Stembrook
Asset Management

Stembrook Market Review — Second Quarter 2016

The second quarter concluded on a dramatic note as the United Kingdom referendum on June 23rd resulted in a vote to leave the European Union. Markets immediately reacted to the news, selling off sharply. In the two days following the so called ,"Brexit" vote, global equities fell -7.1%, the Pound was down -10.7% and global bonds were up 0.2%, as investors fled to safer assets. The last four days of June saw a recovery, as global equites rebounded 5.5%. The British currency remained weak, only rising 0.4% and bonds appreciated 0.6%, continuing to attract investors, even as yields fell to a record low of 1.3%.[1] The long-term economic and financial market impacts of the decision will take time to unfold. Despite the impacts of Brexit, global equities managed to return 1.6% in the second quarter.[2] Globally, economies continue their slow advance, as central banks maintain their exceptionally accommodative monetary policies. As seen in the center chart below, inflation has remained very low, but is forecast to pick up, along with economic growth in emerging economies.

Our proprietary models forecast returns ranging from 0% to 4% for fixed income and 4% to 11% for equities (see table to the right). We continue to favor equity over fixed income and search for investments where prospects look most attractive. Our views are outlined in the following comments.

Economic Backdrop

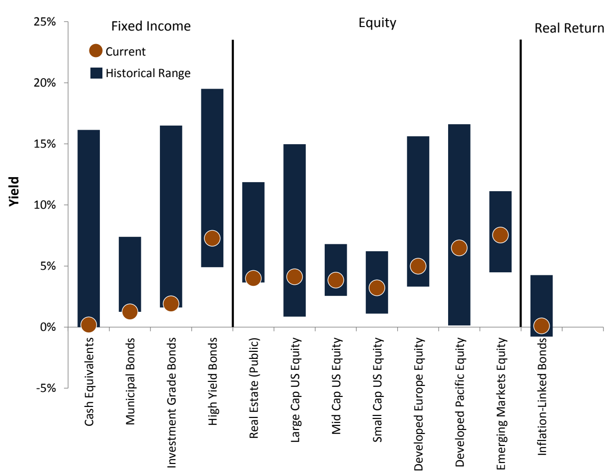
- Global GDP is estimated to have expanded by 2.5% for G-20 countries, a modest improvement over the first quarter.[3] Inflation remains low at 1.6% for the same group of countries.[4] While inflation remains low, it is important to monitor the knock-on effects of historically low, and in some cases, negative interest rates around the globe.
- U.S. GDP growth is expected to expand by 2.5% in the second quarter, after increasing by only 1.1% in the first quarter.[3] Unemployment, at 4.9%, remains below its post-World War II average of 5.8%, after dropping to 4.7% in May.[5]
- Wage growth in the U.S. has picked up to its highest level since early 2009, expanding at a 3.5% annualized rate, versus its long-term average of 3.6%.[6]

Expected Market Returns and Risks
7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
Inflation	1.4%	1.4%	3.1%
Cash Equivalents	0.3%	0.1%	3.3%
Municipal Bonds	1.2%	1.2%	4.4%
Inflation-Linked Bonds	1.4%	0.7%	4.7%
Investment Grade Bonds	1.7%	0.9%	6.7%
High Yield Bonds	3.8%	1.7%	13.7%
Real Estate (Public)	4.0%	2.0%	18.3%
Broad Market US Equity	9.3%	7.3%	17.5%
Developed Non-US Equity	8.9%	6.8%	22.4%
Emerging Markets Equity	11.0%	7.1%	30.6%

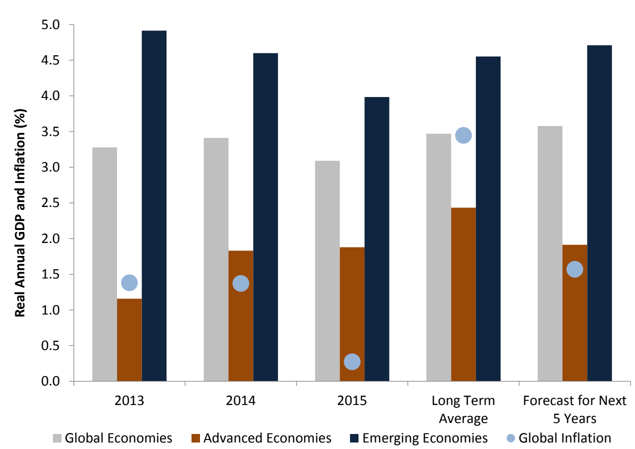
A sampling of return expectations produced by our models. These expected returns are projections and are not guaranteed.

