Pinnacle Financial Partners

Investment Overview

July 2016

Brexit Presents New Risks

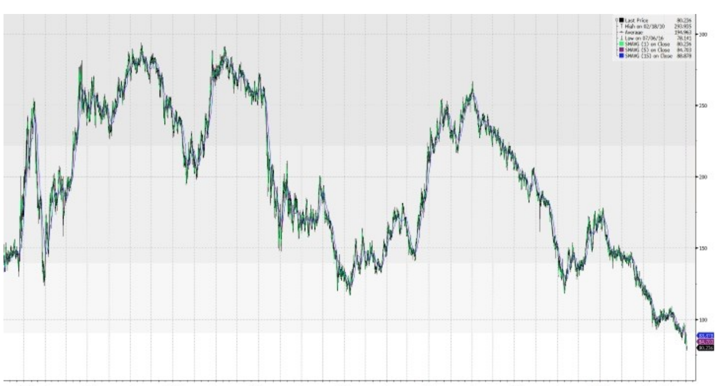
By Mac Johnston, chief investment officer

Review of 2Q 2016

The S&P 500 rose 1.81 percent, bringing the year-to-date return to 3.84 percent. Despite these returns, the markets sold off 5.6 percent in late June as the Brexit vote surprised investors and the markets. The S&P 500 recovered and closed within 1 percent of a new high for the year. Many American investors don't see the risk implications of the Brexit on the U.S. economy and the collateral damage that is happening in banking and the fixed-income markets. The spread between the 2-year and 10-year Treasury yield has ranged from a high of 2.9 percent in 2011 and 0.8 percent recently, which is below the levels we saw in 2008-2009.

Banks are especially hard hit, because net interest income levels will decline over time due to over capacity and competitive loan pricing. The weakness in the spread also has negative implications for the outlook on the U.S. economy. We expect yields on Treasury bonds to remain low, as there will be continued buying power from European investors who are looking for higher yields (the German and French 10-year bonds yield 0.18 percent and 0.13 percent, respectively) and investors who are looking for safety during volatile times.

2- to 10-Year U.S. Treasury Spread



Source: Bloomberg

Other factors that drove the 10-year bond yield from 2.28 percent at the beginning of the year to 1.47 percent at the end of the quarter were:

1. Janet Yellen pushing in the clutch on further rate hikes for the balance of 2016 and possibly 2017.
2. The Brexit vote putting additional stress on the European Union to support the PIGS (Portugal, Italy, Greece, and Spain) without the U.K. As conditions deteriorate with a banking crisis in Italy and a massive inflow of refugees, Germany, France and other solvent E.U. countries are bearing the cost of further weakness.
3. The British pound collapsing to 31-year lows, which is creating stress on investments as some asset managers in the U.K. are not allowing investors to pull their money and causing more panic.

British Pound 5-Year View

Source: Bloomberg

Finally, no one fully understands what will happen to U.K.-based companies as the divorce with the E.U. moves forward. For example, British Airways and Easy Jet, the U.K.'s two largest airlines, fly over 60 percent of their routes to continental Europe. Without the preferred status of being an E.U. member, the airlines could face higher landing fees and other discrimination, thus increasing the chance that the companies could relocate their headquarters outside of the U.K. That would further hurt the U.K. economy and increase the possibility of a recession. This same scenario will play out for other British companies like GlaxoSmithKline, Vodaphone, AstraZeneca, Diageo, SABMiller etc. With this in mind I believe that the E.U. has a vested interest in giving the U.K. a smooth transition out of the E.U. but will have to allow Britain some preferred trading status to not further weaken economic conditions in each area.

First quarter U.S. GDP was revised to 1.1 percent. The bright spot for the economy was spending on housing. We expect consumer spending to pick up in the second quarter, which will help the GDP growth rate to rise above 2.0 percent, the highest sales level since 2000. We have revised our GDP estimates up for the balance of the year but have lowered our 2017 estimate as further uncertainty in the stock and bond markets could create more risk for the U.S. economy.

U.S. GDP Estimates

'14 Act.	'15 Act.	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
2.4%	2.4%	1.1%	2.4%	2.0%	2.2%	1.9%	1.5%

Source: Pinnacle Wealth Advisors

U.S. housing starts continue to improve, but the real estate market looks a little speculative at this point. Housing prices have recovered over 85 percent of the 2007 high, and home prices are rising rapidly across the Southeast and somewhat slower in other parts of the country. We believe that home prices are beginning to top out, but with the Federal Open Market Committee on hold the market might have another six of 12 months of growth left. As above we have increased our housing starts for the balance of 2016 and lowered our 2017 estimate.

