Central Bank Olympics

Economic data in early 2016 stoked recessionary fears, and it seemingly eliminated the possibility of the U.S. Federal Reserve (Fed) raising rates this year. Then, early in the second quarter, some signs of stabilizing economic activity in the U.S. helped to propel U.S. stocks near record highs. This surge brought Fed policy back to the forefront of investor attention. More recently, the domestic economic rebound seems to have lost some steam heading into the end of the second quarter, and ongoing global concerns have once again put Fed officials in a very cautious frame of mind. Ultimately, the June 15 Fed policy announcement indicated a growing number of FOMC members anticipate only one additional hike this year, and the increasing caution apparent in the Fed's outlook led the futures market to price in a less than 50% chance of any hikes in 2016 at all.

Among the concerns that factored into the latest monetary policy decision, Fed Chair Janet Yellen cited the possibility that British citizens may vote to leave the European Union (E.U.)—a move referred to as the "Brexit." On June 23, the United Kingdom held a referendum, on which its citizens voted in favor of their country's leaving the E.U. This outcome largely rejected the status quo in world economic relations, and may elevate market uncertainty over time. The actual short-term effects of a vote to leave may be muted, but the risk that longer term trade and labor related complications might destabilize the region and rattle markets concerned investors. Equity markets had rallied on an expectation of a "Remain" outcome in the week up to the vote, and then reversed course on June 24 as the final count produced an unexpected narrow-margin vote to "Leave" the E.U. With 51.9% voting to Leave, the referendum has divided the country. Other than bonds, gold, Japanese yen and Swiss francs, most other assets, especially risk assets such as equities, sold off in global markets after the surprise announcement. While there are many potential short- and long-term effects on the global economy and world financial markets that need to be further vetted, the immediate good news of Brexit is that the Fed is likely on hold for longer than previously anticipated.

With U.S. equity at least moderately overvalued on many metrics, a rebound in broad economic activity that leads to resurgent earnings growth would be needed to sustain a bull run over the remainder of the year. This sort of rebound has thus far been elusive. However, while the weight of the evidence suggests global growth will remain disappointingly weak heading into the third quarter, economic data suggests the U.S. is *not* headed for a recession in the near team.

Within fixed income, we continue to believe that while short term rates may move modestly higher, long term rates are likely to be range-bound. The yield curve in 2016 flattened as long term bond yields have declined substantially. While these levels may be depressed by the risk-off trade surrounding Britain's vote and may move higher, we do not expect a major uptick from the current levels as demand for Treasury bonds from institutions and international investors is likely to continue and thus keep rates low.

One bright point in the recent labor market data is a record number of job openings. According to the Bureau of Labor Statistics and Yardeni Research, the job openings rate currently sits at a new post-recession high. The recent challenge has been a slowdown in hiring, suggesting the apparent weakness in the May payrolls data was largely attributable to a mismatch between unfilled jobs and skilled workers available to fill them. If the slowdown in hiring is more about a lack of qualified and willing workers rather than a lack of available positions, we should finally see wage inflation start to accelerate meaningfully. Although this acceleration would likely be viewed as a positive economic development in the near-term, it may also make it difficult to return to the peak corporate profit margins that consensus earnings expectations reflect. It could lead to some volatility in interest rate sensitive assets. Viewed in aggregate, the latest data supports the view that while the labor market may be past its peak, there is no near-term recession visible on the horizon.

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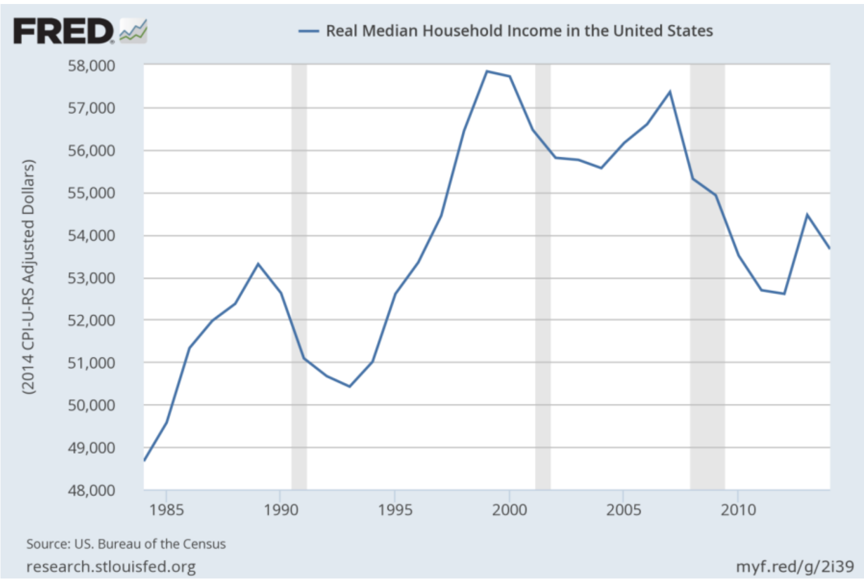
Global Economy

The discussion around whether Britain would remain in the E.U. was fueled by a combination of factors. While some are unique to Britain, one that has far-reaching implications is a broadly felt anti-globalization sentiment that has taken hold in many parts of the developed world. A possible root cause of this trend is the growing income inequality in many developed countries, which has led to a backlash against policies and politicians who are seen to have contributed to the prolonged struggles of the middle class. This trend has undeniably played some role in the U.S. presidential election primaries as well. Exhibit 1 shows stagnating median real incomes and likely explains a significant portion of voters' frustration with the political establishment.

