Photography: Joseph A. Wiggins, Jr., - Europe 2016

Quarterly Update & Economic Commentary—June 30, 2016

Quarter In Review

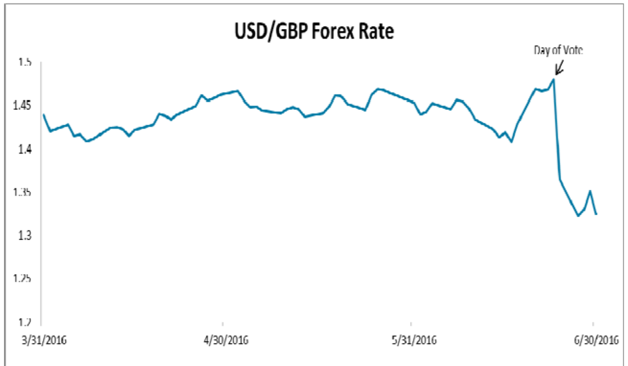
The second quarter nearly came and went without much of the fear-stoking volatility of the previous quarter. Then, in a result that surprised nearly everyone, a majority of U.K. voters decided to leave the European Union. The broad markets were rocked by the so called "Brexit"; however, many broad U.S. indices finished the quarter with a positive return and remain positive year-to-date. The S&P 500 returned 2.46 percent for the quarter and is positive by 3.84 percent year-to-date. Domestic small cap stocks outperformed their large cap counterparts – the S&P Small Cap 600 returned 3.48 percent for the quarter and is now up by 6.23 percent year-to-date. Yield seeking investors looked to dividend paying stocks as interest rates continued to fall. Telecom and utility stocks have benefited from the lower yields. The telecom sector was positive by over seven percent for the quarter and by almost 25 percent year-to-date; utility stocks were up by almost seven percent for the quarter and are up by more than 23 percent year-to-date. As expected, REITs have also performed well – the FTSE NAREIT All Equity REITs index returned 7.41 percent during the quarter and is up by 13.68 percent year-to-date. A rebound in oil prices helped the energy sector outperform all other sectors during the quarter, returning 11.62 percent since April 1 and 16.10 percent year-to-date. Technology and Consumer Discretionary stocks were the only sectors with negative returns for the quarter; the technology sector lost 2.84 percent and the consumer discretionary sector lost 0.91 percent. Driven by the uncertainty of the "Brexit", developed international stocks performed poorly; the MSCI EAFE lost 1.46 percent for the quarter and is down 4.42 percent year-to-date. Emerging market stocks performed much better than the developed markets, with the MSCI Emerging Markets index returning 0.66 percent for the quarter and 6.41 percent year-to-date.

Bond prices benefited from investor anxiety as investors flocked to safe havens. Yields fell significantly during the quarter, with the 10-year U.S. Treasury yield falling 30 basis points to below 1.50 percent. The yields of other traditional safe havens fell further into negative territory, with the 10-year German Bund and the 10-year Japanese Yen falling to -0.12 percent and -0.22 percent, respectively. Lower quality fixed income had a great quarter—the Barclays U.S. Corporate High Yield bond index returned 5.52 percent through the quarter and is positive by 9.06 percent year-to-date.

As mentioned earlier, oil prices continued to rebound. The price of crude oil rose by 26.06 percent in the second quarter and is up by over 30 percent year-to-date. Other commodities benefitted from the flight to safe assets. Gold returned 8.47 percent for June and was positive by 6.88 percent for the quarter. Silver was positive by 16.44 percent in June and 20.43 percent for the quarter.

The Brexit referendum — both the result and preceding anticipation — was the most prominent financial news story of the quarter. The "leave" result caught many off guard; the betting parlors in England—thought to be one of the most reliable sources of which way the country was leaning—suggested a strong probability of the U.K. voting to remain. Viewing the "remain" position favorably, most equity markets posted steady gains in the week preceding the vote. This almost certainly exacerbated losses in the wake of the shocking result.

