Introduction

"Just when you thought it was safe to go back in the water…." This ominous tagline from the sequel to Steven Spielberg's blockbuster film, *Jaws*, seems especially appropriate given the drama surrounding Britain's vote to leave the European Union, which happened to coincide with an anniversary of the film's release. After a rough start to the year, returns of most asset classes were positive heading into the end of the second quarter. However, the 'leave' vote caught the market off guard. As a result, investors piled into low-risk assets while US stocks lost about 5% in just the next two days.

After a sharp recovery in the last few days of June, the US stock market, as measured by the S&P 500 Index, managed to end the quarter up 2.5% for a return of 3.8% year-to-date. The Dow Jones Industrial Average is now up 4.3%. Energy stocks were the outperformers during the period, adding 11.6% to first quarter gains. However, dividend-heavy utility and telecom stocks continue to lead the market for the year, beneficiaries of declining bond yields. Consumer staples stocks also did well, indicating investors are seeking income and low volatility, not necessarily growth, even in their risk investments. Small-cap stocks continued their rally from late in the first quarter and now are positive for the year after rising 3.8% during this period. Britain's vote (Brexit) took a toll on the MSCI-EAFE Index of developed international stocks, which had been up for the quarter before a drop of approximately 6% to end the quarter down 1.2%. Stocks in emerging economies added slightly to gains from earlier this year and are now up 6.6% for 2016.

The disruption around Brexit added to positive bond returns, with the Barclay's US Aggregate Bond Index now up 5.3% this year, adding 2.2% for the quarter, while the bellwether 10-year US Treasury yield fell to 1.49%. After a long period of underperformance, the Bloomberg Commodity Index rose 12.7% and is now up more than 13% for the year. Much of this was the result of the relief rally in oil that pushed the price of the commodity to $48.33/barrel, a stellar return of 26.1%, along with a 6.9% rise in the price of gold.

It is too soon to measure how big an impact will be felt from the UK vote since it will take at least two years for them to officially exit and, until now, no country has left the union. The effects likely will weigh on Fed policy regarding the pace and magnitude of interest rate changes. Heading into the latter half of the year and the US presidential election, another area that bears watching is the wave of populist sentiment among alienated voters feeling marginalized by a global economy; the very same issue that resulted in Brexit.

2nd Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 6/30/16

	2Q 2016	YTD Return	Price / Value
Dow Jones Industrial Average	2.1%	4.3%	17,930
S&P 500 Index	2.5	3.8	2,099
NASDAQ Composite	-0.2	-2.7	5,473
Russell 2000 Index	3.8	2.2	1,152
MSCI EAFE Index	-1.2	-4.0	6,122
MSCI EM (Emerging Markets)	0.8	6.6	1,749
Barclay's Capital US Aggregate	2.2	5.3	107
Barclay's Capital Municipal Bond	2.6	4.3	112
Gold – Continuous Contract	6.9	24.6	$1,321
Light Crude Oil – Continuous Contract	26.1	30.5	$48

Source: Factset

Economy

While pockets of inconsistency remain, the domestic economy managed to shrug off recent headwinds and grow at a near 3% annual rate in the second quarter, driven by solid consumption and a late surge in manufacturing activity. Despite the bounce from the tepid growth in the winter and early spring, concerns remain about the durability of the expansion, mostly in the realm of business spending which could further restrain GDP growth in coming quarters given the unclear ramifications of the historic Brexit vote. While we believe the direct impact of Britain's eventual departure from the EU is de minimis in the near term, there is no doubt many multinational corporations abhor the uncertainty it creates and will tread lightly, delaying capital expenditures and hiring until trade and other agreements are hammered out over time.

Within US borders, activity seemed to be improving as the reversal of last year's dollar strength buoyed manufacturing by quarter-end. The Institute of Supply Management's (ISM) manufacturing survey surprisingly advanced in June to the strongest reading since February 2015, and perhaps no sector benefited more from the Fed's shift to a more cautious stance over the course of this year. The likely delay of future rate hikes also arrested the rapid run-up in the dollar, fueled by the Fed's tightening of monetary policy late in 2015. However, while there is little immediate direct impact from the UK/EU divide, a global shift into the perceived stability of dollar-denominated assets could generate unwelcomed dollar appreciation, which would counteract the Fed's recent dovish shift. We will monitor this trend closely given its impact on the efficacy of Fed policy, as well as on earnings of multinational companies.

