



We open this writing with a 1912 photograph of a man crash-testing a football helmet not only in recognition of the fact that the long-awaited start of football season is finally



approaching, but also because there is probably great similarity between how this product tester felt 104 years ago and how most global equity investors felt in mid-June.

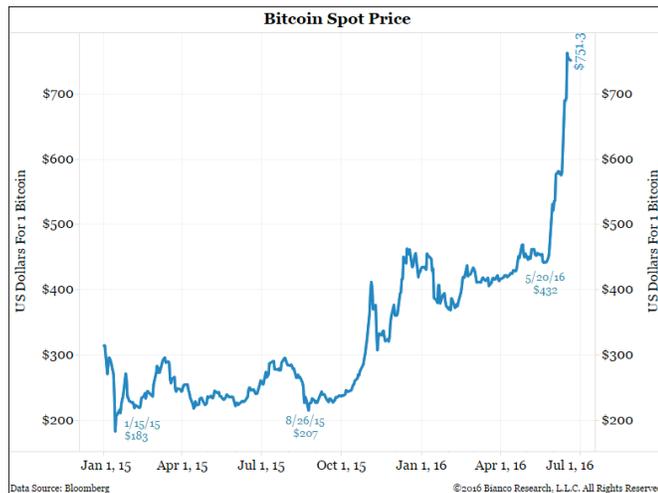
In many regards, the domestic markets running into major resistance at their old all-time highs was almost as predictable as was the collision into the wall back in 1912. As we had noted in the June 6th e-lert sent to clients in the Per Stirling Core Growth Portfolio, “With most of the domestic equity markets back at the top of their long-standing trading ranges, the seasonal weakness often associated with the summer months, the upcoming risks associated with the “Brexit” vote (that will determine if Britain remains in the European Union) and a potential summer interest rate increase in the U.S., we believe that there is a decent chance of a modest, short-to-intermediate term decline in equities, and we want to have some cash available to take advantage of it”.

You can see the investor fear related to these fundamental concerns manifested in a variety of ways including the recent decline in global equity markets, the surge in the price of gold, the virtual doubling in the prices for defensive options, and the parabolic move higher in the value of alternative currencies like Bitcoin.

On top of these fundamental challenges, there is also a very strong technical reason to have expected the equity markets to run into major resistance almost exactly where they did. In its simplest form, “markets have memory”.

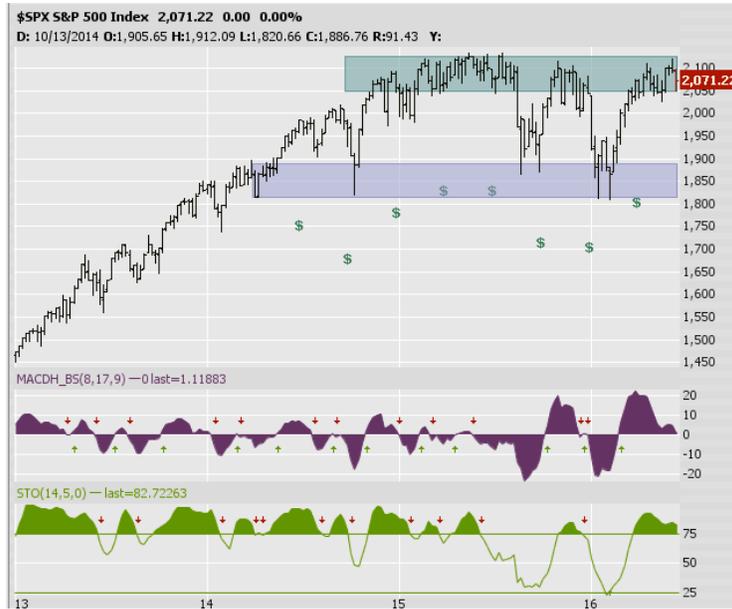
To explain, investors (and people in general) have a very strong tendency to repeat behavior that has been pleasurable or rewarding in the past, and to avoid behavior that has been unpleasant or harmful in the past.

