Quarterly Market Commentary: Brexit — Not the End of the World

Second Quarter 2016

- The most prominent event of the last three months — a vote by U.K. citizens in favor of leaving the European Union (EU) — led to a sharp spike in global financial-market volatility as the second quarter drew to a close.
- Fixed-income markets had a strong second quarter, with most market segments realizing considerable gains in June. Global equities rose modestly during the quarter, and were slightly negative in June.
- Globally, stability and momentum appear expensive within equities, and fixed-income managers favor credit at the expense of interest-rate duration.

Economic Backdrop

The second quarter's most prominent event — a surprise vote by U.K. citizens in favor of leaving the European Union (EU) — took place with roughly a week left in June. Market volatility had increased markedly ahead of the referendum, but not by enough to compensate for the unexpected outcome, as polls and bookmakers, while split, generally projected a victory for the Remain campaign. A sharp spike in global stock-market volatility ensued, yields were driven downward to record levels on perceived safe-haven investments like developed-market government bonds, and the currencies at the center of the developments — sterling and the euro — weakened substantially relative to the U.S. dollar and Japanese yen. Much of the stock-market losses were recovered within a week's time, however, suggesting the impending multi-year uncertainty may not be as detrimental to global health as initial reactions implied.

What about the preceding 12 weeks of the quarter? We stand by our characterization of April as "2016's least-eventful month." Major central-bank policies were essentially on hold, a theme that carried over in large part to May. The European Central Bank commenced two stimulus measures in early June that had been announced in March: corporate-bond purchases and targeted long-term repo operations (bank loans). Oil prices advanced for much of the quarter, then leveled off in June as the Organization of the Petroleum Exporting Countries failed again to agree on a production freeze, and the yen strengthened relatively steadily against most other major currencies.

U.S. manufacturing growth accelerated to healthier levels in June, with new orders a key source of strength. Consumer confidence advanced in June to its highest level since October 2015, as personal spending and incomes rose in May, by 0.4% and 0.2%, respectively. The latest Job Openings and Labor Turnover Survey showed that hiring did not keep pace with increasing job openings in May, while layoffs and quit rates also moved lower. Despite a positive revision, the U.S. economy grew at its weakest rate in a year during the first quarter. Labor productivity (the amount of goods and services employees produce per hour worked) dropped by 0.6% in the first quarter — yet year-over-year productivity advanced by 0.7% as output gained by more than hours worked, suggesting seasonality might have contributed to weakness.

U.K. construction activity contracted with some intensity during June, its first decline since early 2013. Services sector activity decelerated to its slowest level in more than three years, albeit still in growth territory. Manufacturing growth actually picked up to its strongest level in five months, continuing a trend that began during the first quarter and demonstrated marked improvement in April, representing a potential bright spot in contributing to overall second-quarter economic growth. Retail sales volume growth tapered in June, but not by as much as retailers had projected, after an exceptional retail sales report in April and follow-on strength in May. The unemployment rate was relatively steady, with claimant count joblessness increasing to 2.2% in April and remaining there in May, while the unemployment rate for the February-April period edged downward to 5.0%. A final reading of economic growth registered 0.4% for the first quarter and 2.0% year over year.

Eurozone services sector growth softened modestly in June, while an increase in manufacturing growth compensated, keeping the composite level mostly steady going back to February. Consumer confidence slid in June after a significant improvement in May, while industrial sentiment continued to improve. Retail sales gained 0.4% in May, extending a recovery from March's decline and matching their highest level of 2016. Consumer prices crept higher by 0.1% in the year through June, an increase from May's still-negative year-over-year figure. Producer prices jumped 0.6% in May, more than offsetting April's decline, but still deeply negative year over year. Eurozone unemployment remained high in May, declining by 0.1% to 10.1%; however, a 1% drop from a year earlier demonstrates slow and steady improvement in the labor market. First quarter economic growth for the EU was revised upward, to 0.6% and 1.7% year over year.

Market Impact
Fixed-income markets had a strong second quarter, with most market segments realizing a considerable portion of their gains in June as investors sought out less risky investments immediately following the Brexit vote. U.S. high-yield bonds were the top performers during the quarter, followed by foreign-currency-denominated (external) emerging-market debt. Global sovereign securities delivered impressive performance, with June's gains accounting for its entire second-quarter advance. Investment-grade U.S. corporate bonds also performed well during the quarter, followed by local-currency-denominated emerging-market debt, which was the best-performing segment in June. U.S. dollar-hedged (which seeks to reduce U.S. dollar-related volatility) global sovereign securities trailed their unhedged counterpart during the quarter, but still delivered strong returns, as did dollar-hedged global non-government debt. U.S. Treasurys performed well, owing their entire second-quarter advance to gains during June. Unhedged global non-government debt, U.S. Treasury Inflation-Protected Securities, and U.S. mortgage- and asset-backed securities performed in line with each other at the low end of quarterly returns, albeit with firmly positive performance.

