

# ECONOMIC & MARKET REVIEW

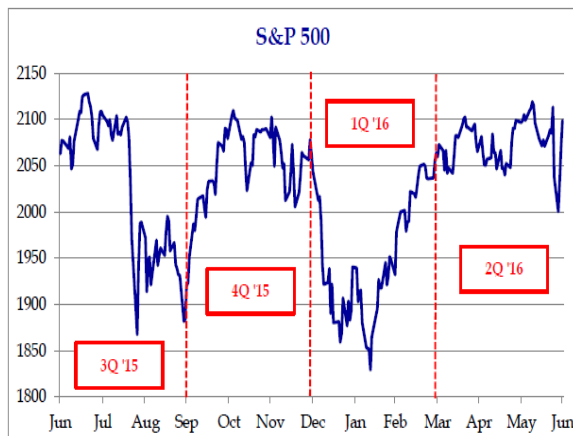
## Second Quarter 2016



Once again, modest performance results for the quarter and year to date contradict underlying volatility in the markets. Aside from volatility, the story for the year is interest rates. The two year Treasury note started the year with a yield of 1.05%, and today yields 0.60%. The ten year Treasury note started the year with a yield of 2.27%; today the 10 year yields 1.47%. U.S. large cap, small cap, and emerging markets equity returns were positive for the quarter and year-to-date, not so for the international developed equity market. Violently flat is a good characterization for equities. In general, U.S. centric economic results were ok... neither extremely strong nor weak. This continues the modest growth trend in place for the last several years in our economy.

### Second Quarter and Year-to-Date Performance:

	2nd Quarter	YTD
<b>S&amp;P 500</b>	2.46%	3.84%
<b>Russell 2000</b>	3.79%	2.22%
<b>Barclays Agg.</b>	2.21%	5.31%
<b>MSCI EAFE</b>	-1.46%	-4.42%
<b>MSCI EM</b>	0.66%	6.41%



Source: Strategas Research Partners

Employment remains one of the bright spots for the U.S. with the unemployment rate down to 4.7%. In order for the U.S. economy to continue to grind higher, employment will need to remain ok. It is hard for me to see employment continuing to improve at the same pace of the last several years though. One positive byproduct of continued job gains is that wages are moving higher. Nominal wages were up +4.6% in the last year through May. The wage gain has supported a +3.7% increase in consumer spending. In addition, the savings rate in America has jumped from 4.8% to 5.3%. Consumer confidence and home prices both moved up in the second quarter. First quarter GDP was +1.10%, and estimates for the second quarter are around 3.00%. So again, U.S. economic growth centers at 2.00%. World GDP has dropped from 3.40% pre-2008 to 2.10% today.

Interest rates are low the world over, even negative in some places. The Federal Reserve was primed to announce a second rate hike this summer, but the weak May employment report caused reconsideration. In addition, Fed Chairperson Janet Yellen, and other Federal Open Market Committee members have made it clear the Federal Reserve is revising their outlook for rate hikes. It seems unlikely to me there will be a rate hike in 2016. The yield curve, (difference between two year and ten year Treasury note) is signaling low growth ahead. The shape and steepness of the yield curve has historically been accurate in anticipating both economic growth and inflation or the lack of growth. The absence of spread in the curve is saying there is little risk of inflation for the next ten years. YIKES. This means the Federal Reserve is going to find it difficult to raise rates. In fact the forward curve of interest rates would allow for only two rate hikes in the next five years. The bond market has the right to change its mind if facts change, but as of today the low rate environment looks to have staying power. While low rates are an economic stimulus, they have not produced strong growth over the last eight years. It's entirely possible that rates have been too high and this has contributed to

subpar growth. Low interest rates are with us for the foreseeable future. Like the corner man for a boxer getting pummeled, the Federal Reserve has thrown in the towel. The Fed and many others have been wrong about interest rates going back eight years. The Fed had consistently anticipated rising rates in the future. After the last FOMC meeting in June... No Mas! So, the fight for yield will continue unabated.

The United Kingdom surprised the bookies, markets and maybe even themselves, by voting to leave the European Union. Short term, growth will slow in the UK. Longer term, I think it likely that the UK does fine. The slowdown can be exaggerated or moderated by the tone and attitude of the EU during the upcoming exit negotiations. If the EU uses this as a wakeup call and focuses on reform, this could be a very positive outcome for the remainder of the EU. Pigs may fly also. The EU made it possible for the unencumbered movement of goods and services for half a billion people throughout Europe... a very good thing. However, the EU has become an extremely bureaucratic organization, run by elites who are distanced from the average European. To their credit, the UK chose not to join the Euro currency in 1999 and kept the pound. Because of that, the UK weathered the recent recession better than the Euro currency group did. There has been a real concern that other EU members may follow the lead of the UK and leave also. It would be decidedly more difficult for a member of the Euro currency group to leave than it is for the Brits. Brexit is not the end of the road for the UK, Europe and certainly not for the US. However, it has introduced uncertainty in an era of low growth. Economic and market risks have jumped for the UK and the Euro area. There just isn't enough growth in the world and that has led to, among other things, political instability.

Central bankers the world over will continue to keep rates low and use unconventional policies to counter the lack of growth. I would expect markets to remain on high alert. Earnings in the U.S. are expected to reverse multiple quarters of decline and show increases. This should allow the U.S. equity market to grind somewhat

higher. I still expect very modest but positive equity returns this year. Interest rates and the shape of the yield curve imply that growth will remain low, and because of that, inflation will continue to be modest.



Jim Huntzinger  
Chief Investment Officer  
BOK Financial Corporation  
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