Financial Insights: Q2 2016

Capital Markets Review & Outlook

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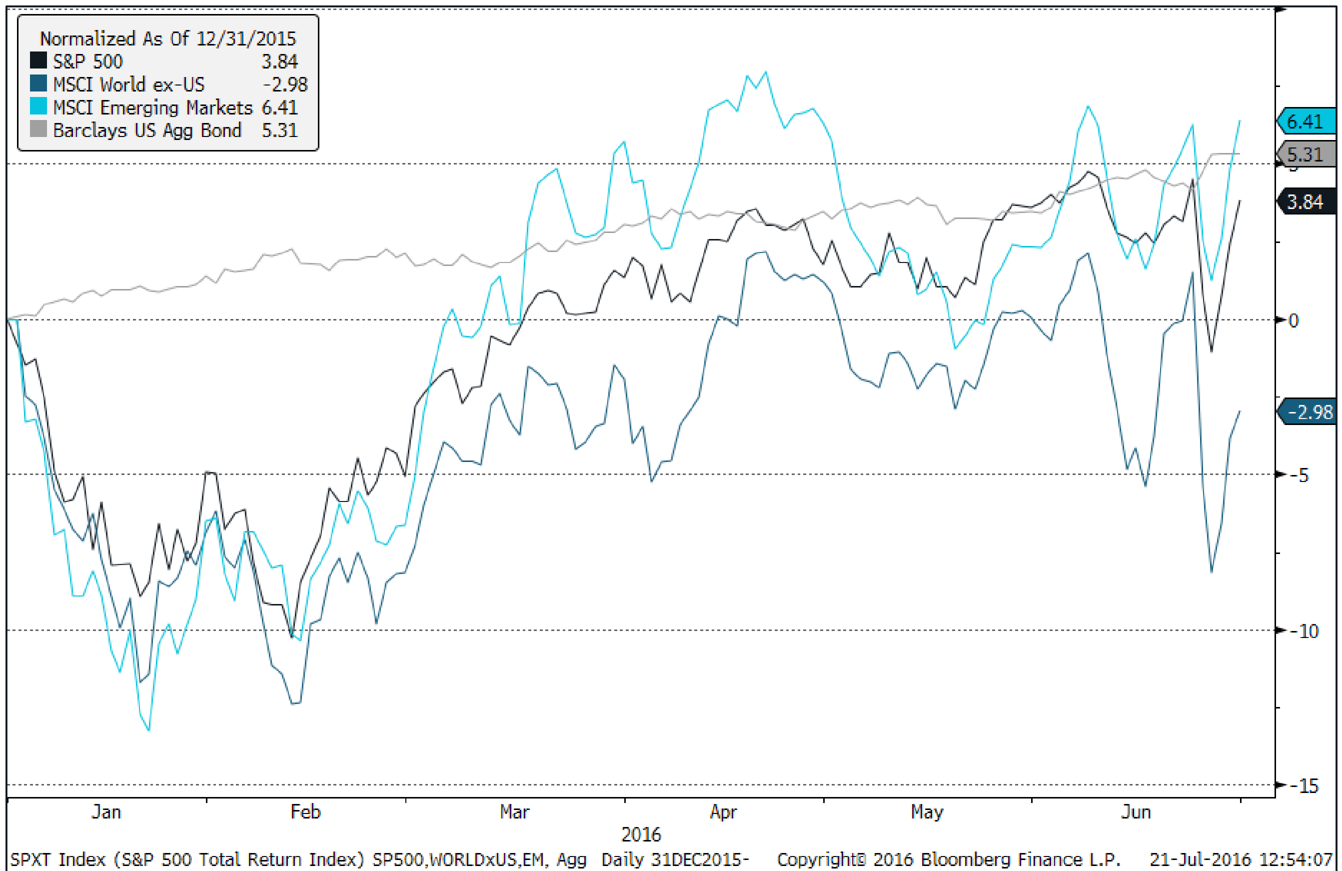
OVERVIEW

Equity markets continued to exhibit heightened volatility in the second quarter of 2016, especially during June. A very weak May jobs report created market turmoil in early June, followed by substantial global market movements leading up to, and immediately after, the June 23 "Brexit" referendum vote. Although the surprising "Leave" vote created uncertainty and substantial downswings in equity markets, especially in Europe, in the days following the vote, many markets were able to recover most, if not all, of the losses by the end of the quarter. As equity markets sold off around the globe, investors flocked to safer investments such as sovereign bonds, driving down already low yields. Many global bonds, including some going out 30 years, finished the quarter with negative yields and as of June 30, nearly $10 trillion of global sovereign bonds carried negative yields. The Fed remained dovish in their commentary and delayed raising interest rates in their

YTD Returns for Equities and Bonds



June meeting, giving investors some comfort that rising interest rates should not be a major concern for at least the next few months.

