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BREXIT Adds to Uncertainties and Slow Growth

There is no point beating around the bush: Today is a watershed moment for Europe, it's a watershed moment for the European unification process."
- Angela Merkel

The 2nd quarter was on track to register modest gains for both the stock and bond markets until the "Brexit" vote took place in late June in the United Kingdom, calling for the nation to leave the European Union. That surprise turn of events ended the relative calm that had prevailed for much of the quarter.

In our previous letter, we discussed four uncertainties that were looming for investors in 2016:

- China's economic slowdown
- Falling oil prices
- Central bank interventions
- Political question marks

We can add to that list a 5th uncertainty – the fallout from Brexit. The full impact of the referendum remains unclear, but one potential positive outcome could be decisive and favorable monetary actions by European leaders. To this point, policy implementation in Europe has not kept pace with what's occurred in the U.S., to the detriment of overseas economies.

As for the other key issues, China's economy seems to have weathered the storm. Its economy is experiencing strong consumer activity and service companies are generating solid growth. Oil price volatility has leveled off and oil markets are achieving a healthier supply-demand balance. Brexit, however, has the potential to alter both of these trends. Slower growth in Britain and the Eurozone could negatively affect China's exports and also curtail oil demand.

The Brexit vote is also likely to handcuff central banks. The U.S. Federal Reserve was hoping to raise short-term interest rates again after first doing it in December, but we believe low interest rates will be with us longer than past business cycles. The European Central Bank and the Bank of Japan both aggressively lowered interest rates into negative territory and expanded bond buying programs (quantitative easing) which now will likely continue into 2017.

Political uncertainty is also likely to continue. Brexit was a prime example. The process of having a country leave the European Union for the first time since its early incarnation in 1958 is unclear. Brazil is another emerging economy going through political turmoil, with a Presidential impeachment trial underway even as it prepares to host the summer Olympics in August. Finally, the U.S. presidential election will be a distraction for the markets for much of the rest of 2016 and into 2017.

BOB'S CORNER

REFLECTING on SUCCESS

When I look back at the last 30 years and ask the question, "What still works and what has changed?" I am more convicted than ever in my answer.

The All Star approach, of using a value driven money management discipline works in every cycle. That hasn't changed, but patience has become essential to allowing it to work.

With the global world that we live in, news, and information is much more available than 30 years ago and we have the chance to react more immediately. This I believe is the difference. But, knowing all of this, **value** still wins the race.

Reflections on 35 years of money management:
1. Always diversify
2. Always look for value
3. Always take less risk than more
4. Always weigh all the factors
5. **NEVER** react from greed and fear

BUILD WEALTH. RETAIN WEALTH.

All Star is passionate about providing a safer way to a successful retirement for people who are serious about their money but uncertain about how to nurture it.

THE ECONOMY

Consumers show prudence while businesses exhibit caution

The environment has been generally positive for U.S. consumers. There were close to six million job openings reported in April. Jobless claims fell to a 43-year low in late June. Consumers are also benefiting from sustained low energy prices and historically low financing rates for mortgages, autos and other credit financings.

Still, economic growth remains less than robust. Even prior to Brexit, consumers were focused more on building up savings and/or paying down debt rather than spending at levels they were accustomed to in the past. **Consumers need to spend to drive the economy!** Businesses continue to demonstrate a cautious view as well, with the pace of new hiring modest and real business investment declining 0.4% over the past year. U.S. GDP grew by just 1.1% in the 1st quarter, down from a fairly tepid 1.4% in the 4th quarter of 2015

Given the caution of businesses and the fact that government spending will be fairly flat through the election, it will be up to **consumers to change the direction of the economy**. Wage growth, improved finances and low interest rates will hopefully spur more consumer activity in the months ahead.

Inflation remains a non-factor. The Consumer Price Index (CPI) was up just 1.1% over the past 12 months, although Core CPI (excluding the widely-variable food and energy categories) rose 2.2% during that period. Energy prices have rebounded and real wage gains are up, which will eventually result in an uptick in CPI to the 2.0% to 2.5% range.

Looking Ahead

While economic growth is likely to continue at a slow pace in the U.S., the bigger question is whether it can do so at an accelerated rate. As indicated above, the answer **is likely to come down to the sentiment of consumers**. The hope is that improving labor markets and lower interest rates will fuel greater consumer spending to trigger stronger economic growth. Another beneficial factor may be state and local government spending, which is up 2.2%, its strongest rate of growth since 2002.