As a result, it is very common for markets to have areas of support and resistance.



In essence, an area of support is a price range which has repeatedly been a “pleasurable or rewarding” level at which to invest. It is a level in the markets at which investors have been trained to invest additional assets based upon both intuition and human nature. An area of resistance is the exact opposite, except that they can often be even harder to break through.

Due to these tendencies, it is not unusual for cash to sit on the sideline until support levels are retested, at which point money pours into the market, ending the decline and launching



the next leg higher. The exact opposite is true of areas of resistance (a.k.a. overhead supply). Many investors will sell at old highs simply because it has been profitable to do so in the past. This brings a new supply of shares on to the market, and often catalyzes the next decline.

Markets (or securities) cannot break above these resistance levels until such time as buying power is more than sufficient to absorb all of that pent up selling pressure. Similarly, markets (or securities) cannot

break below these support levels until such time as selling pressure is more than sufficient to absorb all of the pent up buying power.

You can see this illustrated perfectly in the chart of the Standard and Poor’s 500 Index. Support (underlying demand) is found in the grey-shaded area, and resistance (overhead supply) exists in the green-shaded area. This “tug-of-war” between supply and demand has been ongoing since 2014, and has created one of the longest and tightest trading ranges in modern market history. Again, this trading range will persist until either the bulls or bears become sufficiently dominant to overwhelm either the overhead supply or the underlying demand (respectively).

The area of resistance currently confronting the U.S. equity markets is proving particularly resilient, which we attribute largely to the market’s historically high valuations. Further, we expect that valuations are likely to remain as a formidable headwind for equity prices for so long as productivity gains remain quite muted and earnings growth is only modest at best.

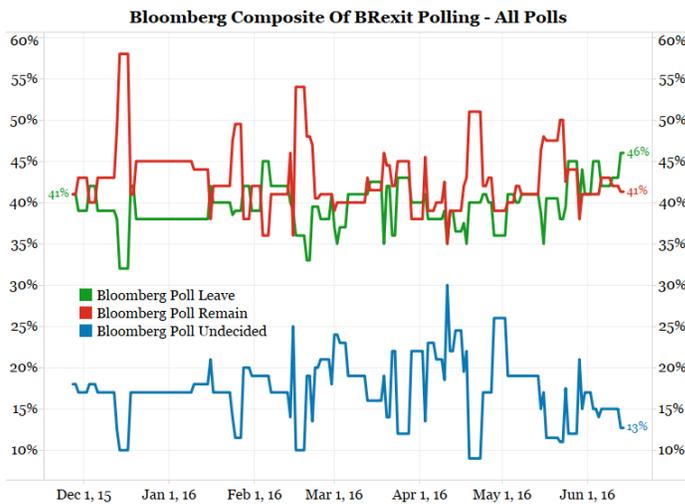
**Exhibit 3: Median stock trades at the 99<sup>th</sup> percentile of historical valuation as of May 12, 2016**

| Metric                         | Aggregate |                  | Median stock |                  |
|--------------------------------|-----------|------------------|--------------|------------------|
|                                | Current   | Historical %-ile | Current      | Historical %-ile |
| Price-to-Earnings growth (PEG) | 1.4 x     | 89 %             | 1.8 x        | 100 %            |
| EV / Sales                     | 2.0       | 91               | 2.5          | 100              |
| EV / EBITDA                    | 10.9      | 86               | 11.1         | 99               |
| Forward P/E                    | 16.8      | 86               | 17.5         | 96               |
| Price / Book                   | 2.7       | 66               | 2.9          | 83               |
| Cyclically adjusted P/E (CAPE) | 22.3      | 73               | NA           | NA               |
| <b>Median metric</b>           |           | <b>86 %</b>      |              | <b>99 %</b>      |

Source: Compustat, I/B/E/S, and Goldman Sachs Global Investment Research.

