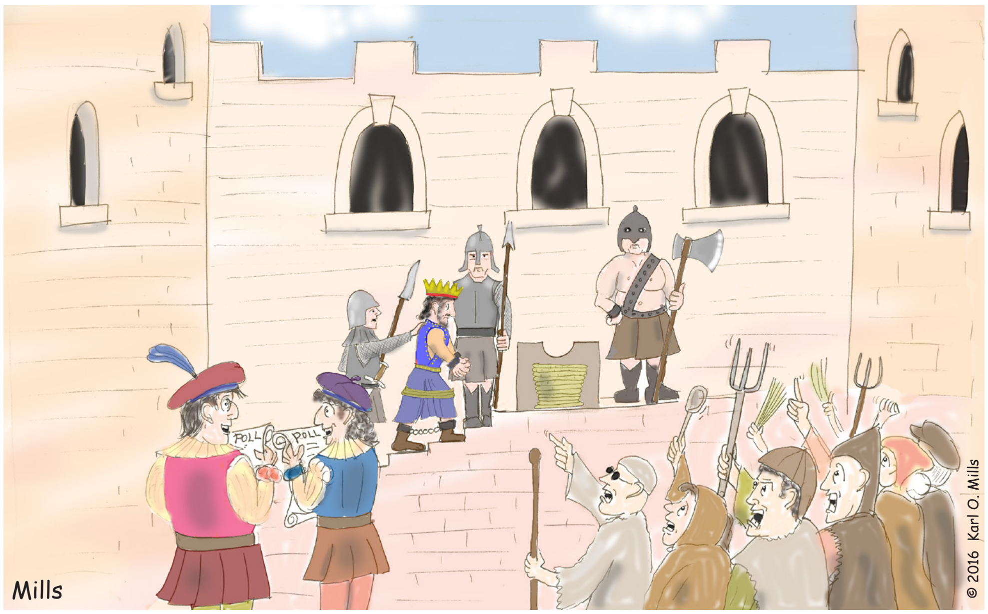
COUNTERPOINT

The Quarterly Commentary of Jurika, Mills & Keifer LLC



Thats funny, he was doing so well in the polls.

Third Quarter: July, 2016

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Unconventional Wisdom

On a recent day, two new polls were released: one by ABC News and The Washington Post showing Hillary Clinton pulling out a commanding 12-point lead over Donald Trump; and another, by the Wall Street Journal and NBC News showing a much tighter race.

This may underscore the idea that poll results may be biased by the organization conducting the poll, but since both polls are trying to predict the same outcome, it also reminds us that poll results and expert opinions should always be taken with a large grain of salt.

One needs to look no further than the recent vote by the

Summary:

- Financial markets had another volatile quarter but most markets ended the quarter higher than where they started. Interest rates continue to sink and stink.
- In a world of very low interest rates, investors are starved for yield and are willing to pay higher prices and accept higher risks for lower prospective returns.
- Meanwhile, economic growth remains sluggish and a new cloud of uncertainty overhangs Europe.
- Global stocks and other risk assets are fully priced overall, but offer some attractive pockets of value in out-of-favor areas.
- We are more cautious but continue to balance investments targeted at areas of long-term growth and value with a core of defensive and alternative strategies, and a foundational base of bonds and cash.

British people to exit the European Union, commonly referred to as "Brexit." The outcome came as a nasty surprise to most pollsters and prognosticators, who were quite certain that the Brits would vote to "Bremain." Rarely have so many Br'experts been so Br'wrong.

The financial markets dislike nasty surprises and promptly declined sharply before realizing that although the world had changed, it had not ended just yet. And, so markets reversed course and rallied strongly back. Much ado about nothing? Perhaps not.

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We see a number of important takeaways from the *Brexit* vote that are worthy of comment.