Exhibit 1. Real Median Household Income in the United States

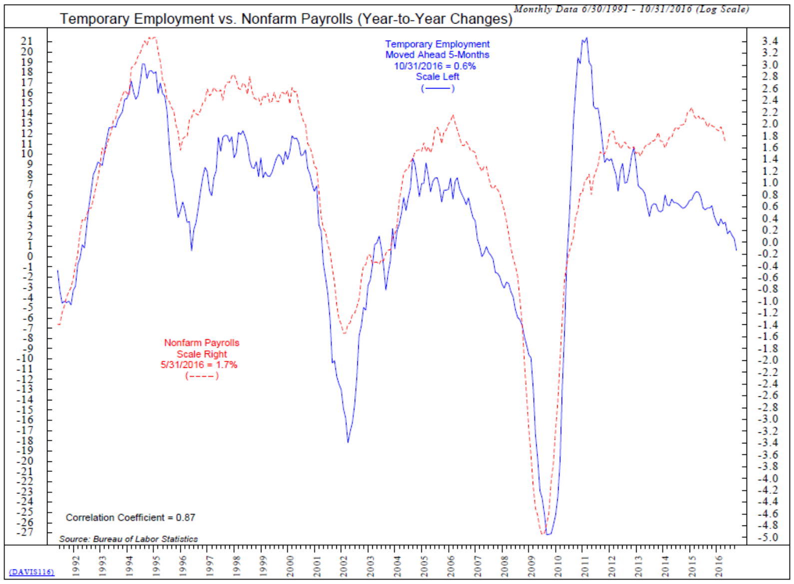


Source: Federal Reserve Bank of St. Louis

In addition, the U.S. labor market has sent mixed signals. Although domestic economic data has been weak in the early part of 2016, one bright spot has been a consistently robust labor market. The strength of the labor market suggests the risk of sliding into a recession is relatively low. However, a surprisingly weak jobs report for May lowered the exuberance in asset markets and touched off an inspired debate between those who believe the report has troubling implications for future growth and those who believe the data is somewhat anomalous.

To recap, the payrolls report indicated the U.S. economy added just 38,000 jobs in May, and, even after adding back the impact of striking Verizon workers, the headline job gains were less than half of consensus expectations. Moreover, the job gains previously reported for March and April were revised significantly lower. The unemployment rate did decline sharply from 5.0% to 4.7%, but the decline was a result of a steep drop in labor force participation, as a large number of individuals stopped looking for work. While many commentators have rightly noted that monthly jobs data is noisy with a significant margin for error, some troubling labor market trends have emerged and should not be ignored, in our view. For example, according to Ned Davis Reseach, temp-agency employment is down 64,000 over the past five months—the worst decline since August 2009. As shown in Exhibit 2, temporary employment has tended to lead nonfarm payrolls by five months with very high correlation.

Exhibit 2. Temporary Employment vs. Nonfarm Payrolls



Source: Ned Davis Research

Similarly, goods-producing employment has now contracted for four consecutive months by a magnitude which has presaged several prior recessions. These weakening trends in historically leading indicators suggest the widely expected strong rebound in economic growth may prove elusive. Pockets of strength remain in U.S. data that mitigates some of our concerns, but the recent employment numbers are consistent with other data and suggest that the outlook for economic activity and earnings remains highly uncertain.

Lastly, the burgeoning health of the housing market is one noteworthy positive economic data point. CoreLogic reports that 268,000 homeowners regained positive equity in Q1 2016 and the percentage of mortgages with negative equity declined 21.5 percent year-over-year (YoY). Recovering home values have a positive wealth effect that should remain a tailwind for consumer spending in the coming months. Although affordability continues to be a headwind to housing activity, near record-low mortgage rates are currently offsetting a portion of the higher prices for new buyers. The supply of homes for sale and new homes under construction also remain constrained, suggesting housing construction activity is likely to remain a tailwind over the next 12 months and potentially much longer.

Europeans joined the global trend of central banks that implemented negative interest rates in 2014 and cut rates deeper into negative territory in March. Sweden's Riksbank was first to utilize negative rates in 2009, followed by the European Central Bank (ECB), Danish National Bank, Swiss National Bank, and most recently the Bank of Japan. Bloomberg reports that a quarter of the world economy is now operating under a negative interest rate regime. The highly aggressive and unorthodox monetary actions—that are intended to jolt inflation and economic growth higher by punishing banks that hoard cash rather than extend loans—may create unintended financial market distortions. A byproduct of the policy is that, according to data compiled by Bloomberg, approximately $8 trillion of government bonds worldwide offer yields below zero. In other words, investors are speculating that interest rates will fall even further into negative territory before the bonds mature.

Europe's deeper foray into the negative interest experiment has renewed stress in European financial stocks, creating a concern that the policy's negative impact on bank earnings could ultimately lead to tighter financial conditions - the opposite of the intended effect. Even more concerning is that two years into the massive monetary experiment of negative interest rates, it remains unclear whether the policy effectively spurs growth. Despite minimal evidence of efficacy thus far, central bankers have cited manageable costs to justify applying this radical monetary medicine indefinitely. They have also expressed a willingness to keep increasing the dosage should the current prescription prove ineffective.

The global economic outlook outside of Europe is also far from certain. Japan's efforts to jumpstart an economy trapped in a 25-year long malaise seem to have stalled, and policymakers appear to have abandoned many hoped-for structural reforms in favor of more aggressive monetary policy. Elsewhere in Asia, concerns over China's increasing reliance on debt to meet reduced growth targets played a major role in January's market volatility. After growth showed some stabilization in March and April, concerns have risen that this rebound was driven to a large extent by an unsustainable level of credit creation, and growth is now set to slow again as policymakers aim to reign in speculative lending.

On the bright side, we see some potential green shoots in emerging markets. All four BRIC economies (Brazil, Russia, India, and China,) posted gains in their composite leading indicators for the past two months—the first time this has happened since 2009. In addition, Mexico, India, South Korea, and parts of emerging Europe seem to be trending toward above-average growth in the intermediate-term.