Of note, the Dow Jones Industrial Average is also facing psychological resistance at the 18,000 level, where it has continued to run out of steam. While it is not at all unusual for equity markets to really struggle breaking through and staying above either technical or psychological resistance, it is important to remember that it has been over a year since the domestic markets have seen new highs, which is remarkable in a bull market cycle.

To explain, areas of support and resistance have historically proven to become increasingly formidable with each failed attempt to break through them, and there have already been more failed attempts to break through resistance over the past eighteen months than can be easily counted. This is why potential big, broad topping patterns can be so ominous. As the



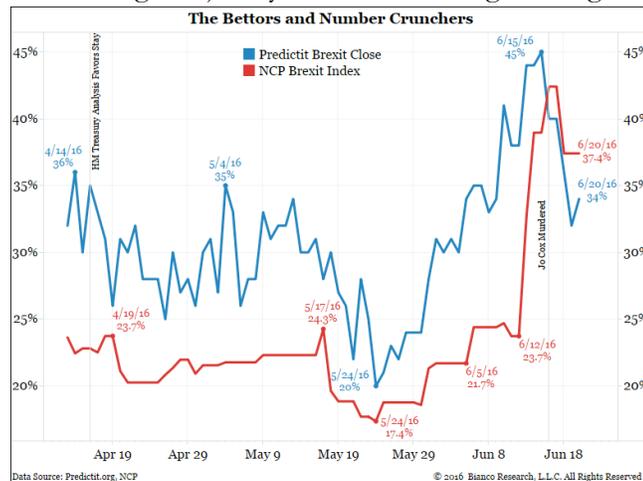
old saying goes, “the broader the top, the greater the drop, the broader the base, the greater the space”.

With the last new high put in place back on May 19<sup>th</sup> of 2015, we believe that it is critically important for the markets to reach new highs before the year is done, which is our expectation. However, if the markets do not break out as expected, this has the potential to be a very broad top indeed.

The likelihood is that someone who is purely a technical analyst would maintain that it is purely this technical resistance and overhead supply that have caused the recent market decline, and that the “Brexit” vote and the concern over the prospect of the Federal Reserve raising short-term rates are simply the excuses that investors are using to rationalize what the markets were going to do anyway.

While there is an element of truth in this perspective, these two factors are classic “tail risks”. Either a vote for Britain to leave the European Union or a surprise rate hike by the Fed would have the potential to roil the capital markets. However, we believe that the likelihood of either event taking place is low enough to justify both maintaining existing risk market exposures, and even using the recent weakness to increase equity weightings.

**The “Brexit” Vote:** As is illustrated in the Bloomberg chart, the **campaign to withdraw from the European Union** had been gaining significant ground over recent weeks, which, with all deference to our technically-oriented colleagues, was clearly having an impact on global equity prices.



All of that seemed to change dramatically with the tragic murder of British Member of Parliament Jo Cox, who was a staunch supporter of the “remain” vote, and who was killed by a right-wing, pro-“leave” activist. Immediately following the murder, **the betting markets** slashed the chances of a “Brexit” from 42.4% to 34.0%. Moreover, polls taken over the weekend for *The Mail* and *The Sunday Times* show a lead for the “stay” camp of 3% and 1% respectively. This is reflected in the **consolidated polling data’s** fall to a 37.4% likelihood of “Brexit”.

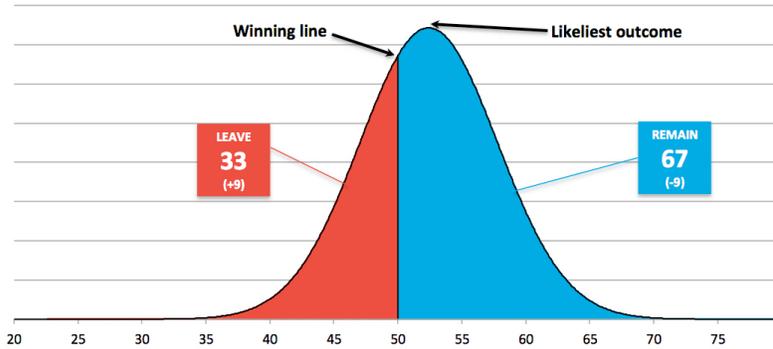
In addition, the betting markets have a much better history of predicting election outcomes than do the British polls, and they have never given the “leave” vote as much as a 50% likelihood of passing, and currently assign it only a 34% likelihood. Indeed, the British have

