Quarterly Economic Update

September 22, 2016

MACROECONOMIC COMMENTARY

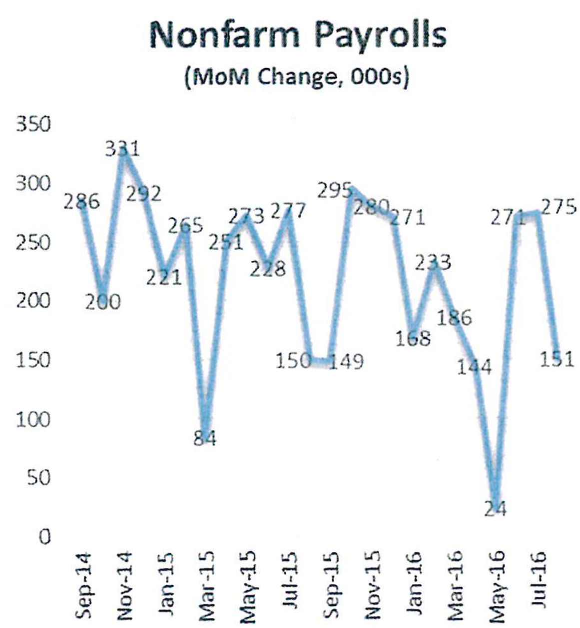
Monetary Policy

By Bobby Long

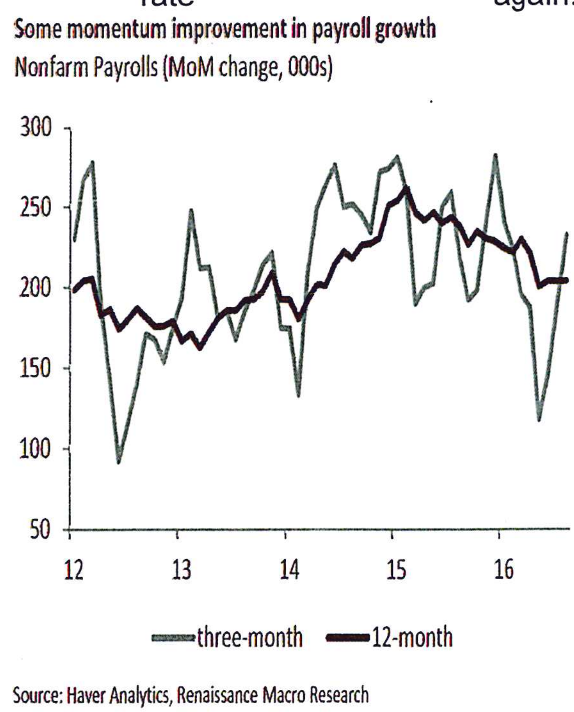
While the Federal Open Market Committee (FOMC) has met only once since our last update and has made no change to monetary policy, the markets have continued to speculate about the next rate increase and the odds around the timing of the next rate hike have fluctuated with the incoming economic data and FOMC member commentary. The FOMC met in July and again left the target range for the federal funds rate unchanged at ¼ to ½ percent. They also continued their policy of reinvesting principal payments and maturities from their securities holdings, which they have stated is likely to continue until normalization of the level of the federal funds rate is well under way. Following the Brexit decision, there were no expectations for a change to the federal funds rate at the July meeting. The July meeting did not include an updated Summary of Economic Projections, but we did get a more constructive assessment of economic conditions in the FOMC statement following the stronger nonfarm payroll number in June. The statement noted that since their June meeting, "the labor market strengthened and that economic activity has been expanding at a moderate rate." The July statement also stated that "near-term risks to the economic outlook have diminished." The combined upgrade to the statement's language around labor conditions, economic activity, and risk seemed to indicate that the potential for a rate increase at the September meeting remained on the table.

The FOMC minutes provided further clarity around participants' and committee members' thoughts and discussion on whether economic conditions were moving in a direction consistent with their mandate and when it may be appropriate to increase the federal funds rate further. There seemed to be agreement that labor markets were strengthening and economic activity was expanding at a moderate pace. While FOMC participants did not submit updated projections at this meeting, the minutes say they generally indicated that their growth, labor market, and inflation forecasts had changed little since the prior meeting. The minutes also reflected the opinion that market stability following the Brexit vote and the stronger payroll numbers in June had reduced two large uncertainties to their June forecasts and generally lowered the downside risk to their near-term outlooks. In regards to discussion around taking another step to further remove accommodation and increase the federal funds rate, *many* viewed it appropriate to wait for additional information on the momentum behind improvement in labor markets and economic activity, especially with inflation continuing to run below the two percent objective. They argued that there was ample time to react if inflation rose more quickly than anticipated and they preferred to gain more confidence that inflation was moving towards their target. They also advocated waiting until the data provided a greater level of confidence that economic growth was strong enough to withstand a possible downward shock to demand. Other participants viewed that labor market conditions were at or close to maximum employment and were confident that inflation would continue to move toward their target, advocating that a rate increase would be warranted soon, with a couple having the view that an increase at the July meeting should be considered. These participants expressed concern that an unwanted buildup of inflationary pressures could require a rapid increase in the rate if they waited too long. There were also concerns that holding rates low may incentivize some investors to reach for yield, leading to increased risk of financial instability down the road.

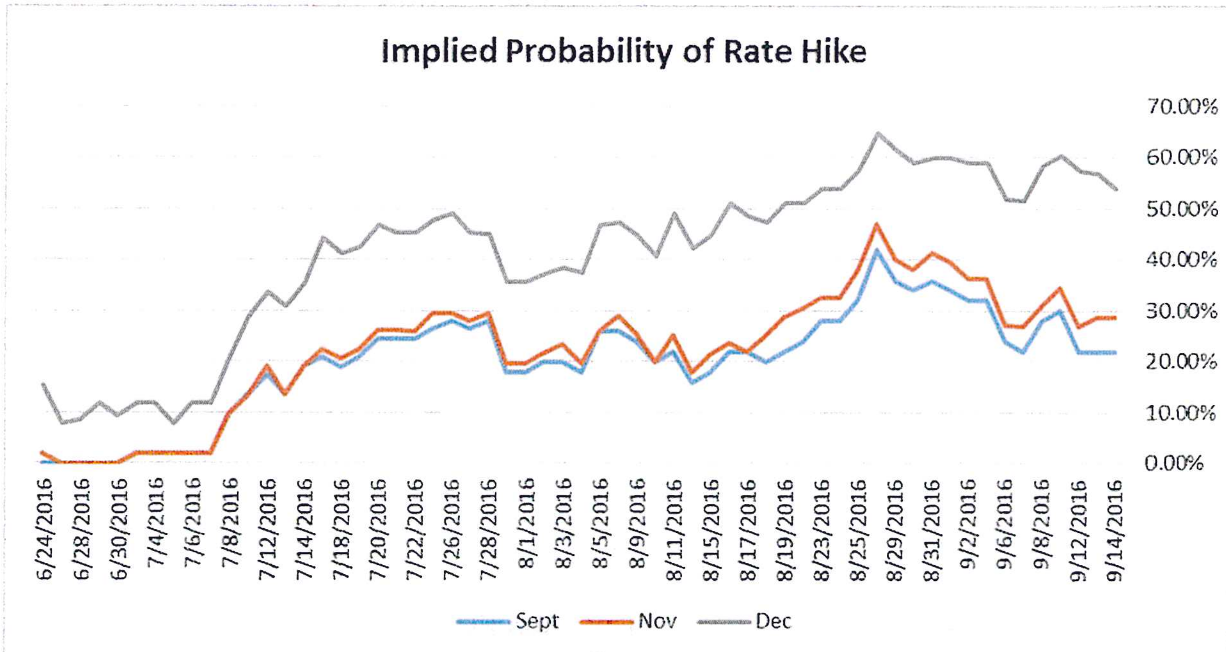
The FOMC as a whole does seem to want to raise the federal funds rate higher, especially in light of its continued low level. They have seen economic activity and labor conditions improving toward their objective, but it has been slow and the improvement has lacked the consistency that some would like to see. Inflation has continued to run below their objective, and while they have maintained their outlook that it will move toward their objective, it has been persistently low. The lower running rate on inflation has allowed them to approach removing accommodation a little slower as the labor market shows signs of moving toward full employment. One of the issues has been the volatility in the nonfarm payrolls data. The charts below highlight the recent volatility in month over month payroll gains and the loss of momentum of the rolling average of gains. Nonfarm payroll gains had been running fairly strong, but unexpectedly dropped in April and May, which gave many FOMC members pause. As the three month rolling average turned down sharply and the 12-month average trended lower, some members expressed concern at the declining momentum. June and July nonfarm payrolls rebounded sharply back above 200,000 month over month gains, which helped alleviate some concerns and suggested that perhaps the weak gains in the spring were an anomaly. August payrolls fell back down a little, but was still a decent month over month gain. Many FOMC members would like to see a little more stability in the pace of job gains and have more confidence in the momentum of labor additions before increasing the rate again.



Source: Bloomberg



Federal Reserve Chair Janet Yellen and the FOMC have maintained that the timing and path of rate increases will be dictated by the economic data. The implied probability of a rate increase has fluctuated with the economic data over the past several months as shown below. Odds of a rate increase dropped after the weak payrolls in May and the Brexit vote. As financial markets shook off the Brexit concerns and the June payrolls came in strong, odds began to increase again. A weaker 2Q GDP report brought odds back down some before payrolls came in strong again for the month of July, leading the implied probability of a September increase to trend up to 40%. August payrolls came in a little lighter than desired and the odds of a September increase have trended lower to around 20%, but that certainly does not mean it is off the table.



Source: Bloomberg

The FOMC has three more meetings this year with the next meeting held September 20-21st, so we will have an answer soon regarding the possibility for a rate increase at that meeting. If they leave the rate unchanged at that meeting, it is likely markets will look to December for a potential increase. All communications signal that if economic activity and labor conditions remain supportive, they are likely to increase rates again before year end. Their previous projections for the appropriate path for the federal funds rate indicate another increase before year end and communications from various FOMC members indicate a desire to increase the rate assuming economic conditions are supportive. In Yellen's most recent speech at the Jackson Hole symposium on August 26th, she stated that "in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months." The exact timing of the next increase seems to be less certain and the mixed communications from various FOMC members seem to be reinforcing the likely desired communication that every FOMC meeting is a live meeting with the potential for an increase and the decision will indeed be driven by how the incoming economic data affects their outlook. We will get updated projections from the September meeting. With only two meetings after that to be held in November and December, the projections should paint a pretty clear picture of if and how many increases they are thinking about through the remainder of the year.

As the chart highlights below, the market is still pricing in a significantly lower pace of rate increases compared to FOMC projections. Individual projections are represented by the dots, with green x's indicating the projected median path. Market expectations are represent by the blue dots.

Appropriate pace of policy firming dot plot:
Current FOMC participant medians vs. market pricing

Source: Morgan Stanley Research, Federal Reserve

The difference between market expectations and FOMC participants' projections is fairly wide when considering if the FOMC moves in 25bp increments, the difference in 2017 represents a difference of three or four rate increases. This difference may also indicate that the FOMC has a credibility problem in the view of market participants, which makes FOMC communications a less effective tool. Something will have to give here. So far, it has been FOMC participants moving their projected pace and normalized longer term rate lower. Updated projections will come with the September meeting and again in December, with the individual dots and the median path likely shifting lower.

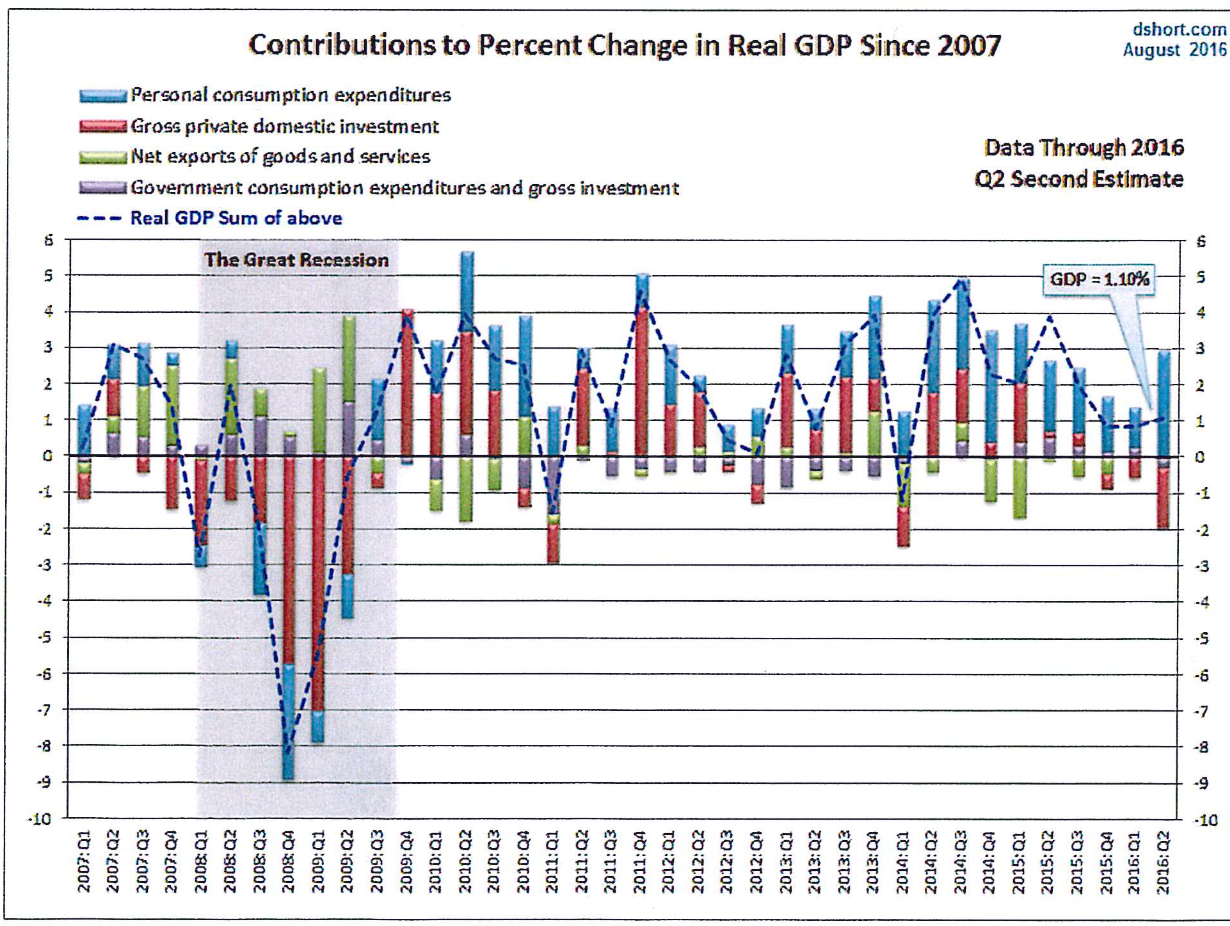
Economic Outlook

By Hunter Bronson

According to the BEA's second estimate for the second quarter, The US economy grew a disappointing 1.1% annualized, after adjusting for inflation. The tepid growth was mostly driven by relatively strong consumer spending. Coupled with its most recent 0.8% estimate of Q1 GDP growth, the BEA estimates that GDP grew at an annualized real rate of 1% over the first half of the year – decent, but not strong.