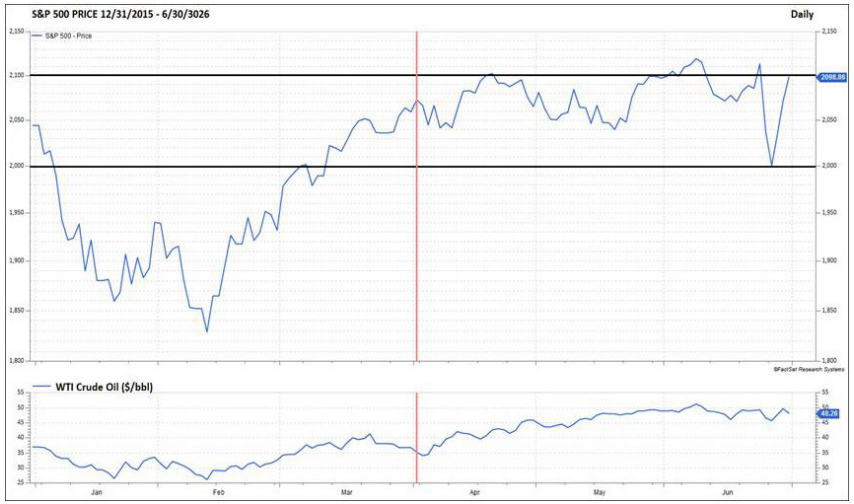
Meanwhile, our expectation for an overdue revival in domestic consumer spending seemed to finally gain traction, as the lack of spending through the winter months admittedly confounded us. Robust payroll growth and low gas/energy prices on the heels of an extended period of deleveraging have bolstered disposable incomes and nurtured a healthy spending environment, yet personal consumption increased only a meager 1.5% in the first quarter. While lower costs typically bolster consumer confidence with a lag, it seemed that the hangover from the financial crisis still hindered otherwise solid fundamentals. However, the recent quarter finally showed broad-based progress, with retail sales exceeding expectations in May after surging 1.3% in April. While auto sales came in a touch below consensus in June, they remain close to the sturdy 17 million annualized rate that has prevailed for much of the year. Meanwhile, recent data for personal spending posted the strongest two-month advance since 2009; in June, consumer confidence jumped to an eight month high.

Despite recent tragic episodes of terrorism and the uncertainty of the Brexit vote, there seems to be resiliency among US consumers which should carry the economy forward over the balance of the year. Layoffs remain low and wages advanced in May even while the pace of hiring slowed during the month. While we would be supportive of a rate hike later this year, it is clear that borrowing costs will remain low regardless of Fed action. This should further support the auto market as well as the housing market, which has been additive to overall growth despite its inconsistencies. We continue to believe job growth is the key to future growth, since it underpins consumer confidence. We doubt events overseas will significantly dent the recent momentum in the labor markets, although we expect the economy to settle back into the low-2% annual rate of growth consistent with the modest "new normal" that continues to define this post-crisis recovery.

Equities

Global political headlines dominated equity investor attention for most of the quarter. At the end of the period, the decision by voters in the UK to leave the EU provided investors with a roller coaster ride befitting the official start of summer in the northern hemisphere. The short-lived 6% price decline for the S&P 500 did not measure up to the level of angst generated by media headlines, but a good roller coaster ride offers more than one loop to make your heart race.

For most the of quarter, strength in the price of oil provided investors with confidence that this important segment of the global economy would not fall into the abyss, triggering problematic credit and capital expenditure weakness. Even with the recent volatility, the S&P 500 stayed well above the low levels that existed after the sharp selloff early in the year.



Source: Factset

The S&P 500 returned 2.5% for the quarter, after peaking at 4.7% in early June, bringing the year-to-date return to 3.8%. The current level represents a significant recovery from the 10.3% decline in January and February and a welcome bounce from the immediate post-Brexit shock. Small-cap US stocks are more domestically-focused and less subject to currency swings, which proved attractive to investors in the quarter. After lagging for 2015 and the first quarter of 2016, they bested the S&P 500 in this quarter with a return of 3.8%.

