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Market Commentary
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Introduction

Investors around the globe are grappling with the reality and ramifications of the historic vote for the U.K. to leave the European Union, known as "Brexit". The economic implications of a Brexit are wide spread and the impact on investments is significantly different abroad as opposed to at home. The process of the U.K. leaving the EU will be laborious and take several years to complete. What is clear is that economic growth could slow dramatically, with revised economic forecasts showing a fall of roughly 1% in GDP this year. There are short to intermediate-term ramifications, as it is yet to be seen what results will bear from negotiations between the U.K. and EU in regards to trade treaties, borders, labor mobility, financial systems, and many more.

Amidst all of the global turmoil, we believe this will be a shock for markets, as opposed to a financial crisis. The United States is a closed economy with 70% of our growth tied to the U.S. consumer. We believe the U.S. consumer is the healthiest they have been since the start of this economic recovery and should drive equity markets higher. Unemployment today is at its lowest level since the beginning of 2008 and wages have slowly improved to 2.5% growth from its low of 1.6% at the end of 2012. This global uncertainty has now pushed expectations for the Federal Reserve to raise interest rates out to next year, which should benefit U.S. equities. With that said, we have positioned our portfolios to absorb this volatility through diversification within equities and across fixed income and alternative investments.

Domestic Equities

Despite elevated, the S&P 500 finished the quarter up 2.46% and is now up 3.84% YTD. Unlike the first quarter, domestic equity diversification was a positive contributor to performance with mid and small cap stocks finishing the quarter up 3.18% and 3.79%, respectively. With the rest of the world riddled with uncertainty and concerns over growth, the U.S. has quietly continued to build strong positive economic momentum. After a sluggish start to the year, U.S. consumers have started to increase their spending, with retail sales in April and May beating expectations. This should quiet fears of soft corporate earnings, which have been hampered over the past year by low oil prices and a stronger dollar that has made our goods more expensive to foreign buyers. Earnings should have a better second half of the year, due to an increase in consumer spending, along with the recent rise in oil prices and a more stable U.S. dollar. A strengthening U.S. economy and stronger corporate earnings should help push stocks higher despite the added volatility from the Brexit and the U.S. elections.

International Equities

The Brexit outcome was a shock to many as 52% voted to leave and 48% voted to remain. Investors sold off risky international assets in fear that the U.K.'s decision to leave the EU would have consequential effects on the global economy. This in turn resulted in a rather significant drop in international equity indices, with the MSCI EAFE index returning -9.68% YTD through June 27th. Subsequently, international stocks were able to recover some of their losses in the remaining days of the quarter finishing down -4.42% YTD. Foreign currencies also plummeted as a result of the Brexit news. The British Pound fell 12% to $1.32 on June 27th, its lowest level since 1985. The outlook for markets abroad is unclear but rather than trying to time pullbacks or bet on short lived rallies, we believe it is most beneficial to remain disciplined in our approach and diversified with our international allocation.

So far this year, emerging market equities have recovered some of their losses from 2015 but not enough to break even. Emerging market stocks finished the quarter up 6.41% YTD but like other global equities, were not sheltered from the Brexit event. The positive performance for emerging markets this year can be primarily attributed to firming commodity prices and attractive valuations. Although strengethening commodity prices can contribute to outperformance in emerging markets, it can just as easily dampen performance in this region as we saw with oil prices and emerging market results in 2015. This close tie to commodities, coupled with heightened political risk make emerging markets a riskier asset class.

Fixed Income

Fixed Income enjoyed another rally during the second quarter as demand for the 10 year U.S. Treasury yield increased causing the yield to decrease from 1.77% all the way down to 1.47%. The Barclays US Govt/Credit Index surged another 1.59% after finishing the first quarter up 2.5%. The outperformance in fixed income was attributable to a few factors. First, yields plummeted as uncertainty over global economic softness prevailed, which was heightened by the Brexit. German 10-year government bond yields dipped below zero for the first time a few days before the Brexit poll result was released, which marked a milestone for investors' flight to safer assets. In addition, supportive central bank policies from major economies around the globe helped to suppress yields further as over 25% of sovereign bonds generate negative yields. Last but not least, as yield-starved U.S. baby boomers enter retirement, they are searching for yield, driving prices up significantly. As a result, the yield curve continues to flatten, with longer duration fixed income securities outperforming those with shorter duration.

The market turbulence and global uncertainty will keep the Fed restrained from hiking interest rates. Currently, the market isn't anticipating any rate hikes. As economic growth remains low, it is unlikely that the Fed will want to add fuel to the fire by raising rates unexpectedly. We think the "lower for longer" theme remains, which should benefit our fixed-income allocation.

Alternatives

During this period of economic uncertainty, alternatives can play a key role in protecting against the downside. As an illustration of the ability of alternative strategies to protect a portfolio during periods of market turmoil, when the S&P 500 was down -4.47% in the month of June, the Deutsche Bank Hedge Fund index was down only -0.65%. Our allocation was designed specifically to handle uncertainty, offering the potential to outperform during periods of high volatility and provide a cushion during down markets. Unlike our previous allocations to single alternative asset classes (gold, MLPs, REITs, etc.) we have transitioned our alternative allocation to significantly reduce volatility, while maintaining little correlation with traditional asset classes. With the goal of maintaining a low correlation to the equity market as a whole, we take a barbell approach by allocating across higher volatile alternatives and less volatile alternatives through 3 sets of strategies: long/short equity, market neutral, and multi-alternative products.

Real Estate

While new single-family home sales fell -6% in May, the trend remains positive in the domestic real estate market. As consumers continue to strengthen, unemployment remains low and wage growth picks up, the prospect of buying a home is within reach for more people. The homeownership rate is still historically low, leaving plenty of potential buyers on the table. Though the Brexit shocked markets globally, the ripple effect may turn out to be a positive for the U.S. real estate market; Rate hike expectations have been pushed further into the future, leaving the cost of borrowing at attractive levels. Moving into the second half of 2016, real estate should continue to be a bright spot in the U.S. economy.

Conclusion

The S&P 500 started 2016 with a major market correction of over 10%, followed by the volatility inducing historic vote of the U.K. to leave the EU, yet equity markets have continued to climb higher. This global uncertainty has also put the Fed on hold from raising interest rates and we would expect rates to be range bound for the rest of the year. Despite all the headlines and negative news, U.S. equity markets have been able to weather the storm and navigate these volatile times. This is a great reminder to investors that markets are historically volatile and drawdowns are normal, but the U.S. economy is strong enough to handle these shocks due to a strengthening consumer, low interest rates and an improving labor market. With the impacts of the Brexit still unclear and an uncertain U.S. election on the horizon, we expect volatility is here to stay, but there are enough positive improvements within our economy for markets to climb higher.