Equity Markets

The three Rs have long been a commonly used as an abbreviation for the basic elements of primary school curriculum - reading, 'riting (writing), and 'rithmetic (arithmetic). Yet, a new set of three Rs may describe equity market performance in the first three quarters of 2016 – recession, range-bound, and rotation. The year began with widespread fears that the domestic and global economies were sliding into recession, resulting in a very volatile first quarter. By the end of March, the volatility had subsided, and in June the S&P 500 was within 1% of its all-time high. In Q3, a number of lingering headwinds could limit the market's upside, but we believe one compelling theme that may emerge is a rotation out of perceived "safe" sectors into two of the worst performing groups over the first half of the year: financial and healthcare stocks.

One notable change from the first quarter has been a recent reemergence of U.S. equity leadership, with both large-cap and small-cap domestic equities easily outpacing their international counterparts. Recent evidence indicates that China's growth has again started to slow and concerns about the potential ramifications of Britain exiting the E.U. have weighed on global markets. Renewed stress in the European financial sector has also dragged on European equity markets, as the impact of negative interest rates on bank profitability in the region has become a key concern.

Exhibit 3. Equity Market Performance as of 6/15/2016

	Q2 2016	YTD 2016
Developed Foreign Equities - MSCI EAFE Index	-3.3%	-6.1%
Emerging Market Equities - MSCI Emerging Mkt Index	-3.5%	2.0%
Global Equities - MSCI World Index	-0.6%	-0.2%
US Equities - Russell 2000 (Small Cap)	3.3%	1.7%
US Equities - S&P 500 Index	1.2%	2.6%

Source: Morningstar; as of 6/15/2016

Many valuation metrics continue to show U.S. stocks trading at the very high end of historical valuations. As shown in Exhibit 4, unattractive valuations make stocks more vulnerable to a significant correction and likely limit the market's upside barring a remarkable recovery in corporate earnings. Interestingly, while U.S. equity markets appear moderately overvalued by many metrics, we observe some notable divergences at the sector level.

Exhibit 4: S&P 500 valuations have usually been elevated ahead of large drawdowns
S&P 500 real total return drawdowns of more than 20% since the 1950s

		Length	S&P 500 drawdown			P/E Ratio*			Shiller P/E		
Start	Trough	(days)	Nominal	CPI	Real	Start	Trough	Chg (%)	Start	Trough	Chg (%)
Aug-56	Oct-57	446	-18	4	-21	13.8x	12.0x	-13	18.7x	14.1x	-24
Dec-61	Jun-62	196	-27	1	-27	22.5x	16.0x	-29	22.0x	16.8x	-24
Feb-66	Oct-66	240	-20	3	-22	17.5x	14.0x	-20	23.7x	18.8x	-21
Nov-68	May-70	543	-33	9	-38	18.4x	13.7x	-26	22.2x	14.0x	-37
Jan-73	Oct-74	630	-45	20	-54	18.1x	7.7x	-58	18.7x	8.7x	-53
Sep-76	Mar-78	531	-13	10	-21	11.0x	8.1x	-26	11.8x	9.0x	-24
Nov-80	Aug-82	622	-20	14	-30	9.2x	8.0x	-13	9.7x	6.6x	-31
Aug-87	Dec-87	101	-33	1	-33	14.9x	10.5x	-29	18.3x	13.4x	-27
Jul-90	Oct-90	87	-19	2	-21	12.5x	10.8x	-13	17.7x	14.8x	-17
Jul-98	Aug-98	45	-19	0	-19	22.2x	20.6x	-7	38.3x	35.4x	-7
Mar-00	Oct-02	929	-47	6	-50	22.6x	15.4x	-32	43.2x	22.0x	-49
Oct-07	Mar-09	517	-55	2	-56	14.8x	10.8x	-27	27.3x	13.3x	-51
Apr-11	Oct-11	157	-19	1	-19	13.2x	10.8x	-18	23.1x	20.2x	-13
	Average:	**388**	**-28**	**6**	**-32**	**16.2x**	**12.2x**	**-24**	**22.7x**	**15.9x**	**-29**
	Median:	**446**	**-20**	**3**	**-27**	**14.9x**	**10.8x**	**-26**	**22.0x**	**14.1x**	**-24**
	Current:					**16.9x**			**26.1x**		
	Avg. since 1950:					**14.1x**			**19.0x**		

** 12-month forward P/E ratios after 1985, trailing P/E ratios before 1985.*

Source: Goldman Sachs Global Investment Research

The median price/earnings (P/E) ratio of the stocks in the S&P 500 ended May at over 23x, well in excess of the historic average of 16.9x and the highest reading outside of recession since the late 1990s. Similarly, the forward P/E of the S&P 500 is at the top-end of its 5-year range, incorporating what may prove to be overly optimistic earnings estimates.

One mitigating factor that continues to temper our valuation concerns is the remarkably low yield of safe fixed income assets, with an abnormally high number of stocks offering dividend yields well in excess of 10-year Treasury yields. This condition may continue to limit the downside risk of equities and suggests the equity valuation concerns highlighted above may ultimately be corrected through a prolonged period of somewhat subpar stock returns rather than a bruising bear market downturn. Another mitigating factor is that global equity valuations are less stretched than domestic valuations.

To be clear, while we highlight some growing risks that warrant watching, we continue to believe the weight of the evidence indicates that the economic recovery that began in 2009 will continue at least into 2017. We also believe that equity markets will ultimately work their way moderately higher by year end. Reasons to maintain a cautiously optimistic outlook include:

- An abating currency headwind.
- Energy and materials sectors are likely to rebound.
- Potential for upside surprise.
- The recession risk is not elevated.
- Failing equity correlations.
- Global monetary policy remains highly supportive for asset prices.

The following sections discuss each of these reasons in further detail.

