Third Quarter Market Forecast: Sunny with a Steady Breeze

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Executive Summary

- *United States markets have been somewhat insulated from the British decision to leave the European Union and continue to exhibit relative financial and economic health.*
- *Rate hikes in the next year are still possible because economic growth and unemployment levels are strong enough to meet the Fed's criteria. Markets are not expecting hikes and could be surprised.*
- *At the most basic level, investing (and economics) is about opportunity cost: what is the value you leave behind in order to pursue a different investment with different risks?*

The Brexit Surprise

Well, they actually did it. The British voted to leave the European Union raising a series of uncertainties that were considered far-fetched only a few weeks ago. For the United Kingdom and the European Union, we foresee a great deal of posturing, with few details of the new arrangement certain before 2018. The United Kingdom wants to give up only specific commitments to immigration and regulation that some British citizens found unpalatable. The leave camp won by a small margin overall and lost by a significant margin in several potentially fractious regions of the United Kingdom: Scotland and Northern Ireland. The abrupt departure of most of the fire-eaters from the scene highlights the delicate balance of reasserting British control over British policy and maintaining political order in the British Isles. Members of the European Union will want to set an example that makes the idea of seceding unpalatable to other European Union members that are disenchanted with the project. The deliberations will be noisy and they will create uncertainty, neither of which is good for equity markets in a region struggling with excessive debt, poor political cohesion and persistently slow growth. However, the British and Eurozone economies are both growing between

1.5% and 2%, equity valuations are attractive and the British referendum is likely to create more of a drag than an abrupt reversal of economic activity. At this point in time, we see international markets "climbing the wall of worry" after a sharp drop on the surprise British referendum results.

Looking Beyond Britain

United States markets have been somewhat insulated from the British decision. As of June 30, 2016, the S&P 500 returned 2.46% for the quarter and 3.84% year-to-date. After a sharp drop on the news of election results, US stocks have rallied. Financials have seen the most pronounced and sustained decline because of the virtual elimination of hope for another increase in the federal funds rate in the near term. Somewhat surprisingly, emerging markets have also been resilient, which is probably a response to the decline in interest rates across developed economies. Large company stocks that pay high dividends have led performance by a wide margin year-to-date as investors seek income in an extremely low interest rate environment.

The United States continues to exhibit relative financial and economic health. After a disappointing May report, the US economy added 287,000 jobs in June versus expectations for 180,000 and a six-month average of about 172,000 per month. First quarter GDP was revised from .8% to 1.1% as negative aberrations in private sector investment and external trade were mitigated or eliminated in the final revisions. The forecast for the balance of the year suggests 2% or greater GDP growth. Forward looking surveys provide an optimistic outlook. Most notably the ISM Purchasing Managers Index, a survey of producers around the country, continued to show improvement predicting manufacturing expansion after a long period of inventory adjustment and foreign exchange headwinds. The capacity for the

Equity Market Index Returns

As of June 30, 2016

Asset Class	Index	2Q 2016 (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	2.46	3.84	4.00	11.66	12.10	7.42
	Russell 1000 Large Growth Index	0.62	1.36	3.03	13.08	12.35	8.79
	Russell 1000 Large Value Index	4.57	6.28	2.84	9.86	11.35	6.13
	DJ US Select Dividend	5.40	15.54	17.86	14.11	14.23	7.52
Mid Cap U.S.	S&P 400 Mid Cap Index	4.00	7.93	1.33	10.53	10.55	8.56
Small Cap U.S.	S&P 600 Small Cap Index	3.48	6.23	-0.03	10.23	11.20	7.85
Developed International	MSCI EAFE Index	-1.46	-4.42	-10.17	2.07	1.68	1.58
Emerging Markets	MSCI Emerging Market Index	0.66	6.41	-12.05	-1.57	-3.79	3.54
Commodities	Bloomberg Commodity Total Return Index	12.78	13.25	-13.32	-10.55	-10.82	-5.59
Real Estate	NAREIT Equity Index	6.96	13.38	24.05	13.57	12.59	7.44
Global Market Cap Weighted	MSCI World Index*	1.00	0.66	-2.78	6.94	6.63	4.43

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of June 30, 2016

US consumer to contribute to economic growth remains on a solid footing following years of steady job growth, increasing home values and deleveraging of personal balance sheets. Consumer sentiment currently stands near multi-year highs.