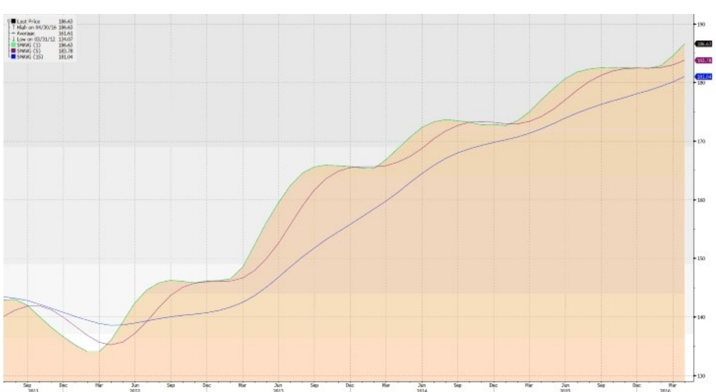
U.S. Housing Starts

'14 Act.	'15 Act.	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
1,001	1,102	1,089	1,160	1,125	1,035	1,102	1,189

In thousands seasonally adjusted

Source: Pinnacle Wealth Advisors

Case-Shiller Home Price Index 20 5-Year View



Source: Bloomberg

Unemployment Rate

'14A	'15A	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16E	'17E
5.7%	5.1%	5.0%	4.9%	4.8%	4.9%	4.9%	5.1%

Source: Pinnacle Wealth Advisors

Economic Outlook

As we continue to look to the second half of 2016, the risks continue to grow. As mentioned above the Brexit presents many risks not only to the E.U. but also to the U.S. economy, as you can see from the chart below. While China, Canada and Mexico are the U.S.'s largest trading partners with 45 percent of total trade, the E.U. and U.K. combined made up over 11 percent of our total trade during May 2016.

May Trade by Country

Rank	Country	Exports	Imports	Total Trade	% of Total Trade
-	Total, all countries	119.6	183.6	303.2	100
-	Total, top 15 countries	84.0	142.2	226.2	74.6
1	China	8.5	37.5	46.1	15.2
2	Canada	22.9	23.0	46.0	15.2
3	Mexico	19.0	24.8	43.9	14.5
4	Japan	5.2	9.9	15.1	5.0
5	Germany	4.1	9.8	13.8	4.6
6	South Korea	3.7	6.2	9.9	3.3
7	U.K.	4.2	4.5	8.8	2.9
8	Switzerland	1.9	4.0	5.9	2.0
9	France	2.4	3.4	5.8	1.9
10	India	1.6	4.1	5.7	1.9
12	Italy	1.4	4.0	5.4	1.8

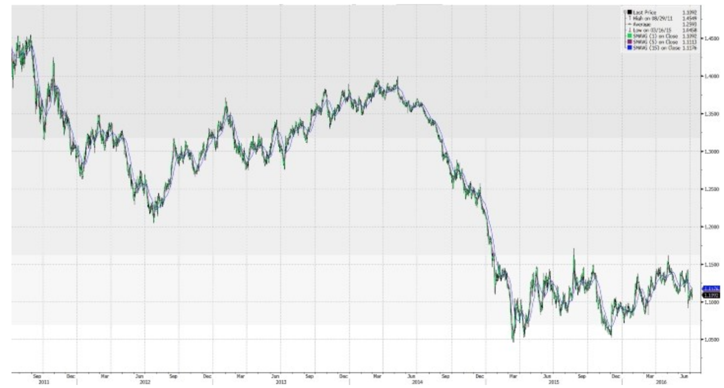
Source: Census.gov

Our 2016 S&P 500 earnings growth rate has been lowered slightly from 5-7 percent to 4-6 percent. However, our year-end S&P 500 target remains 2,165, or up 6.5 percent. Below you can see how far the euro has fallen as a result of the rally in the dollar. We expect the euro to continue to be weak as global investors look for signs that the divorce with the U.K. are proceeding in an orderly way.

The combined actions of the FOMC and the Brexit will prevent the U.S. dollar from weakening in the near term, which will lower our year-end 2016 crude oil price to $50/bbl and $60/bbl in 2017 and will lower our CPI and inflation projections. In addition, without the prospect for higher Federal Funds rates, bank stocks have sold off across the board. Earnings estimates will continue to come down for the sector as competition and over capacity in banking will lead to lower and lower margins and stock prices for the industry.

Our outlook for 2017 stock market returns continues to fall, as Chinese growth expectations vary widely and how the E.U. handles the Brexit remains to be seen. As mentioned above, the E.U. has to maintain trading with the U.K. as it benefits both parties. They can talk tough to keep the other 26 member countries in line, but they cannot carry a big stick, as the risks for the E.U. are greater if the transition is not handled properly and other E.U. countries consider leaving, which will jeopardize its very existence.

U.S. Dollar/Euro 5-Year View



Source: Bloomberg

Consumer Price Index Estimates

'14A	'15A	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16E	'17E
1.6%	0.2%	1.0%	1.1%	0.9%	0.8%	1.0%	0.8%

Source: Pinnacle Wealth Advisors