An Abating Currency Headwind

The U.S. dollar had a significant run higher from mid-2014 into 2015. Recent weakness in the dollar means that multinational companies should experience less of a headwind from translating earnings in foreign currencies back to the U.S. dollar.

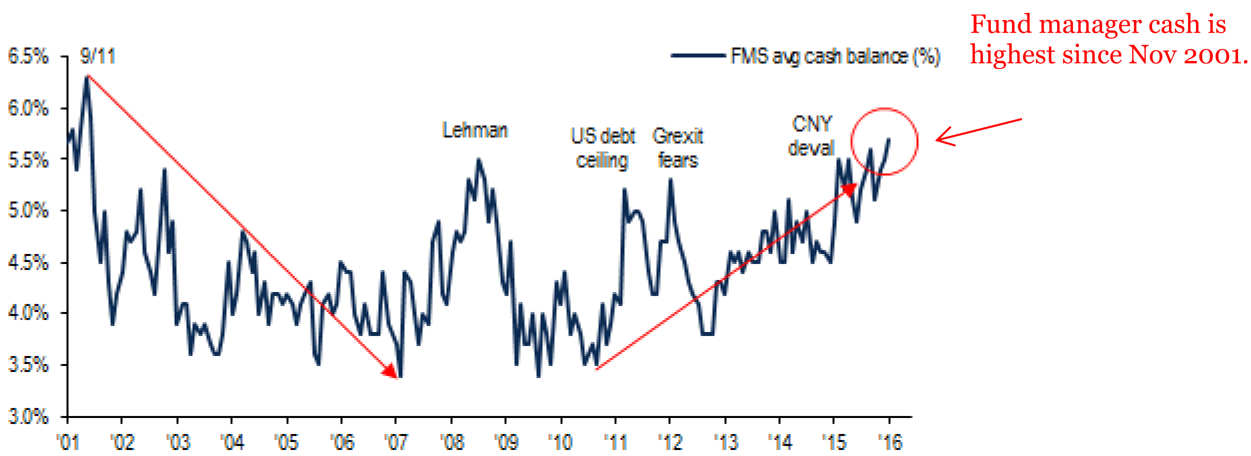
Energy and Materials Sectors Likely to Rebound

Energy and materials companies, as well as industrial firms that sell into these markets, are likely to see earnings rebound from extremely depressed levels.

Potential for Upside Surprise

The “wall of worry” remains intact. Investors’ fears have been stoked by a number of concerns during in the first half of the year, including possible recession, the Brexit debate, contentious U.S. election politics, slowing growth in China, a fomenting anti-globalization movement, and extreme volatility in the energy sector. Moreover, the generally decelerating global economic trends detailed earlier in this outlook remain in place heading into the third quarter. Not surprisingly, these issues have weighed on investor psychology with sentiment polls and mutual fund cash levels (as shown in Exhibit 5) indicating widespread caution despite the S&P 500’s approaching all-time highs in June. With all the general skepticism regarding the economic and equity market outlook, the potential for positive surprises that could create another leg to the bull market cannot be underestimated.

Exhibit 5. Global Fund Manager Survey Shows High Cash Balances

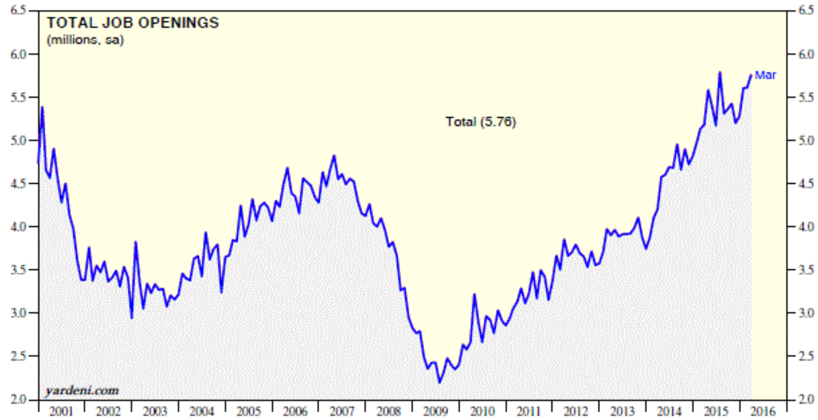


Source: BofA Merrill Lynch Global Fund Manager Survey

The Recession Risk Not Elevated

While there are strong indications that labor market momentum has peaked, job openings remain plentiful—as shown in Exhibit 6—which suggests the next recession is not yet on the near-term horizon.

