Quarterly Economic Update

June 24, 2016

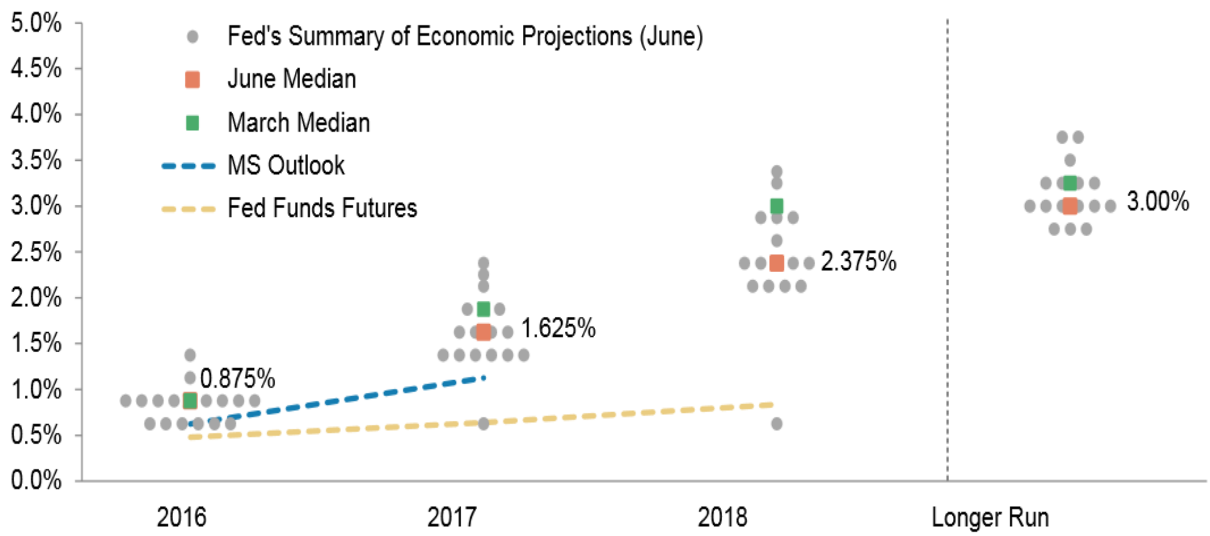
MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

After raising the federal funds rate in December for the first time in seven years, the Federal Open Market Committee (FOMC) has not taken the next step to move the rate higher. FOMC members met most recently on June 14-15th and left the target range for the federal funds rate unchanged at ¼ to ½ percent. They also continue to hold the Federal Reserve's balance sheet at its elevated levels by reinvesting principal payments and maturities from its securities holdings. Federal Reserve Chair Janet Yellen and FOMC members would like to move the federal funds rate higher, but are cautious to act too quickly in light of mixed economic indicators and lower inflation. The June 15th FOMC statement noted that the pace of improvement in the labor market had slowed since their April meeting, referring to the weaker nonfarm payrolls numbers for April and May. On a more positive note, the statement acknowledged that growth in economic activity and household spending had improved from the weaker first quarter. Lower inflation has been a more persistent problem and while FOMC members continue to express confidence that inflation will move towards their 2 percent objective, the updated statement repeated that it continues to run below their longer-run objective and acknowledged market-based measures of inflation compensation had declined more recently.

While there was no change in policy at the June meeting and the post-meeting statement was relatively benign with no real change other than the updated economic view, the Summary of Economic Projections and more specifically the dot plot provided much more information. The median projection for the federal funds rate at the end of 2016 did not change, remaining at 0.875% and suggesting two rate hikes before year-end. A closer look at the projections however indicates a fairly substantial shift in views on the projected path for the federal funds rate. The chart below shows the individual projections represented by the dots, and also compares how the median projected path has shifted downward since March.

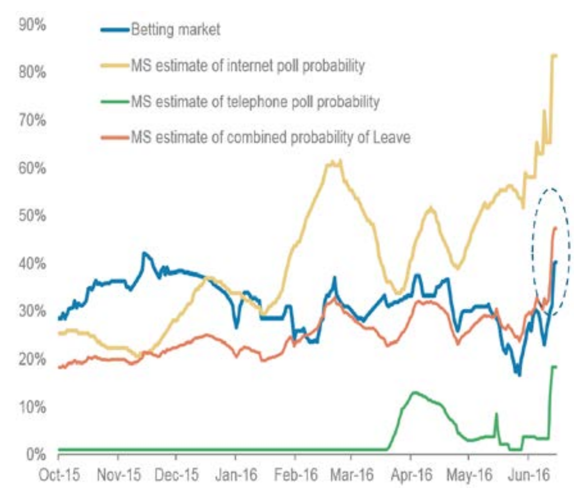


Source: Federal Reserve, Morgan Stanley Research

There are several things worth highlighting about the updated projections for the appropriate path for the federal funds rate. Looking at 2016, while the median remained the same at 0.875%, the composition of those projections changed substantially. At the March FOMC meeting, only a single dot projected one rate increase in 2016. The June projections show that an additional five dots shifted down to project that it might be appropriate to raise the federal funds rate only once this year. This represents five members who, since the March meeting, have changed their opinion that the Committee should implement two or more rate increases before year end. The level for the federal funds rate also shifted down by ¼ percent in 2017 and by ½ percent in 2018, indicating a more gradual approach to the pace of rate increases. This represents a shift towards a pace of three hikes a year, versus the March projections of four. The median longer-run level for the rate shifted also, down by ¼ percent to 3.0%, signaling their views that economic conditions and inflation may warrant a lower normalized rate going forward to meet the FOMC's objectives. One other thing to notice in the chart is that the fed funds futures path remains significantly lower than the FOMC's median path, suggesting the market is much more pessimistic on economic activity, employment, and inflation than FOMC members and the FOMC's ability to push the federal funds rate higher.