Yields Across Asset Classes



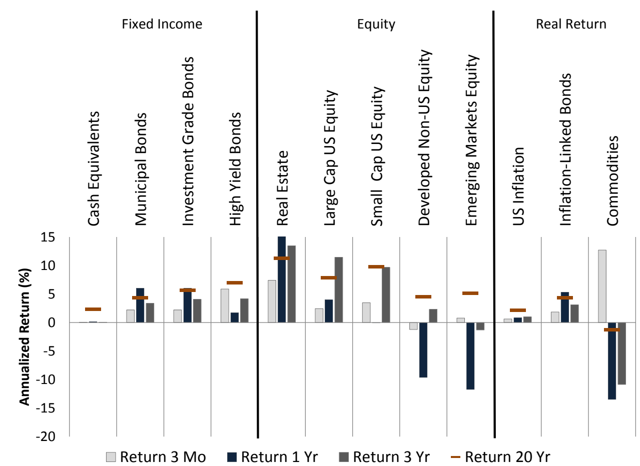
Yields are an indicator of future returns. Orange dots show current yields. Blue bars show historical ranges. Yields are generally low versus their historical range.

Global GDP and Inflation



Both GDP and Inflation are below their long-term averages. The IMF forecasts higher inflation and growth, especially in Emerging Economies over the next 5 years.

Historical Market Returns



Historical market returns as of June 30th, 2016. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

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- In addition to the Brexit vote, which caused a brief panic in equity and currency markets, the Eurozone economy slowed to a 1.5% growth rate.[3]
- Growth prospects in Japan continue to look challenging, as GDP grew by only 0.4% in the second quarter, after a flat first quarter and contracting in the last quarter of 2015.[3]
- Economic growth in emerging economies picked up by approximately 0.5% since last quarter, with growth of 4.1%.[3] Still, laggards exist in the emerging markets, most notable, Brazil, Argentina and Russia; all of which are forecasted to contract in the second quarter.
- Consumer confidence in the U.S. was up 2.0% in the second quarter, this comes after a slightly negative first quarter and a strong 2015.[7] In a predominantly consumer-led economic recovery, there appears to be more optimism from manufacturers. The ISM Purchasing Managers Index again increased to 53.2, its highest level since February 2015.[8] A reading of greater than 50 represents expansion, while a reading of less than 50 indicates contraction.

Currencies

- The U.S. Dollar was up 1.6% in the second quarter, with much of the appreciation coming in the wake of the Brexit vote. Despite the recent run-up, the Dollar is still down 2.8% year-to-date.[9]

Equities

- Stocks in the U.S. continue to outperform their other developed market counterparts, finishing the quarter up 2.6%,[10] versus a small drop in developed non-U.S. markets of -0.3%.[11] The local Japanese stock market fell -7.8%, but was up 0.52% in Dollar terms as the Yen tumbled.[12]
- Emerging markets had positive returns for the quarter, up 0.8%,[13] versus a 1.2% gain in developed stocks.[14]
- The CBOE Volatility Index (VIX), a measure of fear versus complacency, ended the quarter close to its average at 15.6. This occurred just days after the index reached 25.8 as a result of Brexit fears in the global equity markets.[15]

Fixed Income

- Yields across the maturity curve fell in the U.S. The majority of the compression came in the days following the Brexit vote as investors fled to perceived safe havens.
- The global bond market continued to become less attractive as central banks pushed rates to historical lows and in some cases, such as Japan, below zero. Investors must be cautious of the risks of rising rates in the fixed income markets.