The markets sold off because of the shock and uncertainty around the unprecedented event. Because the vote only decided whether to leave or remain, the matters of when and how will be decided by politically pressured bureaucrats in London and Brussels. The economies that will be



Source: Board of Governors of the Federal Reserve System (US)

hardest hit will be the U.K., E.U. and Japan. One of the biggest uncertainties is the future of trade agreements between the U.K. and E.U. Roughly half of the U.K.'s exports are to countries in the E.U. but only about 10 percent of the E.U.'s exports go to the U.K. New trade agreements will need to be signed between the U.K. and E.U., and while both sides would like these negotiations to go seamlessly, the E.U. may feel the need to impose unfavorable terms on the U.K. to deter other E.U. members from leaving as well. Some companies with operations in Britain may decide to restructure their operations by moving headquarters and jobs out of the U.K. and moving them to other E.U. member countries. Ireland, for example, is speculated to be a beneficiary of this because of its E.U. membership, favorable tax structure and cultural similarities to the U.K. The U.K. does stand to benefit from some of Brexit's impact, though; the weakening pound will make the U.K.'s products more attractive to foreign buyers, which will help export-oriented industries. Whatever the political outcome of Brexit, the increased uncertainty will hinder personal and business spending until the future becomes clearer. The British economy was beginning to show signs of weakening prior to the vote, which suggests that a recession in Britain in the next couple of quarters is likely.

The impact of Brexit on the European Union will likely be more political than financial. The E.U. is unpopular in several member countries; France, for example, has a lower approval rating for the E.U. than the U.K. does. Despite its flaws, the E.U. has been a force for good in the past half-century. It has driven economic growth, as people, goods and services have been able to flow freely within E.U. borders. This in turn has created economic incentives for European countries to cooperate politically despite a history of frequent war that goes back centuries.

Outside of the U.K. and Europe, the next hardest hit country will be Japan. Japan's government and central bank have taken aggressive action in recent years in an effort to stimulate their weak economy. The Bank of Japan has been weakening the yen in order to support Japanese exports. Unfortunately, panicked investors poured into the traditionally safe Japanese yen, sending the price of the currency significantly higher. This has wiped out years of the central bank's efforts to help the country. Unless the yen reverts to pre-Brexit levels, policy makers will be looking for ways they could take action to help the country's economy.

The impact to the U.S. economy should be minimal. Like in Japan, the flight to safety after the vote led to an appreciation in the U.S. dollar, which hurts U.S. exporters by making U.S. goods more expensive for foreign buyers. On the positive side, U.S. treasury yields plummeted due to uncertainty, which will lead to lower financing costs for businesses and individuals. This should continue to help the housing market and other areas of the economy that are driven by the availability and cost of financing. The Brexit is also expected to slow the Federal Reserve's expected pace of interest rate increases.

China's economic situation is still tenuous. After roiling markets last fall over fears of declining growth rates, the world's second largest economy has largely avoided becoming the central headline in U.S. markets so far this year. Still, observers are still waiting for the economic reforms that the Chinese government has acknowledged are necessary to transition the country to a consumption-driven economy. Cheap credit still abounds, and many are worried about the growing debt bubble.

Brazil is in the midst of a deep recession and its government is mired in a top-to-bottom corruption scandal as it prepares to host the 2016 Summer Olympics. Despite the turmoil, it's equity market has surged so far this year; this is partly a rebound from the huge losses it saw last year, but could also be interpreted as optimism after the country's president, Dilma Rousseff, has been suspended in the wake her impeachment.

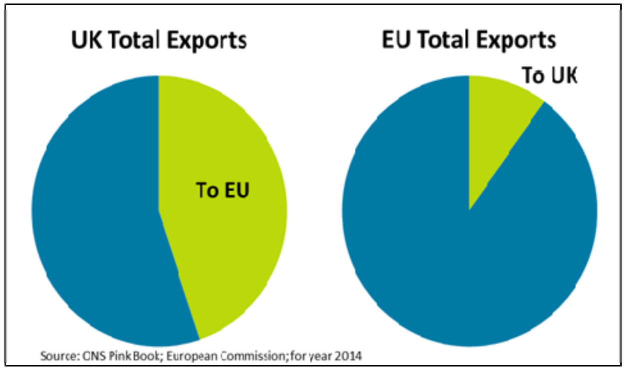
Generally speaking, the U.S. economy is doing well in comparison with the rest of the developed world, but still doesn't seem to have recovered the rate of growth seen before the Great Recession. The jobs climate in the U.S. slowed during April and May, which the Fed seems to see as additional justification for delaying a rate hike. Inflation readings have ticked higher as oil prices rebounded throughout the quarter. The inflation readings remain below the Fed's target of two percent, but inflation does seem to be slightly accelerating. Wage growth, which has been anemic for much of the recovery, has shown some recent signs of picking up. Demand from home buyers has continued to increase, in turn pushing up home prices. Modest wage growth, lower interest rates and a lack of supply have supported the housing market in most areas of the country. There were concerns at the end of last quarter that there would be very little economic growth in the quarter; though initial numbers suggested this was the case, the most recent revision of GDP growth in the first quarter is 1.1 percent. This is not particularly strong, but it is not as weak as feared, especially given the seasonally weak nature of the first quarter. Second quarter economic growth is forecasted to be in the low to mid two percent range, which is consistent with recent years. Other encouraging economic readings in the second quarter include May retail sales, U.S. consumer spending and consumer sentiment indicators.