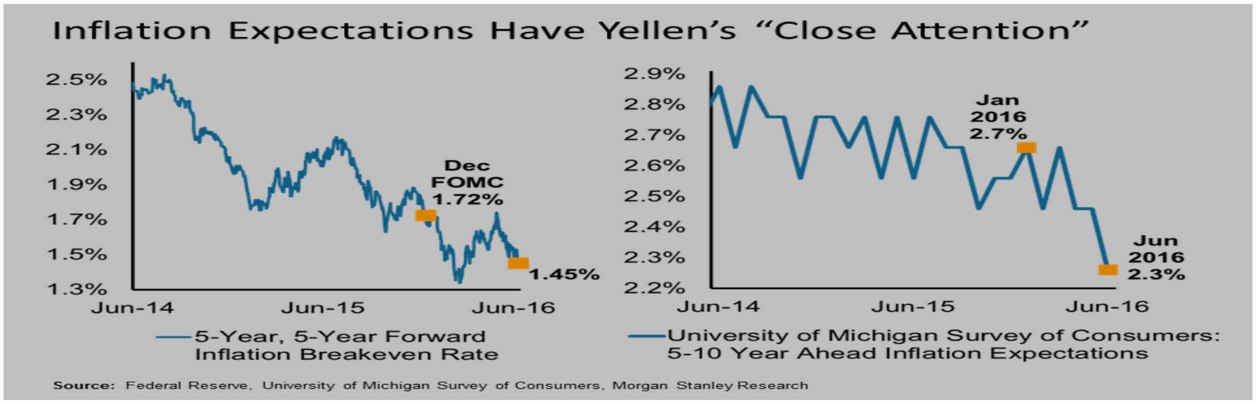
The June projections may indicate a more pessimistic FOMC, but it more likely represents an increase in risk and an acknowledgment of uncertainty in members' outlook. Overall, it paints the picture of a more cautious approach to tightening policy going forward. Several things may be giving FOMC members' pause. The slowdown in job gains has definitely been noticed. In her post meeting press conference, Yellen pointed to this as disappointing, but that "it's important not to overreact to one or two monthly readings." It is somewhat normal that the pace of job gains should slow as the economy moves towards full employment and some indications of wage growth are positive, but they will be watching these readings to ensure a more negative trend is not forming before they go forward with additional rate increases.

The upcoming Brexit vote, the U.K.'s decision on whether or not to leave the European Union, is also an uncertainty that has led to a more cautious approach. The outcome of this vote has become less certain more recently and the implications of a vote to leave the E.U. represent an unknown risk to global economic conditions and financial markets. Yellen and FOMC members do not want to be raising rates into this unknown risk and are unsure of the ramifications should the U.K. vote to exit. The chart on right shows how the odds of a vote to leave have increased sharply more recently.

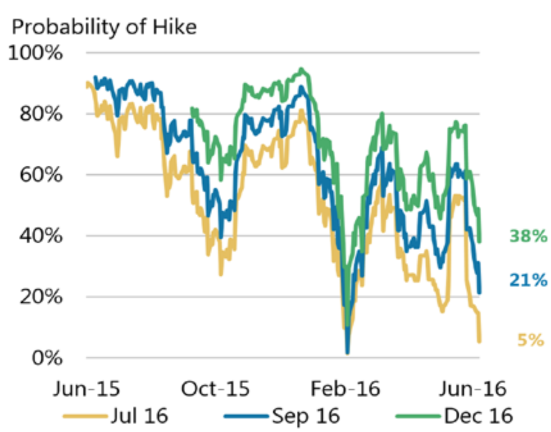


Source: whatukeexpectseu.org, Betfair, Morgan Stanley Research

Another cautionary flag that has been raised is the decline in inflation expectations. Yellen maintains that lower inflation readings have been held down by the declines in energy prices and lower prices for imports. The effects of these lower prices are viewed as transitory and inflation is expected to move towards their objective as these effects fade. They have maintained that longer-run inflation expectations remain "reasonably well anchored," but there have been some weaker measures as shown below that they are watching closely.



All of these issues have the FOMC treading lightly as they move forward with gradually normalizing the federal funds rate. Yellen seemed to be extra diligent in her post-meeting press conference repeatedly using the words *cautious* and *careful* to describe their approach to moving forward with rate increases. She specifically stated that "Proceeding cautiously in raising our interest rate target will allow us to verify that economic growth will return to a moderate pace, that the labor market will strengthen further, and that inflation will continue to make progress toward our 2 percent objective. Caution is all the more appropriate given that short-term interest rates are still near zero, which means that monetary policy can more effectively respond to surprisingly strong inflation pressures in the future than to a weakening labor market and falling inflation."



Source: Bloomberg, Morgan Stanley Research

The FOMC meets again on July 26-27th. They can still raise their target rate twice before year end, but the probability of an increase at the July meeting has now fallen sharply to around 5% as shown in the chart on the left. The odds for a September and December hike, both meetings associated with an updated Summary of Economic Projections, have also come down following the recent meeting. Their decision making will remain data dependent, but it does seem clear that they may move much slower as they move forward to normalize rates and we may only see one or two rate increases in 2016.

Fiscal Policy

By Michael McNair

I have covered a couple a very different topics in the past few editions of the Fiscal Policy Report. In September of 2015, I discussed the Chinese economy and in December of 2015 I explained the conditions under which it was appropriate for the government to increase their deficits and run stimulative fiscal policy. In this installment I am going to bring the two topics together in order to explain the current global economic malaise.

In the September 2015 Fiscal Policy Report, I discussed the role of China's investment driven growth model in driving the country's growth miracle over the last 30 years. I explained that this growth model is just a set of economic policies that channel savings into investment by constraining (i.e. taxing) consumption and subsiding production. These subsidies significantly increase the competitiveness of domestic industry and set forth rapid growth in investment in real estate, infrastructure and manufacturing capacity but this causes the growth in investment to far exceed the growth in consumption. This creates a problem: if the economy has excess production then why continue to increase investment? In the 1890's economist John Hobson explained that the only way for growth to continue in an economy, like China's, with excess savings (savings is defined as the excess of production – consumption) is for the country to export their excess production abroad (i.e. run a trade surplus).

When China was a much smaller part of global GDP the necessary adjustment by other much larger countries was small enough that China's trade surplus could be relatively easily absorbed. But due to China's exponential growth, China has not only become a much larger share of the global economy but their trade surplus has grown to represent the largest trade surplus, as a percentage of global GDP, ever recorded. As early as the middle of the last decade, the necessary adjustment that other countries were forced to make to accommodate China's trade surplus was destabilizing to the entire global economy.

Before the crisis, investment levels were far too high and their investment growth rates were only allowed to continue because the resulting excess production was absorbed by a debt fueled boom in consumption in many western economies. However, this situation was always unsustainable because households could not continue to increase their debt load in perpetuity; thus, consumption inevitably collapsed and it led to a global recession.

