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MONTHLY MARKET UPDATE

July 2016

Economic indicators generally strengthened in the U.S. through July. Most significantly, the labor market continued a rebound which started with the June jobs report. As the economic picture improved, capital markets strengthened and finally traded through all-time highs previously set in May 2015. Global equity markets similarly recovered, retracing losses which followed the Brexit vote.

Key Economic Statistics*	Period	Level	Vs. Prior
Manufacturing Economy Strength	July	52.6	Weaker
Service Economy Strength	July	55.5	Weaker
Monthly Jobs Report	July	255k	Weaker
National Unemployment Rate	July	4.9%	Same
Annualized Quarterly GDP Growth	Q2 – 1st	1.2%	Stronger
Personal Consumption (Spending)	Q2 – 1st	4.2%	Stronger
Inflation–CPI ex.Food/Energy	June	2.2%	Same

** See disclosure for underlying economic indicator definition. FactSet*

Global Markets Find Relief in U.S. Labor Market

Key Index Performance*	1 Mo	3 Mo	YTD	1 Yr	3 Yr	5 Yr	10 Yr
Equities							
Large Domestic Companies S&P 500 Total Return Index	3.69	5.82	7.66	5.61	11.16	13.38	7.75
Small Domestic Companies Russell 2000 Total Return Index	5.97	8.29	8.32	0.00	6.74	10.43	7.17
International Developed Companies MSCI EAFE Index	5.07	0.62	0.42	-7.53	2.00	3.02	1.98
Emerging Market Companies MSCI EM Index	5.03	5.16	11.77	-0.75	-0.29	-2.75	3.91
Taxable Fixed Income							
Short Term Bonds Barclays U.S. 1-3 Year Aggregate Index	0.02	0.55	1.68	1.55	1.19	1.08	2.81
Intermediate Term Bonds Barclays U.S. Aggregate Bond Index	0.63	2.47	5.98	5.94	4.23	3.57	5.06
High Yield Bonds Barclays U.S. Corporate High Yield Index	2.70	4.29	12.01	4.98	4.46	6.16	7.74
International Government Bonds Citigroup World Government Bond Index	0.53	2.67	11.33	11.32	2.37	0.83	4.19
Tax Exempt Fixed Income							
Short Term Municipals Barclays Municipal 1-3 Year Index	0.22	0.52	1.16	1.46	1.09	1.08	2.39
Intermediate Term Municipals Barclays Municipal 5-10 Year Intermediate Index	0.22	1.36	3.65	6.04	4.75	4.30	5.07
High Yield Municipals Barclays High Yield Municipal Index	0.65	5.15	8.69	13.44	7.55	7.59	5.06
Real Assets							
Commodities Bloomberg Commodity Index	-5.11	-1.38	7.46	-7.98	-12.50	-12.27	-6.38
Global Real Estate Dow Jones Global Select REIT Index	4.57	9.83	15.32	17.64	13.40	11.42	6.01

** All data as of 7/31/2016. See disclosures for underlying index definitions. Periods longer than one year represent annualized performance.*

Economic Update

Following the surprise Brexit vote towards the end of June, economic focus returned to the U.S. and the June jobs report at the beginning of July. The report was particularly important because May had disappointed with one of the weakest months of job growth following the Great Recession. By contrast, June surprised to the upside with 287,000 jobs, and markets globally rallied on the strong report. Employment growth continued in July as the economy added 255,000 jobs, surprising to the upside for the second month in a row. The unemployment rate was unchanged as more discouraged workers started actively searching for a job and the labor participation ticked up slightly.

In addition to a rebound in labor markets, both the ISM Manufacturing and Service indices stayed in expansionary territory. The more important Service index stayed at a level above 55, indicative of more robust growth.

The housing market continued to recover as both new and existing residential sales hit a post-recession high. Residential prices climbed in tandem with the increased volume, supported by a continuing low interest rate environment. The strength in housing, along with rebound in equity markets globally, helped to keep consumer confidence up.

