July 1, 2016

The U.S. stock market just completed a perfect one-week lesson on a very important investing rule: don't invest based on politics. Case in point is Brexit, the British referendum to withdraw from the European Union (EU). Britain joined the EU, called the European Economic Community, in 1973 and in 2012 Conservative Party members began discussing a vote to exit. In 2015 Prime Minister David Cameron made a campaign promise to renegotiate EU membership and later hold a national In-Out vote.

Investment market participants had plenty of time to contemplate the issue and make portfolio adjustments, which were reflected in security prices. In early June, as the media began to focus on the topic, global government bond prices increased and stock markets appeared to be reacting negatively to polls showing a higher probability of an exit. The stock price weakness continued until a pro-EU Parliamentary Member was killed by a possible pro-exit assailant. From that point until the vote both the assumption of a stay vote and equity markets rallied.

During this period I thought about Brexit and concluded that neither I, nor anyone else, could have a valid opinion about how the vote would go, or what the impact, including market reactions, would be. In addition, the Brexit vote is non-binding on the Government and will take more than a couple of years to sort out, if the exit happens at all. Since I was already in a defensive portfolio position for my clients, it did not make sense to sell, or be overly concerned.

Well the Brits voted to leave the EU and global stock markets dropped hard for two days only to round trip and finish three days later at about the same level as before the vote. The only profit opportunity was to own government bonds and buy some hard hit shares on the dip, both of which New West portfolios benefited from to a small degree. There were many ways to get stressed out and lose money by trying to predict the outcome, by selling the surprise exit vote and getting whipsawed as the market recovered.

New West Investment portfolios have advanced modestly during the first half of the year besting most of the stock indices by a tiny amount even with much less exposure to the equity markets. The 5-10 year U.S. Treasury bonds I bought a little over a year ago have provided a total return (interest plus appreciation) of about 8% since purchase, much better than equity investment returns for the time frame. The reasons for my muted stock market exposure as I have outlined before is the economic and equity market advances since 2009 are extended based on historic norms, and share prices are on the high side considering the subdued recent and expected growth for the economy and company earnings.

I believe this slow growth is the result of three major factors. First, low interest rates have significantly reduced the income earned on safe investments held by retirees, turning vast numbers of that demographic into hoarders as opposed to spenders or gifters. In addition this group is faced with concerns about the high and increasing cost of possible assisted living care. Second, recent college graduates have significant levels of student loan debt that is delaying new household formation, which is traditionally a large driver of economic growth. Finally, global growth is even less robust than in the U.S., which along with the strong dollar is precluding export based economic growth.

Since I do not expect these economic pressures to abate in the near-term, I am attuned to principle preservation, taking advantage of opportunities in a smaller way and am little concerned about much higher interest rates. I am being patient as I research new investment ideas and wait for prospects to improve either by better company earnings or lower share prices. Enclosed please find your most recent investment portfolio report. Have a great summer!

Best regards,

Peter V. Hedberg