During the financial crisis the Chinese economy seemingly decoupled from the global economy as Chinese GDP surged ahead despite a collapse in global demand. This was shocking because foreign consumption was the source of demand for Chinese exports and China's economy was seemingly so dependent on exports (i.e. their trade surplus). Typically countries with the biggest trade surplus are hurt the worst in a global recession. Yet here is China, with the largest trade surplus in history, seemingly insulated from the drop in foreign demand. Many observers even argued that the Chinese economy was no longer as dependent on foreign consumption. As I will explain later, the truth is quite the opposite.

It turns out that the reason for the stability in the Chinese economy amidst a global economic depression was due to the actions of the Chinese government. Through Beijing's control of the banking system, the government engineered an extraordinary surge in investment that was large enough to make up for the lost demand from foreign exports. China was the first country to recover from the financial crises, as Beijing's policy measures were unquestionably successful in supporting aggregate demand and GDP in their economy, but was this the right policy response?

In our December 2015 report we explained, what John Maynard Keynes first popularized in the 1920s, that increased government spending can make up for the lost aggregate demand from the private sector and stimulate the economy. However, we left out one important point and it is essential to understanding the current state of the global economy. In our December report we only discussed aggregate demand in general but there are two types of aggregate demand: consumption and investment. While Keynes was focused on aggregate demand in general, John Hobson took this idea further and said that the proper policy depends upon "exact circumstances as to which component of aggregate demand should be increased or decreased respectively."

A world with excess capacity doesn't need more capacity

Most economists only focused on the increase in aggregate demand and did not believe that it made much difference that it was almost entirely focused on investment. These economists applauded Beijing's response as a classic example of the effective ability of "Keynesian" policy. But these economists were wrong. Beijing's push to create a surge in investment was a disastrous policy error and neither John Maynard Keynes, nor John Hobson would have approved of such a response.

One reason for the misunderstanding is that in the short-term consumption and investment look the same because investment consumes goods while it is being "built." Investment is commodity intensive and this is why commodity exporting emerging market countries quickly recovered from the financial crises. However, most investment increases supply once it is finished being built. Investment can only tighten capacity as long as it continues to grow at an increasing rate; however, this is unsustainable (just like increasing inventory) and when the growth rate slows (even if you still have growth) you get a process where new supply is coming on faster than the new investment is consuming goods. The result is overcapacity, deflation and falling returns on investment (ROI).

Return on investment is the critical variable that incentivizes business in a capitalistic economy to invest. When there is excess capacity in the economy, ROI will be low. When the crises hit and consumption fell from unsustainable levels of the bubble period, the size of the excess production capacity became apparent.

With too much supply relative to demand, return on investment (ROI) collapsed. Typically, the natural result of falling ROI is that new investment drops faster than consumption but this eventually causes supply and demand to tighten again and ROI recovers. The proper response from governments should have been to increase **consumption** in their economy to speed this up process. Instead, China did the exact opposite and generated the most rapid debt driven **investment** growth the world has ever seen. In other words, China responded to its problem of overcapacity by building even more capacity. It should have been obvious to any economist that when global GDP was driven higher by investment growth, despite the fact that the world already had too much capacity/investment, then that growth will be unsustainable.

Those who believed that China had decoupled from the global economy and was no longer reliant of foreigners purchasing their excess production were fantastically wrong. Beijing was only able to offset the drop in foreign consumption by increasing Chinese investment, not by increasing domestic consumption. However, the purpose of investment is to meet future consumption and the result of China's debt fueled investment surge is that they are now more reliant of foreign consumption to soak up their excess capacity than ever. In 2015, China's manufacturing trade surplus reached an all-time high of $600 billion.

Summary

When consumption fell from the unsustainable debt driven pre-crises levels, the world was flooded with excess production capacity. Believing they were using appropriate fiscal policy, Beijing responded to this oversupply by generating a surge in investment funded almost entirely by debt. As investment was growing at an accelerating rate from 2009 – 2011, it created a huge tailwind to global GDP, tightened global overcapacity and raised return on investment globally. However, the reflationary trend was unsustainable and when investment growth finally slowed in 2012 it led to a surge in overcapacity and global deflation. Today many industries are faced with more overcapacity than during the peak of the financial crises. A natural rebalancing process is now taking place where overcapacity has caused ROI to drop and this is disincentivizing investment. Whereas investment provided a tailwind to growth in the initial recovery, it is now acting as a headwind to growth. However, the result is that consumption is now finally growing relative to the production capacity of the economy.

The initial surge in investment created inflation from '09-'11 but this eventually led to the deflation we are seeing today. In a similar vein, while the falling investment growth rates we are currently witnessing have been deflationary, I believe that the end result will be higher inflation and higher ROI by the end of the decade.

Economic Outlook

By Adam Rogers

GDP

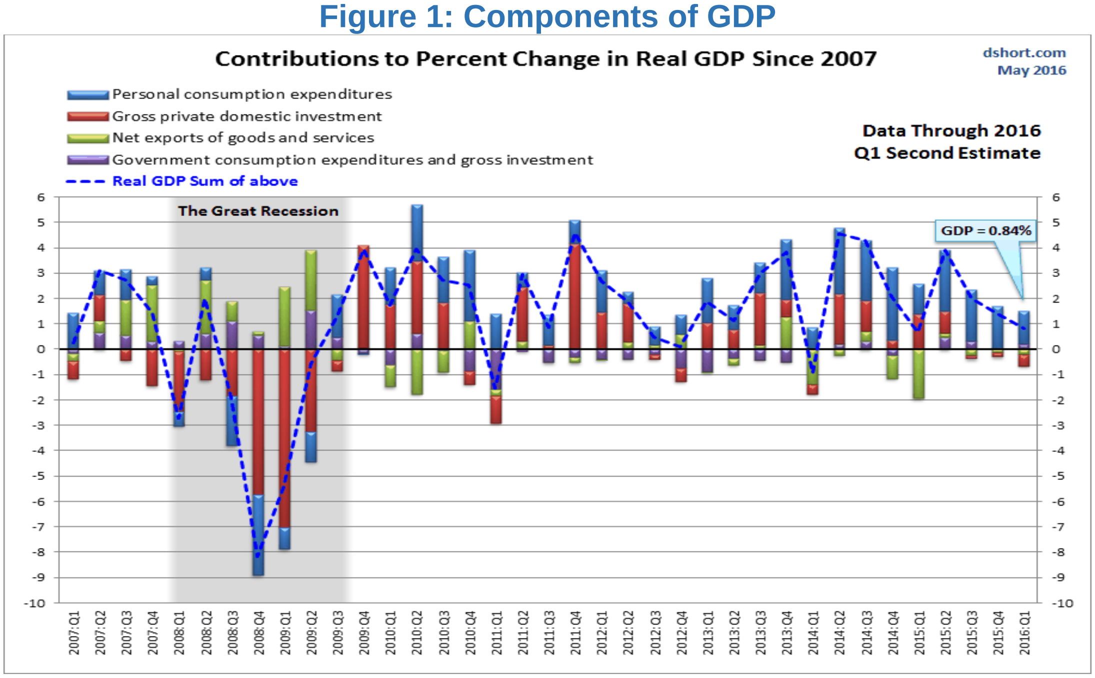
According to the Commerce Department's upwardly revised second estimate for the first quarter, the US economy grew at a 0.8% rate, mostly from higher estimates for residential investment, inventories and net exports.