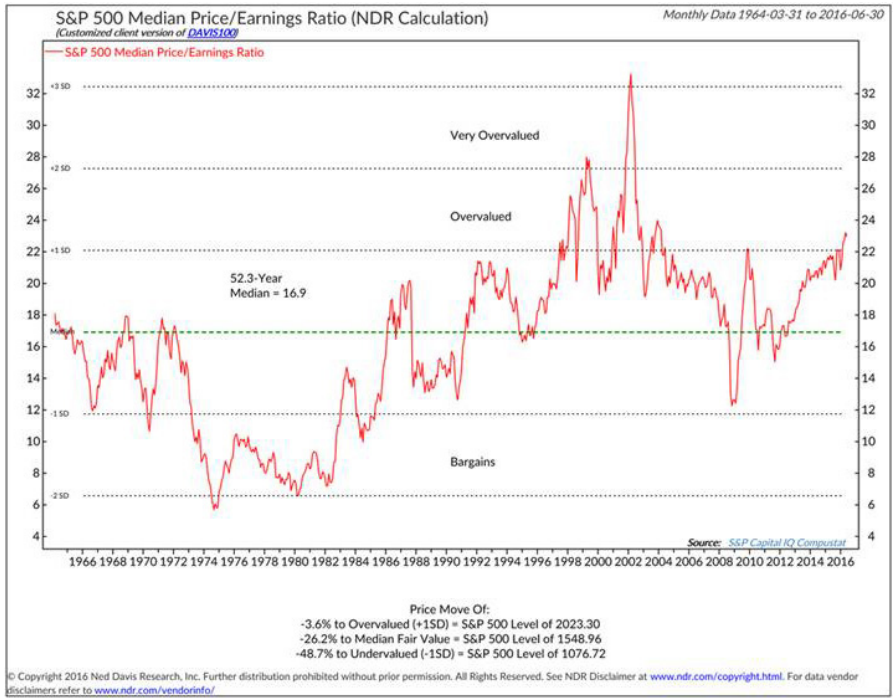
Outside the US, markets were impacted by Brexit to varying degrees, a product of both the market return in local currency and the movement of the local currency relative to the US dollar. As an example, the UK FTSE 100 index rose 6.5% for the quarter when measured in British pounds, but after a 7.5% decline in the pound versus the dollar, the net return for a US investor was a loss of 0.9%. The opposite effect was felt in many emerging markets this year as a weakening dollar, relative to local currencies, reduced pressure on servicing debt that is denominated in US dollars, something that has been weighing on stocks in these economies for quite some time. These countries often rely heavily on the export of raw materials, so the rebound in commodity prices has been a tailwind as well. These factors played a significant role in year-to-date outperformance of emerging market stocks.

As we have written in past communications, the economic strength of the US consumer provides a key component of our view that the US economy is not at risk of a recession and provides an important foundation for the profit outlook for US companies. Along with evidence of a healthy consumer, we were pleased with the recently announced results of the Comprehensive Capital Analysis and Review (CCAR) conducted by the Fed. This annual post-crisis exercise evaluates the impact of various stress tests on the capital of large bank holding companies. The results showed that US banks are likely able to withstand severely adverse economic scenarios, putting the economy on more sound footing than prior to the financial crisis.

We recently reviewed and updated our asset class guidelines in light of Brexit, dollar strength, Fed policy and fluid global political trends. We noted the environment for the US consumer continues to improve due to lower rates, home price appreciation, and a stable job environment. This strength was reflected in the most recent reading of consumer confidence, which rebounded to 98 from a revised 92.4 in May. However, we felt that the uncertainty presented to business owners and capital allocators by the Brexit vote is significant and will likely lead to deferred or reduced spending. If this uncertainty persists, consumer confidence will be impacted as hiring decisions are delayed or eliminated. We do not believe that the US economy will be thrown into recession, but the growth trajectory may end up more flat than previously expected. Similar concerns are evident in recent Fed minutes and comments from Fed governors following the Brexit vote.

The increasing populist sentiment represented by the vote in Britain and other political shifts globally is not conducive to trade and labor efficiency. The additional uncertainty resulting from this movement is yet another challenge for business owners as they make capital allocation decisions.

On a valuation basis, the S&P 500 is currently priced at 18.1x 2016 operating earnings. While not at nosebleed heights, this level is above the long-term historical average. The Ned Davis Research chart below presents a more inflated picture when the median P/E of all companies in the S&P 500 is used (this method helps reduce the impact of extremes at either end that can skew the average). Currently, this median P/E stands at 23x, which is significantly above the long-term median of 16.9x.



Economic and Market Drivers

Tailwinds	***Headwinds***
Improving Real Personal Income	Expanding Global Political Uncertainty
Low Inflation	Slowing Global Growth
Low Energy Prices	Aging Demographics in Developed Markets
Low Mortgage Rates	China Over-Investment
Household Formation Increasing	Higher US Equity Valuations

Combining all of these factors, we believe the risk-reward equation has changed slightly for the worse, and it does not support an overweight position in equities at this time. We are reviewing the equity exposure across client portfolios.

Within the core US portfolio, the healthcare sector continues to offer attractive revenue and earnings growth. We look for companies that provide cost-reduction solutions or compelling new product pipelines, but we do see some risks for this sector from the upcoming election cycle. The persistent low interest rate environment increases the natural appeal of high-quality dividend-paying stocks, which in many cases also offer a lower volatility profile. We continue to be sensitive to stocks with rich valuations in exchange for yield, but we will pursue companies with sustainable cash flows that can support growing dividends and earnings.

Markets for the second half of 2016 will continue to be heavily influenced by the price of oil. At current levels, the earnings drag from declining energy prices will reverse in the 4th quarter. Hopes for a stable or weaker US dollar have probably been put on hold due to Brexit concerns. We expect a mid single-digit total return for US equities for all of 2016 as economic growth remains positive but modest.

