HNB BANK
Trust Services
573.629.3826
816.279.5900
www.hnbbanks.com

PERSPECTIVES

Third Quarter 2016

Stateside Favor

By Bill Koehler, CFA

This past week, Americans celebrated our country's 240th birthday as an independent nation. Declaring its independence from Great Britain on July 4, 1776 was a defining action for the United States. In an ironic twist, the world is also currently digesting another declaration of independence of sorts with 21st century global impact. On June 23, after much consternation from parties on both sides of the issue, the United Kingdom voted to leave the European Union (EU). This is the most significant political and economic event thus far in 2016.

The initial ramifications are that the vote will create more unknowns. How will EU governance be impacted? Will other countries, such as Spain, follow suit? To what extent will trade between EU countries be affected? Given that eurozone growth has already been anemic, how will positive economic growth be sustained? Heretofore, economic growth in the U.K. had been stronger than the rest of the eurozone. However, in the aftermath of Brexit, as it is called, U.K economic growth forecasts are being revised down to below 1% from 2% for 2017, a figure that may be optimistic.

Eurozone Uncertainty

In the two weeks since the vote, the pound sterling and stock prices in the U.K. have both fallen on concerns of expectations of lower economic output. U.K. government debt yields have hit record lows. This means these bonds are then less attractive to foreign buyers, which further weakens the currency. Additionally, the lower interest rates do not help U.K. banks, many of which are struggling with stock prices down more than 20% this year in dollar terms. Like many other eurozone banks, they have questionable loans made to Italy, Portugal and other EU countries.

The European Central Bank (ECB) has continued to cut rates and initiate ever-larger bond buying programs in an effort to stimulate the economy. The "turning on of the spigots" by the ECB over the last two years has not resulted in its desired effect of stimulating the eurozone economy.

Negative Thinking

Another related development we are closely monitoring is Negative Interest Rate Policy or NIRP. We have reached an unusual point in that nearly $12 trillion of global sovereign debt is trading at a negative interest rate. Investors are paying borrowers to hold their money. Imagine going to your local bank and paying them to safeguard your savings. However, this is precisely what is happening in many foreign countries now. Japan was the first major country to officially target negative rates in February. Why would anyone pay to have their savings held? The banks don't want the savings. The central banks are trying to stimulate their economies. What is clear is that there will continue to be unprecedented central bank intervention. In a world awash in negative rates, something that once seemed unfathomable is now accepted.

> ***Nearly $12 trillion of global sovereign debt is trading at a negative interest rate.***

Coming to America

As a consequence of the changing facts across the global investment landscape, it is especially important to understand America's current place in the world. The U.S. capital markets remain the broadest and deepest of any country. In times of increased uncertainty, the liquidity, transparency and safety of the U.S. markets are in greater demand. Investors are flocking to America and dollar denominated assets, particularly our government bonds, as evidenced by the yield on the U.S. 10-year Treasury note falling to a record low of 1.36% on July 8. Relative to the negative yields in Europe and Japan, our yields are towering. In comparison, the dividend yield of the S&P 500 is 2.2%, making stocks relatively more attractive than bonds.

While some currently describe America as the "cleanest dirty shirt in the laundry basket," we think there is more to the story. America has a long-term institutional and philosophical advantage, as articulated below. Simply stated, the eurozone is not going to create companies like Facebook, Google and Apple. This advantage also serves to underscore our thinking in strategically allocating assets globally with an overt, planned and increasing emphasis on U.S. securities.

Post-Brexit, the U.S. does not exhibit signs that might indicate an impending recession. There is no inventory overhang across various industries. The yield curve is not inverted. Rather, we expect a steadily expanding economy. Not at the 3% level, but expanding nonetheless, most likely in the 2% range. Equity market valuation measures appear justifiable relative to the level of interest rates.

Domestic Opportunities

In terms of specific ideas, we see areas of the U.S. capital markets that may provide increased opportunity. In an environment where organic growth is harder for corporations to achieve, we believe merger and acquisition activity will persist. Mid-sized U.S. companies with market capitalizations in the range of $2 billion to $10 billion appear to be attractive targets for growth-hungry CEOs across the globe. We anticipate more transactions such as the early-July purchase of WhiteWave, a U.S organic food company, by Danone, best known for producing Dannon yogurt. WhiteWave, a holding in our Select Growth Strategy, had a market capitalization of roughly $8 billion on Wednesday, July 6 and $10 billion on Thursday, July 7 after agreeing to the acquisition. Another area of opportunity appears to be U.S. preferred stocks, investments offering a yield advantage and a potentially uncommon risk/reward proposition in a low interest rate environment.

Created by Philosophy

Margaret Thatcher was the longest serving prime minister of the United Kingdom in the 20th century. She served from 1979 to 1990 and oversaw a major economic renaissance in the country. She was certainly one of the most influential figures of the 20th century. She was, of course, a politician and not an economist but it is instructive for investors, regardless of political persuasion, to remember how she astutely characterized the difference between Europe and the United States. She said, "Europe was created by history. America was created by philosophy." She also said "There are significant differences between the American and European versions of capitalism. ... [America's] success has been shown above all in the ability to create new jobs, in which it is consistently more successful than Europe."

She meant that our country was founded on ideas of liberty, resilience and adaptability. As long as we continue to be willing to change for the better and maintain our creativity and courage, we will be going in the right direction. As long as incentives exist that induce enterprising people to risk capital for the rewards of enterprise, goods and services will be created. Jobs will be created, profits will be sought and our philosophy, though occasionally challenged, will endure. As investors, we believe Mrs. Thatcher's sentiments are still relevant today. We find them appropriate and validating as we maintain exposures in our client portfolios heavily skewed toward the United States.

> *"Europe was created by history. America was created by philosophy."*