While growth was tepid despite the upward revision, we are anticipating a rebound in the second quarter for a number of reasons. Incoming data has been noticeably stronger, the drags from low oil prices and a strong dollar were lower than previously estimated, and there is still a possibility of residual seasonality which tends to underestimate GDP in the first quarter while boosting it in subsequent quarters. Current consensus for 2Q growth is around 2.5%

Consumer spending increased 1.9%, government spending increased 1.2%, and residential investment increased a revised 17.1%. Nonresidential investment decreased 6.2%, a larger drop than initially estimated. However, drags from inventory accumulation ($69.6 billion) and net exports (-$561.2 billion) were smaller than initially thought.

Contributions to growth of real GDP came from gains in personal consumption expenditures (1.29%), residential investment (0.56%) and government spending (0.20%). Drags on growth came from nonresidential investment (-0.81%), changes in net exports (-0.21%) and changes in private inventories (-0.20%).

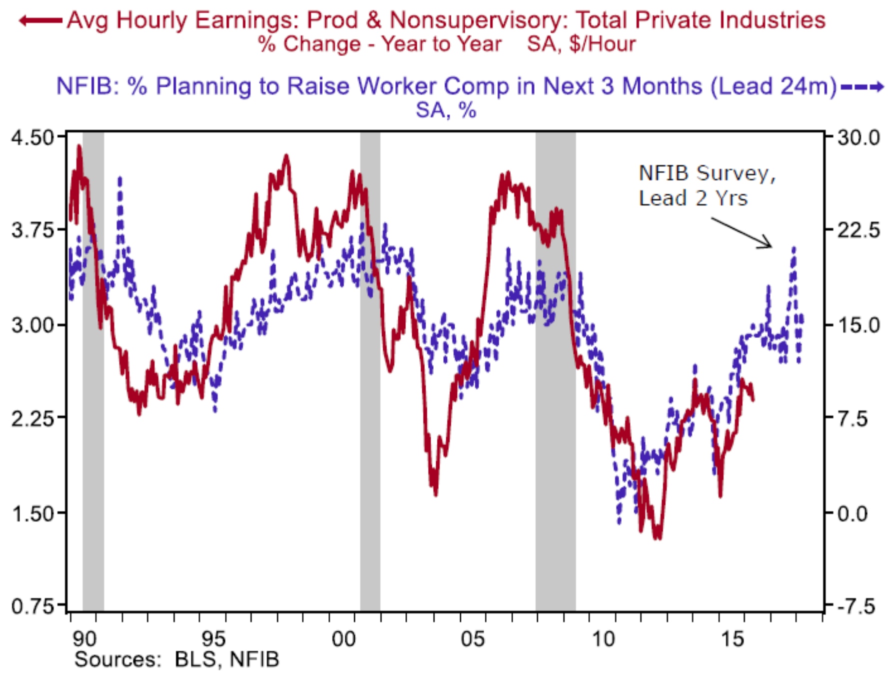
Figure 1: Components of GDP

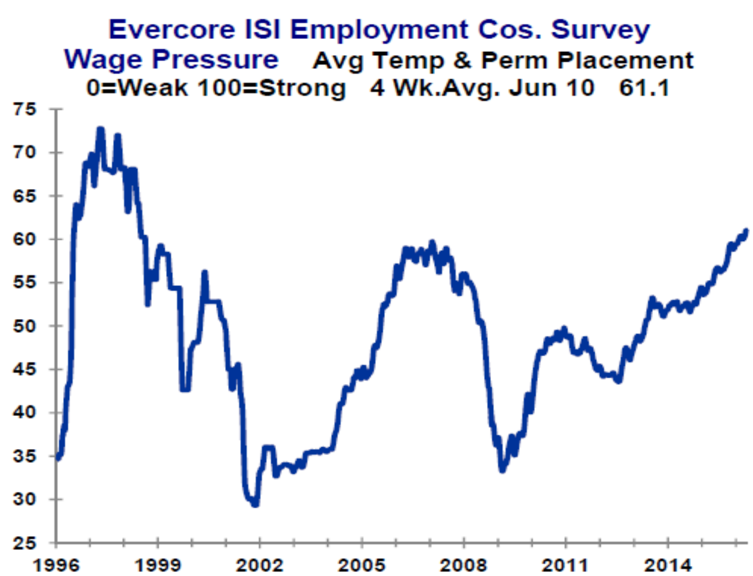


Wages and Spending

We have pointed out for the past year that the National Federation of Independent Businesses (NFIB) wage survey is a leading indicator of wage pressures and that labor takes share in the latter stages of a business cycle. The survey has typically led average hourly earnings by 1 year but as with most things in this expansion, it is working more slowly this time. Nevertheless, the trend in wages is higher and will likely remain so with the economy at or near full employment.