Commodities

- Oil prices rallied 26.1% since the beginning of the second quarter. While this is a significant change in price, it pales in comparison to the volatility witnessed from June 2014 through the end of 2015 when prices fell by -64.9%.[16]
- Emerging markets are a major driver of commodity prices, if growth accelerates, there will be more upward pressure on prices.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Small Cap US Equity	Small Cap 6.6%	Real Estate 36.0%	EM Eq 39.8%	Inv Grd Bnd 5.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%
Large Cap US Equity	S&P 500 6.1%	EM Eq 32.6%	Commod 16.2%	CPI 0.1%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%
Real Estate (Public)	Real Estate 5.9%	Intl Eq 26.3%	Infl-Indx Bnd 11.6%	Infl-Indx Bnd -1.2%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%
High Yield Bonds	HY Bnd 5.6%	S&P 500 15.8%	Intl Eq 11.2%	HY Bnd -26.2%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%
Investment Grade Bonds	Inv Grd Bnd 3.7%	Small Cap 15.1%	Inv Grd Bnd 7.0%	Small Cap -31.1%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%
Inflation-Linked Bonds	Infl-Indx Bnd 3.3%	HY Bnd 11.6%	S&P 500 5.5%	Commod -35.6%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%
Emerging Markets Equity	EM Eq 3.2%	Inv Grd Bnd 4.3%	CPI 4.1%	S&P 500 -37.0%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%
Developed Non-US Equity	Intl Eq 2.6%	CPI 2.5%	HY Bnd 2.2%	Real Estate -39.2%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%
Inflation	CPI 1.6%	Commod 2.1%	Small Cap -0.3%	Intl Eq -43.4%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%
Commodities	Commod -5.4%	Infl-Indx Bnd 0.4%	Real Estate -17.6%	EM Eq -53.2%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Current Positioning

- We remain invested in **lower priced, value-oriented equities**, which tend to outperform the broad market over time and have outperformed in the first half of 2016.
- We remain **overweight U.S. equities and non-U.S. equities.**
- We maintain our **overweight allocation to Japanese equities**, given continued monetary stimulus, ongoing structural reforms and attractive relative valuations.
- We remain **overweight emerging market equities**, where valuations and long-term growth potential remain attractive, though near-term headwinds are all too clear.
- We remain **overweight municipal bonds** for taxable **and** tax-deferred investors, as prospective returns relative to other fixed income sectors remain attractive.
- Given our significant concerns regarding a longer-term, secular rise in interest rates, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries** and investing in **corporate bonds, high yield bonds and floating rate bonds**.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach, incorporating fundamental valuations, time-tested return and risk models and tax-efficient strategies. This investment discipline is tailored to each client's individual situation in order to craft a customized solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA   Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: MSCI ACWI Total Return, Bloomberg British Pound Index, J.P. Morgan Global Aggregate Bond Index 6/23/16 - 6/27/16, 6/27/16 - 6/30/16.
(2) Bloomberg: MSCI ACWI Total Return.
(3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated in to USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/16.
(4) Bloomberg, Stembrook Research: Inflation data as of 6/30/16. Aggregate statistics are weighted by each country's GDP translated in to USD.
(5) Bureau of Labor Statistics: Total unemployed as a percentage of the civilian labor force (U3), as of 6/30/16.
(6) Bloomberg: Atlanta Federal Reserve Wage Growth Tracker, 3.6% average since 3/31/1997, 3.5% as of 5/31/16.
(7) Bloomberg: Conference Board Consumer Confidence Index 12/31/14 - 12/31/15, 12/31/15 - 3/31/16, 3/31/16 - 6/30/16.
(8) Bloomberg: Institute for Supply Management Manufacturing Purchasing Mangers Index, as of 6/30/16. A reading of greater than 50 represents expansion in positive sentiment amongst purchasing managers, while a reading of less than 50 indicates contraction.
(9) Bloomberg: Dollar Index 3/31/16-6/30/16, 12/31/15 - 6/30/16.
(10) Bloomberg: The S&P Composite 1500 combines three leading indices, the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600 to cover approximately 90% of the U.S. market capitalization.
(11) Bloomberg: MSCI Europe, Australia, Far East Total Return Index.
(12) Bloomberg: MSCI Japan Total Return Index.
(13) Bloomberg: MSCI Emerging Markets Total Return Index.
(14) Bloomberg: MSCI World Total Return Index
(15) Bloomberg: CBOE Volatility Index (VIX).
(16) Bloomberg: West Texas Intermediate Spot Prices 3/31/16 - 6/30/16, 6/30/14 - 12/31/15.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/16.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 6/30/16.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank.

Global GDP and Inflation: As of 12/31/15.
Source: IMF. Long-term averages range from 1980 to 2015. Forecasted returns are provided by the IMF for years 2016-2020.

Historical Market Returns:
Source: Bloomberg, Stembrook Research.
Indices: BofA Merrill Lynch 0 to 3 Month US Treasury Bill Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Consumer Price Index – US, S&P 10 Year US TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns:
Source: Bloomberg, Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index Barclays Capital Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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