First, as we said above, treat all poll results, predictions and market forecasts with a healthy skepticism. Pollsters and pundits probably rank below economists and weathermen in their ability to foretell the future. This is kind of ironic given the increase in the number of surveys that are now taken with ever greater science and evermore annoying frequency and invasiveness. We are being surveyed to death. You can't buy or do anything these days without being asked to participate in a survey afterwards. *(We will not ask you to complete a survey after reading this Commentary.)*

A second takeaway is that a lot of conventional wisdom is being turned on its head, and unconventional wisdom seems to be ruling the day. A year ago, few would have predicted that Britain would vote to leave the Eurozone, and David Cameron would resign as Prime Minister; that Donald Trump would be the presumptive Republican Nominee; or that Bernie Sanders would have gotten nearly as far as he has; or that oil prices would fall from close to $100 a barrel to $29 a barrel, before rebounding; or that government bond yields would be below zero in many parts of the world. And, if told that all of these things would happen beforehand, few would predict that the stock market would be near record high levels.

A third takeaway is that the Brexit vote reflects some worrisome trends in the United Kingdom, continental Europe, here in the U.S. and throughout the rest of the world. These trends are driven by swaths of the population who feel increasingly disenfranchised and discontent with the status quo. There are many complex reasons for their discontent but the result is a worrisome shift in attitudes away from the center toward the extremes; towards populism, nationalism, isolationism, xenophobia and the search for easy answers to complicated problems. To paraphrase Yeats' The Second Coming, ***"Things fall apart; the centre cannot hold...The best lack all conviction while the worst are full of passionate intensity."***

There is also a growing and corresponding move away from free trade, easy immigration policy, and a sense of shared purpose and destiny between and among countries and peoples. After several decades of increasing globalization and integration, especially after the fall of the Berlin Wall and collapse of the Soviet Union, it feels that things are threatening to regress towards a more fragmented, multipolar, and less stable world order.

This is a serious concern and, hopefully, just a bad phase we are all going through, like when we were teenagers. In a world where everyone and every nation is out for itself, the sum of the parts of the global economy is much less than the whole.

A fourth takeaway is that markets are volatile and one should be very careful about overreacting to short-term events. Take this year as a case in point. The year started off on a bad footing with concerns about a global recession, divergent monetary policy, and a host of other problems that failed to materialize. Global stock markets declined into February as fear begat fear and selling begat selling.

And of course, television was full of talking heads telling you to sell your stocks, buy canned goods and bottled water and hide under a rock. Then, in mid-February, investors had a change of heart. The world suddenly didn't look quite so bad, even though nothing had fundamentally changed as far as we can see. Markets rallied sharply back to where they started, as if nothing had happened.

Similarly, after the Brexit vote, global stock markets plunged 5 - 10% amid dire projections about the demise of the European Union, and the coming of Winter for the global economy. Again, many experts urged investors to sell their stocks and wait out the gathering storm. A week later, most stock markets had recovered most of their losses, and ironically, in the UK the stock market was actually higher.

One of the worst mistakes that investors can make is to panic and react to events in the moment, a behavior that invariably leads to selling low and buying high. It is easier and more tempting to make this mistake than ever. World events are blown out of proportion on television to generate ratings and sell advertising. And, it is also easier than ever to take action based on near-term emotional impulse. Just a click of a mouse or a swipe of your finger on your smart phone and presto! You just sold your portfolio. You also likely just locked in your losses and missed the recovery.

As we have written many times, just because you can do something, doesn't mean that you should. Most people who are invested in the financial markets are investing for the long-term, meaning the next ten, twenty, thirty years or longer. And yet they are constantly being conditioned to believe that they should be acting as short-term traders, anticipating and reacting to every twist and turn of the global economy and financial markets. This is something very few people can do well. Just look how wrong the experts have been.

Being a long-term investor is something that almost anyone can do well, but it takes discipline, perspective, perseverance and occasionally a very strong stomach. ***The unconventional wisdom about investing is that good investment decisions tend to feel bad in the moment, and bad investment decisions tend to feel good in the moment.***

A fifth takeaway is that the volatility that the markets are experiencing are a result of two competing forces. The first is that global stock markets in general are quite fully valued and therefore more vulnerable to shocks and disappointments. The second is that in a world with very low interest rates, investors feel that there is no alternative source of return other than in traditionally higher risk assets like stocks, high yield bonds and real estate.

Relative to government bonds, stocks and other assets that generate income look cheap. The U.S. 10-year Treasury Bond has a yield of 1.4% and a German 10-year Government bond has a yield of -0.19%. This compares to the S&P 500 with a yield of 2.1% and many individual stocks that yield even more.