Figure 2: Wages



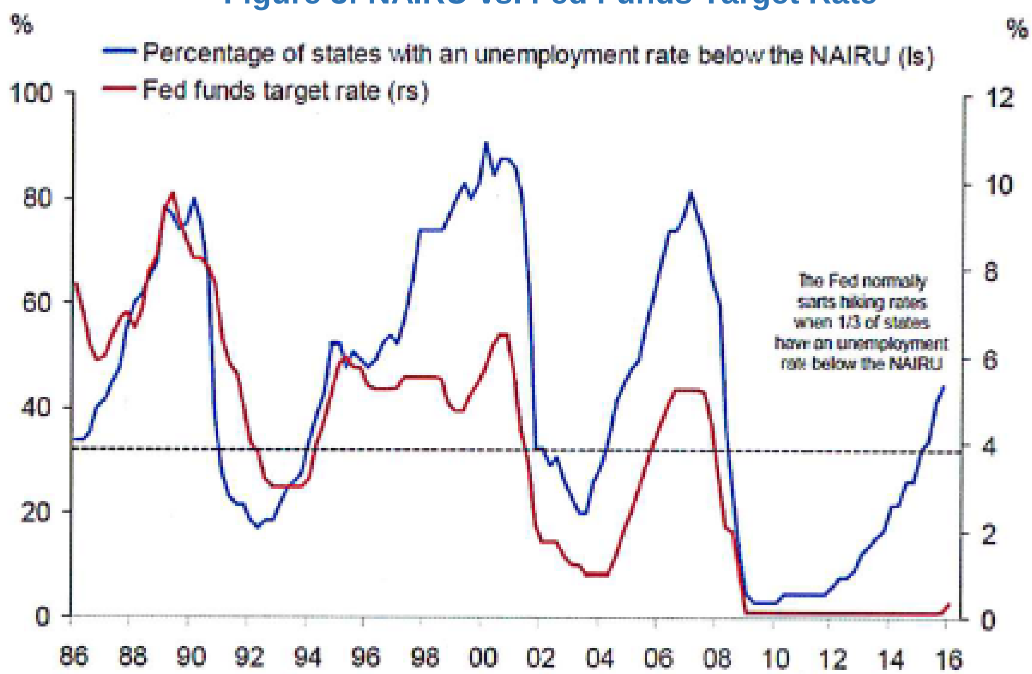


Employment and Interest Rates

In the past, at this level of employment, the Fed has begun tightening to stave off inflationary pressures. However, despite what looks like full employment and rising wage pressures, we've yet to see any meaningful inflation. We believe the primary reason for this is the elevated level of global debt, a deflationary force. The following charts demonstrate the situation. To clarify, we don't feel the Fed should raise rates at all based on employment data alone, but only when inflation becomes a real concern. The charts show the recent breakdown in the correlation between employment and inflation.

In the past, the Fed began raising interest rates when nearly one third of all states had unemployment below the Non-Accelerating Inflation Rate of Unemployment (NAIRU) - a level of unemployment that doesn't cause inflation. This is the first example of the labor market signaling the fed should be tightening, yet they remain on hold.

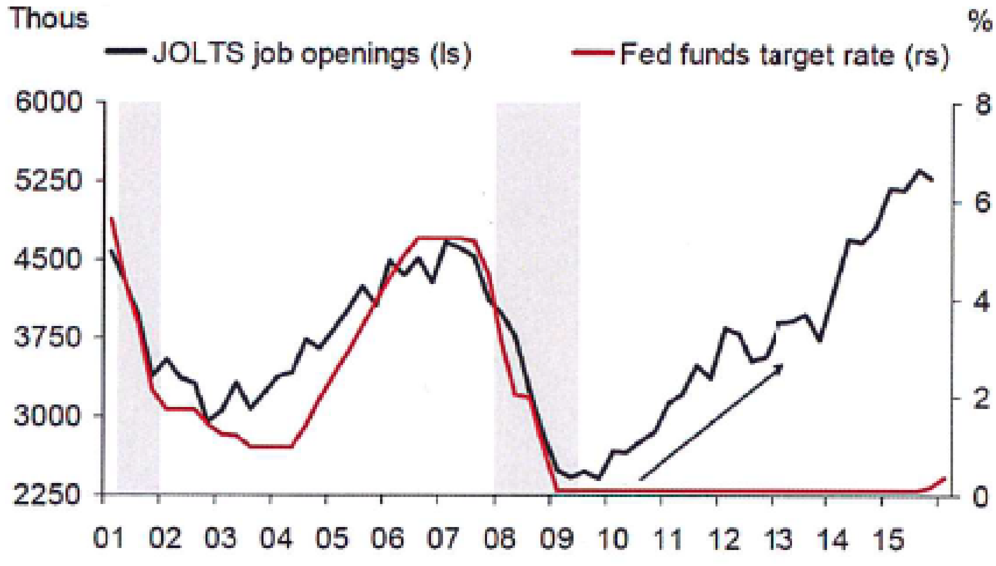
Figure 3: NAIRU vs. Fed Funds Target Rate



Source: Deutsche Bank, Haver Analytics, Federal Reserve Bank, BLS, CBO, April 2016

Another example is the breakdown in correlation between fed funds and the number of job openings.

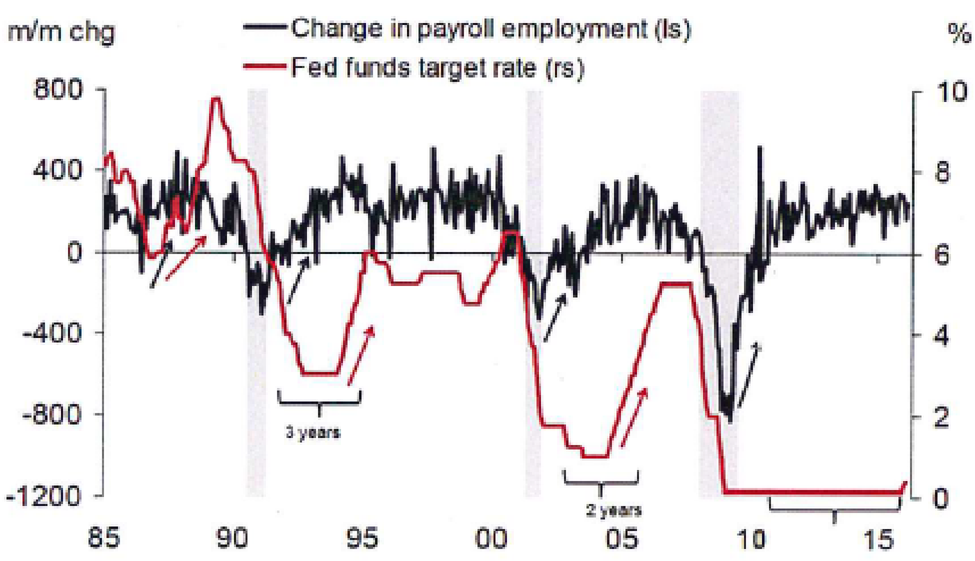
Figure 4: Job Openings vs. Fed Funds Target Rate



Source: Deutsche Bank, Federal Reserve Bank, BLS, April 2016

Typically we see rate hikes within 2-3 years of the trough in employment growth – yet another breakdown.