Exhibit 6. Total Job Openings At Highest Levels Since 2009

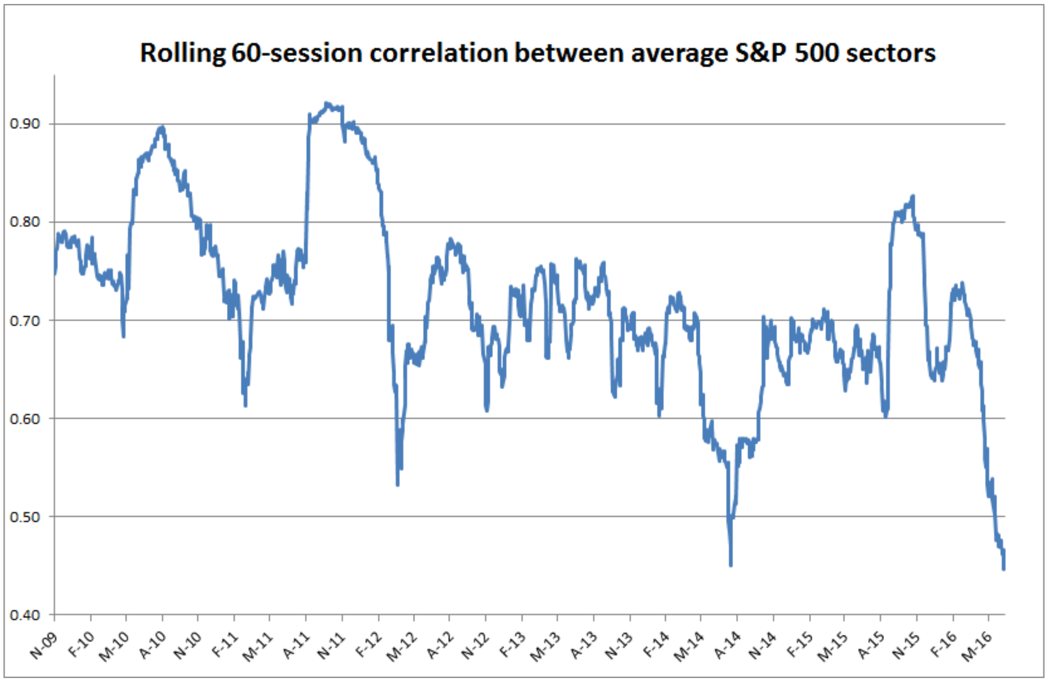


Source: Bureau of Labor Statistics; Yardeni Research, Inc.

Falling Equity Correlations

Exhibit 7 illustrates a decline in the correlation between average S&P 500 sectors. Increasing dispersion among stock returns and sector rotation are themes that we believe will come to the forefront in the second half of the year. They could provide a promising backdrop for actively managed equity strategies.

Exhibit 7. Declining Correlations Between Average S&P 500 Sectors



Source: CNBC.com; 6/14/2016

Global Monetary Policy Remains Highly Supportive For Asset Prices

Global bond yields sitting at all-time lows may send a far more pessimistic message about future economic growth than is reflected in equity prices. However, the prospect of ongoing, extraordinarily accommodative central bank policies should limit the downside associated with equities in the near-term, barring a very significant and unexpected deterioration in economic conditions during the third quarter.

Fixed Income Markets

High grade fixed income sold off early in the quarter as improving economic readings in the U.S. suggested that a Fed rate increase may occur before July. The 10-Year Treasury Yield started the quarter at 1.78% and hit a high of 1.94% before retreating back to 1.83% at the end of April. Market participants also took note of relatively hawkish comments by several Federal Open Market Committee (FOMC) members, including chairperson Janet Yellen. As a result, Treasury rates trended higher in the second half of May. Conditions shifted in June, however, as domestic employment reports came in weaker than expected, reducing the likelihood of a rate hike. International uncertainty surrounding the outcome of Britain's vote on whether to remain in the E.U. caused a flight to safety trade throughout the month, the effects of which amplified the downward pressure on European rates caused by the ECB's bond buying program. As result, most safe haven assets traded higher, and government bond rates worldwide sank to multi-period lows especially following the "Leave" vote in the U.K. They reached negative territory for most Japanese, Swiss and German obligations. Exhibit 8 is a table of rates across various maturities around the world.

Exhibit 8. The Matrix: Race to Negative Bond Yields

The Matrix: Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.87	-0.90	-0.94	-0.90	-0.87	-0.78	-0.73	-0.61	-0.51	-0.45	-0.19	-0.07	0.08
Japan	-0.26	-0.24	-0.24	-0.25	-0.24	-0.24	-0.24	-0.22	-0.18	-0.13	0.01	0.22	0.30
Germany	-0.53	-0.55	-0.56	-0.51	-0.42	-0.38	-0.31	-0.23	-0.10	0.03	0.13	0.36	0.63
Austria	-0.50	-0.50	-0.44	-0.42	-0.39	-0.22	-0.16	-0.07	0.09	0.23	0.31	0.81	1.07
Netherlands		-0.49	-0.46	-0.42	-0.25	-0.23	-0.11	-0.01	0.13	0.25			0.75
Belgium	-0.51	-0.49	-0.46	-0.41	-0.35	-0.25	-0.14	0.12	0.28	0.43	0.81	0.90	1.34
Finland	-0.52	-0.48	-0.45	-0.33	-0.28	-0.12	-0.06	0.03	0.17	0.34	0.58		0.78
France	-0.50	-0.44	-0.40	-0.33	-0.20	-0.14	-0.03	0.09	0.25	0.39	0.75	1.04	1.22
Sweden	-0.50	-0.63		-0.52	-0.33		-0.06			0.30		1.06	
Denmark		-0.40			-0.17	0.31				0.29			0.74
Ireland	-0.18		-0.31	-0.15	-0.07	0.12	0.30	0.50	0.66	0.73	1.09		1.59
Italy	-0.15	-0.06	-0.01	0.19	0.40	0.59	0.79	1.00	1.21	1.38	1.71	2.04	2.43
Spain	-0.16	-0.10	0.00	0.24	0.45	0.49	0.73	1.09	1.24	1.42	1.82		2.57
United States	0.57	0.76	0.91		1.21		1.49			1.68			2.48

Source: Pension Partners (6/10/2016)