The components of real, inflation-adjusted GDP growth were as follows: consumer spending grew at a 4.4% annualized real rate in the second quarter and about 3% for the first half of the year. Residential fixed investment was down -7.7% in the quarter, and first quarter growth was revised down from 17.1% to 7.8%, leaving the first half estimate of growth at roughly zero. Nonresidential fixed investment – or private business investment – was down -0.9% in the second quarter and down roughly -2% for the first half. Government spending was down -1.5% in the second quarter and roughly flat in the first half. Net exports were materially unchanged.

Figure 1: Contributions to GDP

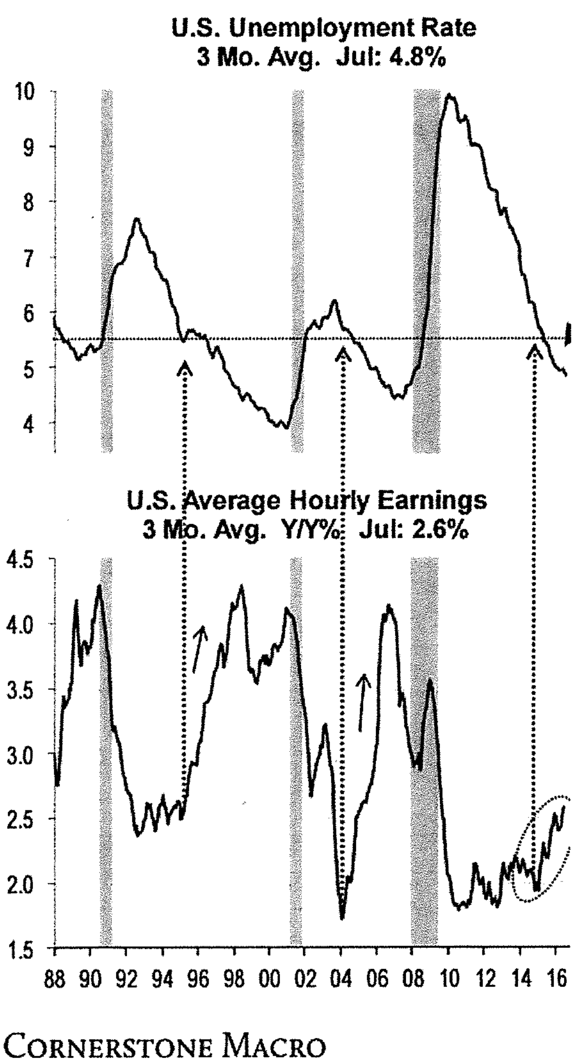


Wages & Employment

According to the Pew Charitable Trust in 2015, "The typical worker enjoyed wage growth of 22% between 1979 and 1999 but only 2% from 1999 to 2009," and, "Even when pooling all of its resources – including from accounts that are potentially costly to access, such as retirement accounts and investments – the typical middle-income household can replace only about four months of lost income." We have repeatedly stressed the urgent need for organic wage growth to repair consumer balance sheets, stimulate demand, and bolster domestic GDP growth.

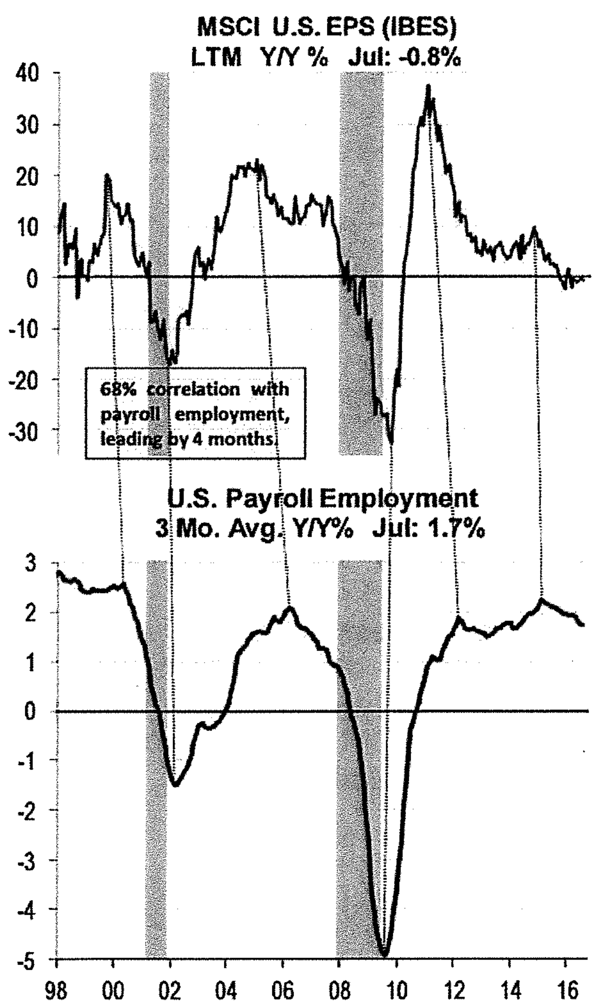
In 2015, the economy crossed the 5.5% unemployment threshold at which wages usually begin to rise. True to form, average hourly earnings have since moved meaningfully higher. Taken together, the improving employment and wage picture has boosted incomes materially. According to the Census Bureau, the median household income rose 5.2% or $2,798 to $56,516, after adjusting for inflation in 2015. This was the largest annual gain on record since the annual income survey began in 1967.

Figure 2: Employment and Wage Growth



A word of caution – it is likely that employment growth will begin to slow as the labor market nears the natural rate of unemployment. While this should not be a surprise, it is likely that many economic participants are extrapolating an improving consumer position that has benefited from the dual tailwinds of both wage growth and improving employment prospects. With the employment story largely played out, wage growth will need to carry the load from here. While this is precisely the point in the cycle when wage growth typically accelerates, it is possible that weakening corporate profit margins may drag on both wage growth and hiring, as shown in Figure 3 below.

Figure 3: Corporate Profits Effect on Employment (Cornerstone Macro)

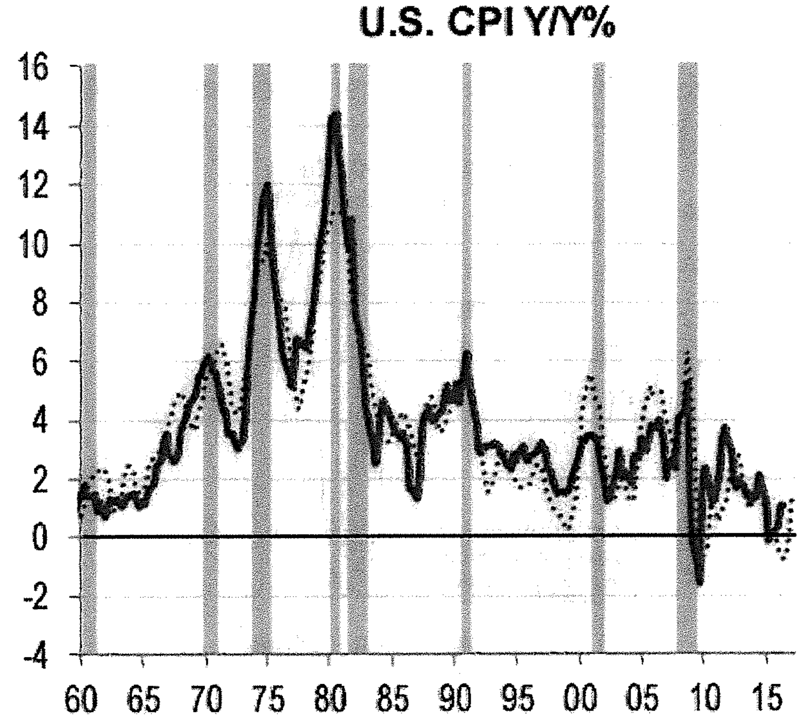


We are encouraged with the progress of the US worker, and we think that his/her improving employment prospects are confirmed by the relatively strong consumer spending contribution to GDP in the first half of 2016. We reiterate that this strength must endure, as it is the fuel for continuing domestic growth.

Inflation

The US Core Consumer Price Index (ex-Food & Energy), a broad measure of inflation, increased 2.2% Y/Y in July. Due to the declines in both food and energy commodities over the year, the all-in inflation number was only 0.8%.

Figure 4: U.S. Headline Consumer Price Index (Cornerstone Macro)

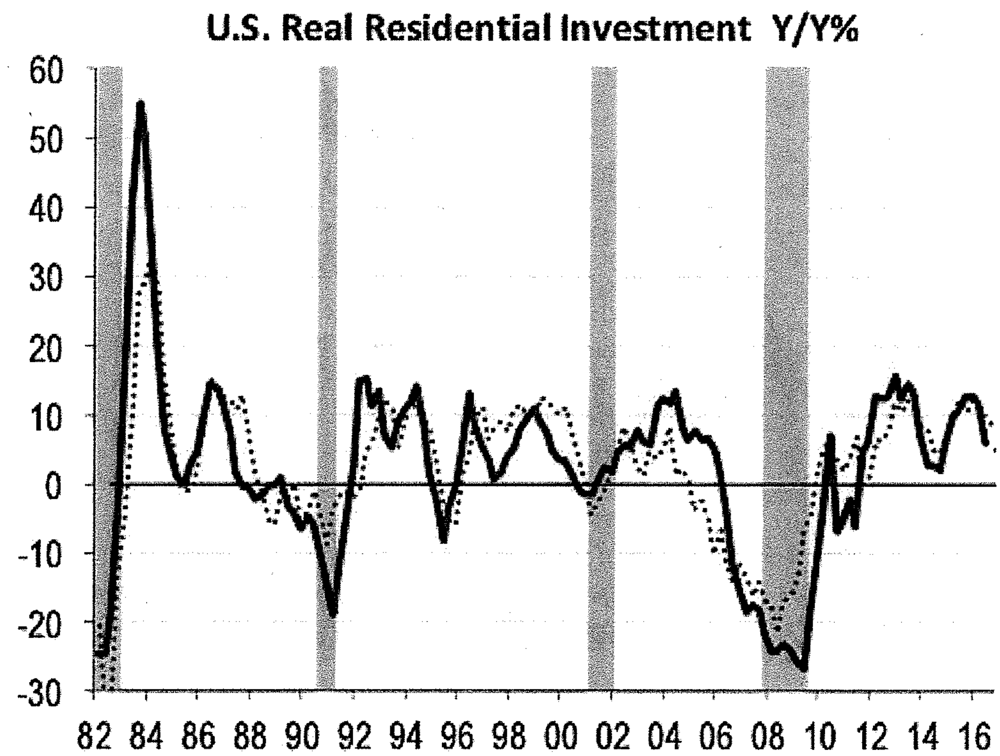


Historically, sluggish levels of business activity and slowing monetary growth will likely continue to restrain inflation over the next year. However, wage gain momentum and the rolling-off of last year's dramatic commodity price dive will put some upward pressure on the all-in CPI number and keep it within striking distance of the Federal Reserve Board's target of 2%.

Housing

Private residential investment has recovered unusually slowly over this cycle, and that sluggish pace has continued over the first half of 2015 – coming in roughly flat Y/Y. Despite extremely low mortgage rates and improving consumer balance sheets, regulatory scrutiny and a new, "smart consumer" have held housing activity in check.

Figure 5: Domestic Housing Activity (Cornerstone Macro)

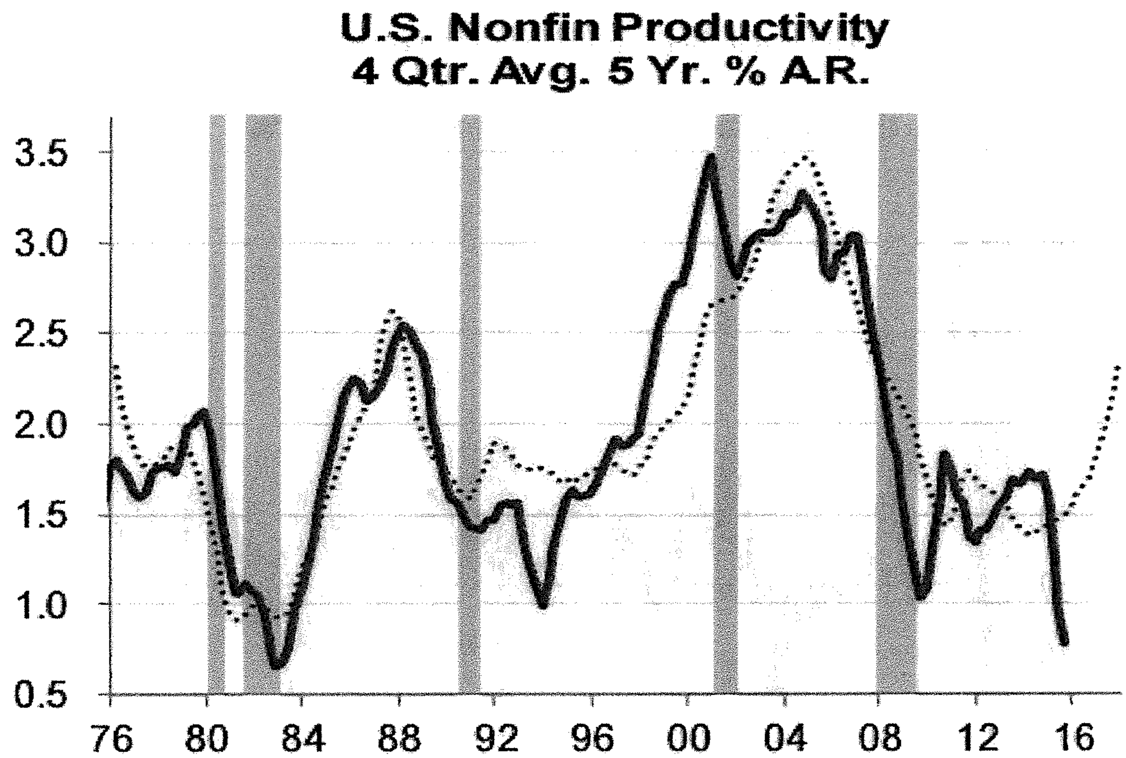


We do not expect much acceleration in real residential investment over the remainder of the year due to higher house prices, lower inventories, higher savings rates, and declining home ownership rates going forward.

