Quarterly Market Commentary
2nd Quarter 2016

"Brexit" shocks markets

The big news for June was the "Brexit" referendum at month-end, when Britain voted to leave the European Union (EU). The result was unexpected, and markets declined sharply in response. After a two-day slump, however, most indices moved back up, recovering much of their losses.

The initial market decline was due to fears of a potential immediate breakup of the EU, with unforeseeable but significant consequences. In the days following the vote, however, both British and European governments took a patient and responsible tack, suggesting that any exit would be gradual and well managed, rather than abrupt.

Markets down but not out

The S&P 500 Index ended the month up 0.26 percent. The Dow Jones Industrial Average performed slightly better, gaining 0.95 percent, while the Nasdaq underperformed, losing 2.06 percent. Markets were flat to positive for most of June, before the Brexit vote and the substantial drop. The subsequent partial recovery reflects the ongoing risks but also recognizes that the exit process will likely be slow and steady.

For the quarter, market results were similar. The S&P 500 led the way with a gain of 2.46 percent, and the Dow was up 2.07 percent. The Nasdaq, however, ended the quarter with a small loss of 0.23 percent. All three indices were positive for the quarter until the Brexit drop.

In addition to international concerns, a decline in expected earnings weighed on market performance. Per FactSet, the estimated earnings drop for the second quarter of 2016 is 5.2 percent, down from a March 31 estimate for a 2.8-percent decline. Moreover, the expectations for a further decline are widespread, with 9 of 10 sectors expecting lower growth rates than anticipated on March 31. If there is a decline in second-quarter earnings, it will be the first time that earnings have dropped for five consecutive quarters since the third quarter of 2008 through the third quarter of 2009.

Technical factors also weakened during June. All three indices dipped below their 200-day moving averages near month-end, but only the Nasdaq ended the quarter below this level. Weak technical factors could suggest future market weakness.

Developed international markets fared worse than U.S. markets for both the month and quarter. The MSCI EAFE Index of developed international markets was down 3.36 percent for the month and 1.46 percent for the quarter. Fallout from the Brexit vote weighed it down far more than the U.S. indices, which is reasonable given its greater exposure to the EU. Technical factors for the index were also weak, as it fell below its 200-day moving average at June's end.

The MSCI Emerging Markets Index performed significantly better than the EAFE, gaining 4.10 percent in June and a smaller 0.80 percent for the quarter. The likely delay of any Federal Reserve (Fed) rate hikes, as perceived by financial markets, helped buoy returns. Technical factors for the index remained positive, as it closed the quarter above its 200-day moving average.

Broad fixed income markets had a strong month and quarter, with global fears increasing flows into U.S. fixed income investments and driving interest rates even lower. The Barclays Capital Aggregate Bond Index rose 1.80 percent during June and 2.21 percent during the quarter. The high-yield portion of the market, represented by the Barclays Capital U.S. Corporate High Yield Index, also performed well, posting returns of 0.92 percent and 5.52 percent for the month and quarter, respectively.

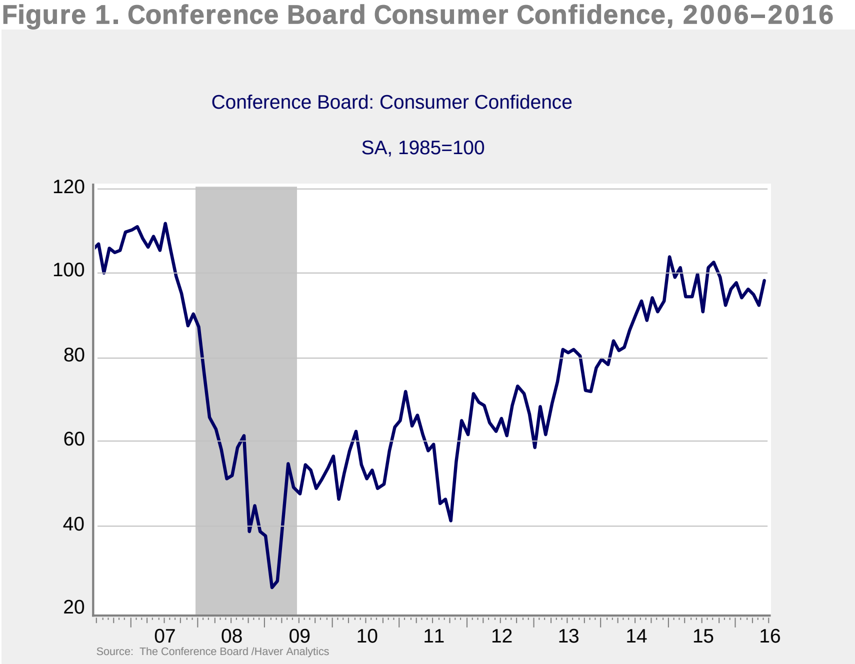
Economic news in U.S. continues to support growth