United States banks generally performed very well in a new round of stress tests, results of which were published June 23. As part of the process, the Federal Reserve approved higher share repurchase plans and dividend increases proposed by large banks. Credit conditions appear stable with a few recent anecdotes of the need for higher reserves in credit card lending and auto loans. European banks are a different story, especially in Italy. There is a lot of bad debt and the falling rates resulting from quantitative easing by the European Central Bank is making it difficult for banks to improve balance sheets through higher earnings or raising capital. While the problem is stubborn, we continue to believe that Europe will muddle through without more crises to match the Greek Crisis from summer 2012.

A Look at Bond Yields

Prior to the June jobs report, derivatives markets had removed all but the slightest probability of another interest rate increase for 2016. In fact, market participants did not expect another increase until spring 2018. Despite the market's expectations for an extended period with no rate hikes, the Fed's primary measures for rate decisions, inflation and unemployment, continue to signal normalization of interest rates through rate increases is more appropriate. Existing bondholders have seen surprisingly strong returns given the low yield to maturity at the beginning of the year.

As of Friday, July 8, the 10-year Treasury sits at 1.4%, confounding a general belief that economic growth will drive long-term rates higher. The decline in long-term bond yields has created all kinds of editorial commentary, mostly foreseeing dire scenarios for investors as yields spring back to a more normal level or actually reflect dismal future global economic growth that we are just not seeing yet. Long-term rates are market driven, so the low rates reflect buying pressure or constrained supply. At such low yield, buying pressure means fear. We do not know where rates go from here. Central banks around the world have committed to accommodative monetary policy in order to drive growth in the real economy. Many investors and pundits disagree with the whole

Fixed Income Market Index Returns

As of June 30, 2016

Asset Class	Index	2Q 2016 (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	2.21	5.31	6.00	4.06	3.76	5.14
	BC Intermediate Government Credit	1.59	4.07	4.33	2.95	2.90	4.48
	BC US Intermediate Credit	2.12	4.88	4.97	3.88	3.96	5.38
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	1.16	2.32	4.19	3.23	3.04	4.35
International Bonds	Citigroup Non-US Government Bond	4.04	13.50	13.85	2.36	0.31	3.97

All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of June 30, 2016

program, some because they want higher rates to realize better investment results in a defined strategy and others because they believe that the artificially low rates promote excessive risk taking, creating bubbles in risk assets. This is uncharted territory, but it is very difficult to tell just how "manipulated" a 1.4% 10-year Treasury yield is when the Federal Reserve is no longer repurchasing new long-term bonds. Foreign central banks are still fully engaged in purchasing bonds of various maturities in order to control long-term rates, so limited supply in foreign markets could be driving demand for Treasuries as a substitute. The European schism and positive nominal yields in the US could also be driving demand for dollar denominated assets in order to remove at least one source of uncertainty.

Maintain Discipline and Diversified Portfolios

Investing is dynamic. Trying to find rules that dictate perfect pricing or timing has always been and will always be frustrating. The complexity of the real world cannot be boiled down into a model. At the most basic level, investing (and economics) is about opportunity cost: what is the value you leave behind in order to pursue a different investment with different risks? At the moment, the opportunity cost of foregoing a risk-free investment in a 10-year Treasury is very low. If the 10-year Treasury yield spikes to 2% then the opportunity cost is a little higher. The price investors are willing to pay for risk assets will be inversely proportional to the opportunity cost. This has been central bankers' intent all along in an effort to avoid insidious deflation by pushing money into the real economy. The strategy makes it hard for banks to earn their way out of poor financial condition. It also makes life difficult for pensions, insurers and retirees who want certainty in forecasting income. The trade-offs are known and the decisions have been made.

So, we continue to find ourselves in uncertain investing conditions as we have for the past year and a half. Sticking with the British theme, The Open Championships will be played July 14 - 17 at Royal Troon in Scotland. Conditions are everything at The Open with extreme variations in scoring depending on whether the wind is blowing and the rain is falling. The players show up for their tee times regardless of the elements. The fundamentals remain the same. Hit the fairways to avoid the extremely punitive rough and bunkers and make puts. Players will take steps to control for risk. At the beginning of the third quarter 2016, we would characterize conditions as sunny with a steady but not overwhelming breeze. We recommend a strategic allocation that fits the clients' goals and risk tolerance. Take advantage of the time-tested relationship between investment grade bonds and common stocks for risk management. Maintain discipline and diversified portfolios so that you do not find yourself in too many bunkers to recover. ■