Well-diversified portfolios - such as those constructed with a mix of stocks, bonds, real assets, diversifying strategies, and cash - have trailed more concentrated portfolios since the end of the Financial Crisis in 2009. The events of the last seven years have not produced a "normal" market environment, thanks in part to the extraordinary monetary policy and low volatility investors have enjoyed over that period. However, in the second half of 2015, and even more so in 2016, we again saw the benefits of diversification. Looking forward, we expect more uncertainty regarding monetary policy, corporate earnings, and geopolitical risks, and we believe well-diversified portfolios will outperform more concentrated portfolios – both in absolute and risk-adjusted terms. This is especially true when accounting for the inherent risk-averse nature of most investors.

U.S. EQUITIES

Domestic large-cap stocks, as measured by the S&P 500 Index, finished the quarter up 2.5% (3.8% year-to-date). Mid-cap stocks (S&P 400 Index) also had a strong quarter, finishing up 4.0% (7.9% YTD). Small-cap stocks (S&P 600 Index) finished the quarter up 3.5% (6.2% YTD). Value-oriented equities generally outperformed growth-oriented stocks for the quarter and year-to-date.

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YTD Returns for U.S. Equities by Market Cap

Although we do not believe the U.S. stock market is due for an immediate correction, we are not as optimistic on the long-term outlook for U.S. equities. According to FactSet, S&P 500 earnings for Q2 are expected to decline, which (if it happens) would mark the first time since the Great Recession that the index recorded five consecutive quarters of year-over-year declines in earnings. Earnings growth has been a major concern for U.S. large cap equity investors for the past several years, yet the S&P 500 continued to climb higher and recently reached new highs, pulling the P/E higher with it. There are other factors – such as low inflation, low interest rates, and lack of attractive substitutes – that justify a higher-than-average P/E ratio today, but many of those factors are likely to fade away or even reverse course over the next several years. U.S. corporations have done nearly all they can since the crisis to reduce costs, so now they must find sustainable growth engines for revenues to increase earnings. If companies struggle to grow profits while inflation and interest rates creep higher over the next few years, U.S. stocks would experience mediocre-at-best returns.

Our portfolios are generally underweight U.S. equities in favor of additional exposure to international equities, real assets, and diversifying strategies. We like U.S. equities in the sense that the domestic economy currently is one of the strongest in the world, but we believe other asset classes have more attractive risk-adjusted return potential over the next several years. Within our U.S. equity allocation, we tend to favor mid-cap equities. Mid-cap stocks have done very well recently, and we believe they have the potential to continue to outperform other U.S. equities in the current economic environment – high exposure to a strong U.S. economy but relatively limited exposure to a strong dollar hurting international sales. Mid-caps provide better growth opportunities than large-cap stocks with less relative risk than small-cap stocks. We still have a slight growth tilt, but may look for opportunities to add value-oriented stocks over the next several quarters.

INTERNATIONAL EQUITIES

International stocks had mixed results for the quarter, but generally underperformed U.S. equities. International developed markets, as measured by the MSCI World ex-USA Index, fell -1.10% for the quarter (-3.0% YTD). Emerging markets, as measured by the MSCI Emerging Markets Index, returned 0.7% for the second quarter (6.4% YTD). Concerns over the effects of “Brexit” weighed heavily on international developed stocks, although many economists believe the majority of effects will be contained in the United Kingdom. Even though international stocks dropped sharply after the vote was announced, Emerging Markets stocks were surprisingly resilient and recovered the losses before the end of the quarter.

We still believe international equities provide more attractive return potential over the next five years relative to U.S. equities. Preliminary analysis indicates the global economy largely will be unaffected by the “Brexit” vote, and the years it will take to work through the details provides markets time to adjust. The effect on the UK economy initially may have been overestimated as well, but that could change if EU and trade negotiations do not go smoothly or uncertainty causes companies to reduce investment. As we stated previously, volatility will likely remain higher in international markets, but patient investors who stay invested should be rewarded in time.

We maintain an overweight to international equities for their favorable long-term return potential. In the short-run, as more economic data begin to flow regarding any potential effects of “Brexit”, we will adjust our views – and portfolios – accordingly, but we do not expect significant changes will develop at the global level in the near term. As various nations and central banks continue to implement plans to boost economic growth, international equities should begin to see the benefit and perform much better than recent years.

REAL ASSETS & DIVERSIFYING STRATEGIES

Allocations to Real Assets (Infrastructure and MLPs) and Diversifying Strategies performed very well during the second quarter, outperforming both equities and bonds. Our allocation to Real Assets returned over 15% for the quarter (over 17% YTD). PIMCO All Asset returned 4.1% for the quarter (9.5% YTD). Allocations to insurance-linked bonds fell -0.7% during the quarter but are up 0.7% year-to-date and continue to provide a low-correlation volatility dampener for overall portfolios.

