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Second Quarter 2016 Market Summary

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Second Quarter 2016 Market Summary

Markets during the second quarter continued to be volatile as investors were confronted with geopolitical uncertainty and concerns over global growth. The quarter ended with markets being surprised with the historic decision by UK voters to leave the European Union. The decision caused equity markets to sell off while bond markets rallied as investors sought safety. The implications of Brexit will take many years to be reveal; however, the vote highlights the structural challenges that countries across the world, not just Europe, are going through. Low economic growth, the distribution of wealth and concerns about immigration are prompting the rise of populist or anti-establishment movements in Europe and the United States. Despite uncertainty, equity markets in the U.S. quickly recovered from the post-Brexit sell off.

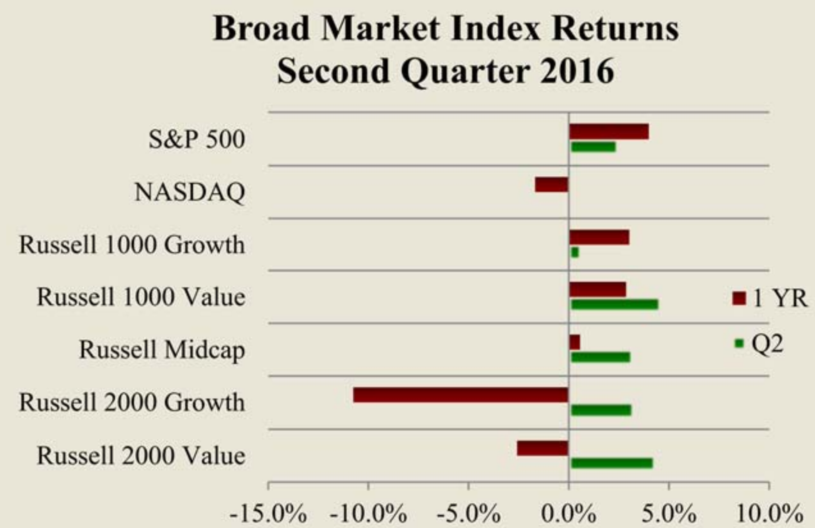
Performance was generally positive for equities and bonds during the quarter. Fixed income rallied as interest rates fell amongst concerns over global economic growth. Equity investors are more optimistic than their fixed income counterparts seem to be and are looking forward to earnings rebounding in the second half of the year as impacts from the price of oil and the U.S dollar subside. U.S. large caps, represented by the S&P 500, ended the quarter up 2.5% driven mainly by “defensive” sectors. U.S. small caps, represented by the Russell 2000, ended up 3.8%. Value oriented stocks outperformed relative to growth oriented stocks, across all market capitalizations, for the second consecutive quarter.

International developed equities ended the quarter with negative returns but were in positive territory prior to the Brexit vote. Economic data in Europe is improving; however, geopolitical events continue to set back equities. Emerging market equities were positive for the third consecutive quarter as a declining U.S. dollar has provided support and commodities have performed well. Investors will continue to monitor emerging markets as there are still concerns about China’s slowing growth and a potential devaluation of its currency.

Coming into 2016, the Federal Reserve was forecasting four rate hikes throughout the year; however, their tune has changed as they have decided to hold rates steady so far this year. It appears, the Fed has put more emphasis on global markets and events, as they have cited rising global economic risks and financial turmoil as reasons not to increase the Fed Funds rate. The Fed has elected to be more reactionary relative to market events, thus they are not expected to raise rates until the end of the year as the markets digest the post-Brexit fallout and the U.S. Presidential elections in November.

Globally, interest rates fell during the quarter as economies around the world continue to struggle to create growth and geopolitical events have created uncertainty. Investors continue to view developed sovereign debt, such as U.S. Treasuries, as “safe havens” in this environment despite record low or negative yields. Trillions of dollars in global fixed income securities now have yields below 1%. Bond returns across sectors were strong during the quarter; in particular, those within the credit sectors (i.e. investment grade corporates and high yield).

Equity market returns have been bifurcated the past year as higher yielding sectors have seen very strong returns while the rest of the market has been roughly flat to negative. Higher yielding sectors such as telecomm, utilities and consumer staples have returned 20-30% over the past year. Quantitative easing by central banks have created an environment in which investors are focusing more on yield than fundamentals. Investors that seek income are being driven to riskier assets, such as equities, due to low yields in core bonds.



HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of second quarter 2016 real GDP, an annual rate increase of 1.2% from the preceding quarter. The estimate was much lower than the 2.6% growth rate analysts were expecting.
- The University of Michigan Consumer Sentiment Index final reading for June was 93.5, which was an increase from the previous quarter. Consumer sentiment remains high despite leveling off during the past year.
- The ISM Manufacturing Index rebounded during the quarter from 51.8 in March to 53.2 in June. The ISM Index has strengthened in the past three months after trending down since the end of 2014. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In June, the Conference Board Leading Economic Index increased 0.3% month-over-month to 123.7. The Index has increased gradually over the past year showing steady, but slow growth in the economy.
- The price of WTI Crude Oil was $48.27 at the end of June, which is 33.6% higher than $36.14 at the end of March. The price of Brent Crude Oil increased 30.7% in the quarter to $48.05. The price of oil has been volatile as the supply and demand dynamics are being affected by a weaker than expected global economy and a market share battle among U.S. shale companies and OPEC members.
- In June, headline CPI increased 1.0% year-over-year, up from an increase of 0.9% in March. Core CPI, which does not include food and energy, had a 2.3% increase. Inflation levels have remained low over the past year and have been less than historical averages and the Fed's 2% inflation target.

HOUSING

- Preliminary existing home sales increased in June with an annualized rate of 5.57 million units from 5.36 million units in March. The June annualized rate is 3.0% higher than the 5.41 million units in June 2015. The strength in home sales that we saw throughout 2015 has continued in the first half of 2016.
- Median existing home sale prices increased during the quarter. The preliminary prices for June were 4.8% higher than the levels of one year ago and have been trending up since the beginning of 2012.
- New home sales increased during the quarter with a seasonally adjusted annual rate of 592k homes sold in June versus 537k in March. On a year-over-year basis new home sales increased 25% in June. The housing sector has been very strong the past few years with increasing sales and home prices.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose 5.2% year-over-year in May.

EMPLOYMENT

- The labor market has generally been positive the past year as the unemployment rate has fallen and wages have increased. However, during the quarter nonfarm payrolls averaged 147,000 jobs added per month, which was 41% less than the second quarter in 2015. It was also lower than the 196,000 jobs added per month in the first quarter 2016.
- The unemployment rate fell to 4.9% from 5.0% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1973.

DOMESTIC CORPORATIONS

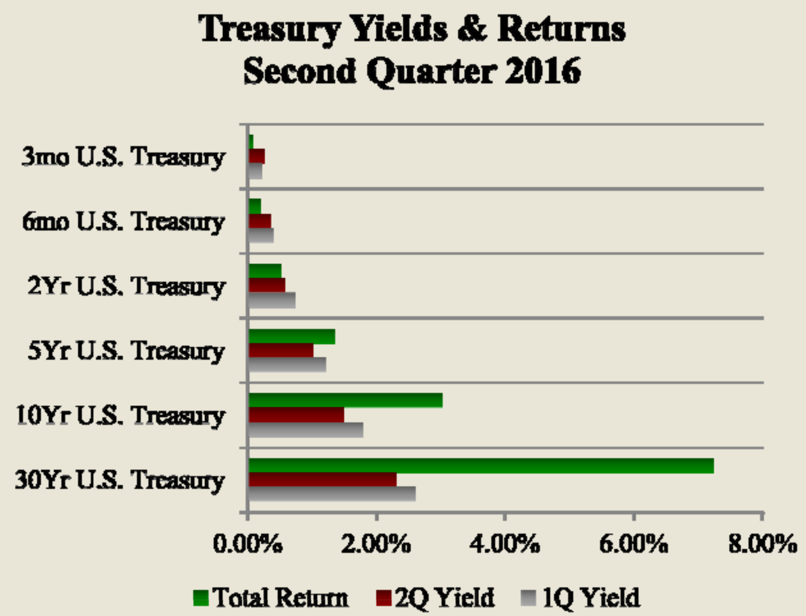
- Corporate operating earnings in the first quarter were slightly higher than the previous quarter. As we go through 2016, earnings are expected to rebound as lower oil prices and weaker foreign currencies should have less of an impact on year-over-year earnings growth than past quarters.
- Operating margins have retreated from highs the past year and a half but remain well above historical averages. Margins could continue to be pressured if rates rise and wages increase.
- Forward and trailing P/E multiples are near or above historical averages.
- The U.S. dollar was roughly flat vs. major currencies after depreciating in the first quarter. Many investors are forecasting the U.S. dollar to resume appreciating as other central banks around the world are providing monetary stimulus.