Not all economic news was good news. At the end of July, the first estimate for Q2 GDP disappointed. Consensus expectations called for a rebound from anemic Q1 growth to a 2.6%. The first estimate came in at less than half of that number at 1.2%. Within the report was both positive and negative news. The positive news focuses on the state of the U.S. consumer, and he second quarter represented one of the strongest quarters of consumer spending growth since the end of the recession. Unfortunately, the second quarter also provided the worst quarter of business spending since the end of the recession. These two measures stand in contradiction to traditional economic theory. Historically, when consumer spending is growing, businesses respond to that growth by investing in capacity intended to meet the increased levels of demand. While consumption growth has been relatively strong since 2013, business spending has declined.

Pundits have provided a variety of theories as to why business spending is weak including uncertainty created by a more heavily regulated economy, uncertainty associated with the presidential election, uncertainty created by Brexit, and even the thought that the traditional measures of business investment are missing the changing character of the economy. For example, traditional measures of business investment may miss growth in the gig or sharing economy – think Uber or AirBnB where traditionally personal capital is now being utilized in business and not counted as business investment.

On balance, despite some uncertainty, the U.S. economic recovery continues, albeit at an ever slower pace than previously estimated. On the other side of the Atlantic, U.K. growth expectations for 2017 were slashed from 2.1% growth to 0.5% following the Brexit vote. Eurozone growth was also cut, though not nearly as drastically, with growth expectations for 2017 falling from 1.7% to 1.4%. Expectations likely are subject to large revisions as economists evaluate the near and long-term impact of Brexit.

In Asia, the Chinese economy has not provided any recent downside surprises, lending some stability to the global outlook. By contrast, Japan continues to struggle with Abenomics, which so far appears to be ineffective in generating stronger economic growth.

Capital Markets Update

In the wake of a rebound in the labor U.S. labor market, global equities rebounded through July. The S&P 500 gained 3.69% for the month. As the growth outlook returned to the investor view, more cyclical sectors and small caps outperformed the S&P 500. International stocks outperformed the S&P as well, but much of that outperformance can be considered a recovery from markets overshooting to the downside in June.

The S&P 500 finally broke through the prior high level set in May 2015. As it inches higher, the valuation is inching towards 20x earnings on a trailing basis. Investors appear willing to pay this higher than average multiple because they are buying into the premise that earnings growth, which has been negative for five quarters in a row and is expected to be negative again in Q3, will rebound in Q4 and jump to double digits in 2017. Notwithstanding the earnings recovery projected for the energy sector (which is heavily dependent on the price of oil recovering and stabilizing), there is a significant cyclical bet in the earnings outlook with the top growing sectors (excluding energy) expected to be materials, consumer discretionary, financials, and technology. The two weakest growth sectors are expected to be utilities and telecommunications, which is notable for the fact that those two sectors have been the top performing sectors on a year to date basis.

Globally, international markets continue to trade at a discount to U.S. equities. The MSCI EAFE developed market index is trading at a discount of approximately 20% on a trailing basis, and the MSCI EM emerging market index is trading at a discount of nearly 35%. Of course, these discounts may be warranted given greater geopolitical uncertainty and a weaker growth outlook. In terms of the potential for an upside surprise, U.S. markets appear to be priced more optimistically, providing little room for upside surprise and potentially more sensitivity to any negative news. By contrast, international valuations are more pessimistic, providing more room for upside surprises.

The U.S. 10 year treasury rate traded around a level of 1.45% for most of July. While this level of interest rate is inconsistent with an economy in the 7th year of expansion with labor markets which have arguably approached full employment, it does make sense in terms of the global capital markets environment. Even at a historically low level of 1.5%, a 10-year treasury bond may actually look fairly attractive to an international investor who is deciding between the U.S. rate and foreign rates which are near or below zero. This rate arbitrage may serve to keep U.S. interest rates low even if the Fed decides to move short term rates for the second time since December 2015.

Given the uncertainty associated with the Brexit, the U.S. election cycle and the bet on an earnings rebound, markets have been surprisingly stable recently. The VIX index is a measure of expected market risk implied by option prices. Informally, it is known as the Fear Index, and it has recently traded to levels associated with a more stable outlook. This may be because investors continue to view the Fed as a backstop for the economy and markets. The risk is in becoming too complacent in the view that the Fed will take a long time to normalize rates and being surprised if the Fed moves at a faster pace (which is arguably consistent with the economic data).