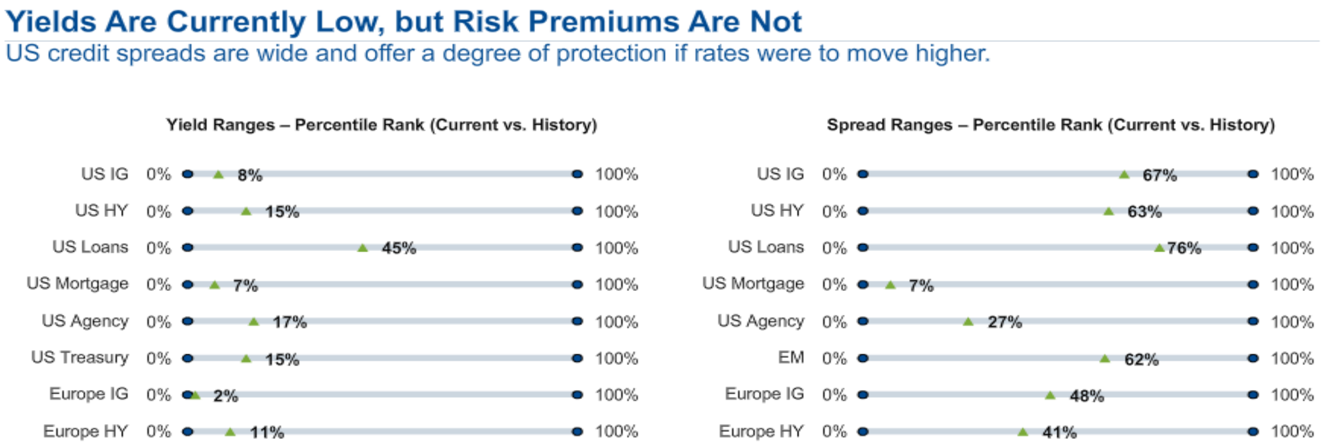
Performance for the first quarter is solidly in the black for the conservative bond sectors, with longer bonds outperforming. More aggressive bonds, including below investment grade and international fixed income, continued to recover. The recovery is due to subsiding U.S. recession fears and their higher yield is relatively more attractive given the very low to negative interest offered by government bonds.

Given the backup in rates and that we have already seen a reasonable return in intermediate to longer duration Treasuries, our outlook for the remainder of the year is flat to modest gains for investment grade bonds. Shorter term issues remain more volatile, but they are also less sensitive to rate moves, which may limit their downside risk. One overall concern we see for a Treasury-only portfolio is a reversal of the low inflation trend we observed over the last several years. We do not expect a substantial spike in inflation, but the low-price effects of a strong dollar and declining energy costs continue to weaken. As input prices stabilize or move modestly higher and wage pressures increase, inflation may move toward or exceed 2%. This movement may result in most Treasury bonds providing a yield below inflation.

Our view is that interest rates may continue to fluctuate within a range as investor and policymaker focus moves from safety and support for growth to possible rate increases to fend off inflation. As inflation continues to trend closer to the FOMC's indicated 2% target level, members of the committee have indicated that rate increases are still on the table for this year. Market consensus continues to estimate a very gradual pace of rate increases, with one rate hike likely by year-end. This expectation was confirmed on June 15, when the FOMC decided not to act and lowered their expectations as seen in the most recent dot plot. Looking at the long run rate, it seems the Fed now anticipates a rate around 3% compared to March where more anticipated a 3.25% final Fed funds rate.

As shown in Exhibit 9, credit spreads in investment grade and high yield have continued to tighten in the second quarter, furthering a decline in risk premiums that began in the late first quarter. Given the reasonable strength in the economy, including healthier housing and consumer sectors, we remain constructive on investment grade bonds. Company fundamentals remain strong and corporate yields, while lower than in Q1, are still reasonably high, and they may offer value if the demand for investment grade corporates picks up as investors diversify out of Treasuries. Although yields are low relative to the past, the spreads over treasuries are higher, signifying relative value. As an example in Exhibit 9, U.S. investment grade (US IG) yields are in the 8th percentile relative to history, meaning 92% of the time yields have been higher. However, looking at spreads over treasuries, US IG is in the 67th percentile, meaning spreads are relatively high comparing to history; in the top third of historical yields.

Exhibit 9. US IG Yields



Source Western Asset

High yield spreads have also tightened considerably since the middle of the first quarter, and the below-investment- grade sector is the best performing bond category for the period. Selective opportunities remain in this space, and as this sector tends to be more volatile, the bonds have fewer natural buyers and are less liquid. Active managers, who may be able to find value on an issue by issue basis, may outperform the broad high yield indexes. We remain positive on high yield for 2016, as the economy continues to grow, which is supportive for earnings of high yield issuers. Some of the pressures on energy issuers, which now represent about 12% of high yield, have abated slightly as oil prices came off their lows.

Looking abroad, foreign bonds may offer diversification from rising U.S. interest rates over the long term. However, given the current low to negative rates that prevail internationally, we feel the opportunity for gains in international bonds may be largely behind us. Risks are also higher. Foreign bonds may rise in value in local currency, but not appreciate in dollar terms. We do, however, continue to maintain a small allocation to foreign bonds for diversification reasons.

The municipal bond market has performed well over the first quarter and may continue to benefit from stronger demand. Municipal yields have been relatively stable, making municipal bonds attractive to treasuries for investors in higher tax brackets. Municipal bond fundamentals, such as increased tax collection associated with improving housing, retail sales and employment, and limited issuance are also positive for municipal bonds. These trends may keep municipal yields more stable than Treasuries. However, there is now some risk that if Treasury rates move sharply from their lows, muni rates may follow higher as well.

We continue to maintain duration below benchmark, with a heavier allocation to credit sensitive and high yield bonds, which we believe may fare better in periods of increasing gross domestic product (GDP) growth and modestly rising rates. We lowered some of the overall portfolio sensitivity to foreign bonds at the beginning of Q2, although we still have a small allocation in this sector.

Risks to Our Outlook

While we maintain a somewhat optimistic view towards the global economy and equity markets, the largest risks to our forecast are more geopolitical in nature. These risks include a limited central bank toolkit, China's dependence on debt to fuel growth, and a growing political climate of protectionism and reverse globalization. While these risks cannot be ruled out, they do not represent our baseline case for how events will unfold. We do believe, however, that these risks may drive volatility in the financial markets for the balance of this year.