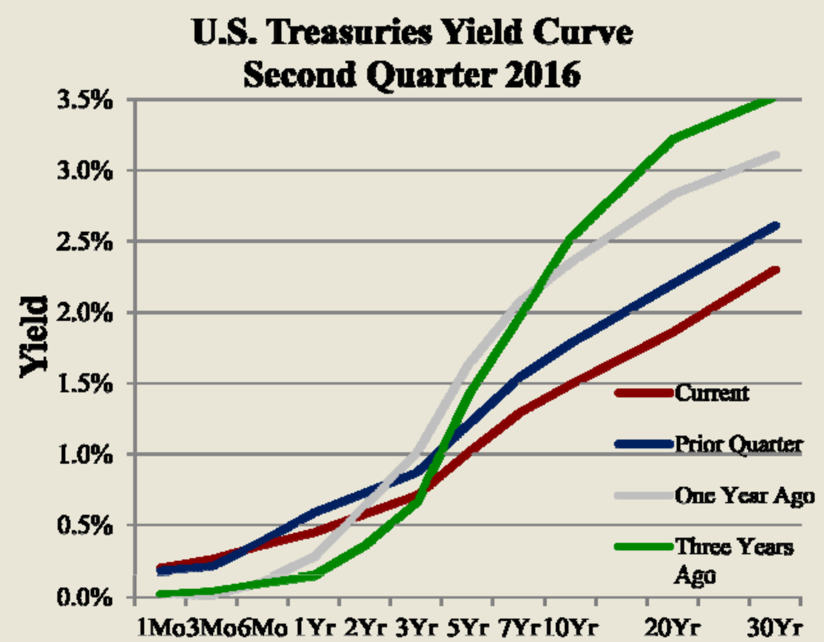
FED POLICY

- In June, the Federal Open Market Committee (FOMC) announced they would leave the federal funds rate at 0.25% - 0.50%. The Fed raised rates last December for the first time since 2006. In their statement, the Fed noted the economy is expanding moderately, supported by an improving housing sector and consumer spending.
- The Fed started the year forecasting four rate hikes during 2016; however, the Fed has changed their tune, as they have decided to hold rates steady the past few meetings. They have noted slowing global growth and volatility due to geopolitical events like Brexit as reasons to keep rates low. The Fed is now expected to raise rates only once in the second half of the year.

FIXED INCOME

- Most yields, except very short-term Treasury securities, decreased quarter-over-quarter causing the yield curve to flatten. The long end of the yield curve has decreased considerably over the past few years as there continues to be concerns about slow economic growth. Following the Brexit vote, rates decreased to multi-year lows. Short term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- U.S. yields remain attractive for the global investor as some central banks have gone to a negative interest rate policy such as the Bank of Japan and the European Central Bank. This is one of the many technical reasons interest rates should remain relatively low.
- There are now trillions of global sovereign debt with negative real yields.



