DMS

Discretionary **M**anagement **S**ervices, LLC

Perspectives and Positions

By James F. Dykstal, CFA, Portfolio Manager, July 2016

This is a summary of our views on the economy and markets as shared with discretionary clients.

Economic Outlook

- After two quarters of below 2% growth, GDP is expected to grow modestly over the next 12 months at approximately 2.0% as global uncertainty begins to fade over "Brexit" and the slow economic growth in China. The Federal Reserve will put interest rate hikes on hold until 2017.
- Headline inflation will remain volatile due to commodity price uncertainty, but recent readings for the core inflation rate (without energy) have been steadily above 2.0%. A growing economy will continue to put upward pressure on prices.
- Wage growth will increase slightly with a tighter labor market. Job creation will be stable with the unemployment rate remaining below 5.0%. Labor force participation will increase.
- The U.S. dollar will remain relatively strong, but stable, versus other currencies. The impact of "Brexit" will be isolated to the British Pound and Euro. The weaker pound may help British exports compete on the global stage. This could impact earnings growth potential of large cap domestic multinational companies.

Strategic Market Outlook and Tactical Allocations

Fixed Income: The Federal Reserve will hold interest rates for the remainder of 2016. The outlook is for stable rates in the near term until global uncertainty wanes. Expect rates to increase in 2017.

- High yield outperformed in the second quarter in response to stability in the energy sector. Higher coupon yields provide attractive yield in this low rate environment.
- We continue to overweight credit versus U.S. Treasuries; duration is tilted shorter than benchmarks.
- Negative yield on international bonds do not appear attractive. However, emerging market debt denominated in U.S. dollars provides diversification and yield potential. Stability in global growth will further entice yield investors to add to positions.
- Commercial real estate continues to provide positive returns. Queues can delay additions to position; an increase in interest rates could dampen valuation improvements. Value-added or opportunistic strategies can be a complement to core real estate exposure.

Equities: The domestic large cap stock market appears to be fully valued. Earnings decelerated due to slower economic growth and a relatively strong dollar. Earnings growth should improve in the second half of 2016 as year over year comparisons become easier.

- Small cap stocks are over weighted versus targets in portfolios. Small cap stocks, while more inherently volatile, are impacted less by currency fluctuations than multinational large cap stocks. We will continue to "buy in" and bolster small cap positions during corrections.
- International stocks are over weighted versus the target. The quantitative easing programs in Europe and Japan should provide a tailwind to stocks as the weaker currencies boost export earnings. "Brexit" volatility presents opportunities for active investors. Within international equities, emerging markets stocks are comparatively attractive due to their low relative P/E multiples and are also over weighted versus targets. Asian stocks are preferred as demographic consumer trends favor that part of the globe.
- The dollar strengthened due to market pricing resulting from the Fed rate increase and monetary stimulus by foreign central banks. The dollar will remain range bound given an absence of positive global economic data. This should remove the currency headwind of the stronger dollar on future expected returns.