Argent Wealth Management, LLC

Investment Outlook

SUMMER 2016

Third Quarter 2016 Outlook; First Half 2016 Review

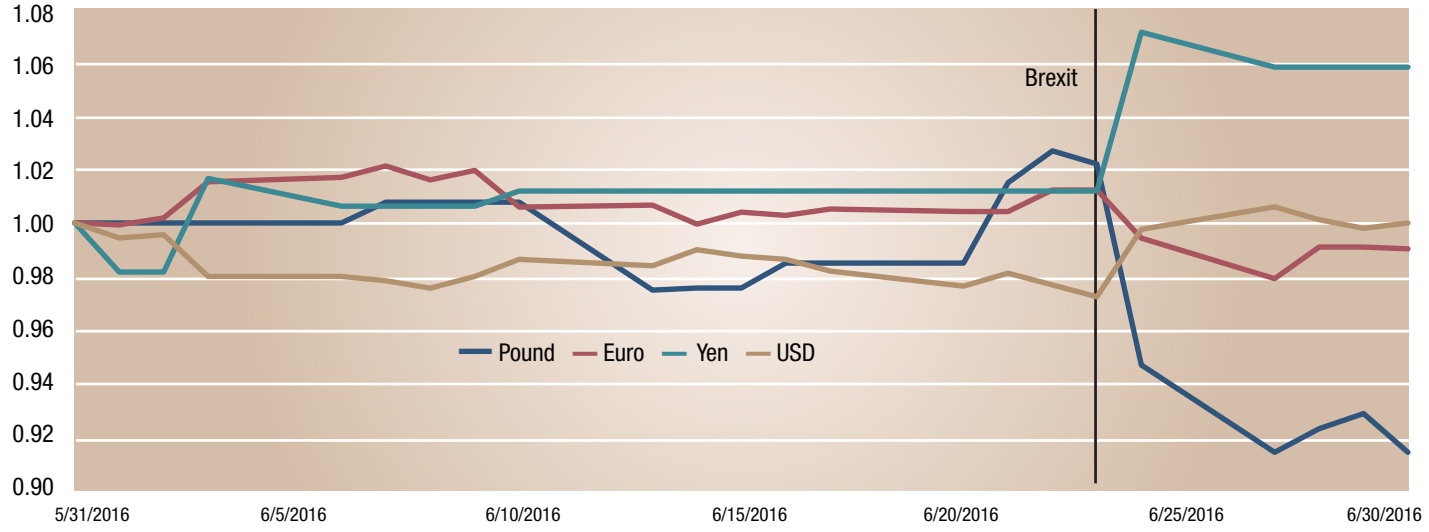
Resilient Markets Shrug Off the Brexit Shock

Voters in the United Kingdom shocked the investment community and the political pollsters by approving a referendum to leave the European Union. Political experts placed the odds of a "leave" decision at no more than 20%. The normal pattern on similar referendums has been to swing in favor of the status quo as Election Day nears. Expressing dissatisfaction with establishment policies is easier in concept than when Election Day arrives and the consequences are fully considered. Not this time. Clearly there is something different going on.

We believe the difference goes well beyond the scope of this referendum. The root cause is a profound frustration with global economic growth that has been unacceptably low and uneven. Additionally, when you consider expanding income gaps, low wage growth, and immigration populism, it is no surprise that more are becoming disaffected. In the case of the U.K. vote, a seemingly tone deaf and excessively burdensome EU headquartered in Brussels tipped the scales away from the normal consensus that a less than perfect "known" outcome is better than potential chaos.

It is not surprising that markets around the globe reacted violently. Currency markets reacted most dramatically with a stunningly large drop in the value of the Pound, a less dramatic drop in the Euro and gains in all "safe haven" currencies such as the Dollar and Yen. Sovereign bond yields plunged to record lows. Equity markets fell sharply initially but staged seemingly remarkable recoveries after two days of panic selling.

