2016 Second Quarter Review

July 2016

Like any good headliner, the biggest news of the second quarter was the final act of the period. Britain's vote to exit the European Union shocked markets worldwide, though the resulting downturn was short-lived in the US. Look for more on these events in this review.

When the Markets Suffer a Shock

At the end of the second quarter we saw huge swings in values as the British voted to leave the EU. During the first quarter, we saw steep declines, followed by prompt recovery, as investors feared a looming recession. Late last summer, worries over China's economic stability shocked markets into a rapid decline, again followed by recovery. Each of these events is an example of a panicked response to an unanticipated event. As we saw in every one of these cases, the market gyrations typically work themselves out over a fairly brief interval. This characteristic is one reason why we advocate against a panic-driven sell when markets take a fall.

Our key objective is managing your portfolios to further your organization's unique goals within the context of institutional best practices. Risk management is a central element of our work. When we talk about managing risk, we refer to knowing what markets and holdings are doing and understanding why. We also monitor trends and pay attention to anticipated events. Prudent management demands both the agility to adapt to ever-changing market environments and the discipline to stick with each client's investment blueprint, rather than joining a selling frenzy. This quarter, as we discuss changes to your portfolios, we will take a closer look at the market influences we follow as we monitor the world's markets.

Brexit

Worldwide reaction to Britain's vote on June 23 to leave the EU had a titanic, but brief, effect on domestic stock prices. The international markets reacted more strongly and have climbed back more slowly; worldwide, markets are nearly back to pre-Brexit levels as of July 15, while in Europe, the recovery has not yet reached positive territory. Here at home, the market was down for only two days: Friday June 24 and Monday June 27. The shock to the markets had little measurable lasting impact on domestic equities; the S&P 500 managed to hang on to a small gain for the month of June and is positive as of July 15.

Political impact within the UK has been more pronounced: David Cameron resigned as prime minister. His successor, Theresa May, has announced that she will not trigger Article 50, the provision within the EU's charter that governs a country's departure, this year. Meanwhile, seven separate legal actions have been filed asserting that only Parliament may invoke Article 50, according to *The Guardian*, a British newspaper.

Going forward, the major concern is that businesses both in the US and overseas will hold back spending during the uncertainty of when, how, and even if Britain will actually sever her ties with the EU, and what the impacts will be. A corporate spending slowdown could hold back world growth for the next few quarters.

If you missed Towneley's founder's commentary on the Brexit, you can find it here.

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Your Portfolio

During the second quarter, we strategically restructured the fixed income segment of client portfolios to accomplish two goals. Our primary goal was to slightly increase weighted average duration of the fixed income segment to take advantage of the continuing low interest rate environment. Our secondary goal was to remove three taxable bond funds that no longer met our criteria—PIMCO Total Return, PIMCO Low Duration and Vanguard High Yield—and replace them with Baird Aggregate Bond, Doubleline Core Bond and Federated High Yield.

We moved to increase duration at this time for several reasons. First, due to concerns about the sluggish global economy and low inflation, the Fed has not raised the Federal Funds rate this year, despite their announcement to the contrary back in December. The recent month-to-month variation in the unemployment data and now, concerns about Brexit have further confused the policy. Second, US Treasury rates have been falling due to continued weakness in the US economy and the influx of foreign buyers fleeing negative interest rates abroad. We expect the longer duration to help returns in the fixed income segment of client portfolios while interest rates continue to decline or remain relatively flat. We do not expect significant changes in this interest rate environment until the economy shows more durable signs of sustained growth.

We monitor economic indicators and market conditions to identify opportunities for growth and enhanced returns or risk reduction. For example, we are currently watching for "hotspots" in the markets due to further fallout from the Brexit vote, effects of China's attempt to shift from an export-based economy to a consumption-based economy, and oil prices. As November approaches, we will be on the lookout for opportunities that may arise from global response to the US presidential election.

Market Hotspots

Britain's historic vote to exit the European Union is unprecedented. Many questions remain unanswered: is the vote a directive, or must Parliament also embrace the decision before it has force? Assuming the vote stands, will the EU or the UK prevail in negotiating the terms of the separation? How strong will the EU's central bank be once Britain leaves? How strong will an independent Britain be? Will other countries follow Britain's lead and make their own exits? Market responses are impossible to predict, so we watch closely for leading indicators of potential shake-ups.

China matters because she is a major player in the global economy. As she transitions to a consumer-driven economy, the market for US exports will increase. Her GDP continues to grow, but at a slower rate than we saw in the last few years. She is also carrying more debt, which remains a concern. And the nation's economic reporting may not be completely accurate.

Oil is important because everyone uses it, either directly or indirectly, so changes in oil prices impact everyone. While the direct consequence for investors may be small (energy comprises only 7.3% of the S&P 500, for example), indirect impacts are ubiquitous: when oil prices rise, shipping costs increase, which is reflected in retail prices. Air travel costs depend on oil prices, but the airlines typically contract for their fuel purchases in advance (by buying "futures") so the impact lags the price change at the commodity level. Consumers also pay more for gasoline when oil prices go up, which reduces disposable income. When oil prices fall, consumers spend less on gasoline, leaving more money for other purchases, and companies that increased prices to absorb higher fuel costs may see their profits rise. Because it is impossible to determine which way prices will move next, we are maintaining a 50/50 growth/value position. A robust oil industry favors value holdings.