For the time being, the base case remains for muted global growth without any major economy falling into recession. In such an environment economic and geopolitical surprises can send shocks through the system. So far, recent shocks have been temporary, but we continue believe investors should be prepared for unpredictable market events by utilizing diversified portfolios of stocks and bonds along with a financial plan to guide financial decisions. If recent market events have you concerned, we suggest speaking with your HD Vest Advisor.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses. Your individual allocation may be different than the HDVAS sample strategic model due to your unique individual circumstances.

Disclosures:

Unless footnoted and disclosed otherwise, all economic data throughout report sourced from FactSet.

Large domestic companies measured by the S&P 500, which is an index of 500 major U.S. large cap corporation.

Small domestic companies measured by the Russell 2000 Index which measures the performance of small-cap segment of the U.S. equity universe. Small domestic companies also measured by the S&P Small Cap 600 index.

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International developed companies measured by the MSCI EAFE Index, which is an unmanaged market capitalization-weighted index of equity securities of companies domiciled in various countries. The Index is designed to represent the performance of developed stock markets outside the United States and Canada and excludes certain market segments unavailable to U.S. based investors.

The Euro Stoxx index measures the performance of a subset of 12 Eurozone countries within the Stoxx Europe 600 index.

Emerging market companies measured by the MSCI Emerging Markets Index, which is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Short-term taxable bonds measured by the Barclays U.S. 1-3 Year Aggregate, which is a subset of the Barclays U.S. Aggregate index, representing securities with 1 to 3 years remaining until maturity.

Intermediate-term bonds measured by the Barclays U.S. Aggregate Bond index, which measures the performance of investment-grade bonds in the U.S. fixed-income universe. It includes U.S Treasury issues, agency issues, corporate bond issues and mortgage-backed issues. It is unmanaged, includes reinvestment of dividends, does not reflect the impact of transaction, manager or performance fees and is unavailable for investment.

High-yield bonds measured by the Barclays US Corporate High Yield Index, which tracks the performance of domestic non-investment grade corporate bonds.

International government bonds measured by the Citi World Government Bond Index (WGBI), which measures the performance of 23 government bonds markets including Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Malaysia, Mexico, the Netherlands, Norway, Poland, Portugal, Singapore, Spain, Switzerland, Sweden, the United Kingdom and the U.S.

Short-term municipals measured by the Barclays Municipal 1-3 Yr index, which measures the performance of investment-grade municipal securities with 1 to 3 years remaining until maturity.

Intermediate term municipals measured by the Barclays Municipal Intermediate 5-10 Year index, which measures the performance of investment grade municipal securities with 5 to 10 years remaining until maturity.

High-yield municipals measured by the Barclays High Yield Municipal index, which measures the performance of below investment-grade municipal securities with at least 1 year remaining until maturity.

Commodities measured by the Bloomberg Commodity index, which is comprised of future contracts on physical commodities which trade here in the U.S. and certain foreign markets. It measures the performance of investment in a broad basket of commodity futures contracts.

Real estate measured by the Dow Jones Global Select REIT index, which represents equity real estate investment trusts (REITs) and REIT like securities traded globally.

Manufacturing economy strength measured by the Institute for Supply Management Manufacturing Index. A measure above 50 indicates expansion while a measure below 50 indicates contraction.

Service economy strength measured by the Institute for Supply Management Non-Manufacturing Index. A measure above 50 indicates expansion while a measure below 50 indicates contraction.

Monthly jobs report measured by the Bureau of Labor Statistics' US Employees on Non-Farm Payrolls Month over Month net change.

National unemployment rate measured by Bureau of Labor Statistics.

Annualized Quarterly GDP Growth measured by Bureau of Economic Analysis and is released as preliminary (1st estimate), revised (2nd estimate) and final over the course of a quarter.

Personal Consumption growth measured by the Bureau of Economic Analysis and represents final market value of all goods and services produced in the U.S.

Annual Inflation Rate measured by the Bureau of Labor Statistics Consumer Price Index (CPI). Value reflects year over year change in the CPI ex-Food and Energy index.

An investment cannot be made directly into an index.

Investments are subject to market risks including the potential loss of principal invested.

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