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MARKET COMMENTARY: Q2 2016

Just weeks ago on Friday, June 24th, we were in the midst of the post-Brexit vote and a global flight to safety. The vote was close at roughly 52% in the "leave" camp and 48% in the "stay" camp. The general consensus, along with betting odds, was that the U.K. would remain part of the Eurozone. Taken by markets as a "surprise" event as a whole, this largely explains why some $2.08 trillion in equity market valuation was lost on the Friday after the vote. European markets were hit the worst but the sting was felt on a global scale – so much so that it was the biggest single-day global equity sell-off in history, surpassing Black Monday in 1987 and the Lehman Brother's collapse in 2008. While we must consider that global equity market valuation is much larger now than in 1987 or 2008 it doesn't negate this was a historical event. I am proud to say that clients were relatively calm (at least as measured by our phones) and we certainly didn't have the same percentage of clients as voters that were looking to make a tactical change. Interestingly from my perspective I had a small handful of clients wanting to follow the market herd to safety and a larger handful of others viewing the sell-off as a buying opportunity. Years of experience has taught me that fear can sometimes force investors to action as a safer alternative to inaction. They aren't sure why, but it just feels good.

Needless to say, we aren't out of the weeds yet as it pertains to the Brexit vote, but I do know from doing this for a long time that such events are generally looked back on as a buying opportunity. In fact, the S&P 500 reached an all-time-high on Monday, July 11th (just 10 trading days later) and since the vote nearly all asset classes have rebounded and then-some in just two weeks' time.

So what does the Brexit vote mean moving forward? In the short term we continue to be in the camp that while we may experience market volatility it will not be a catalyst for a global or U.S. recession. Longer term, we view the Brexit vote in light of similar populism that is in part a revolt to the status-quo that, among other things, is not very welcoming to tepid growth. It may serve us best to remember that markets have cycles – both boom and bust – but things recover and we need to be undeniably focused on our investment objective. Remember, your asset allocation has been tailored to your time horizon and risk tolerance and its entire premise is to ride through market events like the Brexit vote.

On the domestic front economically, the second quarter was largely mixed as it seemed one report after the next yielded slightly conflicting information. Corporate earnings from Q1 came in better-than-expected, retail sales were up and consumer spending increased very modestly. On the flip side there was an ugly jobs report (the worse read since 2009), coupled with declining construction spending (the worse read in 5 years) and a dip in manufacturing. GDP was revised upward to 1.1% in Q1, while core inflation and headline inflation were 2.24% and 1.1%, respectively. The question that seems to be on everyone's mind is "where do we go from here"? Markets seemingly moved sideways in 2015 while Q1 of 2016 brought a lot of volatility and uncertainty back into the markets. Most asset classes were moving along nicely in Q2 until we had a pronounced market event at the end that caused some pullback. As we know, things whipsawed back in the weeks immediately after quarter-end to a point at which some markets (namely domestic) are at all-time-highs. At the same time, we continue to see global thirst for treasuries that has kept yields low.

Beyond the usual domestic economic reports that are published periodically, the financial sector and specifically banks are being monitored closely. Of the 33 banks that were tested recently by the Federal Reserve (Fed) it is compelling to know they all passed, albeit some fared better than others. This is important on two fronts: first, it helps to stem fears over any form of market debacle that can be likened to 2008; second, banks help promote growth in the economy through the efficient allocation of resources (think savings and investment). On the contrary, the Federal Reserve itself appears to be so flexible and patient that investors are having difficulty gauging the Fed's next move. Monetary accommodation by the Fed, in addition to monetary accommodation elsewhere in the world, is perceived as supportive of global growth *but only if* the authority themselves seem to be defensible in why they are pursuing their policy stance. This is perhaps exactly where we have seen disconnect in what the Fed says and what markets anticipate. As Richard Clarida describes in his July 6th commentary, "A fair reading of the Fed minutes from the June 14–15 meeting reveals a committee in search of a reaction function and a coherent explanation for its future (in)actions." (Clarida, 2016)

The minutes go on to describe, as it relates to data necessary to gauge future hikes:

"… raising the target range for the federal funds rate would be appropriate if incoming information confirmed that economic growth had picked up, that job gains were continuing at a pace sufficient to sustain progress toward the Committee's maximum-employment objective, and that inflation was likely to rise to 2% over the medium term."

Internally we track various benchmark indices to gauge manager performance and selection as depicted below. Beyond internal use, the breakdown is occasionally worth sharing in the commentary to help clients understand why we utilize nine asset classes when at times some are "winners" and others are "losers". Likewise, we have discussed in previous commentaries and in meetings the problem of trying to time the selection of asset classes (tactically overweighting the future "winners" and underweighting the future "losers"). Years of experience has taught me that generally clients have a tendency to benchmark performance against the S&P 500. Interestingly enough the S&P 500, year-to-date through the end of Q2, was the worst performing equity asset class next to only international developed markets. In fact, even U.S. Corporate bonds outpaced the S&P 500 in both absolute and risk-adjusted terms.

Benchmark	**YTD thru 6/30/2016**
S&P 500	3.84%
S&P MIDCAP 400	7.93%
S&P 600	6.23%
MSCI EAFE Developed Markets	-4.42%
MSCI Emerging Markets	6.60%
DOW JONES US Select REIT	10.82%
Bloomberg Commodity Index	13.25%
Barclays US Aggregate Bond	5.31%
Barclays Muni Bond	4.33%
Citigroup 3-month T-bill	0.12%

As always, I appreciate your continued trust and confidence in me and my team. Please know we welcome the opportunity to discuss your specific portfolio at any time.

Regards,

Jeff

Prepared on July 15, 2016

References:

Clarida, R. (2016). Fed Minutes: Certainly Uncertain. *PIMCO Blog*. Retrieved from http://blog.pimco.com/2016/07/06/fed-minutes-certainly-uncertain/

Brexit is a term for the potential or hypothetical departure of the United Kingdom from the European Union.

Index Information: Indices are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment or the success of any investment strategy. Index return information is provided by a third-party vendor and although deemed reliable, is not guaranteed by NMIS or NM. Due to real-time market movement and delayed timing resulting from delivery to you of the attached information, indices may be adjusted after the publication of this report. The returns of the indices in this report would be lower if they included the effect of sales charges and taxes. The trademarks, service marks, and copyrights related to the indices briefly described below, as noted, are the property of their respective owners.

S&P 500: The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P MidCap 400: The S&P Mid Cap 400 Index is the most widely used index for mid-size companies and covers approximately 7% of the U.S. equities market.

S&P 600: The S&P Small Cap 600 Index is a market-value weighted index that consists of 600 small-cap U.S. stocks chosen for market size, liquidity and industry group representation.

MSCI EAFE Developed Markets: The Morgan Stanley Capital International Europe, Australasia, and Far East (MSCI EAFE) Index is composed of all the publicly traded stocks in developed non-U.S. markets. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

DOW JONES US Select REIT: The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S. The indices are designed to serve as proxies for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

Bloomberg Commodity Index: The Bloomberg Commodity Index (BCOM), formerly the Dow Jones-UBS Commodity Index, is a highly liquid, diversified and transparent benchmark for the global commodities market. It is calculated on an excess return basis and reflects commodity futures price movements.

Barclays US Aggregate Bond: The Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Brothers U.S. Aggregate Index) is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Barclays Muni Bond: The Barclays Municipal Bond index is an unmanaged index that is considered representative of the broad market for investment grade, taxexempt bonds with a maturity of at least one year.

Citigroup 3-month T-bill: The Citigroup 3-month Treasury Bill Index is an unmanaged index representative of three-month Treasury bills.