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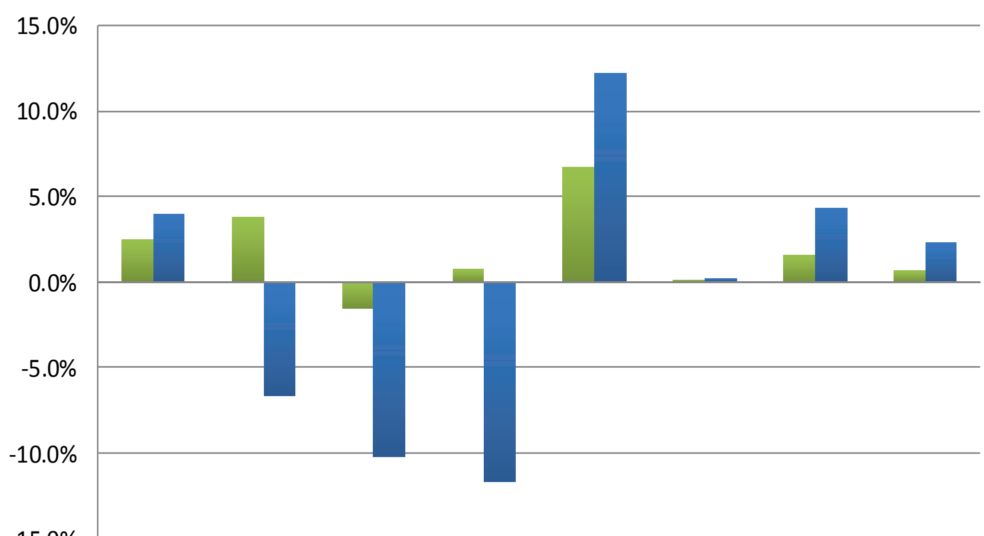
Did You Know . . . .

Our *Nonprofit News* for the second quarter of 2016 is now available on our website. Our feature article describes the services you should expect from an advisor who is truly engaged with your institution. The engaged advisor shares fiduciary liability and simplifies the complexities of financial matters, easing the burden of board and investment committee members. We also provide interesting statistics about charitable donations in the US. Finally, a snippet from our second quarter bulletin on oil charts some changes in patterns of oil consumption over recent decades.

Towneley provides custom research for our institutional clients. If, for example, you are considering a major financial expenditure and wondering how it will impact the organization's wherewithal five or ten years from now, we can help you. If you are working on establishing a spending policy, we can illustrate the impact of various scenarios over time. Contact your portfolio manager and let our expert research team analyze your situation.

As always, let your portfolio manager know if you experience or expect changes in your revenue, spending needs or other financial factors.

Market Returns: Second Quarter and Trailing 12 Months



	S&P 500	Russell 2000	MSCI EAFE	MSCI Emerging Markets	S&P GSCI Gold	90 Day Treasury Bill	Barclays Intrm Govt/ Credit	Barclays Muni 3 Year
Second Quarter	2.5%	3.8%	-1.5%	0.8%	6.7%	0.1%	1.6%	0.7%
Trailing 12 Months	4.0%	-6.7%	-10.2%	-11.7%	12.2%	0.2%	4.3%	2.3%

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The Domestic Economy

Apart from the Brexit, jobs and interest rates impacted our domestic economy during this period.

After a respectable 144,000 new jobs were reported for April, May's tally of a paltry 11,000 net new jobs for the month cast a pall over the economy even though some of the decline resulted from a now-settled strike by Verizon workers. The decrease in job growth convinced the Fed to hold off on raising interest rates at its June meeting. But when figures for June came out, employment had come roaring back, adding 287,000 jobs. We now anticipate no more than one interest rate hike during 2016, rather than the one-to-two increases we previously expected.

Retail sales rose 2.6% year-over-year in April and 2.0% year-over-year in May. These results are better than March's 1.1% year-over-year increase, a hint that we may see better GDP numbers for the second quarter than we did in the first.

Puerto Rico defaulted on a bond payment on May 1. Their bonds were rated as junk, so the long-expected default barely affected the overall muni market. The territory missed another payment on June 30 and the US Congress has sent legislation aimed at providing assistance to prevent a bailout to President Obama for his signature.

Crude oil prices gained some ground during the second quarter. The Brent Crude spot price stood at $48.05/ barrel on June 30 after opening the quarter at $36.42 on April 1. This increase boosted the S&P 500 energy sector returns 11.6% during the quarter. Energy's performance, in turn, helps explain value's favorable showing compared to growth for the quarter and year-to-date. Our second quarter bulletin provides a compendium of information and analyses about the oil industry. It is now available on our website.

The Global Economy

Volatility remains the watchword as we survey the global scene, and effects of the Brexit vote are still lingering in Europe. The European Central Bank, which has been buying government bonds, began buying corporate bonds in June. Generally, as central banks buy more bonds, fewer bonds remain available to other investors and yields overall decline. The German 10-year yield went negative in June and was yielding -0.08% as of June 30.

China's GDP for the second quarter remained unchanged from the first quarter at 6.7%. Many investors were hoping for a lower number, which would have indicated that the country was becoming less reliant on credit-fueled infrastructure spending in order to prop up growth.

China's decreasing appetite for commodities has contributed to Brazil's economic troubles. Brazil, an exporting nation, is in her third year of a contracting economy. GDP shrank 5.4% in the first quarter as the country remains mired in its longest recession since the 1930s. Brazilians live with high inflation and unemployment that is expected to surpass 10% in 2016. A newly-placed interim government, including an experienced and respected finance minister, has a tall order ahead to restore economic health.

Italy faces a banking crisis as Monte dei Paschi, the world's oldest bank, will need a third bailout to recover from a glut of non-performing loans made to small businesses. EU regulations prohibit a third bailout, but the bank is widely seen as "too big to fail," so resolution will require some interesting political maneuvers.