Fixed Income

The mood at the start of the second quarter clearly leaned towards one of risk taking, with longer-dated and lower-quality securities generating the highest returns. When the Brexit referendum drew near, the markets turned optimistic that this global uncertainty would be removed and a vote to remain in the EU would prevail. However, the reality of the 'leave' outcome increased the demand for Treasuries, resulting in a drop in the 10-year yield to 1.38%, before closing the quarter at 1.49% (prices and yields of bonds move in opposite directions). In the end, the risk-off sentiment prevailed with Treasuries leading the way and the Barclays Aggregate Index advancing 2.2% for the three months and 5.3% year-to-date.

Despite the flight-to-quality following the UK shocker, corporate bonds still recorded respectable performance supported by the rally in Treasuries. Spreads between Treasuries and corporate bonds increased modestly, but remained relatively contained considering the volatility, and we do not consider corporates to be inexpensive. Going forward, with approximately $12 trillion of global bonds at negative yields, demand for these securities should persist for the foreseeable future.

Therefore, we believe both our overweight to corporates and our quality bias continue to be appropriate as event risk and liquidity issues persist. We remain wary of the day when rates reverse course, as modest increases could have a significant negative impact, but our forecast is for a modestly higher 10-year Treasury yield by year-end, as the domestic economy is minimally impacted by the UK/EU fallout. In an environment where global headlines easily tip the scales, we believe slightly higher levels of cash make sense, not only to preserve capital, but also to serve as extra liquidity for any unexpected cash needs or buying opportunities.

Tax-free bonds continued an unprecedented run of solid performance, with yields on longer maturities approaching the lowest levels since 1965. 10-year AAA-rated municipal bond yields collapsed, ending at 1.35%. 30-year municipal yields dropped an astonishing 67 basis points during the quarter, ending at 2.02%. Returns again exceeded those seen in the investment grade taxable bond market even on a pre-tax basis. For the quarter, the Barclays Municipal Bond Index, a proxy for the overall market, advanced 2.6%, for a surge of 7.7% over the last 12 months.

Similar to last quarter, the volume of bonds being sold within the tax-free market, running 3.6% below last year's pace, is insufficient to keep up with unrelenting demand, as evidenced by 38 straight weeks of positive mutual fund inflows. As has been the case for some time, most of the issuance is for refunding purposes, which does not add to the stock of outstanding bonds, but instead replaces older, higher-yielding debt with new debt paying lower coupons. What started as a trade to maximize after-tax returns in the aftermath of an increase in tax rates has since ballooned into a flight-to-quality trade benefiting all dollar-denominated fixed income assets.

Clearly the market is not in balance. Given that US fixed income assets comprise almost half of all global fixed income securities with a positive yield, it seems likely that non-traditional buyers will work their way into a high-quality market such as the

domestic municipal bond market. This includes foreign buyers who do not benefit from the tax exemption, which is a new phenomenon. Clearly this is a different environment than we are used to seeing, and the Brexit vote only adds to the confusion, further fueling safe-haven demand. We view fixed income as the ballast within an overall asset allocation, and will maintain a defensive duration stance accordingly.

Commodities

Following a rally late in the first quarter, commodity markets showed considerable strength in the second, helped significantly by a 26% rise in the price of oil, the largest component of the Bloomberg Commodity Index. Oil settled at $48.33/barrel at the end of June, an 86% increase from the lows in mid-February, which was a welcome relief after a bearish two-year decline. It has been a volatile first half of the year, with the price of oil moving more than 5% in a day nearly a third of the time. Despite a drop of nearly 5% following Brexit, due to concerns about slower global growth, the positive factors of a weaker US dollar and a number of supply outages managed to win out during the quarter. A weaker US dollar makes dollar-priced commodities such as oil and gold more affordable in other currencies. Gold also rallied, adding 6.9% to strong returns last quarter, due to its role as a safe-haven investment. Declining interest rates around the world make this non-yielding asset attractive as well. As with oil, gold also benefited from a drop in the dollar.

Ultimately, we believe relatively weak global demand will keep a lid on commodity prices. However, over the next few months it is difficult to gauge what oil prices may do, as the competing forces of potential production declines in the US and abroad square off against oil inventories that remain above average. As always, there is the headline risk affecting so many of the oil producing regions of the world. Additionally, a resumption of dollar strength will be a tailwind for both oil and gold.

Conclusion

We have not altered our view that the US economy will continue to experience growth of slightly above 2% this year, on the low end but still positive. Additionally, because of demand for positive-yielding Treasuries in a world of negative rates, we now expect the benchmark to end the year with a yield near 2%, above its 1.49% level at quarter-end but below our view of even a few months ago. We continue to favor stocks over bonds since bonds have become even more expensive as the year has progressed. However, due to the uncertainties around Brexit, we will look to trim equity exposure where appropriate.