We think this is why the markets seem paradoxically so hypersensitive and yet also so resilient, overreacting to a problem at the outset and then quickly rationalizing it away and recovering as if nothing has changed.

This relative value rationale can be treacherous because it falsely presumes that government bonds are fairly priced and that the prices of stocks and other securities fairly reflect their intrinsic value and risks. They aren't and they don't. Government bond yields are being artificially depressed by Central Banks around the World, and overpriced stocks can lose substantial value very quickly as we have seen.

We can understand why the markets have recovered most of their losses since the Brexit vote. We don't think that the vote marks the imminent demise of Great Britain or the European Union. Great Britain may actually end up better off in the long-run and the Brexit vote may lead to greater resolve to keep the rest of the European Union together.

But, we also don't think that everything is the same. The U.K. is now without cohesive political leadership and the potential risks in continental Europe have also increased. A higher level of uncertainty should put an additional damper on near-term economic growth and prices should decline in a measured way to reflect this changed reality.

Investment Outlook:

And so, our investment outlook has become slightly more guarded. Overall valuation levels for almost all financial assets are full, especially here in the United States, making them increasingly vulnerable to further disappointments. This does not mean that markets won't rise higher, or that good things can't happen, but at current prices, the expected return for stocks as a broad asset class, relative to the risks is not very appealing.

The unconventional wisdom about investing is that good investment decisions tend to feel bad in the moment and bad investment decisions tend to feel good.

Underneath the surface of the broad stock market, there are some attractive pockets of value and opportunity to be found, particularly in areas that are currently out of favor.

For example, in the U.S., bank stocks are cheap and unloved, mostly because they can't make a lot of money with interest rates so low. At some point, interest rates will move higher and so too, presumably, will bank stock prices. In the meantime, U.S. banks are very well capitalized and probably don't have a lot of downside risk. Healthcare and biotechnology stocks are also out of favor and have good longer term prospects.

Meanwhile, investors have been bidding up the prices of stocks that are perceived to be safe and defensive, such as consumer staples and utilities. These "defensive" stocks may be the most overvalued part of the whole stock market and may prove to be much less defensive in the future than they have traditionally been in the past.

Outside of the U.S., our outlook on Europe has grown more cautious, and we reduced our exposure to European equities in May.

We continue to think that developing world equities offer good long-term prospects. Our primary focus has been on Asian equities geared towards the burgeoning Asian middle class consumer, but we have also seen good performance this year from deeply oversold markets like Russia and Brazil, where the bad news is widely known and expectations are extremely low.

Bonds remain unattractive other than as a foundational base for a portfolio. High yield and emerging market bonds, which had a rough start to the year, have powered to new high levels and offer a fairly high level of risk for a fairly limited return.

Investment Strategy:

Putting it all together, we continue to see a world generally characterized by slow growth, high valuation levels and heightened volatility and investment risks.

There are still pockets of value and opportunity to be found and we are tilting client portfolios in their direction, while balancing these investments with more defensive core holdings as well as a greater allocation to alternative investments that can benefit from rising and falling markets. We think that this is a time to be more cautious in portfolio positioning.

We have no special insight about what the markets will do next, and stocks could continue to move higher. We are just looking at the current balance of opportunities, prices and risks. There are times to lean into and away from risk assets like stocks. The time to lean into risk assets is when others are fearful and prices are down. The time to lean away from them is when investors are overly hopeful or complacent and prices are high, such as now. We think that the odds are quite high that we will have a better opportunity to invest on more favorable terms down the road.

As always, we focus and invest for the long-term, balancing diversified investments focused on areas of long-term growth and innovation with more defensive equity, alternative and bond strategies to mitigate volatility and risk.

We thank you for your ongoing interest and welcome your questions and comments.

Jurika, Mills & Keifer, LLC
July 2016

Jurika, Mills & Keifer is a private wealth management firm serving a select group of individuals and families.

Our firm is built on a core set of values and investment principles that have been central to our identity and success for over 30 years.

Our objective is to preserve and build the purchasing power of our clients' capital over time through forward-looking investment management and smart financial planning and counsel.

Our offices are in San Francisco, California. We welcome your inquiries.

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