

Investment Update



August 2016

The Long and Winding Road

On my family's recent driving trip to one of our favorite summer destinations, Boothbay Harbor, Maine, my GPS rerouted us from our familiar path along the Maine Turnpike. Instead it directed me via surface roads in order to avoid an accident ahead that was causing significant delays. I followed these new directions and arrived at our destination safely, although it did take us a bit longer than initially planned.

While this is a simple example of adjusting as new information becomes available, the same thought process applies to investing. As the facts of the markets change it is critical that opinions adapt to evaluate whether an investor is on track to reach his or her investment goals or if a change in route is in order. As my old boss used to say, "Lose your opinion, not your money."

Navigating Unexpected Outcomes

Investors were recently challenged by a large roadblock following the U.K. referendum on membership in the European Union (EU). We factored this risk into our 2016 forecast for persistent volatility; however, a vote to leave—Brexit—was not our base case. Although the polls predicted a tight race, the markets were signaling that a vote to remain would prevail. The facts changed and our strategy committee immediately convened to assess this new market environment.

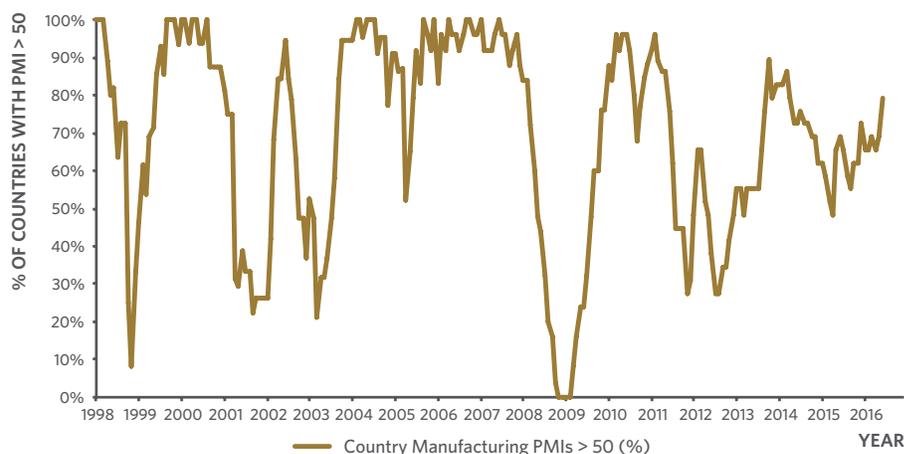
While the financial markets would bear the immediate fallout, our post-referendum analysis revealed that Brexit would have long-term implications for global growth, interest rates and U.S. corporate earnings. Amid internal political chaos and a depreciating pound sterling, the impact has been most directly felt in the U.K. itself. We believe this self-inflicted wound will cause their already slowing economy to fall into a recession, particularly considering the uncertainty that negotiations with the EU would bring should Article 50 be invoked.

The EU is also vulnerable, as it is still in the early stage of recovery, despite bouncing back from a double-dip recession. Although we expect that the EU will avoid recession, a Brexit will put upward pressure on the unemployment rate and downward pressure on profits, slowing the pace of economic growth. In contrast, the U.S. should see fewer spillover effects and GDP growth should be only modestly suppressed. Our earnings outlook has softened in the aftermath of the Brexit vote, as markets have seen a stronger U.S. dollar, slower global growth, lower global consumer confidence and reduced business spending. We anticipate a slight slowdown in the global economy, but do not foresee a stall into recession as central banks have already started to respond.

Checking the Mirrors

During uncertain times, investors and the media often fixate on one aspect of the markets, sometimes ignoring most other factors. Without denying the longer-term ramifications of a Brexit, we see strong supporting indicators that give us confidence in the overall health of the global economy.

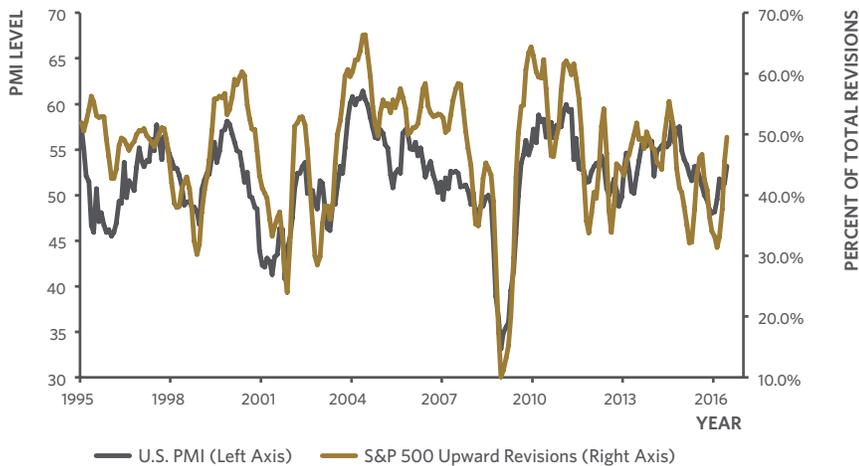
Figure 1—PMIs and Economic Strength
Breadth of Country Manufacturing PMIs Reach 2-Year High in June



Source: Cornerstone Macro

Purchasing managers indexes (PMIs) is a measure of strength in a country's manufacturing sector, with a reading above 50 seen as "expansionary." The breadth of global PMIs above this key level at the end of June has reached nearly 80% of countries, as illustrated in Figure 1. That's a two-year high, after hitting a low in April 2015, and a strong indication of the world's overall economic strength. Leading economic indicators (LEIs) also continue to surprise on the upside, after coming off their lows in the first few months of the year. This rebound, illustrated in Figure 2, often signals an improvement in S&P 500 earnings per share estimates. Both PMIs and LEIs are showing strong evidence for a pickup in 2017 earnings.

Figure 2—Leading Economic Indicators
Improving U.S. PMI Indicates Improving Earnings Estimates



Source: Cornerstone Macro

Although the data represented in these figures reflects pre-Brexit economic conditions, there is strong support for this positive momentum to continue, evidenced by the quick global market recovery following the surprise referendum results. In fact, these factors were critical as we assessed portfolio positioning following the U.K. referendum.

We had positioned client portfolios for an environment of lower expected returns and heightened volatility since the start of the year, but following the U.K. referendum vote, we recommended a shift in asset allocation. Considering the ramifications of a Brexit in conjunction with our outlook on the health of the global economy, we recommended a neutral posture. Based on our revised growth, interest rate and earnings forecasts, we reduced exposure to those asset classes most likely to feel the brunt of Brexit. We also desired the flexibility to re-deploy proceeds back into global equity markets if future dislocations were to become overstated, while also providing clients with additional shock absorbers in their overall portfolio.

Specifically, we recommended shifting exposure from international equities and putting the proceeds into shorter-term fixed income instruments and diversifying investments, such as managed futures and absolute return.

Eyes on the Road

Just as road traffic will cause our GPS to reroute in order to reach a destination, the Brexit vote has prompted us to redirect our clients' portfolios in order to reach their investment goals. While this has meant taking a more conservative path, we remain confident that the overall global economy will continue to expand, albeit at a somewhat slower pace. There are plenty of potential bumps in the road ahead, including uncertainty about the Federal Reserve's policy, the upcoming U.S. presidential election and the negotiations between the U.K. and EU, but we'll keep our eyes firmly on the road for you. The path may wind and might even take a little longer, but we'll be there to help you successfully reach your destination.

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