U.S. economic news during the second quarter was mostly positive, with strength in housing and consumer data offsetting a worrying drop in job creation. Also positive was the fact that first-quarter gross domestic product (GDP) growth, initially estimated at 0.5 percent, was revised up to 1.1 percent. Overall, the economic data has supported continued growth.

One of the few weak data points released over the past month was a disappointing May jobs report, which showed an increase of 38,000—far less than the 160,000 forecast. It was the worst jobs report in five years, although transient factors, including a Verizon strike, negatively impacted the headline number. Nevertheless, the report raised concerns about the U.S. economy and appears to have reduced any chances that the Fed will raise interest rates at its next couple of meetings.

Despite the weak jobs report, and consistent with other, stronger labor market indicators, consumers remain both willing and able to spend. Consumer confidence hit 98 in June—its highest level since last October—and is approaching prerecession levels (see Figure 1). Personal income was up 0.2 percent in May, with April's number revised up to 0.5 percent. This strong income growth translated into equally strong overall spending growth—0.4 percent—and a 0.5-percent uptick in retail sales.

Figure 1. Conference Board Consumer Confidence, 2006–2016



Housing also continued to support the economy during the quarter, as the National Association of Home Builders survey increased to 60 in June. Existing home sales increased from 5.33 million to 5.53 million in May, higher than the initial estimate of 5.40 million. Additionally, the 2.4-percent year-over-year increase in pending home sales reported in May indicates that continued growth in the housing sector is likely.

The mix of generally positive data has supported increased GDP growth projections for the second quarter, with the Atlanta Fed GDP now forecasting a 2.7-percent uptick. This is up considerably over projections made in early May for 1.7-percent growth. Though only projections, this positive news for the U.S. economy has generally remained supportive of increased domestic growth going forward.

International risks continue to drive global markets

Even with the upbeat economic news from the U.S., negative headlines around the world continued to move markets during the quarter. The major story for the period was the Brexit vote, which roiled equity markets at the end of June, though markets soon largely recovered.

From a fundamental perspective, the long-term impact of the Brexit vote on the U.S. economy is likely to be minimal. The fact that the U.K. and Europe account for only 3 percent and 7 percent, respectively, of S&P 500 corporate revenue also suggests a limited impact. Future uncertainty in Europe could increase, especially if other EU countries try to hold similar exit referendums, but, at this time, much of the volatility from the vote may be in the rearview mirror.

Looking toward Asia, China continues to add risk by raising the ante around a border arbitration case in the South China Sea, announcing that the United Nations tribunal hearing the case has no legal authority. This could increase both political and economic tensions in the region going forward. At the same time, as its growth has continued to disappoint, China has been devaluing the yuan, leading to the currency's lowest exchange rate against the U.S. dollar since December 2010. While the devaluation and slower-than-expected growth are not yet major causes for concern, they are worth monitoring because the situation could bring about further instability in global markets.

More U.S. growth and international risk

We end the quarter in a generally similar position to where we started. U.S. growth continues, with some concerns and risks. International political and economic risks ebb and flow. And worries abound—even as the economy muddles along.

Those conditions notwithstanding, we have made progress. Consumer confidence and spending are on the upswing, we survived the Brexit vote without serious damage, and economic headwinds continue to abate. In addition, growth around the world continues.

From a big-picture perspective, even though risks certainly remain, the U.S. economy leads the developed world, and U.S. markets are still attractive to global investors. International markets look risky, but, as we have just seen, even real risks won't necessarily derail the recovery. As always, we continue to recommend a well-diversified portfolio; it is the best path for arriving at a long-term financial destination despite short-term uncertainty.

All information according to Bloomberg, unless stated otherwise.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Nasdaq Composite Index measures the performance of all issues listed in the Nasdaq Stock Market, except for rights, warrants, units, and convertible debentures. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.*

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