Expect business investment to contribute little in the months ahead. Another concern is that corporate earnings will likely continue to decline in the 2nd quarter, though not as significantly as the falloff in the 1st quarter.

BOND MARKETS

Low and falling interest rates

Though the Federal Reserve was poised to raise interest rates this year, the bond markets had different ideas. Interest rates on the benchmark 10-year U.S. Treasury bond dropped 33 basis points from already low levels during the 2nd quarter. Government bond yields fell across the globe as well, particularly in Europe as the European Central Bank continued to take aggressive actions to stimulate growth.

Corporate credit (+3.48%), emerging market debt (+5.02%) and high yield bonds (+5.52%) benefited from rallies in energy and materials prices. The dollar lost 2.4% as the Fed delayed further interest rate hikes. The euro, yen and emerging market currencies firmed 1% to 6% during the quarter, relative to the dollar.

Bond defaults have been limited to weaker issuers in the energy and material sectors. Defaults have been rare across other industries. Corporate bond issuance leveled off during the quarter, down 6% from last year through May. Municipal bond issuance is up slightly as state and local government finances improve.

Looking Ahead

Global government bond yields have little room to decline. In the wake of the Brexit vote, yields on government bonds in Britain dropped below 1.0%. U.S. Treasury bonds should hold up relatively well and look attractive on the world market, even with yields below 1.50%.

Emerging market debt in both the corporate and government bond sectors continue to offer competitive yields and spreads, often with improving credit quality. Domestically-issued corporate and high yield bonds should perform well with default rates remaining low. Floating rate debt and short-duration bonds offer protection for investors in the event interest rates should begin a more significant turnaround.

Domestic Stocks

Treading water and defying gravity

Domestic stocks managed modest gains in the 2nd quarter. Investors did not seem to be discouraged by the 6.8% drop in earnings for S&P 500 companies during the 1st quarter and an anticipated additional decline of 4.8% when 2nd quarter earnings are released. The Brexit selloff in the last week of June temporarily erased most of the gains in U.S. stocks, only to rebound nicely the last few trading days of the quarter.

Value stocks, with a return of 4.6%, outperformed growth stocks (0.8%) for the second consecutive quarter. The attraction of dividend paying stocks was enhanced by the persistent low interest rate environment. Small-cap stocks outpaced large-cap stocks during the period. The Russell 2000 Small-Cap Index rose 3.8%, compared to a 2.5% return for large-cap stocks represented in the Russell 1000 Index.

Energy stocks benefited from rising oil prices and were the best-performing sector during the 2nd quarter, registering 11.4% gain. Materials stocks rose 4.7% and Health Care stocks jumped 6.3%.

Even with the modest gains we saw in the domestic markets, we remain cautious in our intermediate-term outlook and are holding higher-than-expected levels of cash until we see improvement in corporate earnings. This is comparable to what we're seeing industry-wide, as mutual fund cash is near historically high levels.

Looking Ahead

Entering 2016, the forecast was that earnings for S&P 500 companies would grow by 6-8% this year. As things stand now, earnings will be relatively flat for the full year at best. The Brexit vote could potentially result in a slight downgrade in earnings even from that modest forecast. The energy sector is one industry that experienced earnings growth in the first half of 2016 but is projected to have earnings decline post-Brexit.

The best opportunity in stocks may be among growth issues, which could benefit from seasonal improvement at the end of the year. If we see some resolution to the political uncertainties that remain (Brexit, U.S. election), that could also work to the advantage of growth stocks.

> "Value always wins, just give it time!"
> –*Bob Klefsaas*

International Stocks

Value for investors who can see beyond the risks

Overseas markets finished the 2nd quarter in negative territory following the Brexit vote. The MSCI EAFE Index declined 1.5% while the S&P Global Index (ex-U.S.) fell 0.2%. Central banks in Japan and Europe continued to follow aggressive strategies to provide a lift for their respective economies. Yet European stocks fell 2.7% during the period while Japanese stocks ended up 1.0%.

There were encouraging signs from China. Retail sales rose 10% and housing markets remained steady. The pace of manufacturing activity is contracting across several industries as China restructures many state-owned enterprises and reduces excess capacity.

