DEIGHAN
WEALTH ADVISORS

MARKET COMMENTARY

The end of the second quarter was a wild ride. On Thursday, June 23rd the United Kingdom voted to leave the European Union. The result, dubbed "Brexit" for British-Exit, took investors completely by surprise and sent shockwaves through markets the world over. By Monday, the S&P 500 had fallen 3.08% on the quarter, the Dow Jones 3.25%, and the NASDAQ 5.64%. The UK saw a similar drop with the FTSE UK 100 falling 3.56%. Europe fared much worse. The STOXX Europe 600 fell 9.51%. According to analysts, Brexit was "not supposed to happen," but then again, the referendum on Brexit was "not supposed to happen" either.

In the lead-up to the UK's 2015 parliamentary election, an attempt to appeal to Eurosceptic conservative voters was made by Conservative Party leadership, who chose to include holding a referendum on EU membership in the party platform. At the time, the promise seemed hollow. The Conservative Party led a coalition government that relied on support from the pro-EU Liberal Democrats who would surely block such a referendum after Election Day.

Surprise! In the 2015 election the Conservative Party won an unexpected majority. Without the Liberal Democrats to block the vote, the conservatives had to make good on their promise. To hedge their bets, Cameron began talks to renegotiate the UK's relationship with the EU. He called for stricter immigration controls, reductions in benefits for migrants, recognition that the UK was not committed to an "ever closer union" with the EU, and protections for non-Eurozone countries (those not part of the currency union). Cameron got concessions on all key demands and proclaimed victory. Cameron declared he could now put his "heart and soul" into campaigning for the UK to remain in the EU.

The leaders of the other major UK political parties (Labour, Liberal Democrat, and Scottish National) joined Cameron, in supporting the "remain" vote. With the support of the party leadership of all the major political parties, few imagined a "leave" vote could prevail. All those "in the know" predicted the UK would vote to remain in the EU.

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When the “leave” vote won, the fallout was immediate. Cameron announced that he would resign as Prime Minister and the Labour party began a revolt against its leader Jeremy Corbyn. Suddenly the whole of the UK erupted in debate.

London, Scotland, and Northern Ireland all voted overwhelmingly to remain. England and Wales voted to leave. The divide was more than geographic. Overwhelmingly, the older, less wealthy, and less educated voted to leave. As Britain transitioned from a manufacturing economy based in the coal fields of Wales and the steel mills of England to a service based economy centered in London, many Britons felt themselves left behind. Many saw the open border and free trade policies that allowed the financial sector of London to become the financial center of Europe as the cause of the decline of Britain’s “blue collar” jobs. Britons found the situation to be bad enough to take the plunge into uncertainty and vote to leave the EU.

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Financial markets abhor uncertainty. Immediate uncertainty surrounded the future of the UK’s access to the EU’s single market. The EU’s single market allows free-trade across the bloc in exchange for following EU membership laws and regulations. The UK is the EU’s second largest economy and the EU is the UK’s largest trading partner. To remove the UK from the single market would create trade barriers that could significantly harm the competitiveness of UK businesses within the EU.

Non-EU countries have negotiated access to the single market area. Norway, Iceland, and Liechtenstein have access to the EU’s single market through the European Economic Area. Switzerland has access through bilateral treaties. However, to gain access to the single market, all these nations have had to accept the very EU laws and regulations that the UK wishes to avoid and EU diplomats have roundly rejected the prospect of allowing the UK access without also acquiescing to EU laws.

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All this uncertainty drew markets lower. But then, a peculiar thing happened. On the 28th of June, markets began to recoup losses. The S&P 500 and the Dow Jones rebounded ending the quarter up 1.69% and 1.21% respectively. The NASDAQ made significant gains and ended the quarter down only 0.55%. Impressively, the FTSE UK 100 surged and ended the quarter up 4.85%. The STOXX Europe 600 also rebounded but still ended the quarter down 2.27%, deepening losses that have plagued EU markets for more than a year.

