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Market Memo: Cloudy with a chance of rain (or sun)

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As we approach the unofficial start of summer this weekend, the market outlook strikes us as unsettled at best, with several key hurdles/risks for the market to pass through in the coming months that leave the potential for either a renewed move down or a push to new highs. At Federated, one of the mantras of our equities team is, “You don’t need to swing at every pitch. Just the ones you have a read on.” So for now, our balanced moderate risk PRISM portfolio model remains precisely at 50% stocks, 2% under neutral, waiting for a pitch we can get a better bead on.

Among the hurdles ahead, beyond any black or white swans that might swoop in unannounced, we list the following:

- **The U.K. 'Brexit' vote.** The June 23 referendum on whether the British stay or exit the European Union (EU) could either unsettle Europe or give the market a big sigh of relief. We think the undercurrent of British discontent with the EU is larger than analysts estimate, which could lead to a vote to leave. In the long run, a Brexit probably would be OK for the U.K. economy, but the vote would cause near-term dislocation for sure and would instigate a renewed bout of worries about Europe’s weak links also exiting the euro and possibly the EU—a seemingly never-ending drama that has dogged the EU in the post-global financial crisis years.
- **June's, or more likely July’s, Fed meeting.** If the more hawkish tone emanating out of the mouths of various Fed policymakers is to be believed, either June’s meeting, which comes a week before the Brexit vote, or July’s could result in another rate hike. As we’ve noted previously, another step toward policy normalization via a quarter-point move would be positive for financial sector earnings, while a decision to pass on it would be negative. For emerging markets and commodities, the opposite is the case. As we stand here today, we think the likelihood of a July move, if the “no” Brexit votes prevail, is rising.
- **The presidential and congressional elections.** The markets will remain absorbed by all the possibilities as long as the outcome remains unclear and the media continues with its near breathless focus on the various political horse races. Given the polarization of the electorate and the sharp differences between the two likely candidates, the election’s outcomes are all over the map, from a Trump sweep strong enough to hold both houses of Congress, a close presidential election with the Republicans holding the House while the Senate and presidency remain up for grabs until Nov. 8, to a Democratic runaway with Elizabeth Warren the new majority leader in the Senate and Nancy Pelosi back in her old job in the House. Each of these outcomes have policy implications for the markets to worry about, along with worries over which outcome investors will get. More uncertainty.
- **A soft landing or crash in China.** In recent months, we’ve written much about China’s ongoing attempts to soft land its economy without crashing into the control tower on the way down. We would only add that while recent massive credit infusions have stabilized growth for the moment, debt levels continue to rocket to new highs and overcapacity is plaguing much of the manufacturing and building sectors. The possibility of another spate of bad news out of China remains high. If we survive the summer without another China lurch downward, markets will be relieved; if not, expect more volatility.
- **A lot of earnings 'ifs.'** Now that the Q1 reporting season is behind us, S&P 500 earnings estimates have drifted lower but the collective forward estimates of the consensus seem to be stabilizing, suggesting the year-long earnings recession may be ending. If oil can hold near present levels, if the dollar does not resume its sharp advance of last year and if the Fed gets back on its policy normalization track with a couple of more rate hikes, earnings might finally start growing again in the back half of this year and importantly into 2017. This would be good news, but it hangs tenuously on several important “ifs.”

Against this uncertain backdrop, we have a stock market that has rallied 13% off its February lows and is trading at 17 to 18 times forward earnings estimates. We think this fairly discounts the less negative news of the past three months and is reasonable given the balance of risks ahead, but it certainly does not remotely appear cheap enough to warrant a more aggressive stance.

Bottom line: Our recommendation to investors is to remain cautious, maintaining equity exposures at present levels just below your normal risk tolerance points. For new money, we continue to like large, diversified companies with plenty of

cash flow and hopefully dividend generation and below-market valuations. In particular, we would point toward large-cap pharmaceutical names, the big banks (including, by the way, selective exposure to the best of the European banks whose valuations remain depressed), and big U.S. telecom stocks. There will come a time to take a bigger swing, one way or the other, but now is not it. Wait for a less cloudy forecast.

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