CRIBSTONE
CAPITAL MANAGEMENT

Second Quarter Newsletter

July 20, 2016

The July 4th weekend marks the official start of summer here in Maine, but the weather during the weeks leading up to the holiday had been fantastic. Indeed, it's been remarkably "summery," here, characterized by a steady stretch of warm, sunny and calm days.
The financial markets, on the other hand, have been anything but. Our recurring theme, which you're quite familiar with by now if you've been keeping up with our communications, is volatility. From our vantage point, we expect the volatility to continue. As such, we have generally been taking a cautious stance toward our exposure to global equities, and deploying strategies that should help to offset volatility. This includes, for the most part, paring back our allocation to equities and adding to other asset classes including, for example, fixed income and gold. Our goal, as always, is to help you achieve your investment objectives while paying very close attention to risk management.

Half Time Report

Let's take stock of what transpired in the first half of this year. After a weak start to 2016, where the first 10 days of January were the worst in the Dow Jones Industrial Average's history—going back to 1897--the index actually finished the second quarter up 2.9% for the year. Highlights include the following:

- Performance of stocks was driven by industry sectors that are perceived to be defensive, or should hold up better in a tough market environment. These include high dividend paying utilities, telecommunications companies like AT&T and consumer staples like Wal-Mart, which rose 25.6% and 19.2%, respectively, before dividends.

- But even so called riskier asset classes like emerging markets fared well in dollar terms thanks in part to a rebound in their currencies as well as the prices for some of the commodities they produce. The iShares MSCI Emerging Markets exchange traded fund (a broad measure of emerging markets) was up 6.7%.

- Oil prices, which were ravaged last year, also staged a big recovery after initially diving below $27 in January (as measured by the West Texas Intermediate spot price). They are now hovering around $47, a more than 25% increase year to date.

- Gold, which had been in steady decline since its peak in mid-2011, popped close to 26% for the first six months of this year, as measured by the SPDR Gold Shares exchange traded fund. A flight to the safety of gold during rocky times explains just part of its appeal.

Playbook for Rest of Year

We expect our recurring theme of volatility will continue to take center stage. For one thing, as we have written in past newsletters, we feel that segments of the US equity market have been priced nearly for perfection. But the world, as we know, has been anything but perfect. We believe this makes equities vulnerable to a correction on any hint of weakness or crisis. These could (and have) come from a variety of sources. For example:

- The price people are willing to pay for a stock, in many respects, is a function of the underlying earnings growth of a company. So it must follow that with the US stock market having ended the second quarter just 1.5% shy of its all-time record, corporate earnings growth must be setting records as well, right? Remarkably, it's been almost the opposite: Wall Street analysts estimate that second quarter earnings for the benchmark S&P 500 actually fell 5.4%. This would mark the fifth consecutive quarterly drop. (Second quarter earnings season gets under way as we speak, so stay tuned.) We think that with valuations already high, stock prices need not only earnings growth, but probably *better than expected* earnings growth to move higher.

- US economy is one of the few bright spots on the globe, but growth is still fairly muted. Most of the data on the US consumer, which accounts for two-thirds of economic activity, signals a moderately healthy situation. First of all, the labor market is fairly steady with low unemployment and wages that are climbing, albeit slowly. In addition, the energy sector, which has represented a significant drag on the economy, seems to be stabilizing and could actually show improvement by the end of this year, assuming oil prices remain in their current range. According to a Wall Street Journal poll, the majority of economists expect second quarter and second half real GDP growth to accelerate to 2.4% from the first quarter's 1.1% rate. While somewhat encouraging, the data also suggests we may be in a fairly tenuous situation. The same Wall Street Journal poll shows a small, but growing, probability (still just 21%), of a recession occurring in the next 12 months.

- International headlines keep rocking the boat. Remember China? It seems so long ago that all we were focused on was China and the negative impact its economic slowdown may be having on the rest of the world. That worry still has not gone away. But now we have Brexit too, about which there is no shortage of opinions on what outcome it may have. As we said in our communication to you the day after the vote, Brexit adds another layer of uncertainty and complexity to a global economic environment that is already challenged by a host of other issues.

Fixed Income: Unchartered Territory

Fixed income markets continue to attract the most attention as falling global bond yields have boosted the prices of underlying bonds. Through June 30th, the 20 year Treasury bond has returned close to 17%, while its yield dropped from 2.67% to 1.86%. Surprisingly, while 1.86% is an historic low for the 20-year, it is still pretty attractive by global standards. We've read that 36% of global sovereign debt yielded less than 0% on June 30, while another 41% yielded between 0 and 1%. Brexit provided a further boost to US Treasuries, as the pound plunged to a

30 year low versus the dollar. This extremely low-to-negative interest rate environment is literally unchartered territory for the global financial markets, and we don't see an end to it anytime soon.

Meanwhile, as mentioned above, we increased our fixed income exposure AND duration (length of maturities). In most situations, during the second quarter we established a significant position in the 20 year Treasury Bond exchange traded fund (TLT). Moves like this have not only boosted returns but helped soften the blow on the days when the equity markets are in the red. Our view has been that inflation will remain contained and growth will continue to trend below its historical average, keeping potential Federal Reserve interest rate hikes few and far between. Fed Chair Janet Yellen indicated that concerns about the potential negative impact from a Brexit vote factored into the Fed's decision to hold rates steady in June. We believe Yellen and others on the Fed may be even less confident about the need to raise rates when they next meet this month.

These are very interesting – if not confusing – times. For a host of reasons, both economically and geopolitically, volatility in the financial markets is likely to continue. Our commitment is to help manage risk while at the same time seeking out the investments that we think can provide attractive returns over the long run.

We are also committed to provide you with the best service possible. To that end, we welcome a new member to the Cribstone Team, Perian Moore. Perian joins us as Client Service Manager primarily working with John Duffy and Matt Daigneault out of the Brunswick and Cumberland offices. Perian comes with a degree in Leadership and Organizational Studies from the University of Southern Maine. For the last 25 years she has been working in the fitness and wellness Industry. Fourteen years ago Perian started her own business, InspireME Personal Fitness and Wellness in Bath. Perian was looking for a new challenge and decided to try something completely different. We're thrilled she's decided to join us. Perian lives in Bath with her husband Michael Clarke and two cats.

So when you call us for help or with questions or concerns, in addition to Tina and Maranda, Perian may also be answering your calls. In the meantime, please enjoy your summer.

With warm regards,

Scott Upham, Managing Partner | Odette S. Galli, Partner | John D. Duffy, Partner