Pinnacle Capital Management, LLC

July 2016 PCM UPDATE

Equity Strategy

The second quarter of 2016 was humming along just fine. By the end of May, the S&P 500 returned 2.18%. Then the markets began to get nervous about the Brexit vote (see our companion Commentary for a fuller discussion). In mid-June, polls indicated that there was little to worry about. Markets returned to taking the vote in stride. As Gomer Pyle used to say (Google him if you're too young to remember), "Surprise, surprise, surprise!" The markets took a hit as a result of the vote before rebounding. The S&P 500 reached new highs in July. Still, as of June 30th the S&P 500 had returned 2.46% for the quarter. All in all, not so bad.

PCM portfolios were generally up for the period, but there were definitely some impacts as a result of the Brexit vote. As we discussed in our Commentary, economically sensitive sectors were particularly hard hit. While these have comeback somewhat - particularly in early July - they clearly underperformed for the quarter. We discussed in our April Update the performance of the auto sector and our investments in Fiat Chrysler Automobiles (FCAU), Ford Motor Co. (F), and Tenneco, Inc. (TEN). These stocks all had negative returns for the quarter, but still remain among our favorite holdings going forward. Additionally, other industrial companies, such as Barnes Group Inc. (B), The Dow Chemical Company (DOW), Eastman Chemical Company (EMN), and ITT Inc. (ITT) had disappointing performance for the quarter. Xylem Inc. (XYL) was a notable exception to the performance of our industrial holdings, as the stock returned 9.56% for the quarter. We can only say that continued solid fundamentals and market recognition of those fundamentals drove the performance.

Our top performer for the quarter was Fidelity National Info Services, Inc. (FIS) which returned 16.79%. As was the case with XYL, good earnings and a solid business were the primary drivers behind those returns. Our sole oil holding, Hess Corp. (HES), generated solid double digit returns as well. Oil prices rebounded in the quarter, and HES has been somewhat successful in finding new oil deposits. Still, we do not think it's time to overload on oil stocks. There is still is a big glut of oil in the world, and it will take some time to truly eliminate the excess capacity.

Our telecom holdings, Verizon Communications Inc. (VZ) and AT&T Inc. (T) followed up their strong first quarter performance with continued gains in the second quarter. The gains were driven by a combination of their high dividend yields and a recognition by the markets that the competition from Sprint and T Mobile weren't going to prevent these companies from continuing to grow their profits.

Our consumer products companies, including Mondelez International, Inc. (MDLZ) and Kellogg Co. (K) performed well, especially in the face of the Brexit vote. Additionally, on the last day of the quarter, MDLZ made a bid to purchase the Hershey Company (HSY). It was heartening that the markets viewed this favorably, as MDLZ's price advanced 5.9% on the day of the announcement. More often than not, stocks fall in price when they offer to buy other companies

Contrarily, our generic drug companies, Mylan NV (MYL) and Teva Pharmaceutical Industries LTD (TEVA) continued to show weak stock performance. We find this weak performance particularly frustrating as the markets fail to credit these companies for strong sales and earnings growth while continuing to penalize them for the behavior of certain companies that raised drug prices to obscene levels. We believe this association is absolutely unwarranted. As such, we will continue to hold these stocks in client portfolios.

There was not much trading activity in the quarter. There is a simple reason for this. We had positioned the portfolios throughout 2015 and early 2016 for what we perceived as a proper balance between appropriate risk and sufficient potential return. 2015 was a disappointing year as far as stock returns go, but we saw little in terms of underlying fundamentals that shook our outlook for the holdings in the portfolio. As a result, most of the holding only became more attractive to us over the last year. Less than stellar recent performance is probably the worst reason to shake up a portfolio. We've planted the seeds. It's time to let them grow.

Fixed Income Strategy

What can we say about the fixed income markets that we haven't already said? As 2016 has progressed and it become apparent that the Federal Reserve would not continue to raise rates, yields in general ceased their recent upward trend. Beginning the quarter at 1.77%, the U.S. 10 year Treasury bond remained relatively stable until June 23rd (the day of the Brexit vote results). Fear prevailed and by quarter end, the 10 year yield dropped to 1.47%. This is absurd.

Permit us to go on one of our periodic rants about the failure of Central Banks - not just the Fed - throughout the world. By keeping rates artificially low, only the most established companies and governments can borrow readily. As a result, new business formation and expansion of business by smaller companies is stymied. While this has the benefit of keeping industrial capacity and business inventories in check, which in turns reduces the risk of a recession, it has the much larger effect of tamping down economic and job growth, discouraging savings, and leading investors to take many inappropriate risks. By funding government debt at virtually no cost, governments avoid making hard decisions about taxing and spending priorities. The ultimate reckoning will eventually be worse than it would have been. There, we're glad we got that off our chests!

Of course, our job is to invest according to the reality. And the reality is, interest rates are very low. As we keep repeating, there are no easy answers. The choices are simple: 1) take on credit risk, 2) take on duration (maturity risk), 3) take on virtually no risk. While in hindsight taking on duration risk was the thing to do, we still remain with our previous decisions. To a limited extent, we are taking on credit risk to enhance returns. We take this approach based on our view of the economic cycle. While the markets periodically enter into a mania concerned about the next downturn, we have stated repeatedly that we don't see anything of the sort in the immediate future. We know that at some point this will not be true, but we still have confidence about the near term. Therefore, we think default risks are overstated for the present. As a result, relatively higher yields are available on lower rated bonds.

For the most part, we've invested in bonds and bond funds where the underlying credit rating is at the low end of the investment grade scale (BBB- or better). However, we have invested in some below investment grade funds. In these cases, diversification is essential. We've primarily relied on the Fidelity Floating Rate High Income Fund (FFRHX) and to a lesser extent SPDR Barclays High Yield Bond ETF (JNK). We'll continue to monitor these holdings and the underlying economy. At some point, we'll have to make a call as to the likelihood of a recession. We just don't believe we're at that point yet.