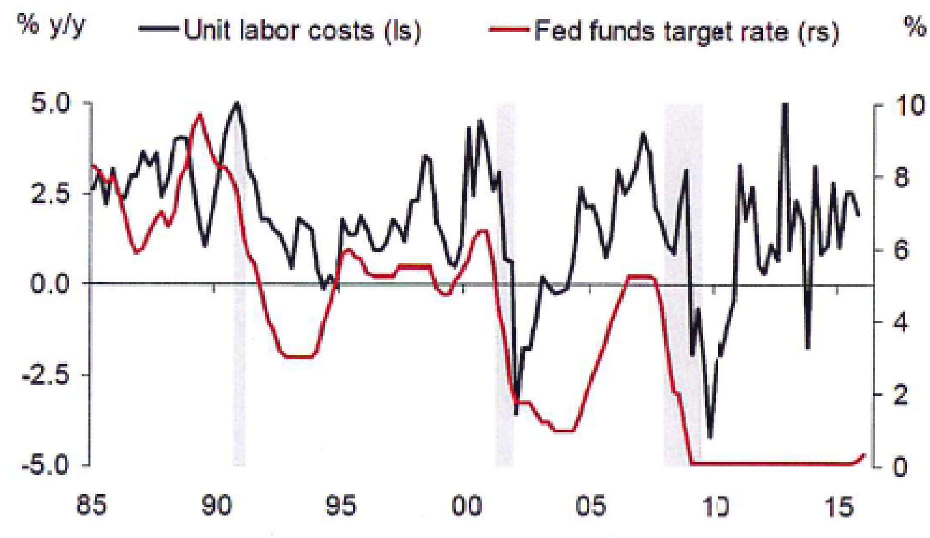
Figure 5: Change in Payroll Employment vs. Fed Funds Target Rate



Source: Deutsche Bank, Federal Reserve Bank, BLS, April 2016

The Fed does not appear to be concerned with rising unit labor costs.

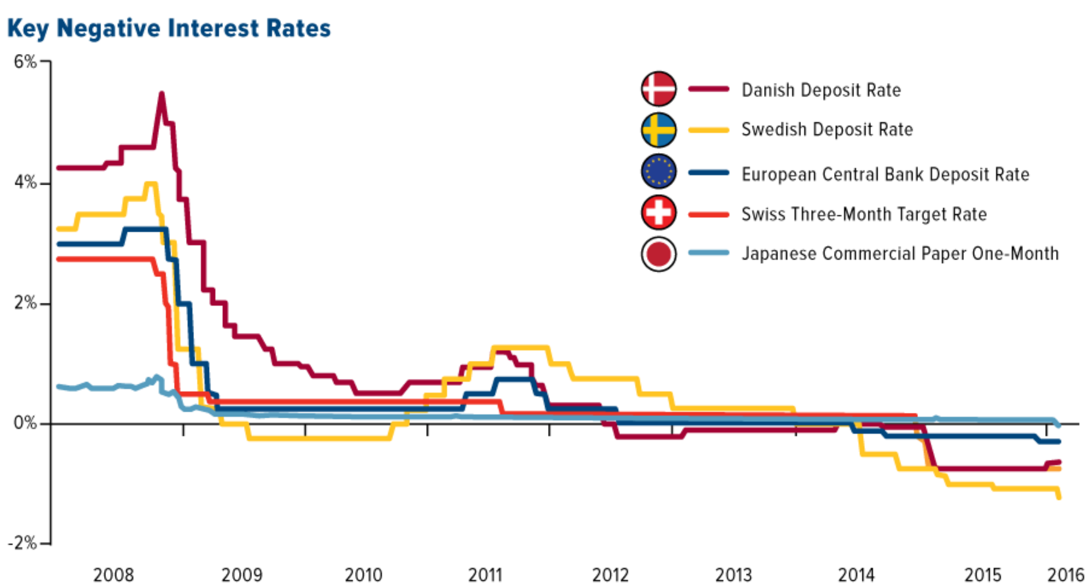
Figure 6: Unit Labor Costs vs. Fed Funds Target Rate



Source: Deutsche Bank, Federal Reserve Bank, BLS, April 2016

As mentioned above, the Fed (and the rest of the globe) are being forced to keep rates low due to high levels of global debt. It wasn't that long ago that the concept of negative nominal interest rates was deemed impossible, yet Japan and some European countries have recently opened the door to negative yields.

Figure 7: Negative Interest Rates

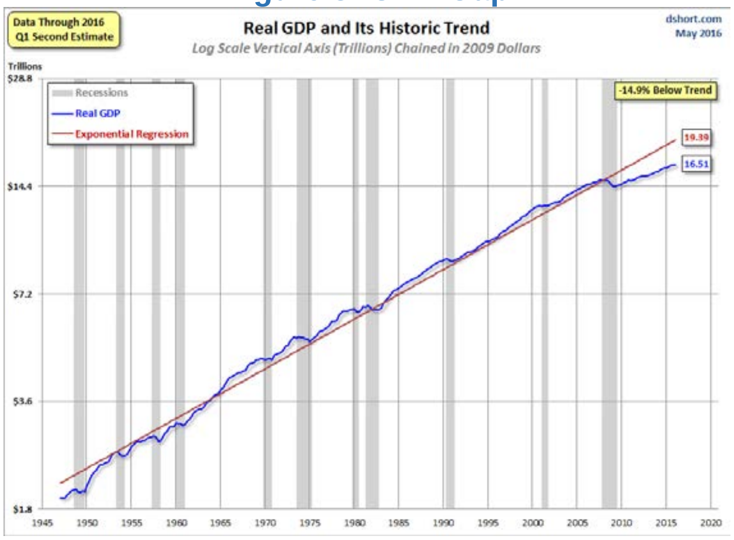


Source: Thomson Reuters, U.S. Global Investors

Stagnation

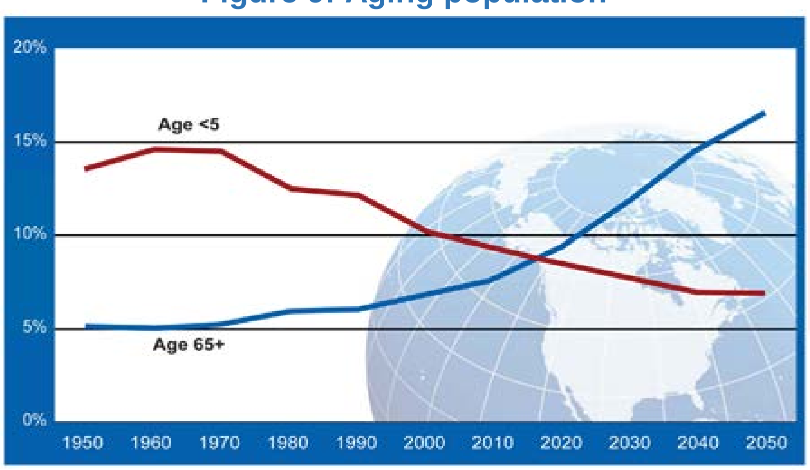
Due to the high levels of global debt, this recovery and expansion have not followed the typical pattern. Coming out of such a deep recession, most expected a rapid recovery with output eventually returning to trend levels. Yet even on the back of historically aggressive monetary stimulus, we are still below trend.