Global equity markets, as reflected by the components of the MSCI AC World Index (Net), rose modestly during the second quarter, and were slightly negative in June. Global sectors were mostly positive, led with a sharp gain by energy, and followed at a distance by healthcare and utilities. Consumer staples, materials and telecommunications also had a good quarter, while industrials was modestly positive. Consumer discretionary had the deepest losses, while information technology and financials also declined. At the country level, Peru and Brazil led, continuing their red-hot performance from the first quarter. New Zealand and the Philippines followed with impressive performance, trailed by Indonesia, Russia and India. Unsurprisingly given the Brexit vote, Europe was heavily represented at the bottom; 16 of the 22 countries that registered a decline during the second quarter were European. Poland delivered the quarter's worst performance, followed by Greece, Italy and Austria. Ireland, Turkey and Spain also performed poorly

Index Data for Second Quarter
- The Dow Jones Industrial Average Index returned 2.07%.
- The S&P 500 Index rose 2.46%.
- The NASDAQ Composite Index declined 0.23%.
- The MSCI AC World Index (Net), used to gauge global equity performance, rose by 0.99%.
- The Barclays Global Aggregate Index, which represents global bond markets, advanced by 2.89%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the "fear index", increased in the quarter as a whole, moving from 13.95 to 15.63, peaking at 25.76 on June 24 (the day after the Brexit vote).
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, moved from $38.34 a barrel at the end of March and briefly topped $50 for the first time this year before ending at $48.33 on the last day in June.
- The U.S. dollar strengthened sharply against sterling during the quarter, and moderately versus the euro, but weakened considerably relative to yen. The U.S. dollar ended June at $1.34 versus sterling, $1.11 against the euro, and at 102.6 yen.

Portfolio Review
U.S. equity strategies were challenged during the quarter, as markets continued to recover from their mid-February lows on increasing commodity prices, followed by a strong risk-off move during late June in response to the Brexit vote. Large cap underperformance was due primarily to style positioning, as allocations to most value-oriented strategies struggled, especially around the Brexit vote. Sector allocation was a modest negative, with an overweight to technology serving as the largest detractor. Selection was weakest in healthcare and industrials, as well as within consumer discretionary. Within small caps, underperformance was attributable mainly to selection in energy, materials and consumer discretionary, while positioning in utilities and staples was positive. Allocation was a slight positive overall, driven by an overweight to energy and underweight to consumer discretionary, while an underweight to utilities detracted. Internationally, developed-market strategies performed in line with the benchmark during a negative quarter that was punctuated by June's decline. U.K. positioning was the most significant driver of performance, with poor selection in financials and materials detracting. The rest of Europe performed even worse, but stock selection — especially within France and the Netherlands — helped boost returns. Underweights to Germany and Spain also helped. Japan's positive absolute returns (in U.S. dollar terms given the strong yen) were enhanced enough by selection in financials and the consumer sectors to more than offset an underweight to the country, while an underweight to Australia detracted. Emerging-market strategies performed well in a lackluster quarter for the asset class. The best results came from Asia, followed by Europe, the Middle East and Africa (EMEA), while Latin America was neutral. Within Asia, selection in Korea and Taiwan, along with an underweight to Malaysia, contributed. In EMEA, an underweight to Poland contributed, while an overweight to Turkey detracted. Latin America had the best absolute returns, as Brazil and Peru continued to recover amid stabilizing commodities prices. An overweight to Brazil contributed, but was offset by underexposure to some of the best-performing companies. Selection was strong in Mexico, and an underweight to the country helped.