a reputation for “polling with their heart and voting with their head”. A recent example of this is found in last year’s Scottish referendum on remaining as part of Britain, where polls predicted a very close vote only to have an overwhelming majority of Scots vote to stay as part of the United

**NCP EU referendum outcome probabilities**

Modelled percentage probabilities of Remain vote share based on NCP polling average and historical data. As of 13th June. Data source: NCP

Number Cruncher Politics  
www.NCPolitics.UK



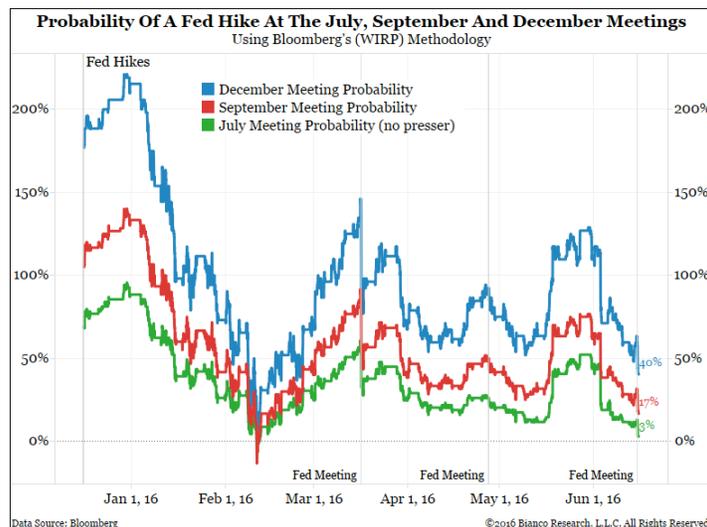
Kingdom. In sharp contrast to the polls a year ago, the betting (prediction) markets were overwhelmingly predicting a “stay” outcome, just as they are today.

In addition, it is important to remember that this is a non-binding referendum that would actually need to be passed through Parliament (where 75% of members favor staying in the European Union) before it could become effective (although a landslide “leave” victory would likely be perceived as a mandate for change).

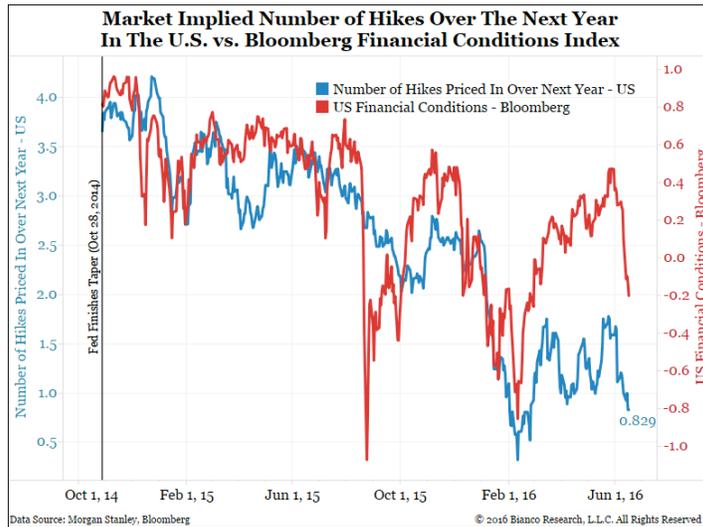
Even if it did pass Parliament, Britain’s relationship with the EU would not suddenly end. Instead, a two-year negotiation between the parties would begin. How those negotiations would go is hard to anticipate. There is one camp of analysts who believe that the rest of the EU needs Britain’s involvement (as the world’s fifth largest economy) and will need to make concessions to maintain close economic ties between the two parties.