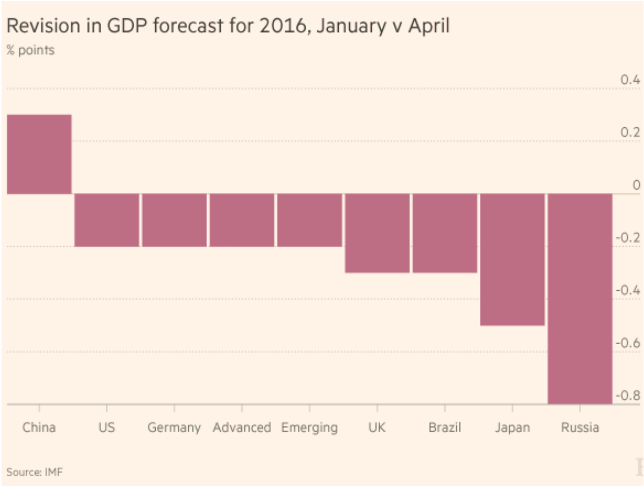
Central Bank Toolkit

As global GDP output continues to weaken and stall across the world, central bank policymakers are running low on options for stimulating economic growth. Traditional and less conventional methods (i.e. quantitative easing, negative interest rates) have done little in changing consumer and corporate executive spending behaviors. Exhibit 10 shows revisions in GDP forecasts for 2016 across several geographies as recorded by the International Monetary Fund (IMF).

Seven years past the Great Recession, capital expenditures and personal consumption have yet to normalize, and leading central banks venture further into the fringe of alternative policy looking for options. This fact is evidenced by the surging "helicopter money" conversation at the Fed, ECB, and major financial institutions. This concept is aimed at putting money directly into households, whether through tax rebates or direct cash distributions, to entice households to use the extra money to buy more goods and services.

Here, we see a myriad of risks. Monetarily financed stimulus blurs the separation between central banks and elected officials, creating an opportunity for political abuse. Examples of political abuse include stimulating the economy ahead of elections or for the benefit of constituencies. In addition, there is no guarantee that households will spend the money at first, requiring further rounds which could create unwanted inflation and expanded central bank balance sheets. Yet, there is the danger that if these policies are not legitimately considered or allowed to be used, central banks might be out of options if there is a severe downturn in global economies.

Exhibit 10. IMF Revision in GDP Forecast for 2016



Source: International Monetary Fund

China's Reliance on Debt for Growth

Despite progress in shifting toward to a service based economy, China's debt as a percent of GDP pushes to new highs each quarter as the government tries to achieve stated growth targets. These levels have renewed concerns that the world's second largest economy could cause the next global recession. This dialogue sparked recent volatility in currencies, commodities, and a global equity during the summer of 2015 and the first quarter of 2016. China's borrowing reached $25.6 trillion at the end of 2015, almost four times what it had been in 2007 according to McKinsey Global Institute. As recently as May, the People's Bank of China disclosed new loans for the month increased 77% over credit extended in April (985.5 billion Yuan to 555.6 billion Yuan).

Although higher debt-to-GDP ratios exist around the world (the U.S. is over 330%), it is the escalation in non-financial corporate debt that poses the greater risk. The IMF estimates state-owned firms in this sector account for over 55% of China's problem. It's especially troubling given this portion of the economy only represents 22% of economic output. If problems arise, the tight link between China's government-backed banks and state-owned firms could spell disaster. The story here is: global economies, corporate profits, and securities markets cannot help being tied to the ebbs and flow in China.

Protectionism and Reverse Globalization

People around the globe are not satisfied with their progress since the 2008 Great Recession and have become increasingly fearful of terrorist threats. These worries have individuals voting for action by their governments, expressing a desire to turn attentions inward. This movement is evident in the political rise of Donald Trump and Bernie Sanders domestically, in the U.K. with Brexit, and in the protests throughout Europe on immigration and austerity. Ideas of protectionism—closed boarders and trade restrictions—pose a major potential threat to future global growth. A slowdown in globalization from protectionism, though difficult to demonstrate empirically, has been cited as major concerns by the IMF, the World Bank, and Central Banks. It remains to be seen how much of this political rhetoric makes its way into policy. If it does, it also could cause a corresponding slowdown across the globe.

Brexit's Long Term Impact on European Institutions

The U.K. referendum to leave the E.U is non-binding, meaning that the British government still needs to make an official decision on the matter and submit a notice of Britain's intent to leave the union to European authorities. However the impact of the vote is significant, as the prime minister, who was advocating for Britain to remain in the E.U. has resigned, and a new government, to be elected later this year, may face this tough decision.

If Britain ends up leaving the E.U., it will be the first country to do so, and this move may weaken the cohesion of the union, as well as lower investor faith in its institutions. We should note that Britain's exit from the E.U. may not impact global trade as much as one might expect. Britain never adopted the Euro as currency and has an independent central bank, so the there are fewer hurdles for financial institutions to overcome. Nevertheless, trade negotiations may take years to finalize and, as a result, may limit the free flow of goods and lower GDP in Britain and in parts of the E.U.

There is also some risk of political contagion, if populist movements gain traction in other parts of Europe where several countries have upcoming elections this year. Should this occur, Europe's political stability may be further shaken, possibly lowering the continent's economic prospects, as well as the value of its currency.