Other Asian Emerging Market countries that are replacing China as low-cost manufacturers experienced healthy growth, including Thailand, Malaysia, Indonesia, the Philippines and Vietnam. MSCI's India index gained 3.9% in the 2nd quarter while China and Asia ex-Japan stocks gained just 0.4% during the period. Oil-dependent countries Brazil and Russia remain in recession although stocks in both countries rebounded in the 2nd quarter as oil prices recovered.

Looking Ahead

The surprise Brexit result created significant volatility in the markets at the end of the quarter, despite the rebound the last few trading days. Nevertheless, the challenge it creates may present an opportunity for European policymakers to implement strategies that could support the stimulus efforts of its central banks. Although the European Central Bank and the Bank of Japan have yet to deliver results to economies or the equity markets, the impact of their monetary policies is often delayed and we may see more improvement in 2017.

China's economy appears to be making progress in its transition, enough to support a 6% rate of economic growth through the rest of 2016. The nation is also making strides in regulating its stock markets, and its mainland A-shares are expected to be included in MSCI indexes in 2017, an important level of recognition.

Valuations, earnings and dividend yields all favor foreign market stocks, but the reluctance to implement stimulus efforts as quickly as did the U.S. has delayed the payback for investors in these markets. The additional uncertainty created by the Brexit vote may prolong the wait, but patient investors will be rewarded.

PERFORMANCE UPDATE

The Second Quarter

All Star Portfolios	3 Yr Beta	3 Yr Alpha	5 Yr Beta	5 Yr Alpha	2nd Qtr	1 Year	3 Years	5 Years
Income								
Balanced								
Cons Growth								
Growth								

Beta & Alpha (vs. Global BMI)

Market Index	2nd Qtr	1 Year	3 Years	5 Years
DJ Industrial Average	2.07	4.50	8.99	10.41
S&P 500	2.46	3.99	11.66	12.10
Russell 2000	3.79	-6.73	7.09	8.35
S&P Mid Cap 400	3.99	1.33	10.53	10.55
Russell 3000	2.63	2.14	11.13	11.60
S&P Global BMI	**1.22**	**-3.44**	**6.66**	**5.93**
MSCI EAFE	-1.46	-10.16	2.06	1.68
MSCI Emerging Mkts	0.66	-12.06	-1.56	-3.78
NASDAQ Composite	-0.23	-1.68	13.85	13.18
Barclays US High Yield Bond	5.52	1.62	4.18	5.84
Barclays US Aggregate Bond	2.21	6.00	4.06	3.76
Barclays Global Aggregate Bond	2.89	8.87	2.80	1.77
JPM Emerging Bond Diversified	5.02	9.79	7.20	6.45
Barclays US Government Bond	2.04	6.04	3.45	3.38
Barclays US Credit Bond	3.48	7.55	5.26	5.20

*The above after-fee annualized total returns and betas represent All Star Financial models. Your portfolio's actual returns and betas may differ depending on your specific portfolio holdings.

SUMMARY & OVERVIEW

Global markets were thrown into uncharted waters as a result of the vote by the United Kingdom to leave the European Union, more commonly known as "BREXIT". This comes at the same time that Global government bonds yield less than 1%, a nearly unprecedented circumstance. Central banks have little ammunition available to prop up economies if problems should ensue. It illustrates the challenges and degree of uncertainty that investors will have to deal with through the rest of 2016.

With extremely low bond yields, equity volatility, and slower growth we are focused on diversification as our best tool to continue to maintain the purchasing power of your dollar as well as achieve long-term risk adjusted portfolio returns. Fear and greed can cloud investors' judgement during periods of uncertainty, but staying disciplined and focusing on long term objectives and risk tolerance will be the key to managing your portfolios until the uncertainties we've described work their way through the global economy.

Global Economies – Where do we stand?

As self-proclaimed "econ geeks," one of All Star's key competencies is evaluating the relative status of the world's primary economies. Deciphering the current valuations, stimulus opportunities, and challenges of the economies provides us a road map to properly evaluate the vast investment choices our clients can access.

In the chart below, we are providing a very basic evaluation of the dynamics facing the global economies. A thumb-up would indicate the criteria is assisting the economic growth and the thumb down indicates the opposite. First, let's define what criteria we are using:

Monetary Policy is the use of interest rates by an economy's central bank (The Fed, European Central Bank, Bank of Japan, etc.) to stimulate or control growth. When central banks lower rates, that is referred to monetary "easing" and when rates are raised that is referred to as "tightening." Central banks have also recently stimulated economies through bond purchase programs called Quantitative Easing.

