



## Market Commentary June 30. 2016

### ***The Big Picture...***

The second quarter witnessed potentially one of the most consequential political/economic events in recent history. After a relatively calm start, the quarter ended in tumultuous fashion following the U.K. vote to separate from the European Union. The referendum's outcome on June 23 shocked most observers and financial markets reacted violently, sending equity prices down across the globe. However, by quarter-end, markets generally had recovered from a two-day post-"Brexit" swoon. The broad non-US equity market was down about 1.0% for the period. European markets were down 2.7%. Commodities were the best performing asset class in Q2 and safe haven assets such as US Treasuries and Japanese Government Bonds rallied on "risk-off" sentiment.

More broadly, global economic growth remains weak as structural headwinds, in the form of declining productivity in both developed and emerging economies, and an aging global population, constrain business investment and trade. We expect global equity and currency markets to remain volatile as investors monitor the events in Europe and await the policy responses from other regions of the world.

### ***United States...***

"Brexit" notwithstanding, the U.S. economy remains on solid footings – employment, inflation, and consumer confidence are all trending in the right direction or holding steady at benign levels. Just released June employment data (+287k jobs on a seasonally adjusted basis) was much stronger than consensus. The unemployment rate for June was 4.9%. While employment data has been lumpy in recent months, the trend is positive and suggests rising incomes and a solid outlook for consumer spending and, hopefully, corporate profits, which have been on a steady decline for five quarters running. Earnings growth is the key to rounding out an otherwise rather constructive posture for the U.S. Thus, on balance, we don't see a recession on the horizon for the U.S.

After a very shaky start to the year, U.S. equity markets have clawed their way back to new highs. As for equity market valuations, with the S&P 500 Index recently hitting new highs on an intra-day basis, P/E multiples are above long-term averages and are less attractive than non-US equities generally.

### ***Europe...***

The "Brexit" vote set in motion a process of negotiation between the U.K. government and the EU as to the terms of the separation, which could take up to two years. At stake are trade agreements, financial treaties, immigration policies, etc. It is a complicated endeavor that, in hindsight, most thought would never come to pass. Some recent polls even show many who voted to leave are regretting their decision and are asking for a second vote! Adding to the confusion, England's Prime Minister David Cameron announced his intention to resign in a few months, but left office on July 13. The longer-term political implications of this event are impossible to discern, thus we won't hazard speculation here. However,

we believe the longer term economic implications are manageable IF policymakers respond appropriately.

### ***Japan...***

Output growth has been slowed by a drop in demand from China and other Asian countries and by sluggish private consumption. Per the OECD, growth is projected to be around 0.7% in 2016 and 0.4% in 2017, as labor and capacity shortages and record-high corporate profits support business investment, employment and wages.

Raising output growth is essential to reduce the ratio of public debt to GDP, which will reach 234% in 2017. To achieve a primary budget surplus and maintain confidence in Japan's public finances, it is necessary to implement a more detailed and concrete strategy to reduce spending and raise revenue. Continuing the quantitative and qualitative easing policy until the 2% inflation target has been sustainably achieved is also necessary.

Structural reform to raise productivity is fundamental to long-term growth. Narrowing the productivity gap with its global peers requires bold reforms, such as enhancing trade integration through the Trans-Pacific Partnership and other agreements, and increasing business-sector dynamism through improved corporate governance and regulatory reform.

### ***Emerging Markets...***

A positive result of the Brexit vote is that emerging markets, despite fragile investor sentiment and uncertainty, held up well in the wake of the surprise outcome. Emerging markets equities, as represented by the MSCI Emerging Markets Index, were up just under 1% in the quarter and have generated respectable returns in 2016, up more than 6%. In contrast, developed markets, represented by the MSCI EAFE Index, have fallen more than 4% this year.

Brazil continues to struggle through the fallout from the Petrobras scandal, but there has been evidence of progress. Both the Lower House and the Senate have voted to impeach President Dilma Rousseff, with the trial scheduled for August. Interim President Michel Temer, Rousseff's former vice president, has faced criticism because of his alleged role in the scandal. He has, so far, been able to fend off challenges and offer some continuity and credibility in a country struggling for both. We believe the danger of default in Brazil has lessened. However, we note that Brazil will be in the spotlight during the upcoming summer Olympic games and that there will be little room for error.

In conclusion, while U.S.-based investor sentiment toward allocating assets outside their home country has seldom been more skittish (and for some good reasons), we would be remiss not to remind our constituents of the long-term benefits of global equity diversification. The global investment proposition is not a simple bi-lateral decision of the U.S. versus the rest of the world. But indeed a much larger opportunity set of countries and regions that should be evaluated discreetly in order to find the most compelling investment opportunities within a defined investment universe. In the face of challenging – and in many cases unprecedented – exogenous factors, we continue to work hard to identify and capture these opportunities.

Sources: MSCI; Organization for Economic Cooperation and Development (OECD); U.S. Department of Labor; Gratry Research