Productivity & Investment

The solid line in the following figure charts the disappointing progress of U.S. nonfinancial productivity over the course of the recovery.

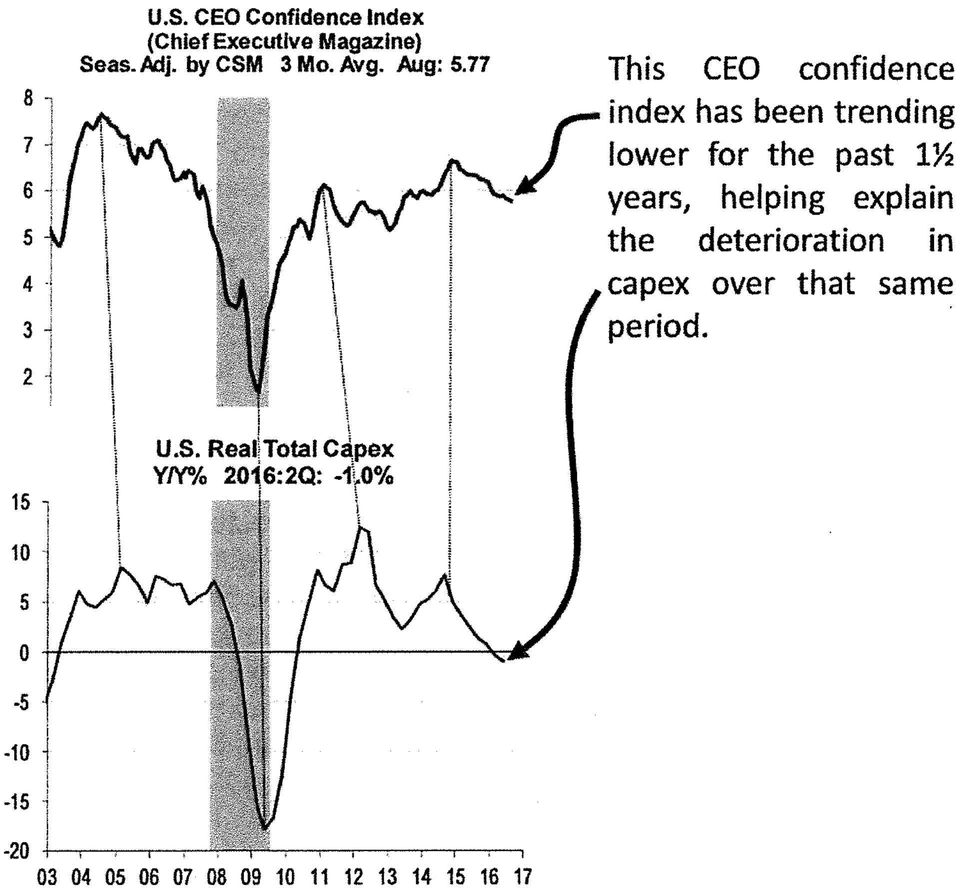
Figure 6: U.S. Productivity Growth (Cornerstone Macro)



While there has been a lot of speculation and angst among economists about why productivity growth has been so weak, we think the most likely explanation is the simplest – businesses haven't invested enthusiastically through the recovery. Figure 7 indicates that, aside from the snap-back recovery following the Great Recession, real CAPEX growth has been rather anemic. The trend has continued in 2016, as non-residential fixed investment is down over 2% for the first half of the year.

Unfortunately, we think that this is unlikely to change in the back half. The Business Roundtable's quarterly survey of CEOs recently indicated that business leaders are still unenthusiastic about the domestic economic outlook. The leaders indicated that they are most reluctant to increase capital investment due to uncertainty about the upcoming election. CEOs' outlook on business investment was virtually unchanged from the second quarter, with only 38% expecting to boost business spending in the next six months. Figure 7, below, indicates that CEO confidence is a good coincident indicator of domestic real CAPEX growth.

Figure 7: U.S. Real CAPEX growth & CEO confidence (Cornerstone Macro)



CORNERSTONE MACRO

We would also add that U.S. corporate profits and profit margins, which seem to have reached at least a momentary peak, tend to be leading indicators of CAPEX spending. We are hopeful that the U.S. consumer will prove resilient enough to give business leaders the confidence they need to increase investment spending – providing a natural boost to GDP and setting the stage for increased productivity in the future. If the consumer is unwilling to lead the charge, the next president and Congress will likely need to step in with a comprehensive fiscal stimulus package to boost demand, bolster private sector profits, and put a floor under GDP growth.

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our previous meeting on June 24th, the result of the Brexit referendum in the United Kingdom was announced that morning. This event produced significant volatility in the capital markets as investors became risk averse. The S&P 500 fell 3.59 percent on that day while the yield on the 30-year Treasury fell 14 bps. The markets were clearly caught off guard as evidenced by the dramatic moves in various securities. Treasury yields remained low through the end of the month with the 5yr settling at basically 1 percent and the 30-year at 2.28 percent. In total, Treasuries as an asset class returned 2.32 percent for the month. A dovish Federal Reserve combined with a weak May jobs report also helped to lower yields according to BofA Merrill Lynch.

With yields falling precipitously, government-related sectors lagged as their convexity properties weighed on their performance. Agencies returned 1.28 percent while mortgages returned .81 percent. On the corporate front, high grade bonds returned 2.18 percent which was the third best month of performance in the last three and half years. Financial bonds, especially large global banks felt the brunt of the Brexit impact by widening 14 basis points (bps) to 162 bps according to CreditSights. Utilities paced the overall index with an 8 bp widening while industrials outperformed with spreads increasing by only 5 bps. Commodity-related names led industrials as energy bond spreads tightened by 7 bps and basic industry names were unchanged in aggregate. New issue supply among high grade bonds numbered $86 billion in June, which was significantly less than the $176bn issued in the prior month per BofA Merrill Lynch. The high yield market did not fare well in the rate rally. The total return was 1.10 percent with a negative 12 bp spread change. Like the high grade segment, commodity names were stellar with energy services posting a 4.7 percent total return and metals & mining registering a 4.2 percent total return.

While Brexit produced dislocations in late June, the S&P 500 staged a dramatic reversal in the last few days of the month as crude oil prices rose, according to CNBC.com. This positive tone for risk assets continued into July with the S&P 500 rising 3.56 percent. The rally was further supported by the better-than-expected jobs number on July 8th when the Bureau of Labor Statistics said the U.S. created 287,000 jobs in June. This environment produced volatile price action in Treasuries. For example, the 10-year Treasury yield fell 15 bps, rose 31 bps, and then fell 18 bps. The net overall movement was only 2 bps for the month. The 2s/10s curve flattened during this time by 9 bps as the front end sold off. The Federal Reserve maintained its target interest rate at the July 27th meeting and in their economic assessment, they "pointed to a bit more confidence in the overall economic outlook (largely hinging upon consumer spending), diminished concern about the labor market and a virtually unchanged inflation assessment" per Bloomberg News.

Government-related sectors were the clear laggards in this environment. U.S. agencies returned 21 bps while U.S. mortgages returned 20.5 bps versus 42 bps for Treasuries. In agencies, the Credit Suisse 3-5 Year Agency Index showed spreads widening by 2 bps. For 30-year mortgages, spread movement was mixed across the curve as they rose versus the 10-year but tightened versus the 5-year Treasury. The US high grade credit market posted stellar returns as "a wall of money" flowed into the space as investors reached for yield in the aftermath of Brexit, per CreditSights. High grade corporates returned 1.45 percent with industrials generating the most excess return of 103 bps as high beta issuers led the way. Metals & mining names were materially tighter by 38 bps while media and telecom posted solid spread compression of 16 bps and 15 bps. While utilities lagged on an excess return basis, their longer duration helped to put their total return of 1.61 percent above the other sectors. The new issue market for investment grade corporates was strong registering $92 billion which was 12 percent higher month over month (MoM). The high yield market did not fare as well on the issuance front as the pace slowed for the third straight month to $16 billion. That pace was down 28 percent from the previous month. This, however, did not deter yield chasing among investors in high yield bonds as Wells Fargo said the space had "robust inflows" to the tune of $7.9 billion in the first three weeks of the month. In total, high yield tallied a 2.53 percent monthly return which was well of ahead of high grade bonds.

August was a mixed bag in terms of asset classes. The S&P 500 oscillated in a range that only produced a 14 bp return while the Treasury market lost 57 bps as yields gradually moved higher. One of the catalysts for the selloff in Treasuries was the strong jobs number on August 5th. The Bureau of Labor Statistics said the U.S. added 255,000 jobs in July. This increased the probability of an interest rate hike in September by the Federal Reserve, according to CNN.com. A second catalyst came from Janet Yellen's comments in Jackson Hole on August 26th when she said, "In light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months."

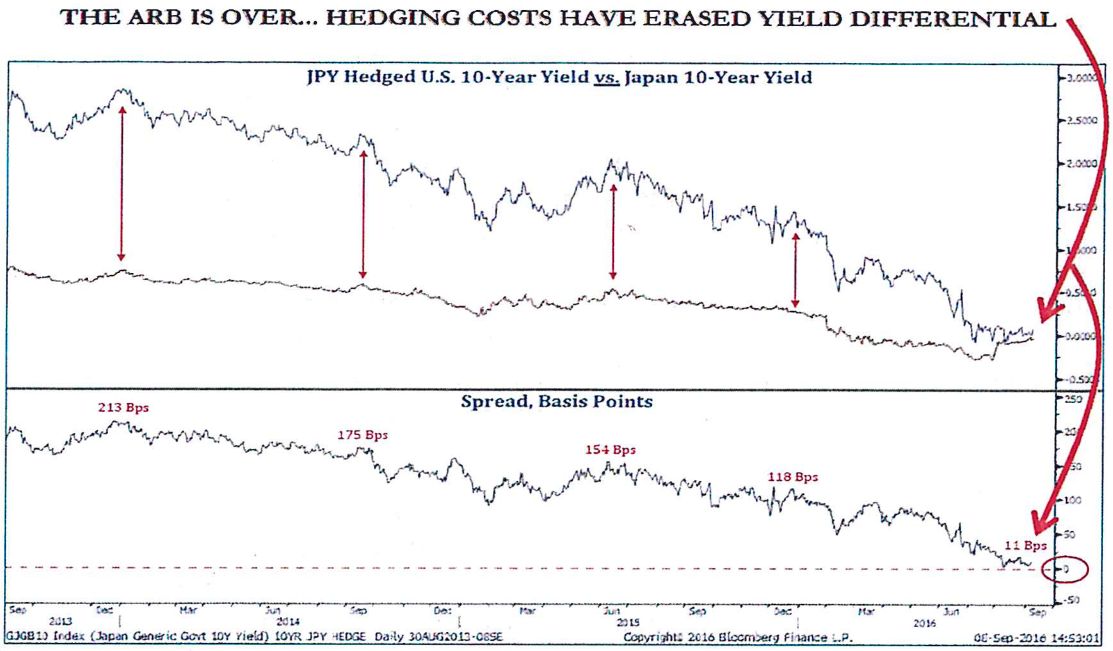
In other areas of the bond market, agencies fell by 20 bps as the 1 bp compression in spreads as reflected in the Credit Suisse 3-5 Year Agency Index was not able to offset the negative interest rate move. Mortgages rose by 11 bps on a total return basis as 30-year MBS spreads versus the 5-year Treasury tightened by 9 bps. The bright spots in the financial markets were largely centered in corporate debt. High grade bonds returned 27 bps with 90 bps of excess return. CreditSights said "global demand for US credit remained notably robust. In particular, retail investors were chomping at the bit to add exposure as they invested nearly $14 bn of new money into investment grade credit mutual funds in the last four weeks according to ICI data." Industrials led the way again with an excess return of 95 bps and even outperformed on a total return basis of 30 bps versus 26 bps for financials and 14 bps for utilities. The commodity-related names were at the apex of excess returns among individual sectors with pipelines registering a 205 bp excess return and oil & gas producing a 194 bp return. Tobacco was the worst sector with a 26 bp excess return. The new issue market was wide-open in August to the tune of $112 billion. BofA Merrill Lynch said that amount set a record for the calendar month.

While high grade bonds did well, high yield corporate bonds did even better with a 2.23 percent total return. Investors were clearly reaching for yield in August.

The month of September has been difficult for both stocks and bonds. A combination of a disappointment from the European Central Bank(ECB) combined with more hawkish comments from the Federal Reserve has produced volatility in the capital markets. On September 8th, "traders were taken aback by Mario Draghi's remarks that the ECB hasn't discussed an extension of its asset-purchase plan at a time of growing concern over a recovery in the euro-zone" per Bloomberg News. This helped ignite a multi-day selloff in Treasuries. Boston Fed President Eric Rosengren added fuel to the decline by saying "if we want to ensure that we remain at full employment, gradual tightening is likely to be appropriate." He also said "a reasonable case can be made for continuing to pursue a gradual normalization of monetary policy." The bearish move in interest rates has been accompanied by spread widening among various fixed-income instruments. The 30-year mortgage spread versus the 5-year Treasury has expanded by 8 bps. The Credit Suisse 3-5 Year Agency Index spread has basically resisted the weakness which is a positive for the asset class. Both CDX investment grade and CDX high yield CDS indices have moved wider though the investment grade CDS index has only changed by 3 bps.