Figure 8: GDP Gap



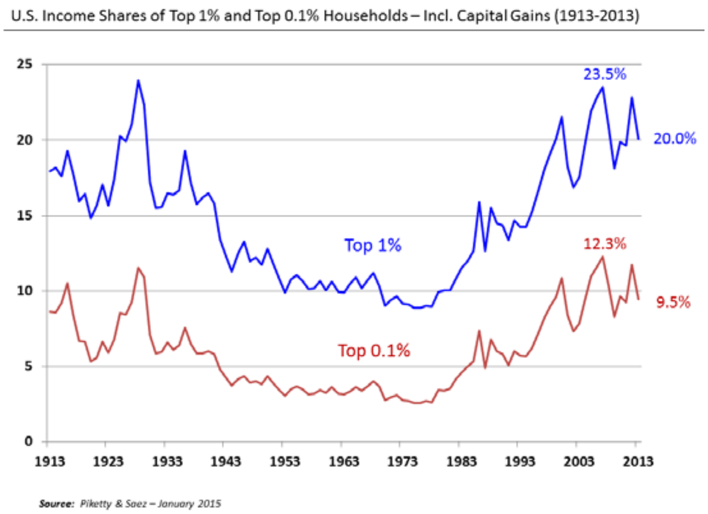
Secular Stagnation, an idea first proposed by Alvin Hansen in the 1930s, is becoming a popular explanation among economists for the GDP gap. The theory states that the economies of the world are imbalanced from too much saving and too little investment. This imbalance drags down demand - reducing growth, inflation, and real interest rates. The economy is stuck under its potential because of a chronic shortage of demand for goods and services and an accompanying excess of savings. Reasons offered include that we tend to save more as we age or that growing inequality puts a bigger share of income in the hands of few who can't possibly spend it productively.

Figure 9: Aging population



Source: United Nations. World Population Prospects: The 2010 Revision.

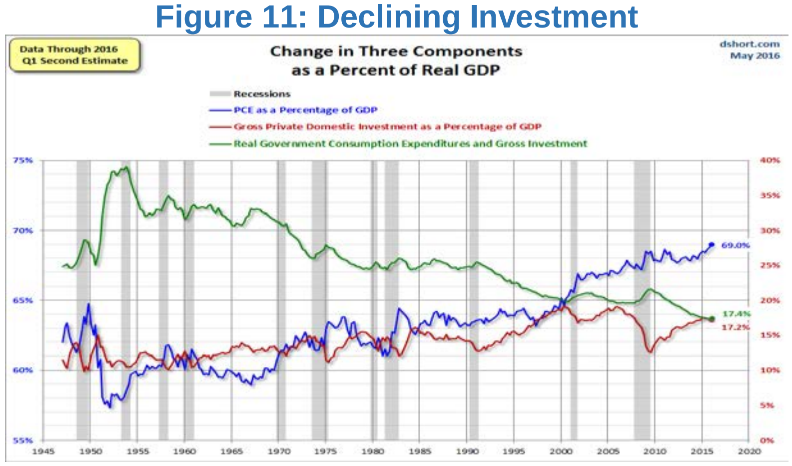
Figure 10: Rising Income Disparity



However, perhaps equally as important is the way technology is changing our collective propensity to invest and soak up excess savings. Many companies in the new economy are asset light and some, such as Airbnb and Uber, only exploit assets that already exist. If you think about Airbnb's impact on hotel construction, Uber's impact on auto demand, Amazon and the death of malls, you can see how new companies are making their way without the need for big capital investments. Also, when technology is advancing quickly, it makes sense to defer investment over the worry that any investment may soon be made obsolete. This is one of the reasons companies like Apple and Google are careful in how they deploy their vast hoards of cash.

If the economy's problem is too much saving and too little investing, the secular stagnation theory states that the solution is to reduce national savings, raise neutral real interest rates, and stimulate growth through expansionary fiscal policy. Monetary policy has likely done all it can - though we don't know the full implications of negative rates yet. Currently federal infrastructure investment is nearly non-existent and net government investment is at a 60 year low. In order to make up the output gap and return to trend growth, the stagnation theory tells us that the stimulus will have to be more overt.

Figure 11: Declining Investment

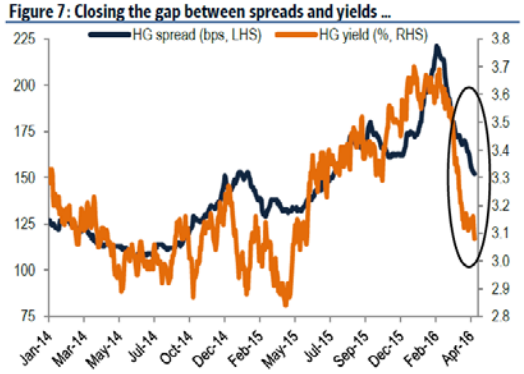


Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last meeting, the Federal Open Market Committee (FOMC) had just gathered and reassured investors that economic activity was expanding at a comfortable level despite recent global developments. One important development was the inclusion of corporate bonds into the European Central Bank's asset-purchase program, resulting in the reduction of credit risk across the globe. Investment grade corporate spreads tightened approximately 40 basis points across the curve during March, providing the asset class with its strongest relative performance since 2011. High-yield debt fared even better, as the uptick in commodity prices led to a sharp rally in the heavily-weighted energy and metals sectors. Treasury securities ended the month essentially flat in terms of total return, despite yields falling roughly 20 basis points in the last couple of weeks. Most of the pullback in treasury yields was due to the Fed Chairman Janet Yellen's recognition that global weakness still poses risks to the country's economic recovery.

