Second Quarter 2016 Market Commentary

Domestic equity indices finished the quarter higher, while international markets ended mixed. The UK’s exit from the European Union dominated headlines throughout the last part of the quarter. Strong equity markets leading into the vote suggested the ‘remain’ faction would prevail, however, once votes were tallied, investors fled to safe haven assets, subsequently pushing fixed income yields across the globe lower and certain commodities higher.

For the quarter, the S&P 500 Index gained 2.5%, while the Russell 2000 Index of smaller companies increased 3.8%. The energy, healthcare, industrial, telecom and utilities sectors were the top performers, while the information technology and consumer sectors were weaker. Across market capitalizations, small-cap securities generally outperformed their large- and mid-cap counterparts. Across styles, value outperformed growth across large-, mid- and small-caps.

U.S. fixed income markets were positive across all asset classes. Long-maturity Treasuries handily outperformed shorter-dated issues as the yield curve flattened. Investment-grade corporate securities were positive as financial-, utility-, and industrial-related issuers were in the black for the quarter. Lower quality, higher yielding corporate securities experienced gains as well. Other sectors, including mortgage-backed securities (MBS), asset-backed securities (ABS) and municipal bonds all ended higher.

International markets were negative as the MSCI EAFE fell 1.2%. Among the largest European markets, France fell 3.5%, while Germany posted a 5.0% loss. Meanwhile, Italy and Spain declined 9.7% and 7.4%, respectively. Within the Pacific region, Japan gained 1.0%, while Australia added 0.5%. In the emerging markets, the MSCI EM Index ended 0.8% higher amid resiliency against the backdrop of largely declining foreign developed markets.

See disclosures at the end of this document for information on indexes used for asset class, sector and country returns referenced.

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World Market Recap

Economy

- According to the third estimate of economic growth released by the Bureau of Economic Analysis (BEA), first quarter GDP increased at an annual quarter-over-quarter rate of 1.1% compared to the second release of 0.8%. This reflected positive contributions from personal consumption expenditures (PCE), residential fixed investment, state and local government spending and exports. This was partially offset by negative contributions from private inventory investment, nonresidential fixed investment and federal government spending. The advance estimate of second quarter GDP will be released on July 29th, 2016.

- The Federal Open Market Committee (FOMC) decided to maintain the target range for the federal funds rate at 0.25% to 0.5% following their June meeting. Chairwoman Yellen noted that uncertainty surrounding Britain’s (then pending) decision to leave the EU played a role in the decision to leave interest rates unchanged. Additionally, during the post-meeting press conference, it was noted that median projections for rates in 2017 and 2018 among voting participants edged down slightly from where they stood in March. The FOMC will hold their next scheduled meeting July 26th-27th, 2016.

Fixed Income

- U.S. Treasury yields fell during the quarter as the rate on the 10-year decreased 30 basis points during the quarter to end at 1.47%. Yields were higher for much of the quarter, but fell sharply following Britain’s decision to leave the EU. Investors took a risk-off stance and repositioned portfolios in anticipation of increased central bank intervention.

- Investment grade corporate securities were sharply higher for the month. The utility sector, which advanced 4.6%, was the strongest performing corporate credit sector. Industrial-related credits followed closely with an increase of 4.0%, while financial-related issuers gained 2.5%.

- Lower quality, higher yielding corporate securities also finished higher. For the quarter, BB-rated issues gained 3.6%, B-rated issues climbed 4.8%, while CCC-rated credits returned 11.8% as energy-related issuers continued to stabilize.

- Fixed rate MBS gained 1.1% during the quarter. A survey by the National Association of Realtors reported that Chinese buyers were the top foreign purchasers of U.S. real estate for the fourth consecutive year. For the 12 months ending March 2016, Chinese investors purchased 29,195 properties worth $27.3 billion. Canada was the second largest buyer and purchased just $8.9 billion worth of U.S. properties while India ranked third, and spent $6.1 billion.

- Municipal bonds gained 1.2%. As expected, Puerto Rico defaulted on $800 million worth of general obligations bonds on July 1st. The government made the decision to continue paying government employees over repaying the debt.

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U.S. Equity

- U.S. stocks finished mostly higher during the quarter. The S&P 500 Index rose 2.5%, while the technology-heavy NASDAQ Composite fell 0.2% and the Dow Jones Industrial Average gained 2.1%.

- Energy was the top performing sector for the quarter as a sharp rally in spot prices provided a more attractive backdrop for energy companies. Crude oil rose 19.2% for the quarter while natural gas increased 31.0% both of which benefited from exploration and production firms as well as pipelines and equipment companies. Alternative energy names generally remained weak throughout the quarter.