Despite the end-of-quarter turnaround, the Bank of England has warned “[t]he current outlook for UK financial stability is challenging.” We expect to continue to see market volatility as a result of Brexit. Market pundits Liz Ann Sonders, Brad Sorensen, and Jeffrey Kleintop, have analogized Brexit to other post-recession market shocks such as the Japanese earthquake, the US debt ceiling crisis of 2011 and the European debt crisis of 2012. All were followed by a period of three to four months of volatility before markets fully recovered. Sonders, Sorensen, and Kleintop point out that, “[a]lthough the Brexit is not a perfect parallel with any of the above shocks, the delayed recognition of widening impacts from [Brexit] could prompt a further slide in the stock markets....” As markets rebounded, this delayed recognition of impacts became apparent. European markets, with the exception of the UK, did not rebound completely on concerns that Brexit may have a long-term negative effect on the EU.

The EU is more than a trade association. The EU is an economic and political union meant to ensure peace and prosperity in Europe through free trade, free movement, common economic policies, and the protection of human rights. It has been characterized as the “United States of Europe,” a term coined by Winston Churchill. However, as the EU has expanded beyond the more affluent and stable nations of Northern Europe, it has been strained by major debt and immigration crises. Some fear the Brexit vote may be a catalyst for other nations to follow suit.

The imminent dissolution of the EU seems unlikely. For the rest of the EU, use of the euro makes leaving much more difficult. The UK never joined in the monetary union and instead kept the pound, making leaving much easier. It seems more likely that Brexit will cause economic pains in other ways. With the uncertainty of Brexit, European banks are likely to keep interest rates low for the foreseeable future. These low rates will continue to strain banks in the EU. This could be a more acute problem in Italy, where banks are already pinched by high levels of bad debt. The already low interest rates in Europe have spurred investors to seek returns elsewhere, especially in the US where interest rates are relatively high. This has caused the dollar to appreciate.

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Normally, the appreciation of the US dollar would be good for emerging markets. It increases the competitiveness of their goods. However, in June the World Bank adjusted its forecast for global growth downward to below last year’s uninspiring pace. This means there is less of a market for their goods. Moreover, in the low interest rate environment following the Great Recession, many emerging economies took on US dollar denominated debt. Recent appreciation of the US dollar has caused the cost of that debt to rise.

US GDP is on track to grow 2.0% this year. This is not as high as many would like to see, however, it is sustainable and unlikely to lead to sector bubbles. Unemployment is at 4.7%, beating the Federal Reserve’s target of 5.0%. However, Bureau of Labor

Statistics indicate many US workers are under employed and that participation in the workforce is lower than historic averages. American households have finally begun to see income growth above the rate of inflation. However, that growth is spread unevenly across income brackets. Thus, it seems for every positive piece of news there is a corresponding negative. In the face of such uncertainty we expect to see continued market volatility.

Prior to the Brexit vote, we reduced the equity side of portfolios by 2% and reallocated the proceeds into an exchange traded fund (ETF) that invests in Treasury Inflation Protected Securities (TIPS). TIPS are direct obligations of the United States government and are considered low risk. Their interest rate remains fixed while their face value is indexed to inflation as measured by the Consumer Price Index (CPI). While the Schwab TIPS ETF's price fluctuates, it is still considered a relatively conservative fund. Though this particular portfolio move provided some level of protection from the negative effects of Brexit, it was not in anticipation of Brexit. Rather, it was a strategic decision made by our Investment Committee to slightly reduce overall exposure to the equity asset class and allocate the proceeds to the more stable bond asset class. As always, we are watching out for our clients' best interests. Please feel free to call or write with questions or concerns.

We wish you all a wonderful summer, whether you are here with us in our beautiful state of Maine or reading our newsletter from far away!

The Deighan Team

PORTFOLIO CHANGES

ADDED

ProShares S&P 500 Dividend Aristocrats ETF (NOBL)

This exchange traded fund (ETF) tracks an equal-weighted index that contains a minimum of 40 companies in the S&P 500 index which have increased their dividend payments each year for at least 25 consecutive years. These "Dividend Aristocrats" have shown more stable and consistent returns over time than their peers. Additionally, over both the long and short term, the index that NOBL tracks has outperformed the S&P 500 with less volatility.

Dreyfus Small Cap Stock Index (DISSX)

Dreyfus Small Cap tracks the S&P Small Cap 600, a market-cap weighted index that includes approximately 600 stocks of smaller U.S. companies. This fund replaces Schwab US Small Cap ETF. DISSX has better long-term risk-return characteristics, and its rebalancing method ensures the companies it tracks are truly providing small cap exposure.