Over the last few months, we made a number of adjustments to navigate the ever-changing fixed-income markets. In Treasuries, we completed two duration extension trades to hedge against a downward move in interest rates. The first was a swap out of our May 2023 position and into a November 2024 security. This allowed the fund to pick up 11 bps of yield and increased the duration of the portfolio. The second was the purchase of a block of long-dated Treasuries to take advantage of the sell-off in long end of the curve. We remain underweight the asset class, but are long duration to guard against an adverse economic scenario.

The outlook for interest rates is composed of two different trends. The first is focused on the short term cycle which indicates that rates are going higher. Bloomberg Intelligence Economics expects "the next rate rise will come in December, and similar dynamics – namely full employment-induced wage pressures – will justify two or three additional rate hikes in 2017." The market seems to be of the opinion that a rate hike in September is off the table as the probability is only 22%,, according to Bloomberg. The low number can be partially attributed to the cautious comments by Fed Governor Lael Brainard who counseled "prudence in the removal of policy accommodation." After September, the probabilities go up to 57 percent for a December hike and a number of the 2017 dates have 60 and 70-plus percentage probabilities. The market is clearly expecting higher rates after September. Besides the Fed action, the reduced foreign demand for U.S. Treasuries could cause rates to rise. Over the past few years, as one can see in the chart provided by Strategas Research Partners, Japanese investors could buy U.S. Treasuries, hedge out the currency risk and ultimately pick up a large amount of yield over buying Japanese government bonds. This was also the case with German investors buying U.S. Treasuries. These trades created tremendous demand for U.S. Government bonds. Now, the arbitrage has largely ended and U.S. interest rates could rise due to reduced global monetary flows into our sovereign debt market.



-Strategas Research Partners

The second trend is the long term direction of interest rates, which is still down. The chart shown below clearly indicates this. Investors should be looking for a multi-year period of side-ways yield movement before one can call a change in trend. Until this happens, investors need to careful about becoming too bearish on interest rates. However, in the short term, 30-year Treasury yields do appear too low given the green long-term trend line which supports the short-term thesis highlighted above.

Source: Bloomberg

In the mortgage-backed securities space, we purchased multiple pools over the last few months. Two of them were 15-year 2.5 percent coupon Fannie Mae's which were bought to reinvest proceeds from called agency securities as well as mortgage prepayments and to add money to the sector. The yield on these securities were in the 1.60 percent range with 55-57 bps in spread. The other pool that was purchased was a 30-year 3.5 percent coupon Fannie Mae which was done to reinvest prepayments and to increase the weighting of the 30-year pools in the MBS portfolio. This pool had a 2.395 percent yield with a 118 bp spread. Our outlook in mortgages is positive versus government-related fixed-income products as spreads are relatively better. We remain overweight 15-year pools with a long duration tilt. The 15-year pools have better extension protection in a rate rise scenario while the long duration positioning helps the portfolio in a falling rate move. We will be opportunistic about adding more 30-year pools because they do offer greater yield and could perform better if a sideways interest rate market prevails. If rates continue to back up, we hope to take of advantage of prepayment protection stories at the right price to improve the portfolio's convexity characteristics.

The agency sector had multiple issues called in the wake of lower interest rates and some of the proceeds from these issues were reinvested back into various agency securities. One was a June 2024 Federal Home Loan Bank issue which yielded 1.598 percent and had a 28 bp spread. This trade helped to improve the fund's convexity and to lengthen the duration of the portfolio. Another was an August 2023 Federal Farm Credit Bank note with a yield of 1.57 percent and a spread of 17 bps. This trade also helped the portfolio's convexity profile while adding some duration. Currently, we are neutral to slightly overweight the asset class versus the benchmark as well as being a little short duration. We are neutral on agencies going forward as the upside is limited given their tight spreads over Treasuries. We also don't see a lot of future volatility in spreads which limits their potential risk.

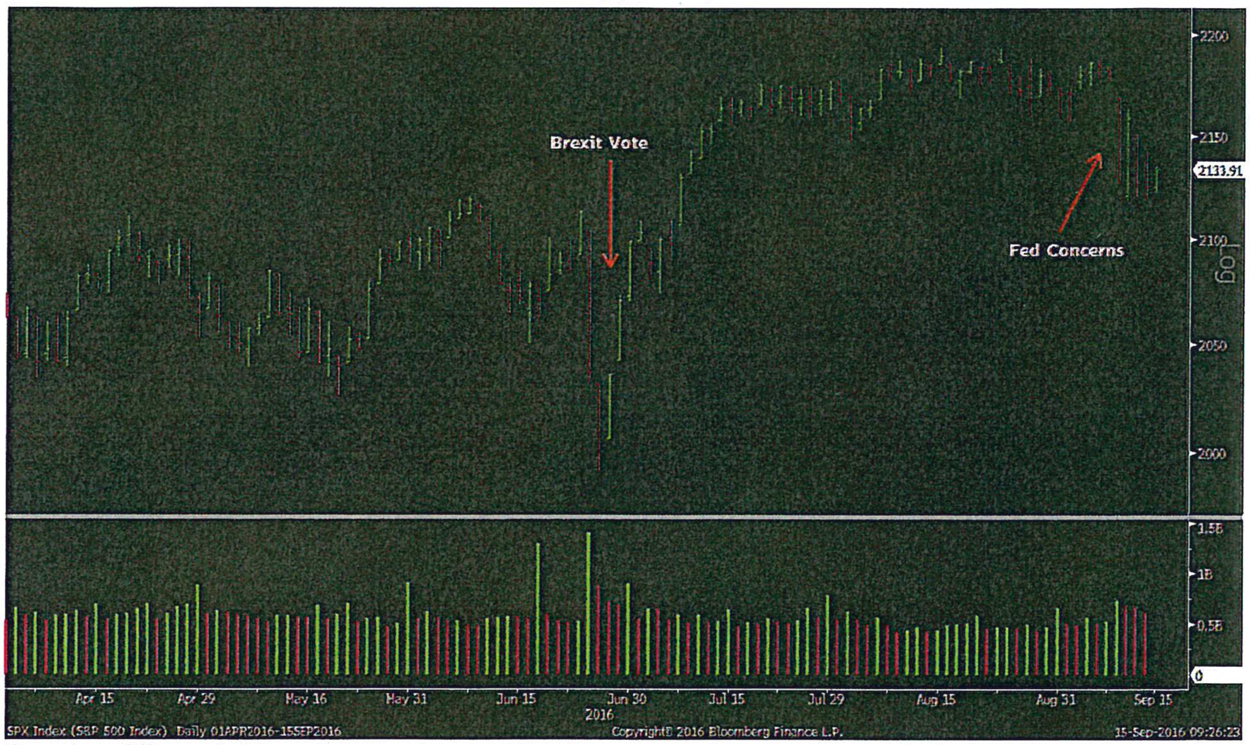
In the corporate bond market, RSA participated in Microsoft's new issue offering as well as W.P. Carey's. Microsoft issued $19.75 billion to help finance its acquisition of LinkedIn. We purchased a $20mm block of the 20yr portion that priced at 120 bps over the long bond. This allowed us to add a little duration to hedge against lower rates and to get 120 bps over its risk-free benchmark which has a lower credit rating than the Company. W.P. Carey sold $350 million 10-year notes to reduce the amounts outstanding under the company's credit facilities. The deal came at 275 bps over the 10-year and we bought $5 million. We felt that the deal offered tremendous value given that the Company's 2024 and 2025 notes were trading at 225 and 235 bps. We also purchased $7 million of NVIDIA's 10yr issue at 150 bps over the 10-year. Our view on corporate bonds is that they remain the place to be. Investment grade corporates offer 134 bps in spread for a 7.4 year duration as of 9/9/16, according to Wells Fargo. With the 7-year Treasury yielding 151 bps on the same day, an investor could almost double their yield by moving to investment grade corporates. High yield bonds have even higher spreads at 518 bps, but also large amounts of risk. With high yield posting a 10.08 percent yearly return to 9/9/16, a degree of caution is warranted in chasing this sector. In total, RSA is maintaining its overweight in corporate credit with a short duration bias. Over time, this overweight should outperform the benchmark.

Domestic Equity Strategy

By Adam Rogers

It's hard to imagine that only a few months ago we were facing an up or down vote in the UK that would "change the whole course of European history". If you remember, the Brexit vote caught a lot of people by surprise, sending the S&P 500 down 5% over two days. The referendum on June 24th to leave the European Union caused the British pound to fall 8%, its largest recorded one-day loss, sending it to levels not seen since the 1980s. The VIX volatility index spiked 50% and global investors rotated out of equities and into sovereign bonds, the Japanese Yen and the US Dollar. Markets don't like uncertainty or the unexpected but once the news was digested, the US equity market took 3 days to reverse those losses and cooler heads have prevailed since. The Brexit vote is a great example of how noise can dominate markets over the short run. As we mentioned in June, this vote was the latest example of the knee-jerk risk-on/risk-off atmosphere that characterized the first half of our fiscal year.

Exhibit 1: S&P500

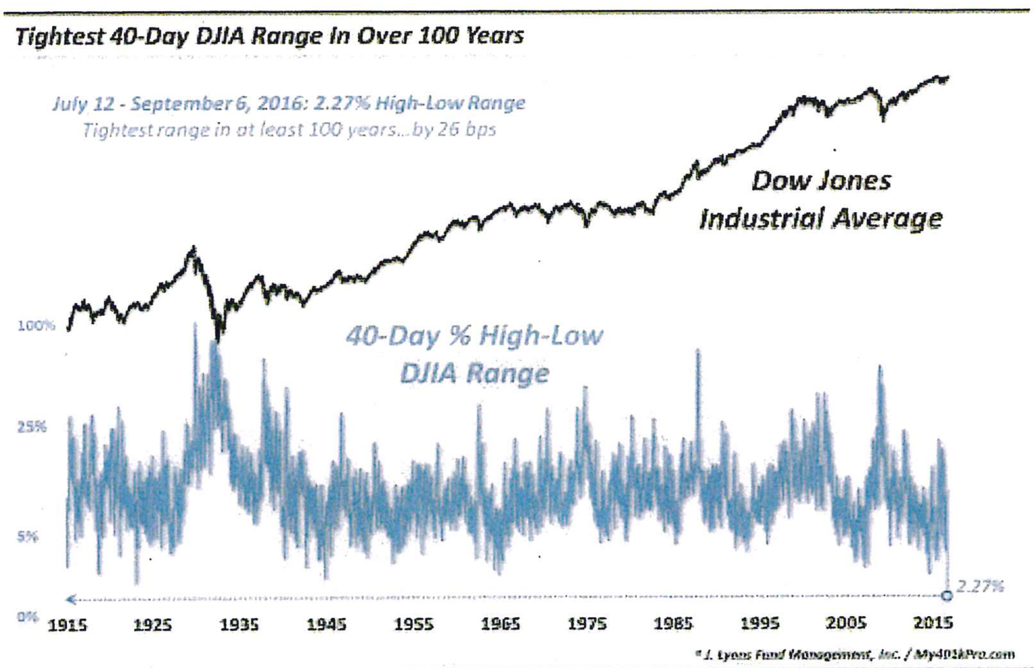


Source: Bloomberg

Post Brexit, during the first part of July, large cap US stocks finally managed to break out to new highs and after several days of follow through, the averages settled into an exceptionally tight trading range. In fact, the S&P500 didn't make a move of more than 1% up or down for the entire month of August as average daily volume dropped about 20% relative to the rest of the year. "Boring" markets like this usually don't last, one reason being investors seek to create excitement through leverage. We spoke last time about the prolific use of ETF's by hedge funds and it's not surprising that, in a sleepy market, the ETF's with the greatest asset growth in August were of the riskier variety – triple levered gold miners and double inverse telco ETFs, for example.

Not to belabor the point, but for context, the high to low range in the Dow Jones Industrial Average (DJIA) for the 40 days ended September 6th was a mere 2.27%. That is a 100 year record.

Exhibit 2: Tight trading Range



Breaking the silence, monetary policy fears crept into the market in mid-September, following a non-committal tone from the ECB and the BOJ. The narrative from those meetings and heading into the Fed meeting this month is that we have reached the limits of central bank effectiveness. A consensus is building that monetary policy, while not hostile, is out of ammo. Central banks are running out of bonds to buy and rates can't go far below zero. People in Japan and Germany are already buying safes to store cash rather than pay the government to hold it.

