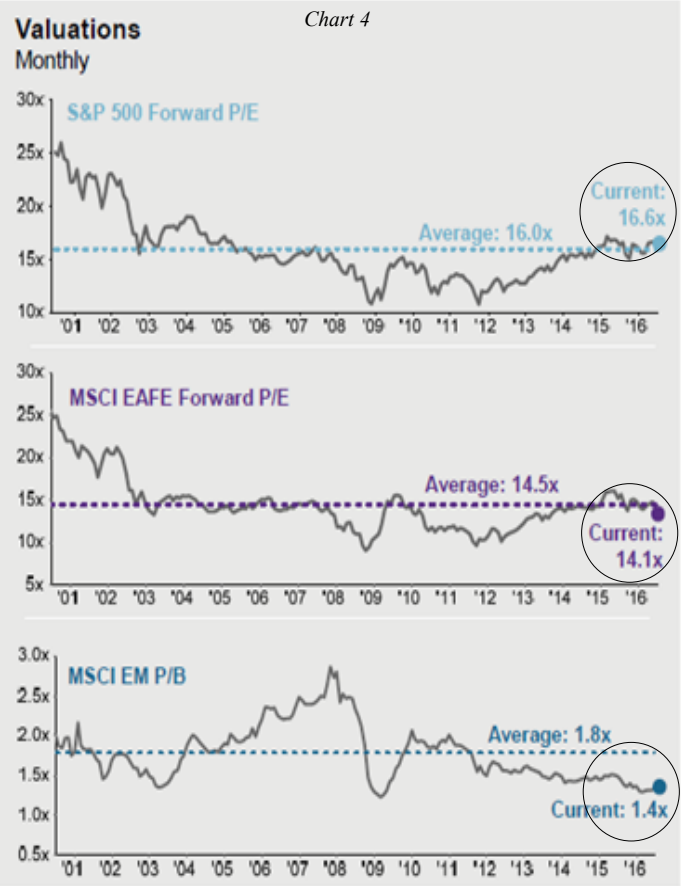
Among international markets, stocks of developed countries fared worse than U.S. stocks, especially in Europe and the U.K., due to uncertainty about the political and economic implications of Brexit. The broad-based MSCI EAFE Index fell 1.5% for the quarter, and is down 4.4% for the year.

In a divergent pattern from developed markets, emerging markets stocks were slightly positive for the quarter. Stocks of previously downtrodden countries including Brazil and Russia rose the most, thanks in part to a rebound in commodities, a major engine of their economies.

The rise in many commodity prices including gold and oil (up 7% and 26% respectively this quarter), helped commodity and energy focused funds bounce back after a difficult 2015. Real estate focused funds also continued to rise, gaining almost 7% for the quarter.

## ARE U.S. STOCKS FULLY PRICED?

As a result of this year's stock market appreciation (almost 4% for 2016 for the S&P 500), valuations for U.S. stocks are now slightly above long term averages. The chart that follows from JP Morgan shows average price/earnings multiples of the U.S. and developed markets as represented by the S&P 500 and the MSCI EAFE Index (based on earnings forecasts for the next 12 months). Valuations of emerging markets (as reflected by the MSCI Emerging Markets Index), are shown by another metric, average price to book value, which measures stock price relative to the value of a company's assets. The numbers represent the period from January of 2000 through June 30 of 2016.




While U.S. stocks are trading slightly above average valuations for the last 15 years, developed and emerging markets stocks appear more attractively valued. Maintaining our allocation to overseas markets, even in the midst of the uncertainty we have seen recently, provides exposure to potentially attractive investment opportunities at reasonable prices.

Performance for stocks in all of these areas will depend on political and economic developments as well as corporate earnings growth. For U.S. stocks especially, earnings need to show some improvement over the negative earnings reported in the last two quarters to justify the higher prices we have seen.

*Source (Chart3 & Chart4): JP Morgan Guide to the Markets. June 30, 2016.*
**Market and performance data: sourced from Morningstar.*

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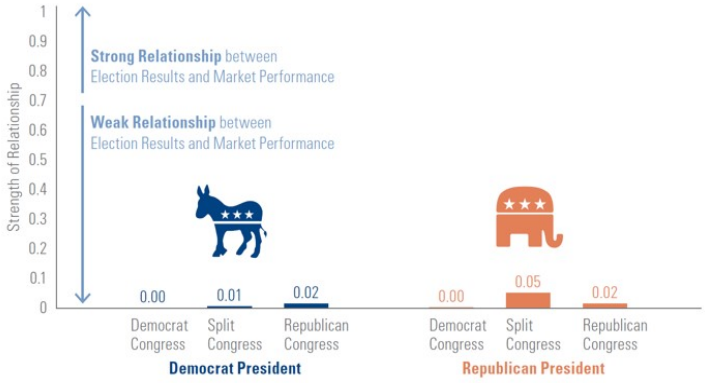


Source: Bloomberg and GSAM.

**The relationship between election outcomes and market performance is extraordinarily weak, statistically speaking.**

The small sample size of US equity returns around US elections necessarily poses inherent limitations for those who would purport to assign advantage for one partisan outcome versus another. For these reasons, we believe investors should strive to separate their political views from their portfolios.

In closing, our outlook for the rest of 2016 is that political developments in the U.K., Europe, and the U.S. will continue to create market volatility and short term disruptions. Overseas growth prospects could be lower as Brexit and its aftermath are worked out in Europe and the U.K. and as Japan and China face their own growth challenges. Economic growth in the U.S. should continue at a slow but steady pace if the consumer continues to spend, jobs continue to be created and interest rates and inflation stay relatively low.

## CCM Update

We spend much of our time reviewing client portfolios, analyzing investments, and staying current on financial planning best practices so we can provide high quality wealth management and financial planning services for our clients. In that regard, it is natural that we are engaged and informed on global markets and economics —that is an integral component to our business.

We also believe that it is our responsibility to be civically engaged and active in our community, both as individuals and as a company, whether it's through pro bono work, donations, board membership, or volunteerism. In April, Colorado Capital Management sponsored a women's leadership conference hosted by the CU Women's Council, and we will also sponsor a concert on August 2 with the Colorado Music Festival. Finally, members of our staff recently volunteered at a painting project with the Emergency Family Assistance Association, as shown in the photo here.

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COLORADO CAPITAL MANAGEMENT provides investment management and financial planning to high net worth individuals and their families. We develop prudent and thoughtful financial strategies designed to both limit risk and meet specific long-term goals.

While the core of our business is portfolio management, we also advise clients on a wide range of financial matters such as planning for retirement, reviewing insurance coverage, and utilizing techniques to reduce income and estate taxes.

We also offer sophisticated impact investment strategies for investors wishing to combine financial returns with positive social and environmental impact.

We provide all of these services for a flat annual fee equal to 1%, or less, of the assets under management. This "fee-only" approach enables us to avoid the serious conflicts of interest that plague other financial firms that sell products and charge commissions.

To learn more about how Colorado Capital Management can help you achieve your long-term financial goals, please visit

INVESTMENTS PLANNING IMPACT

*Source (Chart5): Bloomberg and Goldman Sachs Asset Management. July 2016.*