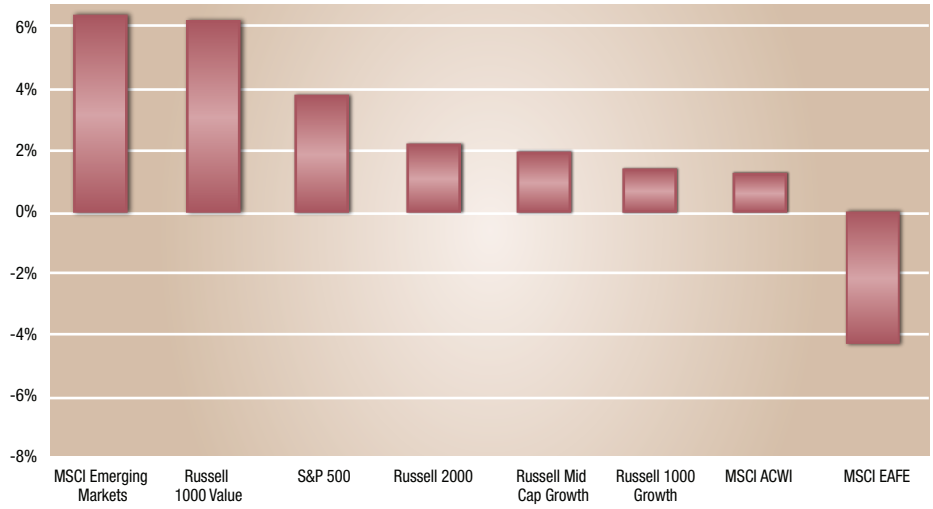
Dollar, Pound, Yen, and Euro Reponse to Brexit



Source: Yahoo Finance, Historical Prices; Chart: Argent Wealth Management, LLC © 2016
Currency Proxies (ETFs): "Pound" iPath GBP/USD Exchange Rate,Ticker Symbol (GBB); "Euro" iPath EUR/USD Exchange Rate, Ticker Symbol (ERO); "Yen" iPath JPY/USD Exchange Rate, Ticker Symbol (JYN), "USD" PowerShares DB US Dollar Bullish, Ticker Symbol (UUP)

The "V" shaped recovery in equity markets may seem surprising but actually makes some sense. While the U.K. referendum will likely shave a few tenths of a point off economic growth rates, it may be more than off-set by super low interest rates and highly accommodative monetary policy. Thoughts of any central bank (including the Fed) raising interest rates anytime soon has been thrown out the window. There is a strong case for super low interest rates extending longer than previously anticipated.

Equity Returns Year-to-Date

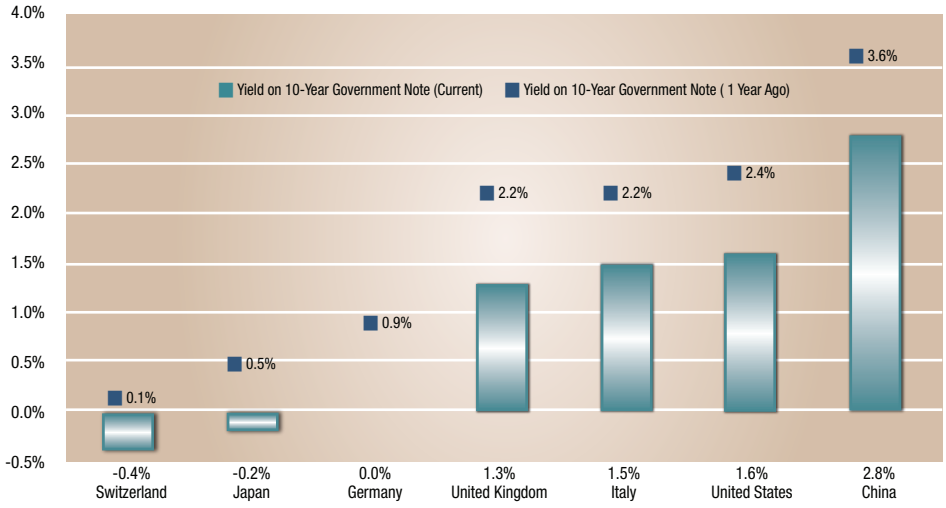


Data: Morningstar, Inc.; Chart: Argent Wealth Management, LLC © 2016

The plunge in sovereign bond yields may be more important and problematic. Record low yields on virtually every higher quality bond around the globe force the most risk averse investors into a set of difficult choices. Those choices involve taking more risk than desired in one of numerous dimensions; extending bond maturity (duration risk), accepting greater credit risk, or migrating to riskier asset classes in order to preserve income (equities, real estate). There are no easy choices.