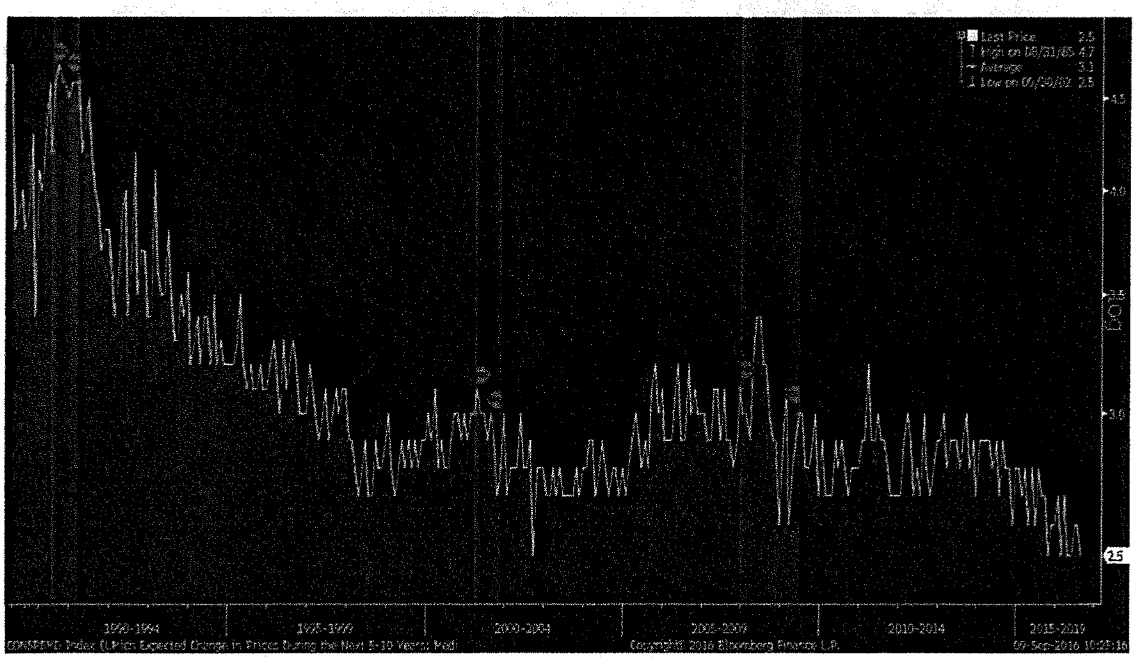
When the market senses a potential tipping point like this, volatility inevitably picks up, even though the transition away from a market dominated by Central Bank action is likely a positive over the longer term. One group particularly at risk within the equity market is the "safe haven" or "bond proxy" stocks. With a lack of yield around the world, money has flowed into dividend payers and ETF's with the appearance of high yielding, safe, predictable income streams. Valuations in this space are lofty, and we see more short term risk here than in the market as a whole. If rates are perceived to be moving higher, the exit from these names will be swift with a twofold headwind of higher rates damaging the underlying businesses as well as invoking less demand for the dividend characteristic of the shares.

Now, after breaking out, consolidating, and retesting, where do we go from here? Our view remains that US equities still have potential to grind higher, primarily because we don't see the triggers typically associated with big market tops. A simple bear market checklist includes the following signals: **problematic inflation, tight monetary policy, euphoric investor sentiment, and extreme valuations relative to interest rates and inflation**. When we dig through each of these items, our conclusion is that none appear imminently worrisome enough to change our stance that the combined effects of dividends, buybacks, and earnings should be enough for mid to high single digit returns over the next year. Though we note that of all of these, any hint that fed policy is tightening would create the most short term pressure.

Inflation

Going through the checklist one by one, what is the inflation landscape? We look for late-stage expansion signals where wages, oil prices, import prices, and inflation expectations steadily accelerate to worrisome levels. Any combination of these would be a reliable signal for future market weakness. Inflation is the checklist item that gives us the most pause. On one hand, while the labor market has certainly improved, there is still a fair amount of slack - enough to mute wage inflation. We've argued that wages need to rise, and they are beginning to, but the pace is slower than usual. So while we don't see any problems with inflation right now, on the other hand, wages are indeed rising, which sets the scene for possible acceleration. But for the moment, we don't see the data resembling what is typically seen at the end of an expansion.

Exhibit 3: UMich 5-Year Inflation Expectations

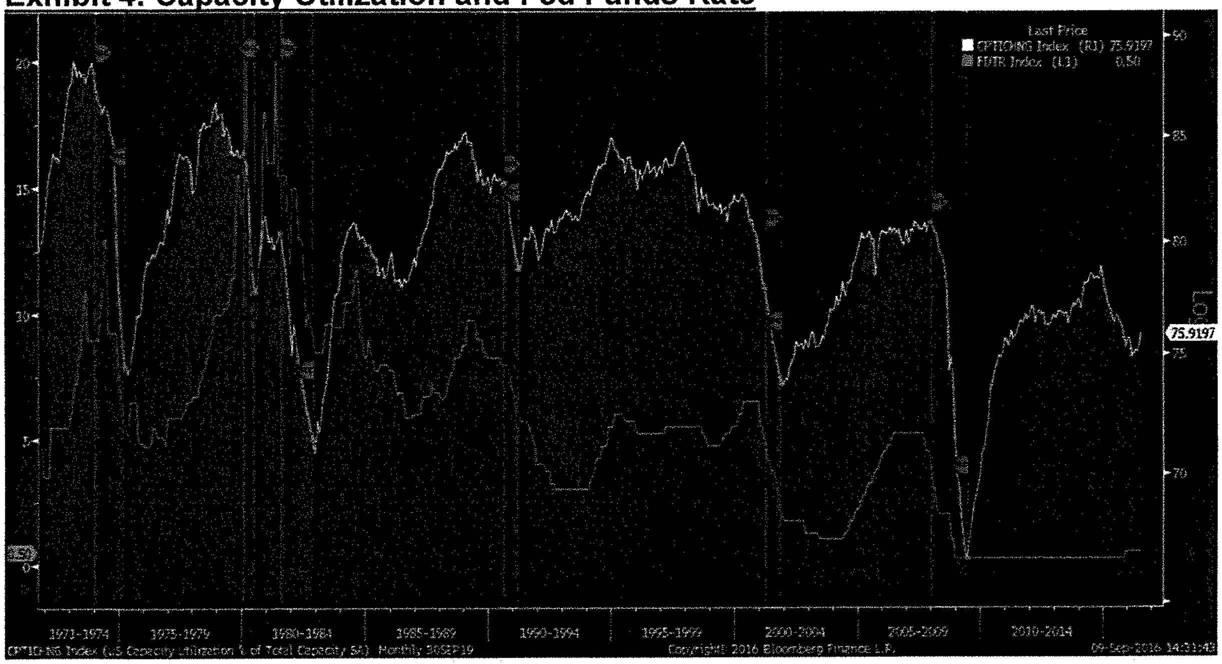


Source: Bloomberg

Fed Policy

Second, as mentioned, when considering the actions of both the Fed and monetary authorities around the world, the novelty of this cycle is that instead of overt hostility, they may simply be running out of friendliness. The current state of our Fed is very friendly and will likely remain so for some time. Reasons being: Chair Yellen has made it clear that economic activity around the world, not only in the U.S., factors into her policy thinking. The Fed would also like to avoid a surge in the value of the dollar, as that would be a headwind to US economic growth and would threaten emerging economies financed with dollar debt. Also, capacity utilization is not near levels historically coincident with aggressive Fed tightening. But as we mentioned earlier, the market seems to be not only concerned with tighter policy, but also with the effectiveness of looser policy.

Exhibit 4: Capacity Utilization and Fed Funds Rate



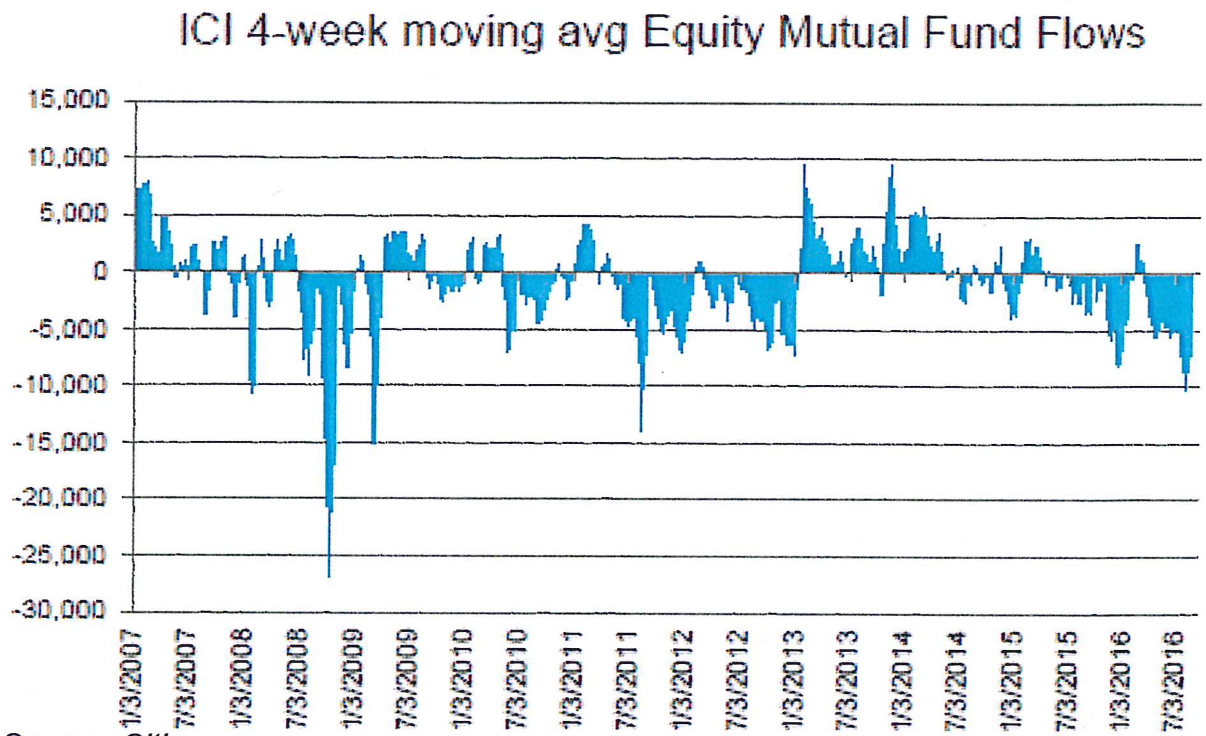
Source: Bloomberg

Investor Sentiment

Third, how are investors feeling? One of the first one-liners I learned in this business is the old adage "the market climbs a wall of worry". On the other side, the time for caution is when worry is absent and investors are exuberantly buying up shares. Today's wall of worry includes: Brexit contagion, a hard landing in China leading to further currency devaluation, politics, trade wars, and loss of central bank credibility/effectiveness. These, of course, are real risks and we do not dismiss their potential to damage US equities, keeping in mind that concerns like these are typical of equity investing and are the equity risk premium's raison d'etre. Without the potential for exogenous shocks there would be no wall to climb, there would be no fear, and fear is half of the greed/fear equation that makes a market. Levels of fear and greed, exuberance and caution, are hard to measure with precision, but we have a few tools, such as fund flows and surveys, which are helpful in gauging these animal spirits. Below are some of these indicators. Note how none appear close to reading what we normally see at market tops, but most reside in what you could describe as neutral territory.

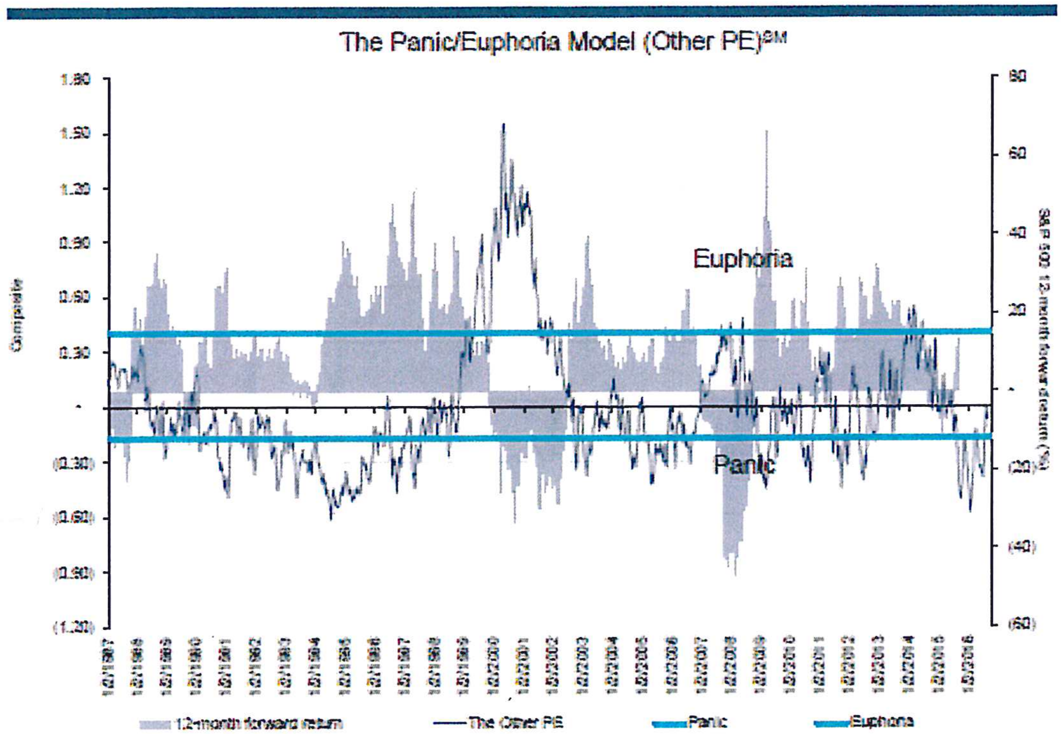
Exhibit 5: Sentiment Indicators

Investors pulled money out of equity mutual funds over the last quarter. Some of this made it's way into positive ETF flows, but the net effect depicts a cautious stance.



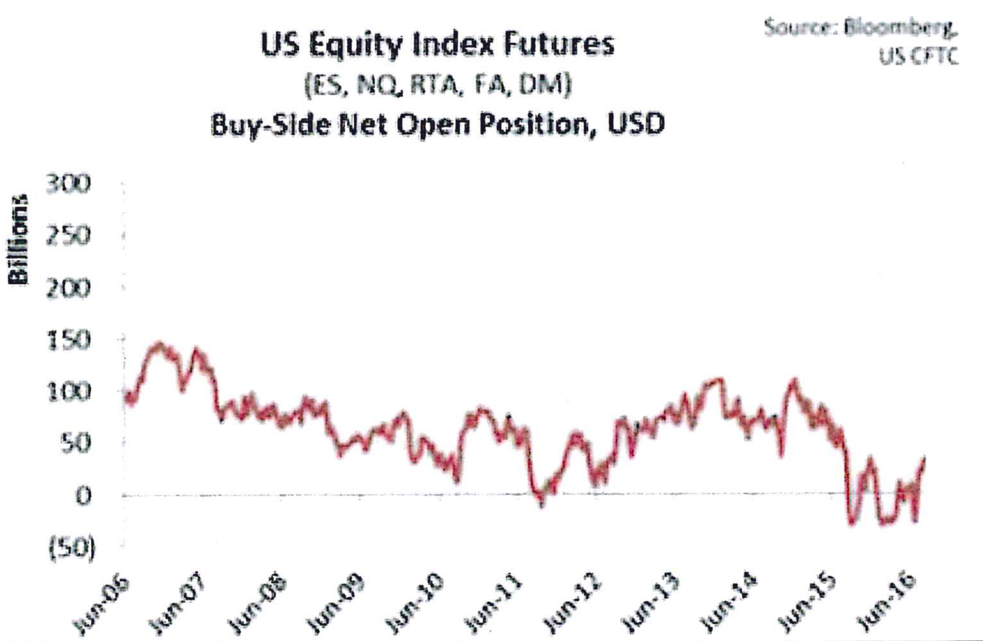
Source: Citi

Citi's Panic Euphoria model, which combines short interest, margin debt, survey data, gas prices, fund flows, and derivative activity in order to gauge investor sentiment remains in neutral territory.