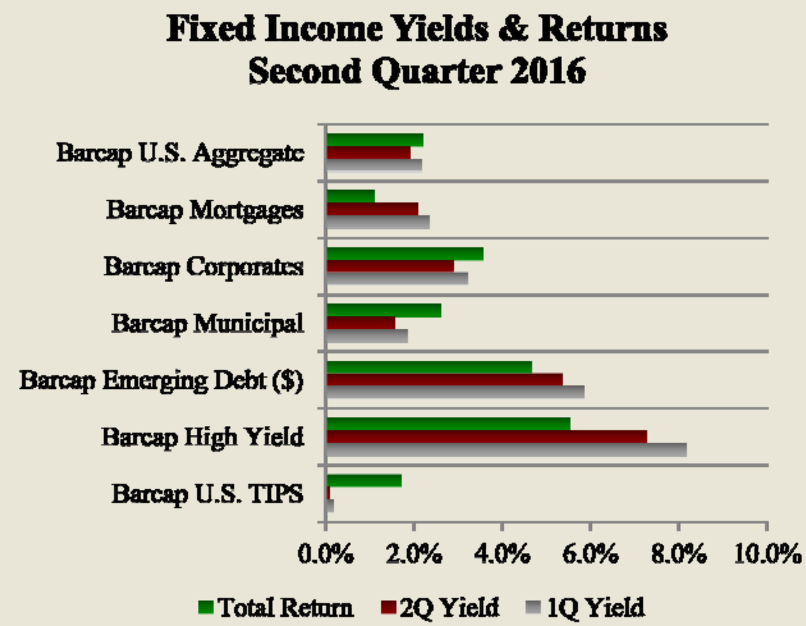


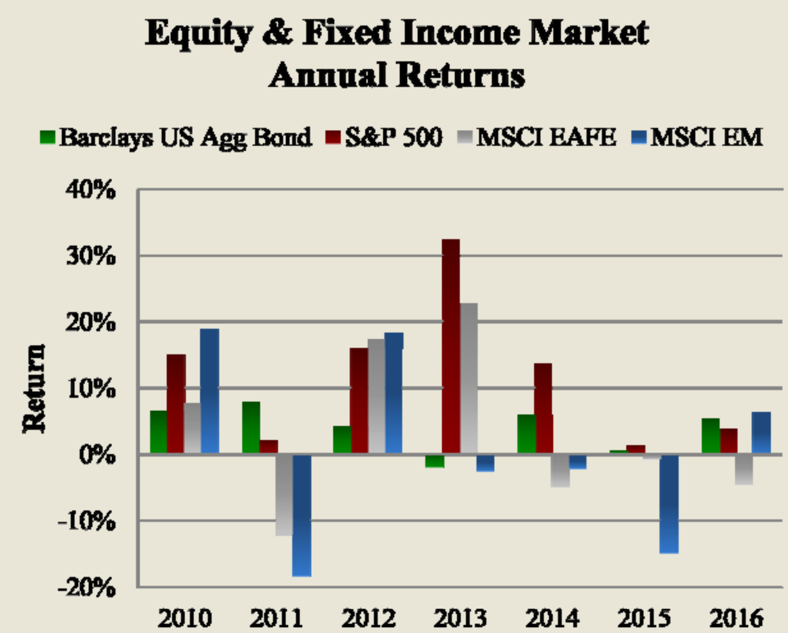
FIXED INCOME (continued)

- Returns across fixed income sectors were strong, particularly in credit sectors such as corporates and high yield. Returns benefitted from lower interest rates and narrowing credit spreads. The Barclays U.S. Aggregate was up over two percent during the quarter. Fixed income continues to perform well compared to equities as economic growth remains limited.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are starting at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. However, spreads in credit sectors are at or above historical averages which could benefit credit returns if the economy continues to grow.

EQUITIES

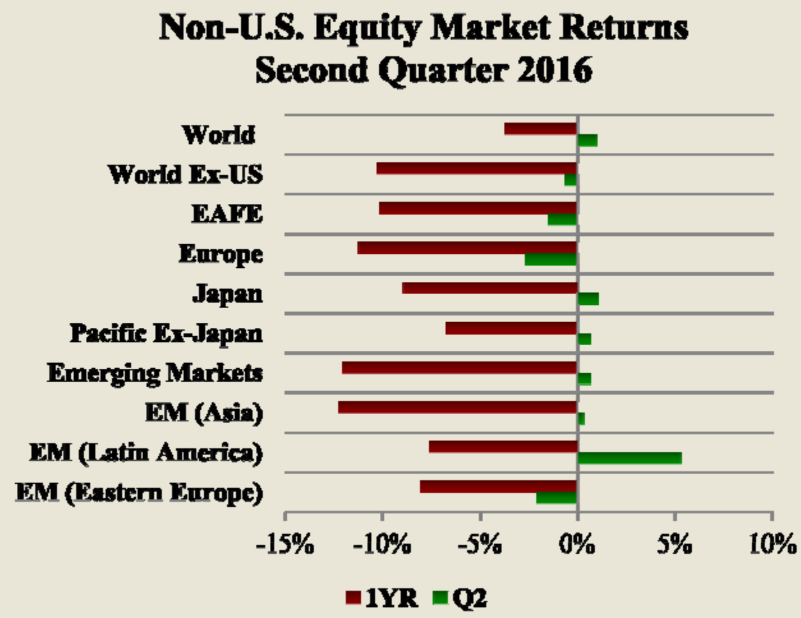
- As forecasted, volatility has continued throughout the first half of the year. Following the surprise Brexit decision, equity markets sold off quickly. However, the equity markets have since recovered.
- Generally, across asset classes, higher yielding assets had stronger returns with investors continuing to search for income during the quarter.
- U.S. large caps have dominated returns relative to other asset classes for the past three consecutive years, which is uncommon. This trend has changed in the first half of the year as a diversified portfolio provided solid returns. Asset classes such as emerging market equities, REITs, and fixed income have performed well YTD.
- After a strong bull market in equities since 2009, future long-term returns are expected to be lower than historical averages as earnings growth remains sluggish and valuations are slightly higher than average. Volatility should continue as 2016 unfolds.