Core fixed income performed well during the quarter as non-government sectors generated positive excess returns even with the rally in U.S. Treasurys. Long-term yields declined by about twice the magnitude of short-term yields, pushing the U.S. Treasury yield curve to its flattest posture in recent years. A modestly shorter duration posture subtracted from returns, but was more than offset by a yield curve flattening bias, especially via an overweight to the long-end of the yield curve. Overweights to corporate bonds, asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) were generally positive as investors continued to search for higher-yielding alternatives to U.S. Treasurys. Non-agency mortgage bonds began outperforming again after a challenging first quarter, benefitting an overweight. Agency mortgages performed in line with Treasury bonds, so an underweight to the sector was a modest detractor. The high-yield market was up for the fifth consecutive month in June, so a more defensive posture hindered relative performance. From a sector perspective, an allocation to structured credit, selection within media and utilities, and an underweight to financial services enhanced returns during the quarter. An underweight and selection within energy and basic industry, and an overweight and selection with retail detracted. Emerging markets debt performed well, with an overweight and selection in Colombia serving as a key contributor. An underweight to Poland also contributed, as did an overweight to Venezuela's state-owned oil company. An underweight to Brazil's currency, an overweight to Mexican local-currency debt, and security selection in South Africa detracted.

Manager Positioning and Opportunities

We are still positive on the outlook for U.S. equities, but expect the volatility to continue given that we are in the mature stages of a bull market compounded by the Brexit vote's shadow of uncertainty, which will take time to resolve. The U.S. consumer still looks healthy enough and earnings are expected to grow in the coming quarters. The headwinds will be the stronger U.S. dollar, political uncertainty, and the sustainability of high corporate profits. We remain committed to the belief that risk premium represents an attractive opportunity, and have been targeting exposure through deeper value managers, but the time horizon has lengthened given Brexit-induced volatility. As a result, we have tempered that overweight, and within large caps we reduced an underweight to defensive stability. Similarly, we have moved to a neutral stance on stability within small caps in an effort to dampen potential future volatility; however, we remain underweight defensive assets, which appear expensive. We also favor sustainable growth managers within small caps at the expense of momentum growth. Within international developed markets, we have retained pro-cyclical positioning and recognize that sensitivity to valuation is prudent. We are concentrating primarily on granular stock-specific drivers and continue to overweight the smaller market-capitalization spectrum. We have retained an underweight to consumer staples given elevated valuations. Weakness in energy presented an opportunity to add modestly to positions; however, we still have a slight underweight to materials. Information technology remains the greatest overweight, while financials remains the most significant underweight. Within emerging markets, the weight of the Chinese information technology sector has increased through the addition of listed American Depository Receipts. We retained an overweight to Taiwanese technology stocks based on attractive valuations, as well as a slightly reduced overweight to consumer discretionary. Consumer staples and healthcare remain slight overweights. Industrials moved to a slight underweight on reduced exposure in China and Indonesia. The largest underweight remains financials, primarily driven by an underweight to Chinese banking stocks. Underweights to defensive sectors — telecommunications and utilities — also remain.

Core fixed income retained a yield curve flattening bias, but at a reduced magnitude given recent flattening, and a slightly short-to neutral duration posture. Bank spreads were essentially unchanged during the quarter but remain wider than they were at the end of 2015. Bank capital positions are much stronger than they were pre-crisis, and the Fund is likely to add selective exposure. A slight overweight to corporate credit is most heavily concentrated in banking and, to a lesser degree, industrials. Overweights to ABS and CMBS remain given their competitive yields, especially when considered on a risk-adjusted basis. An allocation to non-agency mortgages will also remain given strong housing market fundamentals. Due to extreme volatility and uncertainty regarding the price of oil, high yield maintains underweights to the energy sector and metals/mining (excluding steel) subsector. Overweights remain to media and leisure, primarily gaming, as well as technology and electronics. Managers maintain a slightly more defensive posture via bank loan and cash allocations. Within emerging markets debt, external debt remains underweight, with the largest positions in Argentina, Mexico, Indonesia, Turkey, Hungary, Colombia, Ukraine and Brazil. The largest external underweights are to the Philippines, Lebanon, Russia, Poland, China and Malaysia. In conjunction with the underweight to external debt, there is an overweight to emerging market corporates. Local currency debt is neutral weight, with the largest overweights to Indonesia, Colombia and Thailand, and the largest underweights to Hungary, Singapore, China and South Africa. The greatest currency overweights are in Indonesia, Colombia, Thailand, Turkey and Russia, while the most significant currency underweights are in Hungary, Singapore, China and South Africa.