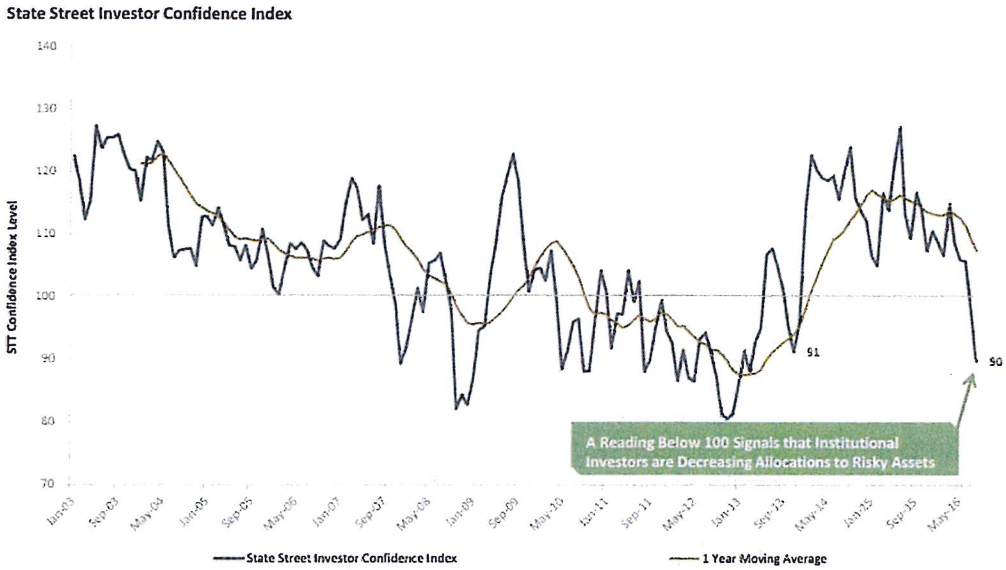
Source: Haver Analytics, FactSet, and Citi Research – U.S. Equity Strategy

More confidence post Brexit, but hardly exuberant positioning.



The State Street Investor Confidence Index analyzes changing levels of risk within portfolios - no exuberance here.

State Street Investor Confidence — Sentiment Significantly Dropped Over the Past Few Months, and is Now at Its Lowest Point Since 2013

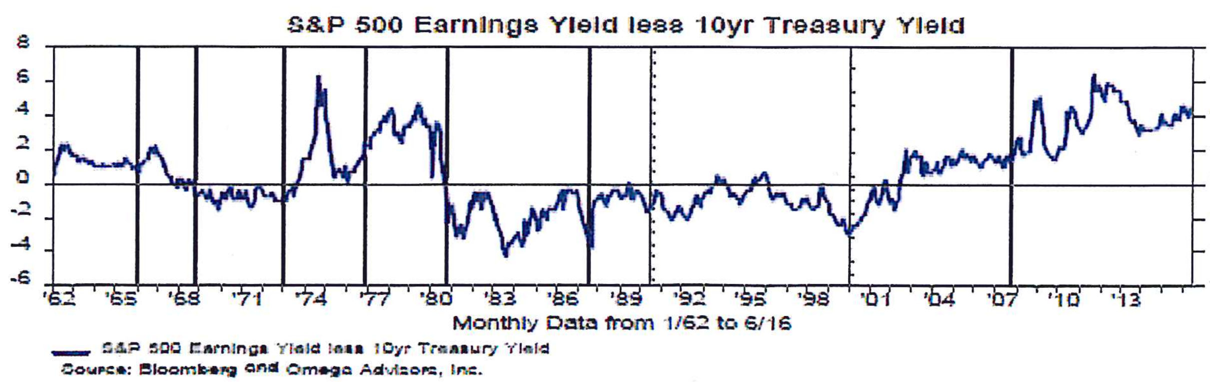


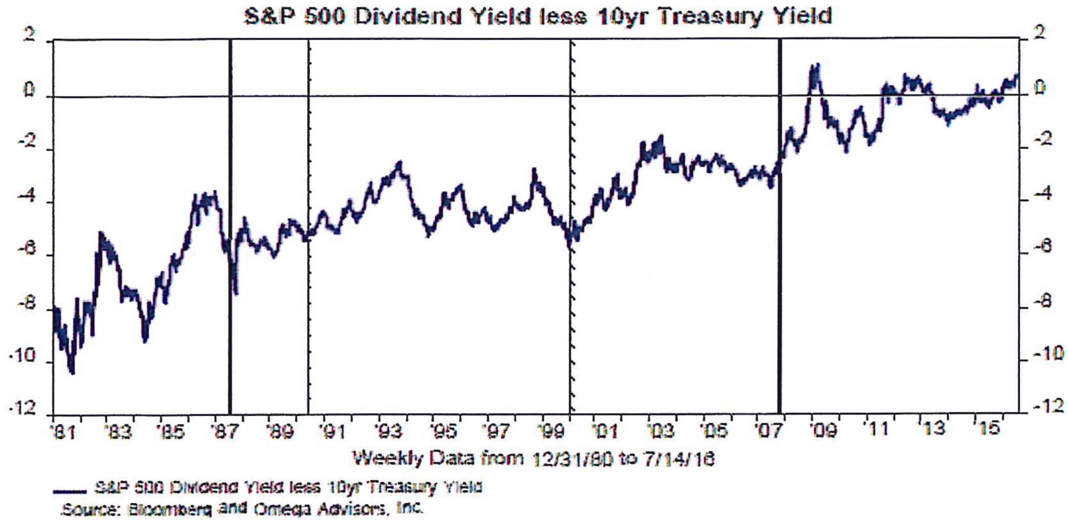
Source: Bloomberg Finance L.P. As of August 31, 2016.
State Street Confidence Indexes Measures investor confidence or risk appetite quantitatively by analyzing the actual buying and selling patterns of institutional investors.
This index assigns a precise meaning to changes in investor risk appetite: the greater the percentage allocation to equities, the higher risk appetite or confidence.
A reading of 100 is neutral; it is the level at which investors are neither increasing nor decreasing their long-term allocations to risky assets.
The results shown represent current results generated by State Street Investor Confidence Index. The results shown were achieved by means of a mathematical formula in addition to transactional market data, and are not indicative of actual future results which could differ substantially.

Valuation

Finally, is the market overvalued? On an absolute basis, we would agree that multiples are extended relative to long term averages, but we wouldn't classify current levels as speculative relative to inflation and global interest rates. In other words, valuation is not ideal, but relative to prior market peaks, we don't see it constraining a continued grind higher. The base case for equities over the next year, even at these slightly elevated valuations, remains that the combination of dividends, a shrinking equity base, and earnings growth will lead to mid to high single digit returns over the next year.

Exhibit 6: Relative Valuation





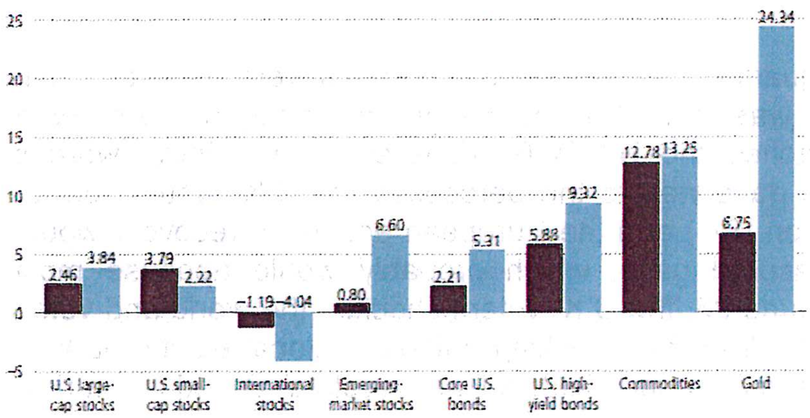
In summary, we remain in the base case camp that equities still have enough factors working in their favor to continue inching higher. Inflation is not problematic, monetary policy is not hostile, sentiment is not euphoric, and valuations are not out of control relative to interest rates and inflation. Short term volatility and weakness can, of course, appear at any time, but we don't see the makings of a big market top at the moment. Given the risk of short term corrections, our activity over the past few months has included using market strength to overlay hedges through put spread collars, staggering the maturities, in order to manage downside risk.

International Equity Strategy

By Steve Lambdin

For most of the second quarter, the global equity markets were relatively calm as equity market volatility was rather low. However, this changed in a hurry in late June as we approached the U.K.'s Brexit referendum. Initial worries surrounding the outcome gave way to the perception the U.K. would vote to stay in the European Union (EU) and the European economic recovery would continue at a slow measured pace, which probably would appease most investors. However, on June 23, the U.K. voters shocked the world and voted to leave the EU. As a result of this shocking outcome, global equity markets sold off sharply and government bond yields fell as investors rushed into a risk-off environment. The U.K.'s sovereign credit rating was cut to AA in addition to several downgrades of European banks' credit outlooks. The British Pound sold off significantly and reached a 31 year low versus the U.S. dollar. Also, U.K. Prime Minister David Cameron announced his resignation following the vote, as his successor will be left to negotiate the "divorce" from the EU after 43 years of EU membership. Unfortunately, the vote has raised more questions than it has answered. However, in the week after the vote, global equity markets staged an impressive rally as nearly two-thirds of lost equity market value from the Brexit vote was recouped. The prospects for significant central bank intervention around the globe was enough to remove a lot of anxiety in investors' minds over what will transpire with these U.K./EU negotiations going forward. Beyond the Brexit situation, investors were concerned with the struggling Japanese economy, the continuing saga of the slowing Chinese economy, rising terrorism in certain parts of the world, anemic global bond yields, and the uncertainty of the upcoming U.S. elections. Commodity prices continued to climb higher in the quarter as crude oil prices rose +26%, gold rose +7%, and silver rose +20%. This was good for emerging markets, as this asset class faired a bit better than its large cap counterparts as a "lower for longer" U.S. interest rate scenario also helped the case for these equities. In Japan, the recent sharp rise of the yen vs. most major currencies has led to fresh growth concerns, reduced earnings expectations for exporters, and difficulty on the deflation front. Meanwhile, the rhetoric out of China in the quarter was generally not much of a surprise for investors. Growth concerns remained a challenge as the government continued to provide stimulus for the economy. Heading into the fall, the uncertainty in Europe with the recent Brexit vote is on the forefront of nearly everyone. The direction of these negotiations could provide a volatile equity market climate, especially as we have recovered very quickly from the shocking losses of late June. This could push the U.K. into a recession and cut the growth outlook of the Eurozone economies at the very least. No doubt, it will be contentious and interesting to watch as it unfolds.

Asset class returns As of June 30, 2016



A partial rebound in energy prices drove commodity and U.S. high-yield credit markets higher for the second quarter, but declining European equities weighed down international developed-market stock indexes.

Source: John Hancock Investments; Morningstar Direct

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -1.46% and +.66%, respectively during the second quarter of 2016 vs. +2.46% for the S&P 500 Index. U.S. equities performed better than international equities as the U.S. was deemed more of a "safe haven" relative to other markets in the turmoil surrounding Brexit late in the quarter. The emerging markets held up a bit better than most expected, as the interest rates in the U.S. remained lower than many had expected. The U.S. dollar was volatile in the quarter, as it rose +2% against the Euro and +6.4% vs. the British Pound, but fell -8.5% vs. Japanese yen. In all, currency provided about a -.75% headwind to unhedged U.S. investors in the MSCI EAFE Index in the quarter. The European region was weaker than the Pacific basin, as fallout from the Brexit vote impacted European equities disproportionately more than other regions. From an economic sector standpoint, the defensive sectors of healthcare, consumer staples, and utilities were relatively stronger, while the more cyclical sectors of industrials, financials, and consumer discretionary were the weakest. The commodity markets continued to rally in the quarter as oil finished near its high for the year at over $48/barrel at the end of March.

Among developed economies worldwide, we expect U.S. growth rates to lead the way

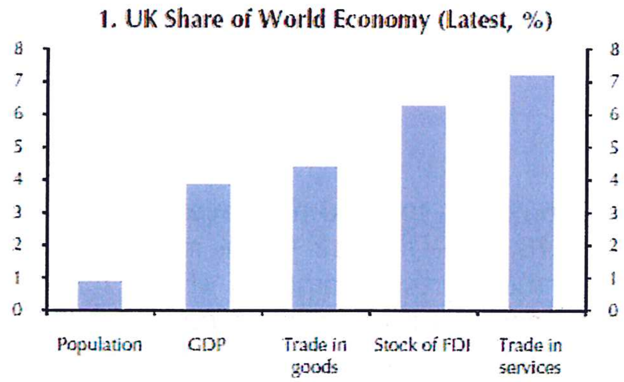
GDP forecast (annual % change)

	Forecasted data					
	2016	2017	2018	2019	2020	5-year average 2016–2020
World	2.2	2.7	2.9	3.0	3.0	**2.8**
United States	2.0	2.3	2.2	2.1	2.0	**2.1**
Canada	1.7	2.2	2.2	2.2	2.1	**2.1**
Eurozone	1.4	1.4	1.5	1.4	1.4	**1.4**
Germany	1.5	1.1	1.2	1.1	1.2	**1.2**
France	1.5	1.4	1.6	1.2	1.4	**1.4**
United Kingdom	0.6	−0.5	1.4	1.5	2.0	**1.0**
Japan	0.3	0.3	0.9	1.0	1.0	**0.7**
China	6.4	6.1	6.0	5.9	5.8	**6.0**
India	7.2	7.2	7.5	7.4	7.0	**7.3**

The Brexit referendum results have reduced our U.K. GDP expectations.

