Investment Strategy Update

ASCENTIAL WEALTH ADVISORS
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Market Report — Quarter 3 • 2016

Markets Resilient but Range-bound

The US stock market managed to close the first half of 2016 with positive results, looking past the worst start to a year ever in January and February, and the unexpected results of the Brexit vote. Foreign markets did not rebound as strongly, holding onto losses through June.

US equity markets have been bumpy but relatively range-bound over the past year, unable to surpass record highs from May 2015. The Dow Industrial Average Index closed above 18,000 seven times in the first half of 2016, but was unable to maintain that level for more than a few days. With economic data still mixed, and rather weak earnings growth, equity investors remain hesitant.

US bonds have benefitted from investor fears and low global interest rates – posting strong returns with yields continuing to drop. The yield on the 10 year US Treasury has fallen from around 2.2% at the end of 2015 to around 1.49% on June 30, moving further below its 25 year average of 4.7%. Since the Brexit vote, expectations for a Fed rate hike this year have fallen from 62% to 23% (CME Group). Coupled with further monetary easing in Europe, there seems little hope for higher yields in the near term.

Index	*2016*
S&P 500	+3.84
DJIA	+4.31
EAFE (Int'l)	-4.42
BC Ttl Bond	+5.31

Dow Jones Relative Risk Benchmarks	
Conservative	+4.46
Moderate	+4.67
Aggressive	+2.82

2016 Outlook

FIXED INCOME/BONDS — Intense demand for conservative assets has continued pressuring yields lower. Over 70% of the bonds in developed-market government bond indexes today have yields < 1%, with roughly a third below zero. (Blackrock, June 2016) We remain cautious about the potential for rising rates. However, given the possibility of an extended period of low rates plus a need for some return, we suggest reducing alternatives and increasing our allocation to intermediate duration US corporate bonds. This can provide additional yield without increasing interest rate risk significantly.

Our View — *Increase intermediate duration US corporate bonds while reducing alternatives.*

US EQUITIES — With the US economy in decent shape, US stocks remain a solid choice for investors despite being close to fairly valued. With fixed income yields as low as they have ever been, and 65% of companies in the S&P 500 offering dividend yields higher than the 10 yr US Treasury, investors seeking return are being forced to equities. We look to US equities to produce modest returns with some enhanced volatility leading up to the fall presidential election. We remain convinced that there are pockets of opportunity in technology and banks which are still attractively valued relative to history.

Our View — *Maintain US equity allocation with overweight positions in technology and banks.*

INTERNATIONAL EQUITIES — Though markets reacted swiftly and negatively to the unexpected vote by the United Kingdom to leave the European Union, the long term impact of this decision is unclear. Realistically, we believe the impact will be more muted than markets initially suggested, and the direct impact on the US will be minimal. The UK represents less than 4% of US exports and less than 3% of US imports. As a share of 2015 world GDP England was 3.9%, Germany 4.6%, France 3.3%, and the US 24.4%. We look to maintain exposure to developed international markets, including the EU, and emerging markets. Currently bargains relative to US equities, eventually the value these stocks hold should be realized, rewarding patient investors.

Our View — *Maintain exposure to developed and emerging markets incorporating some lower volatility strategies.*

Good as Gold?

Gold is good at grabbing headlines, particularly when fear grips the stock market and investors are looking for something to make them feel "safe." But really, is gold a good investment? Consider the following:

- In January 1980 gold was $850/ounce. In order to have kept pace with inflation alone, gold would have had to be $2300/ounce at the end of 2015. It had peaked around $1900/ounce at the end of 2011, and is currently $1365/ounce. Gold's average return over the past 35 years has been below 3%.
- In contrast, in January 1980 the S&P 500 was at 111. In order to have kept pace with inflation, ignoring dividends, the value of the S&P 500 would have had to be 300. It closed the current quarter at 2098. Including dividends, the S&P 500's average return over the past 35 years has been almost 11%.

"You could take all the gold that's ever been mined and it would fill a cube 67 feet in each direction. For what that's worth at current gold prices (2011), you could buy all – not some – all of the farmland in the United States. Plus, you could buy ten Exxon Mobils, plus have $1 trillion in walking-around money. Or you could have a big cube of metal. Which would you take? Which is going to produce more value?" – Warren Buffet

With the recent run-up, the Ten Year US Treasury is more expensive than it's ever been

Investors have been on a bond buying spree the last few years. The main reason? US Treasuries are thought to be among the soundest investments in the world. But are they?

When you buy a 10 year US treasury, you are lending money to the federal government, and they promise to pay you some interest and return your original investment at the bond's maturity. As with any bond purchase, investors should be considering the odds of the issuer repaying their debt (credit risk), expectations for inflation, and the maturity of the bond or the time until you get your money back.

In the case of a US Treasury bond, the chance that Uncle Sam will default is extremely low, so credit risk is not a significant concern. The real risk in owning mid- to long-term treasuries today is inflation. How much will the dollars be worth in ten years when your original investment is returned? The CPI rose just 0.7% in 2015, but since 1926 inflation has averaged around 3%. The Treasury recently hit its lowest yield ever at 1.34%. At this yield, the Treasury is essentially pricing in no inflation over the next 10 years.

As yields have plummeted, bond prices, which move in the opposite direction, have reached heights never seen before. We have been concerned over the last few years that yields would begin to rise and bond prices would fall. This has not yet happened, and we certainly do not know when these record levels will end, but we need to be aware that just a one percentage point rise in 10-year bond rates will drive down the value of those bonds more than 9%. A two percentage point bump in yields would double the damage. The moral of the story? There is no such thing as a completely safe investment. Too many bond investors may be forgetting that.

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