A Look At The Numbers

Name	2nd Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	2.07	4.31
S&P 500 TR USD	2.46	3.84
S&P MidCap 400 TR	3.99	7.93
S&P SmallCap 600 TR USD	3.48	6.23
NASDAQ Composite TR USD	-0.23	-2.66
MSCI EAFE NR USD	-1.46	-4.42
Barclays US Agg Bond TR USD	2.21	5.31
Wilshire US REIT TR USD	5.60	11.09
IA SBBI US 30 Day TBill TR USD	0.04	0.09

Forecast in Brief

Market volatility has seemed relentless – the year got off to the worst start in modern market history and the second quarter ended with the U.K. voting to leave the E.U. – yet many broad, domestic indices are in positive territory.



The markets will seek to understand the details and impact of the U.K. departure from the E.U. The terms of the U.K.'s exit from the E.U. will be closely watched, but another thing keeping markets on edge is the prospect of another E.U. country announcing a similar referendum. As messy as the U.K.'s split will be, it would be even more so if a member of the Euro Zone (which includes countries that use the euro as official currency) decides to leave. France, Italy and other countries are known to contain a large amount of anti-E.U. sentiment. Given the state of uncertainty in the European region, we expect more difficult market conditions, with selective opportunities in the markets.

At this time, it seems that the U.S. Federal Reserve is expected to keep interest rates at the same level at least through the third quarter. After a paltry 38 thousand jobs were added in May, the Fed will watch upcoming reports closely to determine whether May was a fluke or the start of a trend. A rebound in job creation coupled with an uptick in inflation could lead the Fed to move sooner; however, given its recent reluctance to hike rates a move in the third quarter is seen as unlikely.

The Republican and Democratic National Conventions will take place in July. It is expected that businessman Donald Trump will be named the Republican candidate and former First Lady and Secretary of State Hillary Clinton will be the Democratic nominee. Neither candidate has overwhelming support of their respective party bases. Donald Trump has alienated large swaths of the Republican establishment due to his rhetoric, while Hillary Clinton is struggling to overcome questions of integrity, as well as vocal opposition from supporters of Bernie Sanders who feel she is not liberal enough. Data-journalists put Mrs. Clinton's odds of winning at about 80%, though it is worth nothing that similar odds were given to the U.K. voting to stay in the E.U. If there is a lesson to learn from the Brexit event, it is that democracy can sometimes lead to surprising outcomes.

Assuming the Senate and House of Representatives remain controlled by Republicans, which is expected, neither candidate would have much success pushing through their agenda as president. Most traditional Republicans are wary of associating with Trump, and they certainly will not be eager to work with a President Clinton, either. Surprisingly, divided governments have seen strong market returns historically.

Corporate earnings season will be here soon, and corporate guidance has improved compared with last quarter. According to FactSet, 81 companies have issued negative guidance, compared with 96 companies last quarter. This marks the second lowest number of companies issuing negative guidance on earnings since the final quarter of 2012. Large multinational companies were still hurt by the historically strong dollar, but dollar weakening over the course of the quarter actually helped to alleviate that headwind. The other major pressure point on earnings recently has been the low price of oil. While oil is still significantly lower than it was before the second half of 2014, a strong rally in the price during the past quarter will boost profits in the energy sector, which had been a significant drag on corporate earnings in recent quarters.

We expect the U.S. economy to maintain the steady, slow growth that we have seen since the Great Recession. Slight wage increases, low interest rates and oil prices will continue to provide more discretionary income for consumers to spend. Led by a large increase in mortgage debt, U.S. household debt continues to climb but is well within responsible levels. Auto and student loan debts have also increased but credit card and home equity debts have declined. Additionally, credit quality continues to improve. Given this backdrop, the consumer is well-positioned to contribute to economic growth.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure that it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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