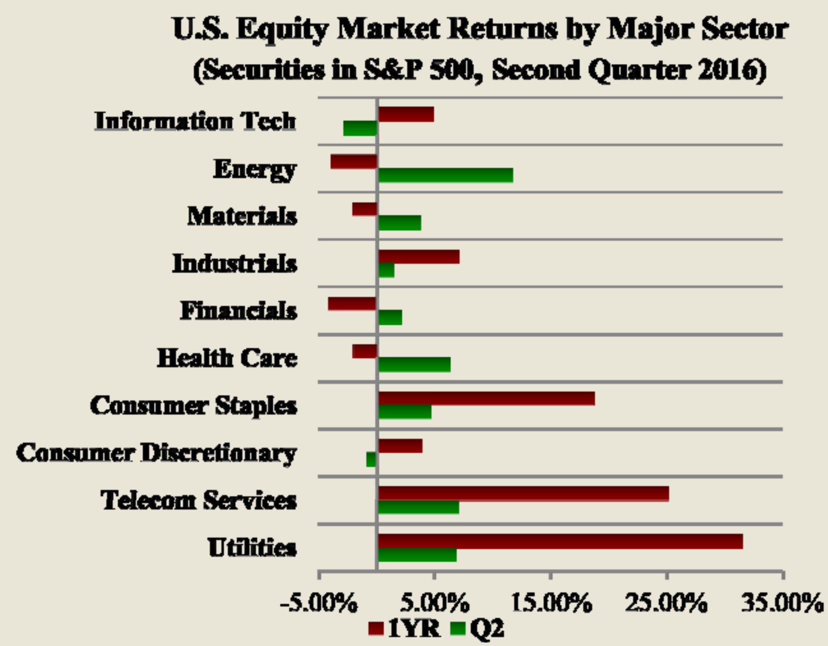
INTERNATIONAL EQUITIES (continued)

- Developed international stocks performed worse than U.S. domestic equities. The MSCI EAFE index of international markets stocks decreased 1.5% during the quarter. On a year-over-year basis, the EAFE is down 10.2%.
- During the quarter, emerging market stocks were higher and performed better than developed markets; however, they are still down significantly on a one year basis. The MSCI Emerging Markets Index increased 0.7% in the quarter and has a negative 12.1% return over the past year. Returns have been greatly impacted over the past year by emerging market currency devaluations and lower economic growth expectations. However, stabilization in commodity prices and currencies should benefit emerging markets going forward.
- Valuations are lower in developed international and emerging market equities than in the U.S.; however, many regions are trying to recover from economic slowdowns or are going through structural changes.



DOMESTIC EQUITIES (continued)

- The Russell 1000 Index of large capitalization stocks posted a total return of 2.5% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 2.9%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 3.9% during the quarter. On a year-over-year basis, the index has declined 6.7%.
- Higher-yielding stocks performed well during the quarter as investors sought income with declining interest rates. Utilities and Telecom were among the best performing sectors. Energy had a very strong quarter with the rebound of oil prices. Consumer Discretionary and Technology had negative returns for the quarter. Value outperformed growth across market caps.



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