We continue to favor allocations to Real Assets and Diversifying strategies for the purpose of inflation hedging and portfolio diversification. Inflation expectations remain low, but it is beginning to trend higher. If this trend continues, or we get a surprise up-tick to inflation, our allocation to Real Assets should provide a boost to performance. With uncertainty regarding equity returns and generally weak expectations for bond returns going forward, our allocation to Diversifying Strategies should provide downside protection and decrease the overall volatility of portfolios while also providing the potential for improved returns.

BONDS

U.S. intermediate bonds (Barclays Aggregate Bond Index) returned 2.2% for the second quarter (5.3% YTD). The index finished the quarter with a yield around 1.9%, down from 2.5% at the beginning of the year and 2.1% at the beginning of the quarter. Intermediate-term municipal bonds also performed well, returning 2.2% for the quarter (3.6% YTD) based on the Morningstar category average. Short-term bonds also were positive, but generally had lower returns. The 10-year U.S. Treasury yield started the quarter around 1.76%, rose as high as 1.92%, but fell significantly after the “Brexit” vote to finish the quarter at 1.47%. As of the end of the quarter, investors were pricing in a very low probability for a Fed rate increase by the end of 2016, but post-quarter positive economic releases may give the Fed enough confidence for at least one hike by year-end.

If the Fed should fulfill their projections of rising interest rates over the next few years, bonds should feel heavy pressure. With yields still hovering around historical lows, this scenario could generate periods of negative (flat at best) returns. Even if the Fed delays raising rates until 2017 or later, the return potential of bonds going forward is bleak. Looking at historical 10-year yields back to 1980 and subsequent 5-year and 10-year returns for the Barclays Agg Bond Index, we see a very strong predictive relationship. If interest rates remained unchanged for the next five to ten years, we would expect bond returns between 1.5-

1.8%. If the Fed is able to reach and maintain their 2.0% inflation target, the *real* return for bonds would be negative. This outlook is even worse if we factor in the probability of rates rising over the next several years.

We continue to underweight bonds in portfolios, and focus on shorter duration (less interest rate risk). We are not utilizing bonds to generate returns – rather we use this allocation as a diversifier from equity and economic risk. We likely are in a period of lower rates for the foreseeable future, so we do not expect bonds to generate the income/return they have for the past 40 years (when the average 10-year U.S. Treasury yield was nearly 6.5%!). However, bonds still provide relative stability and we will maintain at least a minimum allocation for non-aggressive portfolios to provide a buffer for the unexpected. We favor Real Assets and Diversifying Strategies to help offset some of the lower expected bond returns without taking additional equity risk. Our goal is to find the right balance of risk (potential growth of capital) and protection from market downswings (loss of capital).

ECONOMY

The U.S. economy continued its moderate growth rate through the second quarter, with a few negative data points in the mix. Forecasts for Q2 real GDP growth are around 2.5% (annualized rate), driven by an increase in consumer spending. Inflation also showed signs of improvement, with core CPI climbing over 2.0% through June 30. One area that caused concern during the quarter was job growth. The May jobs report from the Bureau of Labor Statistics (BLS) showed a measly 11k jobs added. However, the June jobs report came in much stronger than expected (287k jobs added), continuing the trend in job growth. This scenario is a prime example of why it is important to focus on the trend instead of single data points, and looking at all economic data in aggregate. Considering other economic news during the quarter, the U.S. economy maintained stable, slow growth. The International Monetary Fund (IMF) released their July forecast of U.S. real GDP growth for 2016 and 2017, and project growth of 2.2% and 2.5%, respectively, indicating their belief that the U.S. economy should be well insulated from any potential negative effects of the "Brexit" vote. Although the Fed held off on increasing interest rates at their June meeting, the strong jobs and inflation figures recently reported give more room for the potential for a rate hike before the end of the year. This could put pressure on both U.S. stocks and bonds.

The U.S. economy continues to be one of the strongest, but international economies, especially select emerging market countries, are poised to gain strength in the coming years.

Internationally, the economic picture is much more mixed. Forecasts for GDP growth have been adjusted lower for the UK and to a lesser degree the European Union. Emerging Markets, where economic growth had been slower than developed countries for the past few years, are expected to have GDP growth higher in 2016 and 2017 (the IMF increased their GDP forecasts for Brazil and Russia for 2017). Historically, this has provided the environment for Emerging Markets to outperform their developed counterparts. However, there are large differences in forecasts for emerging markets, with Argentina at the low end (negative forecasts for both 2016 and 2017) and India at the higher end (forecasts over 7.0% for both 2016 and 2017). If international developed countries can establish a stronger footing for economic growth, and emerging countries meet or exceed expectations, we expect international equities as a whole to perform quite well over the next several years.

Summary of Outlook & Positioning

Asset Class	Long-Term Outlook	Current Positioning
U.S. Equities	Relatively Unfavorable	Underweight
International Equities	Positive	Overweight
Real Assets	Positive	Overweight
Diversifying Strategies	Positive	Overweight
Bonds	Unfavorable	Underweight
Cash	Unfavorable	Underweight

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