Fiscal Policy is the use of budgetary power by a government to stimulate economic growth. These policies bring up the classic debate of taxing versus spending and which policy drives economic growth. In general, investment markets are benefited by low tax environments and government spending. However, we know that that combination ultimately leads to national debt.

Politics is referencing the relative stability of the political realm of an economy. We know that markets enjoy certainty and run away from uncertainty in this area.

GDP Growth: Gross Domestic Product growth is the criteria widely used to evaluate whether and how fast an economy is growing or contracting. It measures the monetary value of all the goods and services produced within a country's borders.

Valuations (P/E): Price to Earnings ratio of selected index as of June 30, 2016. Price to Earnings is a ratio that measures relative valuations of investments. Essentially, the ratio describes how much you pay for $1 of earnings of referenced investment. The higher the ratio, the more *expensive* the investment.

	Monetary Policy	Fiscal Policy	Politics	GDP Growth	12-month Return	5 Year Return	Valuations (P/E)
US				1.70%	2.07%	11.60%	19.53x
Europe				1.60%	-10.08%	1.02%	17.57x
Japan				0.70%	-6.34%	4.21%	13.90x
Emerging Markets				3.80%	-11.57%	-3.78%	12.83x
Gold	N/A	N/A	N/A	N/A	12.36%	-3.04%	N/A

Conclusion: We believe that the #1 conclusion that should be drawn from observing the chart above is that global diversification is essential to winning the race of long-term investing. The secondary conclusion is that when you combine the policy & political uncertainties in the developed economies of US and Europe with current valuations, the analysis suggests that Asia & the broader Emerging Markets are a potential source of opportunity to find value.

Lastly, we want to reference Gold. With most investors uncertain of the long-term growth rates, Gold has seen a rise in value after the UK's decision to exit the European Union. However, Gold must be viewed as a temporary investment because it does not have earnings, does not pay a dividend, and does not benefit from global economic stimulus. Gold is a fear driven play!

OUR MISSION IS TO HELP YOU ACHIEVE YOUR DESIRED STANDARD OF LIVING AND FINANCIAL PEACE OF MIND.

The experienced All Star team of professionals is dedicated to understanding your individual needs and objectives, offering a comprehensive wealth management platform designed with one purpose in mind — to serve you, the valued client.

JUST FOR FUN

Restaurant Recommendation

BLUE DOOR PUB

As the summer months continue and you find yourself in the mood to check out a new food spot, you should visit Blue Door Pub in St. Paul or Minneapolis. Among the large list of amazing burgers, they are home to the St. Paul original Blucys, which was showcased on the Food Network show Diners, Drive-ins, and Dives. Blucys are two fresh ground Angus beef patties melded to encompass a veritable cornucopia of ingredients, creating a cavern of deliciousness. They offer other great bar food including cheese curds, soups, fried pickles, fries, and even fried cheese cake bites. Blue Door Pub is a great place to head for an evening to enjoy fantastic food for an affordable price.

Quote of the Quarter

"My favorite things in life don't cost money. It's really clear that the most precious resource we all have is time."

-Steve Jobs

Broiled Salmon with Mustard Glaze

Ingredients

- 2 garlic cloves
- 3/4 teaspoon finely chopped fresh rosemary leaves
- 3/4 teaspoon finely chopped fresh thyme leaves
- 1 tablespoon dry white wine
- 1 tablespoon extra-virgin olive oil
- 2 tablespoons Dijon mustard
- 2 tablespoons whole-grain mustard
- Nonstick olive oil cooking spray
- 6 (6 to 8-ounce) salmon fillets
- Salt and freshly ground black pepper
- 6 lemon wedges

Directions

- Combine garlic, rosemary, thyme, wine, oil, Dijon mustard, and 1 tablespoon of whole-grain mustard
- Grind mustard sauce in for 30 seconds until combined
- Add remaining 1 tbsp of whole-grain mustard to the sauce and stir to combine.
- Line a heavy rimmed baking sheet with foil and spray it with nonstick spray. Place fillets on sheet with salt and pepper.
- Broil for 2 minutes, add mustard sauce to fillets and continue to broil for about 5 more minutes

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