There is another camp of analysts who believe that the European Union must punish a “leave” vote from Britain by making an example of them, via hurting the British economy in every way possible, so to keep other countries (probably starting with France and Finland) from attempting to follow Britain out of the Union.

A “leave” vote would certainly cause us to reexamine our outlook, as it could ultimately catalyze the unwinding of the European Union. However, in the meantime, we are working under the assumption that the “remain” vote will prevail and that, even in the event of a “leave” vote, we have already seen some preview of the market reaction over the past week or two when a “Brexit” seemed inevitable to everyone but the prediction (betting) markets.



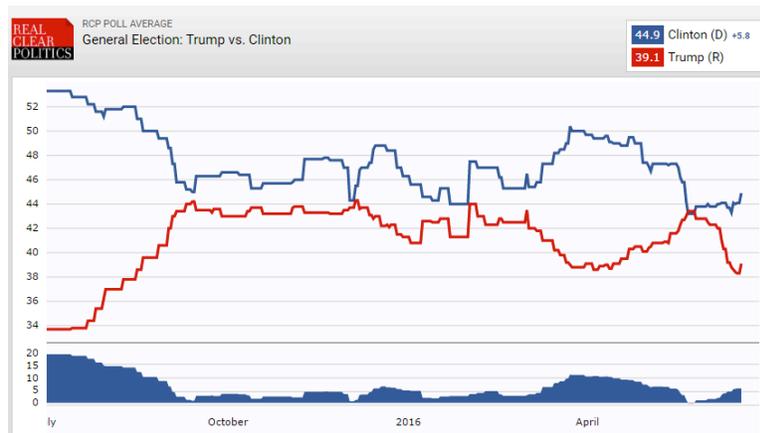
In regard to the Outlook for the Federal Reserve and monetary policy, a recent slowing in the U.S. economy in general and in the labor market in particular has caused the Fed to adopt a much more “dovish” perspective. In other words, they are rapidly backtracking on their recent guidance that they were likely to raise rates this summer.



As a result of this change in guidance, the markets have now taken the likelihood of any 2016 interest rate increases off of the table, with even a **December rate hike** being assigned less than a 50% likelihood, and we know that, since the days of the Greenspan-led Federal Reserve, they have never changed interest rate policy until after the change was already anticipated by the markets.

Put another way, due to the recent slide in the **domestic financial environment**, the markets are now pricing **in less than one rate increase in 2016**. For the time being, we believe that you can safely move the risk of a tightening by the Federal Reserve off of the table.

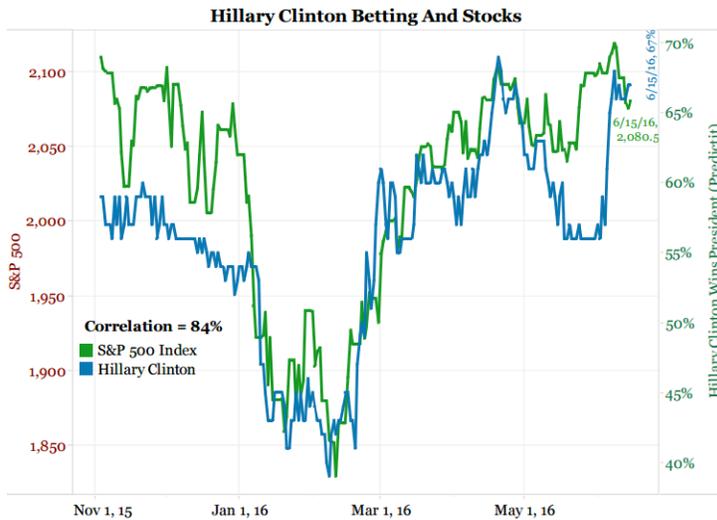
In regard to the U.S. elections, the latest polls show Clinton taking an increasingly commanding lead over Trump, which is being perceived as bullish for domestic equities. As we have noted over recent writings, investors tend to strongly prefer “bad news” over uncertainty, as they at least know how to price “bad news” into the capital markets. While most investors tend not to like Clinton’s policies, they at least know what those politics are, and they don’t worry that those policies will change on a whim, which is a perceived risk with Trump.