Currency markets and central bank policy may be where the rubber truly meets the road. What is becoming increasingly clear is that central bank policy is losing efficacy after years of accommodation. There are limits as to how low (or negative) short-term interest rates can go. Initially those drops in rates do encourage economic activity by lowering the cost of lending and encouraging investment and spending. At very low or negative interest rates, further drops may just intensify uncertainty. Additionally, not every country can devalue their currency and effectively export deflation to others. Eventually there is an end game, and such actions start to backfire as with the recent attempt by the Japanese to take rates deeper into negative territory. We may be at that terminal point. The best action that central banks can take may be to anchor rates at super low (or negative) levels, move to the sidelines, and wait for markets and economies to heal.

10-Year Sovereign Bond Yields

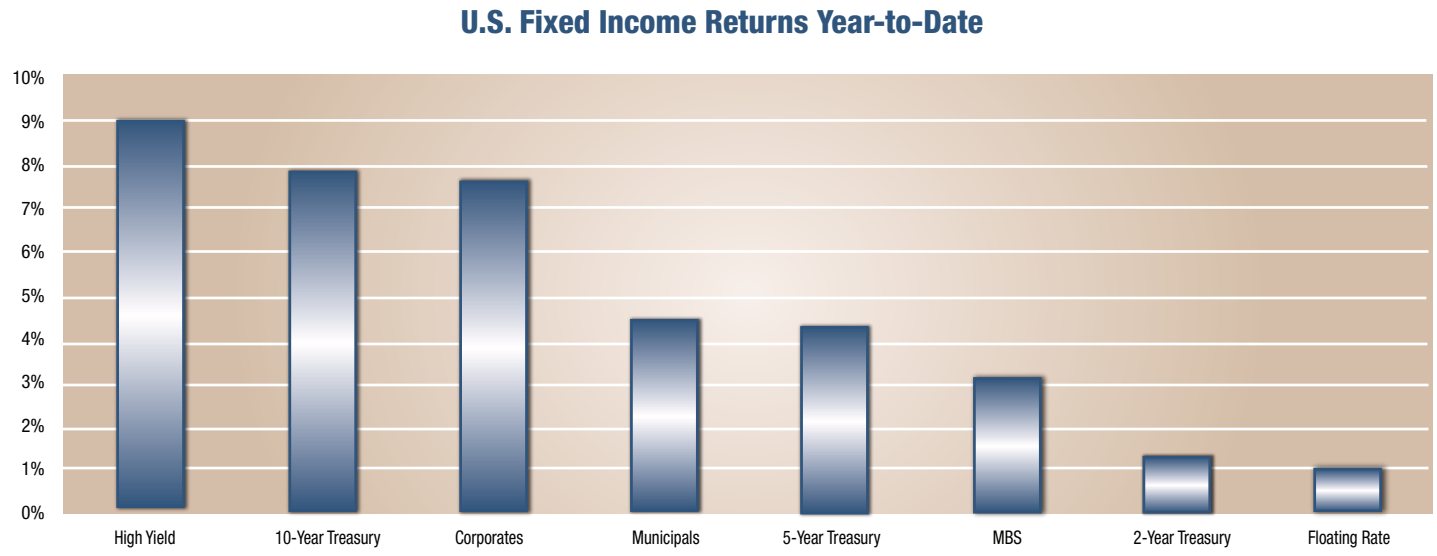


Source: Ned Davis Research, Inc. Chart: Argent Wealth Management, LLC © 2016

Just When We Thought the Search for Yield Could Not Get Any More Intense

A key thesis entering 2016 was that certain credit markets such as High Yield and Senior Secured Loans offered return potential that was higher than both higher grade bonds and equities. That has been the case so far. Credit spreads have come down sharply, and unevenly across a wide range of credit oriented sectors. While the largest appreciation has been in the riskiest rated slices (CCC and below), there have been handsome returns more broadly.

The rebound in oil prices has been a material positive catalyst. Entering



Data: J.P. Morgan; Chart: Argent Wealth Management, LLC © 2016

2016, some analysts were forecasting rapidly rising default rates. In our view, the market in High Yield was priced for cumulative default rates that were three to four times what we believed was reasonable.

Actual default rates have been better than we have expected and dramatically better than consensus estimates. The vast majority of defaults have been in the energy sector. Energy companies, on balance, have been quite adept at reducing leverage, restructuring problematic debt and strengthening balance sheets. Weaker companies have defaulted and have been taken "off the battle field." Companies that remain are a stronger cohort of creditors and are generally capable of servicing their debt even at $50 oil.