Source: John Hancock Asset Management, 7/14/16.

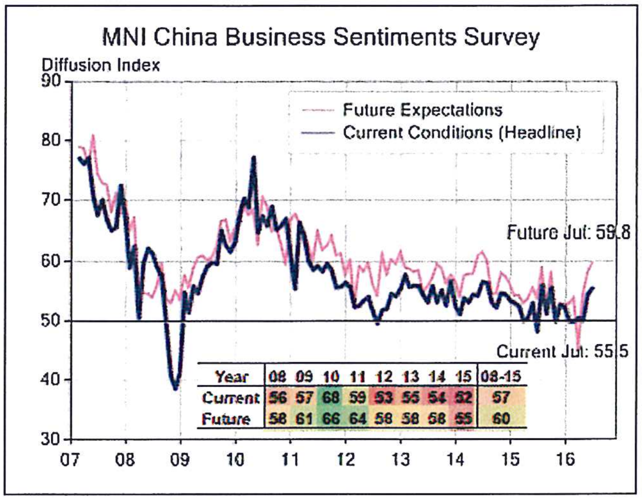
Thus far into the third quarter of 2016, the global equity markets have staged quite a turnaround, completely making up all ground from the Brexit losses. Central bank actions in response to the surprise Brexit vote have been well received and have surprised investors and ushered in another round of the "risk-on" trade. This has pushed the MSCI EAFE Index and the MSCI Emerging Markets Index up +7.95% and +11.3% respectively through early September, vs. +4.5% for the S&P 500 Index. International equities are responding better than U.S. equities lately as they were hurt the most by the Brexit vote. At this point, global investors are becoming more comfortable with the issues they see in front of them at the present time. Interest rates should only rise slowly going forward in the U.S, giving a better outlook for emerging market equities. However, things can change in a hurry as we have seen just a few months ago. The fallout for the Brexit process is yet to come as the many obstacles and issues begin to be re-negotiated. This could create an environment of heightened volatility that we all need to be aware of this over the next several months.



Source: Capital Economics

Asia Update

Coming as very little surprise, The MSCI Pacific region finished as the best performing region within the MSCI EAFE Index during the second quarter of 2016, rising +.90% during the period. While the pacific region certainly did not escape the effects of Brexit, the region was viewed as a destination for investors seeking some level of avoidance from this. The MSCI Japan Index, which constitutes nearly two-thirds of the Pacific Index, rose +1% in the quarter. Even though Japanese equities fell -8% in local terms, a much stronger Japanese yen turned returns positive for unhedged U.S. investors. The yen surged following the Brexit vote as investors sought out safety. Also during the quarter, Prime Minister Shinzo Abe postponed a consumption tax increase as concerns continue to grow over weakness in the economy. This is making it increasingly difficult to fight deflation. Chinese equities were basically flat in the quarter as the MSCI China Index managed a +.28% return in the period. The market's concerns surrounding China's economic growth seemed to recede just a bit in the quarter, which brought a little relief to most investors. Perhaps past stimulus actions are beginning to be felt in the region's economy. However, the massive debt problem is still a big issue here and will probably keep a lid on too much investor enthusiasm going forward over the near term.



Source: Evercore/ISI

The Chinese economy continued to grind at a level consistent with expectations in the second quarter of 2016, as GDP rose +6.7% in the quarter, which was slightly above the official government growth target of +6.5% for 2016. Fiscal stimulus measures enacted in the past are now flowing through the economy and appear to be keeping the growth rate above targeted levels. Industrial output and retail sales beat estimates lately and remains rather stable at the moment. Also, a housing recovery and credit surge have helped growth on the margin as well. Overall, the consumer appears to be in decent shape and remains surprisingly strong. However, credit expansion continued at a heightened pace late in the second quarter, as outstanding borrowing increased +16% in June from a year earlier. The economy continues its debt binge, which could be a major problem at some point. No doubt, officials are "kicking the can down the road" with regard to deleveraging and serious reform. Industrial production rose +6.0% in July, while fixed asset growth continued to slow to +9.0% for the first six months of 2016, which was below expectations and the slowest pace of growth in nearly 16 years. Exports have picked up a bit lately and were reported up +5.9% in Yuan terms in August, well above the +2.9% rise reported in July. This was the third month in a row of export growth improvement and was pushed by the Yuan's -4.5% drop against the U.S. dollar over the last year. Retail sales continue to be solid, rising +10.2% in July, accelerating just a bit from the pace of the first quarter. Inflation continues to decelerate as consumer prices rose only +1.8% in July and +1.7% in August from year earlier periods. Inflation is not much an issue across most regions of the world at this time. As for interest rates, we don't expect much in the way of further cuts or reductions of the reserve requirement ratio over the near term. Growth appears stable at the moment and past stimulus actions seems to be working to some degree. Even with the risks that Brexit could dampen global demand somewhat, government growth targets of at least +6.5% GDP growth this year appear to be manageable at this point, even though risks remain toward the downside at the present time.

Source: Evercore ISI

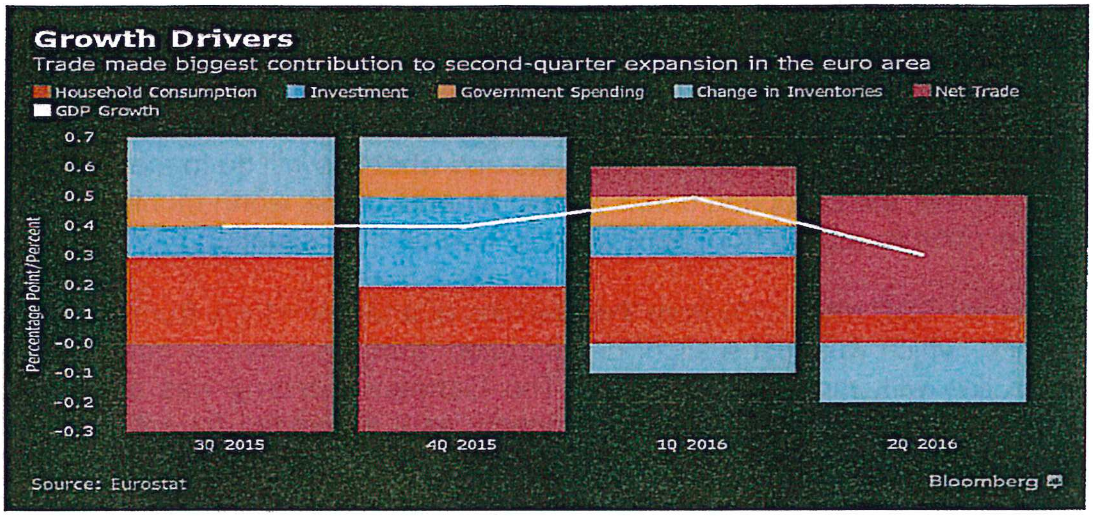
Unsurprisingly, the Japanese economy weakened in the second quarter, as GDP rose only +.7% in the quarter from a year earlier period. The significant strengthening of the yen was the main culprit, as this proved too much to overcome for the economy. This was slightly better than the earlier estimate, as upward revisions to business spending and inventories as well as public investment moved growth from +.2% initially to +.7% now reported. No doubt this will "sound the alarms" for the next Bank of Japan (BOJ) meeting later this month in which an expansion of monetary easing will be decided in an effort to uplift the economy and spur inflation. We believe this is necessary, especially as the yen's movement lately is crimping exporters and adding significant risks to the economy. It's been three years since "Abenomics" was launched and we have yet to see any real measure of decent growth in this region. An aging population and a decade of deflation have simply put a clamp of Japan's ability to grow. Long term economic growth targets set by Abe need to be reset lower as they simply look unattainable at this point. Exports continued to fall in the second quarter, now falling for eleven consecutive months, as July was down a staggering -14% from a year earlier. The strengthening yen from the Brexit fallout is wreaking havoc across this economy with exports. Industrial production remains under pressure lately as output in July shrank -3.8% from a year earlier, as a limited recovery in external demand from a strong yen takes its toll. We are not expecting much improvement over the near term with this economic indicator. Small business confidence continues to meander around past levels with no clear upward or downward bias recently. Perhaps will we see some improvement in this measure in the coming months. Consumer confidence is actually tweaking a bit higher lately as August's reading rose to 42, the highest level since January. Maybe the delayed implementation of the next increase in the consumption tax announced a few months ago is finally being realized by consumers. Core prices in Japan fell for the fifth straight month as July was reported at -.4% from a year earlier. Many businesses simply do not have the ability to raise prices in the current anemic economic growth environment the country is stuck in at present. The labor market still remains very firm as the August unemployment rate fell to 3.0%, the lowest rate since 1995. In addition, the jobs-to-applicant ratio continues to improve, rising to 1.37, which is yet another high point in this data statistic. At some point, this should translate to better wage growth, which would be good news for this economy. Going forward for the next few months, we look for the BOJ to provide more support for the economy here through additional stimulus measures, especially as the yen continues its acceleration trend. With this in mind, we expect growth to remain rather tepid into the latter part of the year. Maybe these measures can bring some life into the equity markets in the third quarter.

Source: Evercore ISI

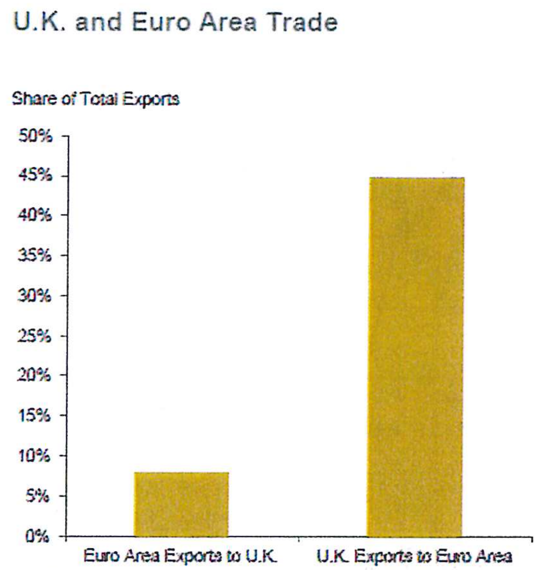
Europe Update

Relative calm in the European equity markets gave way to massive volatility that occurred after the Brexit vote, as this vote to leave the EU pushed markets to finish in negative territory for the quarter. The European Central Bank (ECB) did respond by making known they are more than prepared to inject more stimulus into the markets as needed in order to push the region toward a recovery. However, thus far we have not seen an announced expansion of its asset purchase program. Perhaps this posturing kept the downdraft in equity markets from becoming more severe. At present, we just do not know what the longer term implications are for the Eurozone economy with regard to this Brexit vote. The EU has stated they are waiting for Article 50 of the Lisbon Treaty to be invoked before they will have new negotiations take place with the U.K. Once invoked, there is a two year period to re-negotiate the dozens and dozens of trade agreements that need to be addressed. We would expect this process to drag out considerably with no exact time table, as we have not been down this path before. What we do know is that half of all exports from the U.K. are bound for the EU and only 10% of exports from the EU go to the U.K. With this in mind, we would expect the EU to be in a superior bargaining position with the ability to play "hardball" with the U.K. The EU appears to have much less to lose than the U.K. Considering what transpired late in the second quarter with Brexit, the MSCI European Index (ex. U.K.) only posted a small loss of -.47% in USD. Many of the European markets responded very nicely in the week after the Brexit vote in order to minimize losses in the region. Most investors including us were pleasantly surprised to see this action. As we look out into the fall, Brexit will remain the hot topic of discussion. We just do not know what direction these discussions will take and what this will do to the markets here. Beyond this, the European banks remain an area of risk worth monitoring. A weakened economic outlook from here will only worsen their situation.

Second quarter GDP rose +.3% from the previous quarter, or +1.6% from the year earlier period, which was just a slight deterioration from the previous quarter, but basically in line with most expectations. The German economy was again the main thrust of growth of the Eurozone economy as it expanded by +.4% in the quarter, or +1.8% from the year earlier period. This was in contrast to the economies of France and Italy, which failed to grow in the quarter. On a positive note, the Spanish economy posted another very good result as second quarter GDP rose by +.7%, a continuation from the previous quarter. Inventories, household consumption, public consumption, and investment all decelerated from the previous quarter. However, this was countered as net exports showed a significant bounce from the previous quarter and provided one of the biggest contributions to GDP growth in quite some time. No doubt the euro's depreciation is finally showing up here in a big way. Second quarter industrial production cooled off late in the quarter as June was up only +.4% from the year earlier, which comes as little surprise, as the International Monetary Fund (IMF) lowered its global economic growth rate. Subsequent to the Brexit vote, the index of executive and consumer sentiment lost its momentum and slipped recently to 103.5 in August. Weakness in the indicator was broad based across most countries in the Eurozone. Retail sales did cool a bit from the first quarter as second quarter sales were reported up +1.5% from a year earlier. It's clear the consumer is worried about near term issues in the region. Prices continue to fall as businesses have very little pricing power at the moment as the July CPI rose only +.2% from a year earlier. The employment situation continues to gradually improve as the July unemployment rate was reported at 10.1%, making another low thus far in 2016. However, this rate is still too high for any real progress to be made on wage growth.