The other perceived risk of a potential Trump presidency that is very troubling to both investors and the economic outlook in general is the fact that his campaign has emphasized a message of isolationism and protectionism. This philosophy has traditionally slowed economic growth and exacerbated inflation, and was a key driver of the passage of the Smoot–Hawley Tariff in 1930 that greatly exacerbated the Great Depression.

While there are some appealing components of the Trump economic platform, most investors (ourselves included) are concerned greatly by Trump’s demonstrated ignorance of macroeconomics and his unwillingness to learn the lessons of history.

You can clearly see the fact that investors are more comfortable with Clinton than Trump in the very tight correlation (84%) between Clinton’s poll numbers and the price action in the equity markets themselves. We do wonder if investors will remain as comfortable with



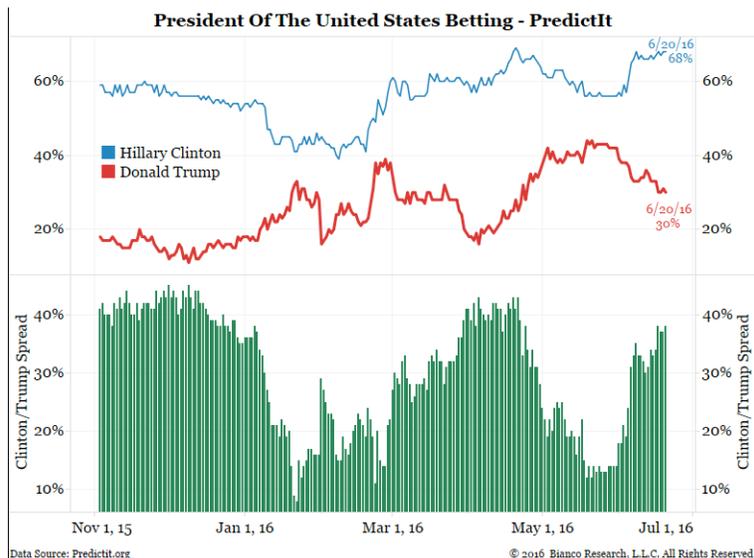
Clinton if she, as is rumored, picks Elizabeth Warren (who rose to prominence by bashing the investor class) as a running mate. We worry about this as well, but suspect that she will need to pick a different candidate, as the selection of Warren would likely cost the Democrats a seat in the Senate, due to the fact that the Republican Governor of Massachusetts would get to select her replacement.

Moreover, unlike in the United Kingdom, the U.S. prediction (betting) markets and the polls are in agreement, with the prediction markets assigning a 68% likelihood of a Clinton victory in November.

In summary, the equity markets still face a variety of challenges. They are confronted with massive overhead resistance. Valuations are quite high on a historical basis. Earnings and productivity growth remain quite poor, and capital gains taxes are at risk of moving much higher in the event of a Clinton presidency.

At the same time, markets thrive on clarity, and investors should get greatly improved clarity of the “Brexit” situation over coming days and on the U.S. elections over the coming months. In fact, equity prices may be a leading indicator of that election outcome. Since 1944, if the S&P 500 rose in price from July 31<sup>st</sup> through October 31<sup>st</sup>, the incumbent party was re-elected 82% of the time. When it fell over that period, the incumbent party lost the White House 86% of the time.

This improving clarity, when combined with the fact that the primarily negative-yielding world of the debt markets



leaves very few viable alternatives in which to invest one’s money, keeps us rather constructive on the global equity markets through this year and into 2017. Moreover, if the “Brexit” vote turns out as we expect, we believe that the recent angst-related sell-off will prove to be a wonderful buying opportunity for longer-term investors to build upon their allocations to the foreign equity markets.