TCW Total Return Bond (TGMNX)

TCW Total Return is a core active bond fund. This fund is less volatile than the fixed income fund that it replaced with better long-term performance than each of the two funds we previously used in the core active bond space (see MWTRX and TGFNX below). It also better complements our fixed income index ETFs by focusing on active management of attractive bond sectors.

Guggenheim Total Return (GIBLX)

This actively managed bond fund joins TCW Total Return in the core active bond portion of our portfolios. This fund's main expertise is in the management of asset-backed securities with cash flows tied to real assets. It has seen consistently strong relative performance since its inception. Guggenheim has a history of managing assets for insurance companies which requires keeping a keen eye on risk.

REMOVED

Schwab U.S. Small-Cap ETF (SCHA)

We chose to exit SCHA in favor of DISSX, a more pure-play small cap index fund that tracks the S&P Small Cap 600. See DISSX above.

SOUNDBYTES

Jean Deighan recently celebrated her birthday and got an unexpected, and well deserved, surprise. The Bangor Rotary Club presented Jean with The Charlie Award. The Charlie is named for Charles F. Bragg and recognizes "continuous and exemplary leadership and service to the club and the community it serves." Jean was deeply honored and humbled to receive this recognition as she takes pleasure in contributing toward making our community a great place to live and work. Jean truly embodies the Rotary ideal of "Service Above Self". Congratulations, Jean!

Derek Jones and **Tyler Hoxie** spent a day at Reeds Brook School in Hampden presenting Junior Achievement's "It's My Business!" program. This program "encourages students to use entrepreneurial thinking as they explore higher education and career choices. Derek and Tyler agreed that this was a great way to spend a day and were impressed with the level of creativity of the students.

Met West Total Return (MWTRX)

This fund was intended to complement both our bond index ETFs and TCW Core Bond Fund's active bond management. However, this fund and TCW Core Bond have tracked very closely, and are now structured almost identically in terms of sector exposure. With the addition of new funds, we have broadened our exposure to other management styles with expertise in specific areas of fixed income and more favorable long term returns.

TCW Core Bond (TGFNX)

As noted above, this fund was selected to complement both our passive bond index ETFs and other actively managed bond funds. We expected to see a better risk-return profile during the time that it was held, and do not believe the added expense of active management justifies continuing to hold this fund. Some clients may notice a small balance remaining in both MWTRX and TGFNX as we work our way out of these positions, avoiding the short-term redemption charge that would otherwise occur on the recently received and reinvested dividend shares.

WELCOME, LAURA LOMMLER!

We are pleased to introduce our new intern, Laura "Lori" Lommler. Lori holds two degrees from the University of Maine Orono: a Bachelor of Science in Environmental Management & Policy with a concentration in Leadership and Advocacy; and a Bachelor of Arts in Spanish. She is currently a Master of Business Administration candidate at UMO. While at UMO, Lori has been instrumental in helping the University carry out sustainability-related initiatives. In her role as Sustainability Coordinator from 2010-2011 she gained formal recognition from the US Green Building Council for her submission about sustainability successes, many of which she initiated and supervised, at the University of Maine. In her current position as Community Education Assistant, she helps to hire, train, and supervise student employees, and to develop and implement programs to advance sustainability goals within Auxiliary Services at the University.

Lori is interested in the Financial Services industry, specifically in the type of highly personalized financial planning and investment management that we do here at Deighan, and we are happy to have her on board. She is already contributing in meaningful ways by helping to organize our financial education presentations, participating in our staff meetings and marketing initiatives, and helping with special projects. We enjoy her upbeat personality, inquisitive nature, intelligence, and great sense of humor.

In what little spare time she appears to have, Lori enjoys spending time with her husband and two young children, camping, swimming, cycling, cross country skiing and generally enjoying the natural beauty of Maine.

We have had a successful paid internship program at Deighan Wealth Advisors for several years. Our goals for the program include teaching the next generation of advisors how to deliver top notch financial services, the importance of a lifelong commitment to continuing education, and sharing our values of honesty, respect, responsibility, fairness, and compassion. In turn, our company benefits from increased productivity with an extra set of hands for special projects, enhanced perspective from a fresh set of eyes and ears, the ability to build a pipeline of talented, young professionals, and most importantly we can give back to our community by helping students expand their knowledge and career growth. Internships are truly a win-win!

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