“BRITISH” DRIVES YIELDS TO HISTORIC LOWS
In a national referendum on June 23, citizens of the United Kingdom voted to leave the European Union. Bond yields, which were already headed lower due to weak U.S. economic growth in the first quarter, a dovish Federal Reserve, and concerns about slowing growth in the Eurozone and Japan, fell dramatically post-referendum. Investors fretted about the political and economic fallout from the referendum and the 10-year Treasury bond settled at 1.49 percent at the end of the quarter, down sharply from 1.78 last quarter. Outside the U.S., negative yields on government bonds are now widespread. German and Japanese 10-year bonds fell into negative territory at -0.13 percent and -0.23 percent respectively. Approximately 36 percent, or $11.8 trillion, of global sovereign debt, all outside the U.S., now yields less than zero.

STOCKS: SEARCH FOR YIELD WAS ALSO THE THEME FOR STOCKS
U.S. equity markets provided positive returns during the second quarter. The Standard & Poor’s 500 Index delivered a total return of 2.5 percent. Energy, up 11.6 percent, led all sectors as companies benefited from the continued rebound in oil prices. Outside of energy, investors remained focused on lower volatility and higher dividend yield. As bond yields fell, sectors with high dividend yields such as telecom, up 7.1 percent, and utilities and real estate investment trusts, both up 6.8 percent, outperformed. Stocks in these sectors offer better yields than bonds, plus the potential for growth. Sector laggards included information technology, which fell 2.8 percent, and consumer discretionary, down 0.9 percent. The Russell 2000 Index of small capitalization stocks was up 3.8 percent and rebounded to outperform the large company Russell 1000 Index, which rose 2.5 percent.

International markets underperformed the U.S. in the second quarter. The MSCI All-Country World Index-ex US fell 0.6 percent. Within international, emerging markets did better than developed markets thanks to the rebound in commodity prices, a weaker dollar, and weakness in Europe as a result of concerns about the United Kingdom exiting the European Union.

BONDS: SOLID RETURNS
All major bond indices posted positive returns for the quarter as yields fell across the curve. Falling yields drove performance of longer duration bonds — the 30-year U.S. Treasury bond has returned a stunning 17 percent for the year. The yield curve flattened during the quarter and the spread between 2-year and 10-year Treasury bonds narrowed to 91 basis points. The yield curve has not been this flat since late 2007.
The Barclays U.S. Aggregate bond index returned 2.21 percent in the second quarter. Within the broader index, the government-backed mortgages sector was the worst performer, up 1.1 percent. Heightened prepayment risk and lower duration caused mortgages to trail other investment grade sectors. Credit spreads tightened modestly and investment grade corporate bonds returned 3.6 percent. Investment grade credit spreads, which started the quarter at +155, dropped to +38 in late April before ending the quarter at +147. Investors chased yield and the Barclays U.S. Corporate High Yield Index returned 5.5 percent for the quarter. Option-adjusted spreads started the quarter at +656 and tightened to +594 at the quarter end.

The Barclays Municipal Index returned 2.6 percent under strong domestic and foreign demand. Municipal bond fund flows have been positive for 40 consecutive weeks. Foreign demand has grown from almost zero in 2012 to $8 billion per year. Long duration securities outperformed short, as the 5-year index returned 1.2 percent and the 22+ year index returned 4.5 percent during the quarter.

COMMODITIES: ENERGY CONTINUED TO RALLY
Helped by stronger energy prices, the Bloomberg UBS Commodity Index, which tracks 22 commodities, was up 12.8 percent for the second quarter of 2016. It was the best-performing asset class for the quarter and for the year to date. U.S. oil prices rose 26 percent in the second quarter to $48.33 a barrel. It was the best quarterly performance for oil since 2009. Prices were boosted by declining production in the U.S.; supply outages in Canada, Libya, and Nigeria; and a weaker dollar. Natural gas prices also rallied along with oil to $2.92 per million BTUs, a gain of 49 percent for the quarter. It was the best quarterly performance for natural gas since 2005. The weaker dollar and uncertainty around “Brexit” helped gold prices rally by 6.8 percent in the quarter.

OUTLOOK 2016
The U.S. economy appears to be growing at an annual rate of about 2 percent. The job market is strong, the unemployment rate is below 5 percent, and wages and inflation appear to be headed higher. However, rates in Europe and Japan are headed further into negative territory and Chinese growth is slowing. The Federal Reserve has said that it will be slow to raise rates in 2016 because “global financial and economic developments continue to pose risks.” “Brexit” is an example of such a risk. The Fed appears willing to accept higher inflation and financial stability risks in the U.S. We believe negative rates in Europe and Japan and continued slowdown in China should spur demand for U.S. bonds and keep a lid on yields. Investment grade corporate bonds are attractively valued and should do well. However, credit conditions for low-rates companies are expected to deteriorate further and we would be underweight high-yield bonds.

The equity bull market is entering its seventh year and we expect muted results for U.S. stocks. High valuations, peak margins, and flat-to-low single digit earnings growth for the S&P 500 all pose challenges. Within the U.S., stocks of large companies should continue to do better than small companies. The healthcare sector should benefit from an aging population and secular trends from the Affordable Care Act. Telecom and utility stocks should continue to do well as long as interest rates remain low. However, low rates and increased regulations continue to be headwinds for banks and financial services companies. Valuations are cheaper outside the U.S., particularly in Europe, where the European Central Bank remains accommodative. However, “Brexit” has shown there are significant political risks and the European banking sector remains undercapitalized. Emerging market stocks, currencies, and local bonds have done well in 2016. However, the credit quality of many government and corporate borrowers is deteriorating, suggesting possible trouble ahead. We are bullish on select countries and stocks.

A slowdown in the Chinese economy and excess supply are not great for commodities. China’s economy is slowly transforming from investment spending to consumer spending, which will continue to be a headwind for commodity prices. Low oil prices may be with us for a while. While U.S. output is down, it is being replaced by increased pumping from OPEC and new supply from countries like Iran. Oil inventories remain 33 percent above their five year average level. Additionally, prices around $50 a barrel allow shale producers to bring idle rigs back online further adding to supplies.

KEY RISKS:
China — a hard landing in China poses one of the biggest risks to stocks and other risk assets.
Federal Reserve — if forced to tighten at a rate that is faster than what the market expects.
U.S. Presidential Elections — the uncertainty of the outcome is often a cause of volatility and puts a lid on market gains.
Global Trade — “Brexit” along with growing populist anger against global trade in the U.S. poses a threat to economic growth.