- The healthcare sector gained 4.2%, with equipment and service providers outpacing pharmaceutical and biotech companies. The FDA approved the first pill to treat all major forms of hepatitis C. The drug, Epclusa, is manufactured by Gilead Sciences and will treat patients with and without liver damage. The broad indication is that the drug could be easier to use than the five other hepatitis drugs recently approved by the FDA which are all tailored toward specific indications. Pricing for the drug is around $890 per pill.

- The technology sector fell 3.8% as hardware and equipment firms underperformed their software counterparts. Falling earnings expectations for the sector was the largest driver as tech companies in the S&P 500 are now expected to report a 7.2% decline in profits compared with the second quarter of 2015. This is down from expectations at the start of the quarter that earnings would fall just 0.2%.

- The telecommunication and utilities sectors gained 6.2% and 5.6%, respectively. The strong performance was largely driven in the latter half of June as risk-off trading ensued following the “Brexit” vote.

International Developed Markets

- Canadian equities gained 3.6% despite a widening trade deficit reported by Statistics Canada, the government’s statistical agency. The deficit, Canada’s largest ever, surprised economists as many had forecasted rising exports due to the weaker Canadian dollar. National Bank Financial forecasted exports to shrink by approximately 15% in the second quarter citing structural deficiencies in the economy. Moreover, exports less energy continue to be 10% lower than their peak in 2007. Fallout from the Brexit vote has led many economists to believe the central bank will delay raising interest rates due to heightened market uncertainty. Despite a relatively small trade relationship with the UK, a flight to safe haven assets would have a large negative impact on Canada’s energy-focused firms.

- Eurozone equity returns were mostly negative to end the quarter. Markit’s Purchasing Managers Surveys (PMI) suggested private sector activity slowed in June due to uncertainty surrounding the “Brexit” vote. The UK is the second largest export market in the currency union. Immediate fallout from the vote was felt in the fragile Italian banking sector as investors focused on the $400 billion in nonperforming loans on bank balance sheets. “Brexit” aside, European Central Bank President Mario Draghi called for much needed economic overhauls and heightened investment spending from member nations. Governments lack the political capital to enact much needed labor market reforms as elections loom in a number of member states.

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The UK equity market fell a marginal 0.7% for the quarter. However, heightened volatility subsequent to the island nation’s historic exit vote from the European Union reverberated across markets. The pound fell precipitously in foreign exchange markets to a new 31-year low of 1.27 pounds per U.S. dollar. Panicked selling also caused six commercial property funds holding approximately $19.5 billion in assets under management to “gate” the funds, effectively blocking investor access to capital. Politically, the “Brexit” vote caused the early exit of Prime Minister David Cameron who promised to abdicate his position in the coming months allowing a new government to form. After a number of high profile “leave” campaigners announced they would not run for election, a BMG research survey suggested a majority of British citizens would support a snap election for new leadership.

Within the Pacific region, Australia posted a 0.5% return, while New Zealand rallied 5.9%. Japanese equities gained 1.0%. The May Nikkei PMI grew marginally to 47.8 from 47.7 suggesting a fourth consecutive monthly deterioration in business conditions. Survey respondents cited ongoing supply chain disruptions from April’s earthquakes. Moreover, the yen rallied 18% to end the second quarter as investors sought safe haven assets adding to pressures on Japanese exports. According to a recent Nikkei poll, Prime Minister Shinzo Abe’s party is expected to maintain its hold on parliament in upcoming elections despite widespread dissatisfaction tied to “Abenomics”, Prime Minister Abe’s economic plan to spur on economic growth.

### International Emerging Markets

- Within Asia, China gained a marginal 0.3%. The National Statistics Bureau announced it had altered its GDP accounting methodology for the second time in less than a year as investors called into question the accuracy of the bureau’s statistics. The revised GDP figures, dating back to 1952, saw a more recent upward revision of 1.3% in 2015 to better reflect research and development spending. India was well insulated from market volatility, posting a 3.7% return for the quarter. Moody’s released a report suggesting the economy could face headwinds due to increased corporate leverage but would still experience outsized growth. Among other large Asian markets, Taiwan gained 1.0%, while South Korea ended 1.2% lower.

- In Latin America, Brazil rallied 13.9% as the Markit Services PMI climbed to 41.4 from 37.3. Despite being well into contraction territory (below 50.0), the jump provided some good news for the beleaguered economy. Additionally, the Brazilian real has strengthened approximately 16.5% versus the U.S. dollar year-to-date. Elsewhere in the region, Mexico fell 6.9% while the smaller Chilean market added 2.5%.

- Among EMEA countries, South Africa posted a 1.7% return. In the Middle East, Turkey slipped 7.7% as terror attacks rattled investor confidence. Within Eastern Europe, Hungary posted a 4.7% loss, while Poland slumped 17.3% on concerns surrounding “Brexit”. Russia added 4.2% despite ongoing economic sanctions imposed by western governments.

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