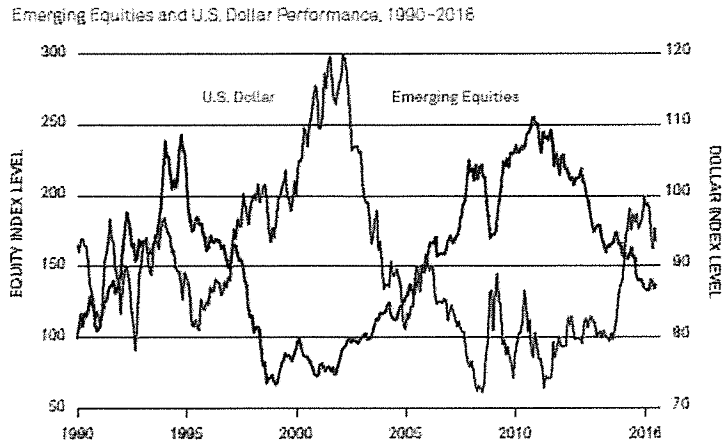
The U.K. economy continues to live with the overhang of the Brexit vote. It's probably the most discussed topic amongst the investment community at the moment. The consensus thoughts at the moment seem to be indicating some level of a recession in this economy in 2017, with only the severity of a recession in debate. This puts a record 14 straight quarters of economic growth in clear jeopardy at some point. The path of this Brexit will take many twists and turns along the way, with a multitude of different outcomes. So in our opinion, it is a bit premature to completely assume the worst possible outcomes for the region. GDP grew by +.6% in the quarter from the previous quarter, or +2.2% from the year earlier period. This rate of growth was an acceleration from the previous quarter and basically in line with most projections. Household consumption was the main thrust of growth, while net trade was the biggest detractor of growth. Retail sales continue to be surprisingly strong, as July sales were up +1.5% from the previous month, or +5.4% from the year ago period. This surprised us as consumers seem rather calm as this is the complete opposite of all the Brexit pessimism. Inflation remains very steady lately as July core CPI was up +1.3% year over year and still remains well below policy levels. It's hard to see this becoming much of an issue in the near to medium term investment horizon. At its recent August meeting, the Monetary Policy Committee (MPC) cut interest rates to a new record low of .25% and increased its bond purchase target to 435 billion pounds, which now includes 10 billion in corporate bonds. This is all in an effort to combat the expected weakness from Brexit as we move forward. The employment situation continued to improve in the second quarter as the June unemployment rate fell to 4.9%, which is at levels not seen since 2005. Employment rose by 172,000 in the second quarter and ending employment was a record 31.75 million workers. Wage growth has remained steady at a shallow pace lately as June wages only grew +2.4% vs. the prior year. It may be tough to even maintain this pace of wage growth if the economy does enter a recession in the near future. Looking out over the next quarter, there is no doubt all eyes will be watching developments with the ensuing negotiations between the new Prime Minister Theresa May and the EU over Brexit. There is much to do with this issue and the path will take many directions. We would expect a volatile equity market in the near term as this unfolds.



Source: Fidelity Investments 3Q 2016 Market Update

Emerging Markets

The emerging markets managed to post a small gain in the quarter as commodity prices firmed up, currencies were stable, and perhaps a positive impact from Brexit seemed to benefit emerging market equities. But the biggest positive for emerging markets was the delayed timeline of rising interest rates in the U.S. This improved fund flows into this asset class as future prospects look much better here. The MSCI Emerging Markets Index (net) rose +.66% in U.S. dollar terms in the second quarter of 2016, the third consecutive quarter of gains in this index. As always, the biggest "wildcard" in emerging markets is China. However, sentiment has improved here lately as investors are becoming more comfortable with its growth and policy direction, which are providing support for emerging market equities. Latin American equities were strong in the quarter as Brazil rebounded nicely from rising commodity prices and the impeachment of the country's president. Russia also benefitted from rising crude oil prices and currency strength. India continued to post results on the heels of continued progress in government reforms and business fundamentals. At this point, we see a much better investment case for this asset class. Commodities seemed to already have made a bottom and are gradually rising, interest rates in the U.S. appear to be "lower for longer" and may not rise nearly as much as many analysts were predicting a few short months ago, and currencies have stabilized a bit lately. Valuations still remain somewhat attractive relative to other parts of the world. Perhaps earnings growth will respond positively as well. With these issues in mind, we are looking to add to our emerging markets exposure on any opportunities that might present themselves over the next several months as perhaps the long period of under-performance of this asset class could be coming to an end as we remain focused on the long term.



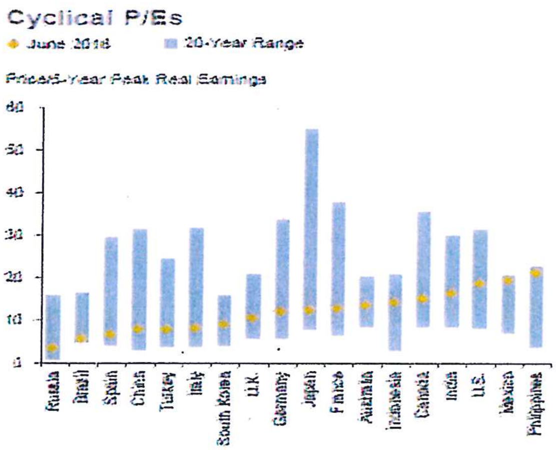
Source: Blackrock Investment Institute; MSCI; Thomson Reuters

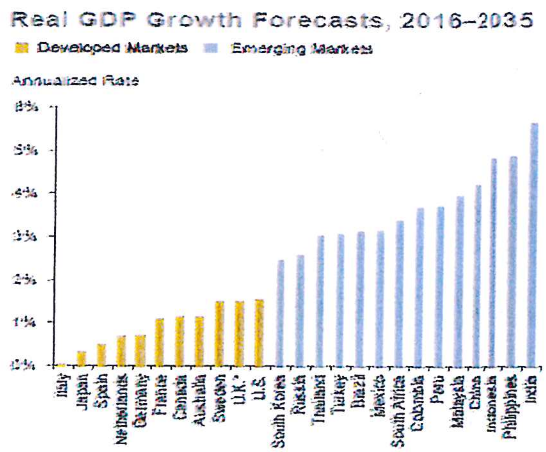
International Equity Activity/Strategy

As we peer out into the investing landscape in late summer, there seems to have developed some level of optimism among investors despite much uncertainty around the global equity markets as a whole. This has pushed many equity markets back to near yearly highs. Earnings trends have become a bit more stabilized, especially in the materials and energy spaces as the recent upward movements in commodity prices could provide for better earnings growth going forward. From a valuation viewpoint, most markets are not "cheap" by historical measures, but are not overly "rich" either. In a good environment, one could make the case for further equity market upside going forward. The prospects for heightened central bank actions in certain regions around the globe remain rather good as the uncertainty from the Brexit begins to play out as this seems to be the base case for many investors. At this point, we don't know what the ramifications will be as the U.K. begins the procedures for formal withdrawal from the EU. No doubt, this could push overall global growth down, but we do not know to what degree at this point. Aside from Brexit, investors will be watching actions by the U.S. Fed, especially with regard to timing of interest rate increases going forward. This could be a driver of equity markets over the next few months. With all of this in mind, we would expect volatility to pick up in most markets as many investors become a bit nervous, with the ultimate direction of markets difficult to determine at the present time.

We have not added to our international equity portfolios since our last addition in the emerging markets index (EEM) back in May, mentioned in our previous quarterly report. However, we are still using market volatility to sell put options at prices below the current price of EEM in an effort to take advantage of premiums in the marketplace in the current state of heightened equity volatility. Premiums for doing this strategy still look attractive in the current low interest rate environment.

Also, we may take advantage of any opportunities that present themselves to add to our large cap EAFE portfolio as this asset class has also vastly under-performed U.S. stocks over the last 10 years. Our current allocation to Emerging Market equities is approximately 1.65% of total assets and approximately 10.5% for MSCI EAFE equities, which still remains below peer group averages. *(Credit is given to the following entities for charts provided: Strategas, MSCI, Thomson Reuters, Eurostat, Bloomberg, Fidelity Investments, John Hancock Investments, Evercore ISI, Blackrock Investment Institute, Morningstar Direct, and Capital Economics)*





Source: Fidelity Investments Q3 2016 Market Update

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING July 31, 2016

STATE STREET

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
U.S. EQUITY										
TRS CORE FUND	2,414,267,540	4.12	5.85	6.16	13.78	3.42	10.47	11.94	7.04	Oct-94
TRS S&P 500 FUND	5,885,414,419	3.21	5.29	7.06	14.60	5.04	11.15	13.28	7.74	Oct-94
TRS MID CAP INDEX	1,251,094,388	4.28	7.12	12.52	15.47	5.53	9.90	12.30	9.41	Oct-94
TRS S&P SMALL CAP INDEX	930,798,521	5.12	7.61	11.95	16.24	6.47	10.13	13.68	9.31	Mar-01
TRS MIDCAP ACTIVE FUND (SSF)	872,009,767	4.68	6.47	8.64	11.09	0.73	7.55	10.44	8.48	Oct-94
TRS LARGE CAP POLICY FUND	146,147,358	5.41	6.72	10.87	20.12	9.20				Jan-15
TRS LARGE CAP VALUE FUND	137,955,755	2.20	2.14	7.84	10.85	2.20				Jul-15
TRS TOTAL DOMESTIC EQUITY	11,637,687,748	3.79	5.89	8.01	14.46	4.62	10.57	12.64	7.75	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		*3.90*	*6.19*	*8.83*	*15.34*	*5.63*	*10.83*	*13.19*	*8.06*	*Jan-94*
S&P 500		*3.69*	*5.82*	*7.66*	*15.25*	*5.61*	*11.16*	*13.38*	*7.75*	*Feb-54*
S&P MID CAP 400		*4.29*	*7.14*	*12.56*	*15.49*	*5.53*	*9.86*	*12.28*	*9.33*	*Feb-82*
S&P SMALLCAP 600		*5.09*	*7.48*	*11.63*	*15.79*	*5.96*	*9.62*	*13.05*	*8.77*	*Feb-84*
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	368,789,896	5.46	6.40	14.59	14.40	0.83	0.50			Oct-11
TRS INTERNATIONAL EQUITIES	2,453,139,171	4.97	1.05	1.31	6.21	-6.52	2.65	3.60	2.55	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,821,929,066	5.04	1.73	2.87	7.27	-5.56	2.51	3.02	2.56	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY INDEX		*5.06*	*1.20*	*1.79*	*6.12*	*-6.62*	*1.83*			*Oct-12*
MSCI EAFE (NET)		*5.07*	*0.62*	*0.42*	*5.15*	*-7.53*	*2.00*	*3.02*	*1.98*	*Jan-70*
MSCI EMERGING MARKETS		*5.03*	*5.16*	*11.77*	*12.50*	*-0.75*	*-0.29*	*-2.75*	*3.90*	*Jan-81*
TRS TOTAL GLOBAL EQUITY	14,459,616,815	4.03	5.05	6.98	13.00	2.52	8.88	10.46	6.57	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		*4.13*	*5.19*	*7.41*	*13.46*	*3.09*	*8.94*	*10.76*	*6.60*	*Jan-94*

Provided by SSGS Performance Services

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING July 31, 2016

STATE STREET

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,561,695,955	0.72	2.51	6.80	6.10	6.61	4.65	4.22	5.86	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		*0.87*	*2.77*	*6.86*	*6.23*	*6.74*	*4.58*	*4.03*	*5.46*	*Jan-90*
TRS TOTAL FIXED (ex. Private Placements)	2,561,695,955	0.72	2.51	6.80	6.10	6.61	4.65	4.22	5.86	Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		*0.87*	*2.77*	*6.86*	*6.23*	*6.74*	*4.58*	*4.03*	*5.46*	*Jan-90*
Barclays Aggregate Bond		*0.63*	*2.47*	*5.98*	*5.37*	*5.94*	*4.23*	*3.57*	*5.06*	*Jan-76*
TRS PRIVATE PLACEMENTS	2,481,674,736	0.49	2.44	6.08	7.64	6.74	14.10	12.92	8.75	Oct-03
TRS TOTAL FIXED INCOME	5,043,370,691	0.60	2.47	6.43	6.86	6.67	9.05	8.17	7.11	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED AND PRIVATE EQUITY	466,553,509	-0.00	0.00	6.53	2.09	4.10	15.11	13.88	-6.85	Sep-03
TRS REAL ESTATE	2,201,243,087	0.01	0.02	0.03	0.03	7.12	5.19	3.88	2.83	Oct-03
TRS TOTAL ALTERNATIVES	2,667,796,597	0.01	0.01	1.12	0.49	6.76	6.35	4.78	0.54	Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,711,167,287	0.40	1.61	4.55	4.60	6.63	8.10	6.96	4.97	Oct-93
CASH										
TRS CASH ACCOUNT	141,339,549	0.04	0.13	0.27	0.33	0.35	0.18	0.17	1.24	Sep-03
TRS SHORT TERM INVESTMENTS	383,128,591	0.07	0.21	0.48	0.61	0.68	0.46	0.45	1.61	Oct-03
TRS TOTAL CASH	524,468,139	0.08	0.20	0.42	0.52	0.59				Oct-14
TOTAL PLAN										
TRS TOTAL PLAN	22,695,252,242	2.67	3.74	5.94	9.65	3.64	8.44	8.93	5.84	Oct-87
TRS TOTAL PLAN POLICY		*2.56*	*3.76*	*5.49*	*9.10*	*2.84*	*7.02*	*7.93*	*5.61*	*Oct-03*

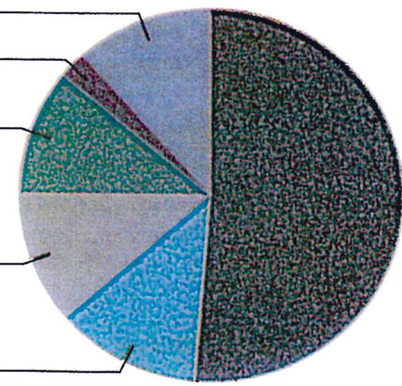
Provided by SSGS Performance Services

RETIREMENT SYSTEMS OF ALABAMA

MANAGER ALLOCATION ANALYSIS
PERIOD ENDING July 31, 2016

STATE STREET.

ALLOCATION BY ASSET CLASS



	MARKET VALUE	MKT VAL ONE YEAR AGO	ALLOCATION
TRS TOTAL DOMESTIC EQUITY	11,637.7	12,098.9	51.3
TRS TOTAL INTERNATIONAL EQUITY	2,821.9	3,037.2	12.4
TRS TOTAL FIXED (ex. Private Placements)	2,561.7	2,543.6	11.3
TRS PRIVATE PLACEMENTS	2,481.7	2,474.4	10.9
TRS TOTAL CASH	524.5	420.3	2.3
TRS TOTAL ALTERNATIVES	2,667.8	2,408.2	11.8
TRS TOTAL PLAN	22,695.3	22,982.6	100.0