Our View

Angst is the one thing everyone seems to share in common across the world. The U.K.'s vote to leave the EU is a major political and economic event that will likely weigh on international financial markets, not just for weeks and months, but perhaps for years. The leap into the unknown will likely depress economic growth as business spending gets frozen until some clarity re-emerges on the country's trading relationships. Sterling's plunge immediately following the Leave vote, however, should provide a much-needed offset to the mostly negative impact of all the uncertainty, as U.K. exporters find themselves in a more competitive position.

Britain's growth prospects were decent prior to Brexit; by contrast, continental Europe was already struggling to improve. Of the many economic imbalances that exist in the world, among the greatest is the huge trade surplus run by the eurozone. In the aftermath of the Leave vote, nationalist parties in various countries are lobbying for their own referendums on continued membership in the EU, which adds to the uncertainty facing investors. The ability of the equity market to bounce back from the immediate shock is heartening, but it is hard to draw firm conclusions on how disruptive Brexit will be on future EU and eurozone economic activity. The fragility of the recovery going into this crisis is a matter of deep concern. The fact that bond yields did not bounce higher even as stock prices rallied post-Brexit is a divergence worth noting.

The U.S. remains, in our opinion, the cleanest shirt in the laundry bag, staying resilient despite numerous shocks over the past seven years. We would bet this resilience will once again be on display following the U.K. vote. The May employment figure was the weakest since 2010, but it's worth noting that other labor market data are not quite as downbeat. Job openings remain in a solid uptrend, rising well beyond the previous cycle's peak reached in mid-2007. The first hints of wage pressure are coming through, with a moderate acceleration in wages and total labor compensation apparent on a year-over-year basis. As corporate margins get squeezed by the pick-up in labor costs, the pressure to raise prices will likely intensify.

This puts the Federal Reserve in something of a quandary, since the Brexit shock has seemingly upended any possibility of a near-term rise in the funds rate. Market-implied expectations for the next policy-rate move have been pushed out to late-2017; in fact, futures traders have priced in the mild possibility of a rate cut in the near term. Yet, we admit to a growing uneasiness that the central bank may be a falling behind the inflation curve.

We understand that the still-soggy global economy and the shock delivered by the U.K. vote argue for a very cautious process of interest-rate normalization. But if the upward trend in labor costs is sustained, a more aggressive response by the U.S. central bank eventually will be justified.

In the months immediately ahead, investors' attention mostly will be focused on the U.S. presidential election. Secretary Clinton starts out with a huge fundraising advantage, a formidable lead embedded in the Electoral College, and small poll leads in all the important swing-vote states. We want to make one simple point: markets hate the unknown. For good or ill, Secretary Clinton is the familiar, status quo candidate. Donald Trump, on the other hand, promises to shake things up. In a year where voter dissatisfaction is exceptionally strong in the U.S., we would not hazard a guess as to the outcome this early in the process. Investors need to be prepared for a bit of volatility in the months ahead, since the uncertainty level has been ratcheted upward, and will likely remain elevated between now and the elections. For now, we lean toward the optimistic side, mainly because U.S. economic and financial fundamentals appear relatively healthy.

One of the more surprising market responses to the U.K. Brexit vote is the sharp appreciation of the Japanese yen. This is the last thing that the country needs, since an ultra-strong currency exacerbates downward pressure on inflation. Corporate earnings have begun to roll over in response to the currency's appreciation. As Japanese yields sink further into negative territory across the curve, we wonder what kind of rabbit the Bank of Japan can pull out of its hat, since the most recent interest rate moves have failed to weaken the currency or boost the economy.

Investor fears earlier this year of an imminent Chinese debt and currency meltdown have receded. China's economy mostly appears to be treading water, much like the rest of the world. The government continues to use the old and familiar economic playbook: encourage growth fuelled by additional debt, prop up state-owned enterprises and allow its currency to fall. Economic and financial reforms are proceeding, but at an erratic pace. Chinese equities have not shown much spark, however, despite the risk-on environment for emerging-market assets that began in late January.

Globally, the points of general consistency in our investment outlook and positioning are that stability and momentum appear expensive within equities, and that fixed-income managers generally favor credit at the expense of interest-rate duration.

Benchmark Descriptions

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of *The Wall Street Journal*.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

The NASDAQ Composite Index is a market value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system.

The MSCI All Country World Index is a market capitalization-weighted index composed of over 2,000 companies, representing the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

The Barclays Global Aggregate Bond Index is a market capitalization-weighted benchmark, tracks the performance of investment-grade fixed- income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility.

The BofA Merrill Lynch US High Yield Constrained Index measures the performance of a representative basket of high-yield bonds.

Disclosures

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