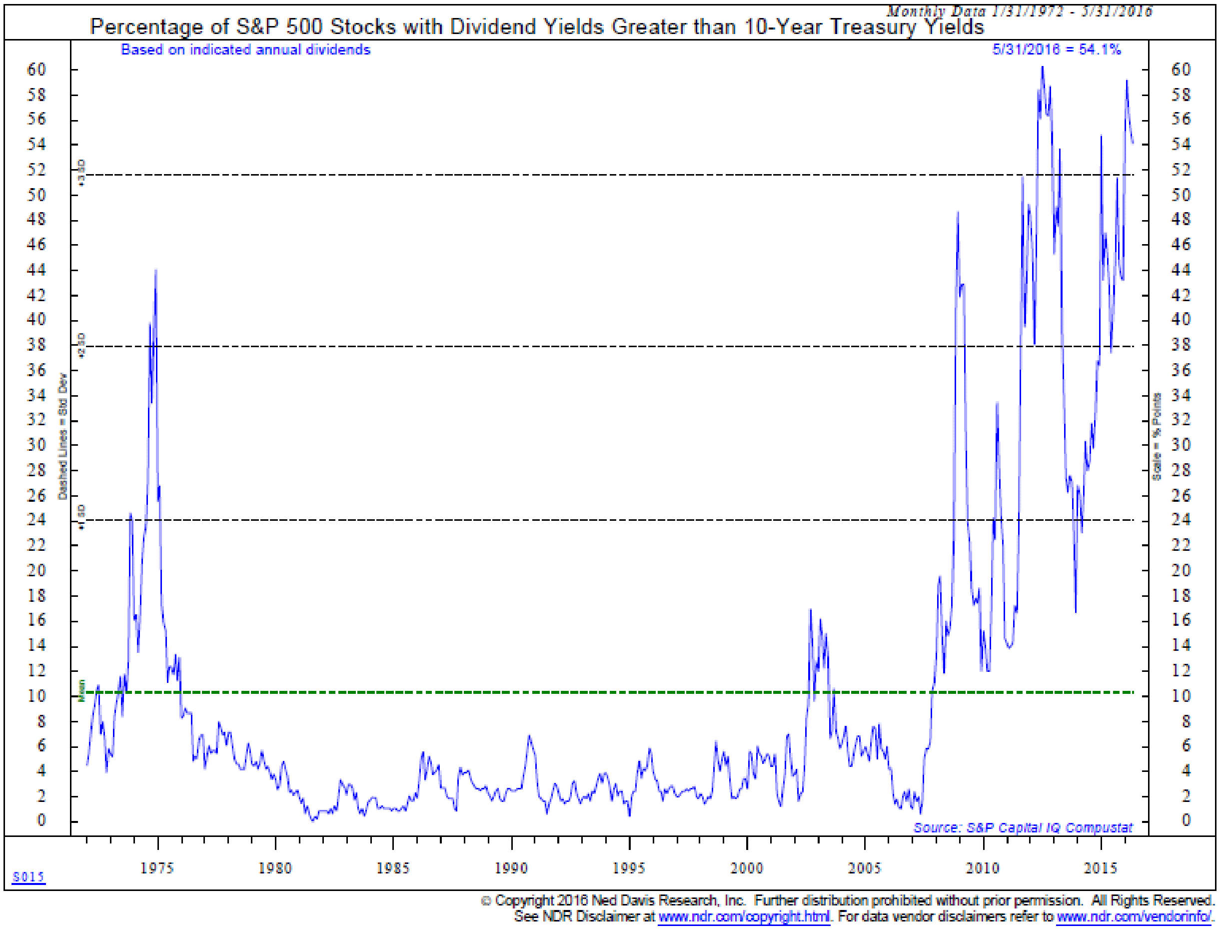
Investment Implications

Barring a domestic recession, which we view as highly unlikely, we expect the secular bull market to continue, albeit with more measured gains. We believe markets may be range-bound, but that we will still see upside for the year and, as such, do not recommend drastic deviations from long-term stock/bond targets. Globally, central bank stimulus should provide a floor under markets to protect from bear market downside, but may also contribute to volatility as unconventional monetary policies are introduced. Increased volatility should provide opportunities for active managers to differentiate themselves.

Stabilizing energy prices and a steady U.S. dollar should provide opportunities in emerging markets, given their lengthy period of underperformance. Despite the Fed hiking cycle, we still view rates as being lower for longer. However, given sub-1.75% rates in the short-term, the risk is greater that rates rise from here, so some caution is warranted regarding interest rate sensitivity. While interest rates remain low, we observe risk of building inflation pressures, which could provide a compelling opportunity within commodities and/or inflation-protected securities.

Historically, election years bring a volatile and sideways market in the first half year, followed by a stronger second half. We would view any material sell-offs in the summer as an opportunity to deploy sidelined capital. Considering the anticipated volatility in equities, we see good risk/reward opportunities in high yield bonds given potential credit spread contraction. We also like dividend-paying equities as cash flow becomes an increasingly important part of total return in slower growth periods. The chart in Exhibit 11 shows 54% of stocks now have yields higher than 10-year Treasuries.

Exhibit 11. Percentage of S&P 500 Stocks with Dividend Yields Greater than 10-Yr Treasury Yields



Source: Ned Davis Research; Data from 1/31/1972-5/31/2016

Slow economic growth should continue to favor growth strategies over value. However, we are in the longest period in which growth equities have outperformed value equities since 1969, so value is becoming increasingly attractive on a relative basis. We also see sector rotation as an important theme as money flows out of expensive sectors like Consumer Staples and Utilities and into cheaper sectors like Healthcare. Over the past five years, the U.S. has outperformed international developed markets by the widest margin since the period from 1996-2000. Given more accommodative central bank policies in Europe and Japan, coupled with better valuation and earlier stages of economic recovery, we expect to see some mean reversion with better long-term opportunities outside the U.S.

In summary, we expect equities to trade within a range, though central bank stimulus should provide support to financial markets and backstop against any type of major bear market selloff. As such, we would not recommend drastic deviations from long-term targeted allocations. Within stocks, we still favor domestic equities; however, opportunities in international developed markets have increased. Within fixed income, we continue to maintain a somewhat defensive position; although, we favor an allocation toward the long end of the duration spectrum as longer term rates are likely to be more stable. Lastly, to mitigate unforeseen volatility in an increasingly uncertain environment, we believe it prudent to retain an allocation to alternative investments that have low correlations to traditional investments. From a portfolio implementation standpoint, we prefer managers with flexible investment styles that provide discretion and ability to move nimbly within their mandates when faced with the changing circumstances we anticipate going forward.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

***MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.*

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*The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.*

***Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

*The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*