Market Observations
August 2016

"Toto, I've a feeling we're not in Kansas anymore."

The Wizard of Oz, 1939

NOT IN KANSAS ANYMORE

While Dorothy's exclamation could apply to current U.S. presidential election campaigning, the focus here is on unusual current conditions impacting financial markets. Decelerating economic growth and negative yields in a growing number of global bond markets have led to higher uncertainty over future investment opportunities and how to best position portfolios today. To paraphrase one recent commentator, "The world has been turned upside down. Stocks are bought today for income and bonds are bought for appreciation."

Perspective

Most markets have provided both income and price appreciation in the first seven months of 2016. Expectations at the start of the year were moderately favorable for stock returns and rather modest for bond returns. The dividend yield of the Dow Jones Industrial Average ("DJIA") began the year at 2.33% but the near-term trend in earnings growth had been unfavorable. The yield on the 10-Year U.S. Treasury note ("UST10") was 2.27% and the consensus forecast was for this yield to trend modestly higher during the year. Table I shows income, price appreciation and total return for DJIA and UST10. DJIA income was helped by dividend increases and a more favorable earnings outlook helped lift stock prices. The big surprise was a decline in the UST10 yield to a near-record low of 1.46%. (A 45-year record low yield of 1.37% was set on July 5.) The result was price appreciation and total return for UST10 well ahead of DJIA.

How favorable can bond returns be ahead with yields currently near record low levels (see Chart I)? Perspective comes from combining bond mathematics with global bond yields. The current yields on 10-year government bonds in many developed markets are at, near or below 0%. If the UST10 yield were to decline to +0.5% over the next year, the resulting total return would be +9.9% (1.5% income + 8.4% price appreciation). Low odds but not impossible.

How favorable can stock returns be ahead with price levels near record highs? The dividend yield of the DJIA stands at 2.30%. As shown in Chart II, overall stock prices relative to earnings (P/E) are above the long term average but not egregiously so. An improving trend for earnings can supplement stock income return with further price appreciation. Moderate odds but not impossible.

Investment Implications

If being there means a return to long term normalcy, financial markets are not in their Kansas equivalent. This is not to say that favorable returns are unlikely. However, a clear understanding of current parameters and their implications for alternative outcomes ahead must guide portfolio decisions. Diversified portfolios remain the prudent approach for Kansas, the other forty-nine states and beyond.

Table I

Market Returns
1/1/2016 to 7/31/2016

	Dow Jones Industrial Average	10-Year U.S. Treasury Note
Income	**1.6%**	**1.3%**
+		
Price Appreciation	**5.8%**	**7.1%**
=		
Total Return	**7.4%**	**8.4%**

Chart I

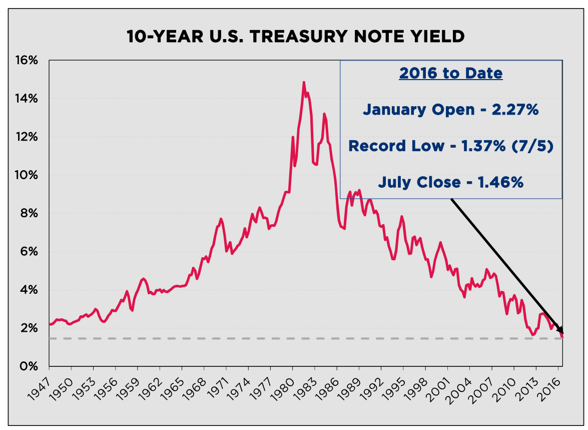

Chart II