We continue to favor Senior Secured Bank Loans. They sit at the top of the capital structure, and have commensurately lower default rates and higher recovery rates than High Yield bonds. While this sector is by no means immune from credit shocks, it typically has less volatility than High Yield bonds.

Private Real Estate/Private Equity; the Cycle May Be Extended

Brexit concerns, currency turmoil, super low bond yields and general uncertainty all favor assets such as U.S. real estate. We expect demand to continue. We are delighted with what we own and still find compelling opportunities. Expensive valuations in core properties dictate a more selective screening approach and also a focus on strategies that have a shorter anticipated holding period.

A critical distinction from past real estate cycles continues to be a lack of new construction in many markets and still tight lending standards. Most transactions are still being done with significant equity capital relative to debt. This is a healthy sign that should result in a longer and less dramatic cycle than the past one.

Private Equity is also generally experiencing rising prices and leverage. These are not encouraging developments and they typically set the stage for the peaking of a cycle. Importantly, prices are not at all rising to the same degree by sector. There is much better value in the mid-cap market than in large-cap market for several critical reasons. First, much of the competition for capital comes from traditional bank lending and that kind of capital availability remains tight. Second, this market has more companies and is less efficient than the large-cap market. While purchase multiples have risen, they have not risen evenly and skillful operators can still find bargains. Finally, much of the gains in the mid-cap space come from making companies better, not from financial leverage like many of the gains in the large-cap market.

Equities; Where to go, Where not to go

Expected equity returns are higher than the near zero expected returns on cash and Treasury bonds. Notably, there are compelling opportunities on the sector and stock specific level, but there is no free lunch. Financial shares have been sold off viciously as a consequence of expected low interest rates indefinitely. Regulation remains strict,

	FINANCIALS	CONS. STAPLES	UTILITIES
Trailing P/E Ratio	14	24	22
20-Year Average	17	21	15
Trailing/Average	82%	114%	147%

Source: J.P. Morgan; Chart: Argent Wealth Management, LLC © 2016

and many investors will simply not own banks as 2008 is still fresh in their minds. We expect at some point that these pressures will subside. Many of these large banks and other financial companies have re-built rock solid balance sheets and have earnings power that exceed what very low valuations would suggest.

> *"Staying anchored at an appropriate risk tolerance is critical. Extending out the risk curve is a big mistake."*

Equities that act as bond proxies like utilities and other areas that are viewed as safety stocks such as consumer non-durables have been bid to relatively high prices. While these valuations can persist for a while, it is nearly impossible to generate above average returns over a longer period by buying a company at a very high valuation.

Like the current market, we tend to prefer dividend stocks; however, there is a critical difference between owning dividend growth stocks and high dividend paying stocks. For us, it is all about the combination of starting dividend level and the growth of dividend over time. Often it is not the highest yielding sectors that are winners, rather those that have better growth rates. Interestingly, financial companies are growing their dividends at a relatively fast pace.

The Sober Reality of a Low Absolute Return World

It is not as bad as it sounds! "Real" after tax returns are reasonable.

Persistently low interest rates present a host of challenges for constructing a properly diversified portfolio. For example, historically, the best balance for equity markets has been higher grade Municipal and/or Treasury bonds (core bonds). Typically when there is volatility in equity markets, bond markets remain resilient and increase in price. We saw this recently with the Brexit vote. Although core bonds still provide balance for equities, these assets are simply not as attractive as they once were due to super low interest rates around the world.

However, since inflation remains subdued at 1% to 2% levels versus around 4% historically, returns measured after inflation (real returns) and taxes similar to historical real returns are still possible with a properly diversified, rigorously constructed portfolio. Moreover, we can still identify and tilt portfolios to areas that have more attractive return profiles while staying within clients' risk profiles.

You must invest in the market that exists, and not the market you would hope to exist. Staying anchored at an appropriate risk tolerance is critical. Extending out the risk curve is a big mistake. When one is at a proper risk level going into a volatile market event, it becomes easier to maintain discipline, and take advantage of opportunities the market creates.

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All of us at Argent thank you for your continued support and confidence. If you know of anyone that might benefit from Argent's services, we would welcome the opportunity to discuss their particular situation with them.