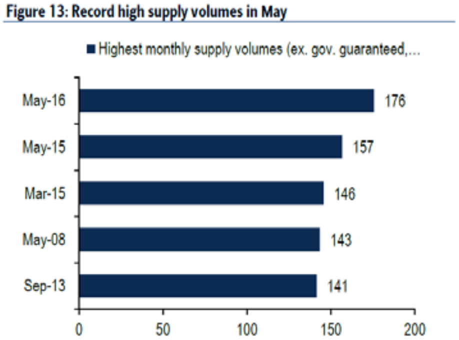
Figure 7: Closing the gap between spreads and yields ...



Source: BofA Merrill Lynch Global Research

The rally in corporate credit continued into April as commodity prices steadily climbed higher. Investment grade spreads tightened an additional 20 basis points during the month, leaving levels 70 basis points off the wides of mid-February. Total returns for high grade and high yield debt in April were approximately 1.50% and 4.00%, respectively. As one would expect, the further out the yield curve and down in quality investors went, the better off they were. Treasury securities, on the other hand, were down marginally despite the 10yr bouncing between the 1.70%-1.90% yield levels. Corporate issuance was rather muted as companies typically go silent during earnings reporting season.

Figure 13: Record high supply volumes in May

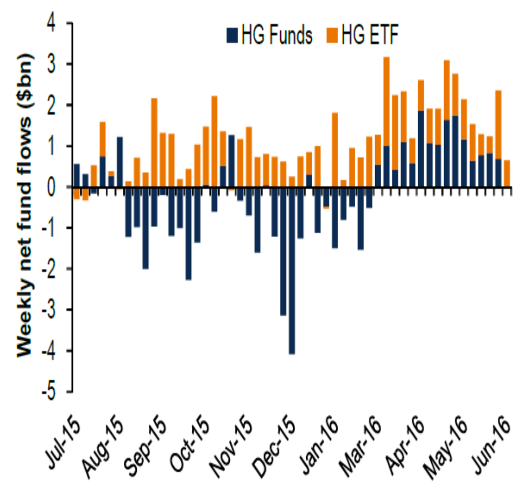


Note: highest monthly HG new issue supply since at least 1998, ex. government guaranteed.
Source: BofA Merrill Lynch Global Research

Primary market activity surged in May with approximately $175 billion of supply from investment-grade companies. An increase in M&A-related deals, coupled with issuers exiting earnings blackouts led to a very robust calendar. High yield issuance also increased from the previous month as smaller names seemed to have regained access to the market. Performance was somewhat mixed with the down in quality trade still ruling the day. However, the front end of the corporate credit curve held in a little better than the long end. Returns from government-guaranteed securities were negligible during the month. Treasury yields, especially those on the front end of the curve, drifted higher during the latter part of the month as the potential for summer rate hikes began to emerge.

The underlying theme for some time has been global central banks' attempt to boost growth and inflation in their respective countries by any means necessary. These actions have come in the form of purchasing financial assets, currency intervention, and the setting of negative interest rates. For instance, the size of the Bank of Japan's balance sheet is now roughly equivalent to 80% of the country's GDP. The European Central Bank is just now beginning to snatch up corporate bonds as a part of its asset-purchase program. The effect of these exercises has been a substantial increase in the value and the elimination of yield in global fixed income assets. The 10 year German Bund finally crossed into negative territory this week to join the likes of Japan and Switzerland. Currently, there is $8 trillion of global sovereign debt carrying negative yields, in which Japan is responsible for $6 trillion. Global investors are in dire need of yield-producing assets and they are struggling to find them. The Barclays' Aggregate Index now yields a paltry 2.04%, which is a 75 basis points pickup compared to the Global Aggregate. Bond exchange-traded funds have seen net inflows for 25 straight weeks, accumulating $61 billion in the process. Indirect bidding, a proxy of demand from foreign investors, hit a record high of 73.6% at the last 10 year Treasury auction.

Figure 2: High grade fund and ETF flows



Source: BofA Merrill Lynch Global Research, EPFR Global.

In light of this global policy backdrop, news that Britain could potentially leave the European Union (Brexit), has been met with much trepidation. After little chance of leaving the EU a few weeks ago, the momentum has shifted in the polls leading up to the June 23rd U.K. referendum. While the long term ramifications are unknown, an exit is widely believed to stall economic progress and potentially throw Britain into recession. Rather, the risk of contagion is the most frightening aspect. There has been a pickup in volatility, a strengthening of safe-haven assets and currencies, and a widening of peripheral spreads. Global credit-default swaps have also drifted back to March levels as a hedge against an U.K. exit. Europe and Japan are really struggling to get off the mat with prices in Europe falling on an annual basis in back-to-back months. Japan's inflation rate could very well be negative and the 15% increase in the yen year-to-date is suffocating the export-driven economy. At home, the economy posted a rather benign 1Q GDP print, which has been recently coupled with a disastrous May employment report. This development essentially squashed the potential for a June rate hike by the FOMC.

On June 15, 2016, the FOMC left short-term interest rates unchanged as expected. Near-term growth projections were lowered while the number of participants expecting only one additional rate hike for 2016 increased from one to six. More shocking, the median estimate for the longer-run federal funds rate fell to 3%. This revision can be interpreted as the level of interest rates the economy can absorb is likely to be materially lower over the longer term. Fed Chair Yellen's remarks were cautious at best, pointing out that recent payroll growth had fallen "markedly." She also made reference to the notion that slow productivity growth and an aging society may keep interest rates at depressed levels. It was reported that the words "uncertain" or "uncertainty" were used over ten times during her speech. Those words are ranked right there near the top that frighten investors the most.

The 30yr Treasury note is currently sitting at a 16-month low, while the 10yr is just 20bps above its all-time low established in June 2012. Credit spreads have drifted slightly wider over the last couple of weeks with the financial sector bearing the brunt of the damage. The fixed income portfolio has been relatively inactive over the last couple of months. The fund has reinvested the prepayments from its mortgage-backed holdings and extended duration within the agency sector. Within corporates, the fund has added quality and duration selectively. While the total return has been quite favorable year-to-date, there is recognition of the historic low levels of yield in the current environment.

Going forward, all eyes are on the referendum result this coming Thursday. It seems as though the "remain" camp has swung the vote back in its favor on Friday. This should provide a much-needed relief for risk assets and sentiment. The Bank of Japan appears to be keeping its powder dry for a potential Brexit by taking no action at Thursday's meeting. Britain leaving the EU would likely bring about a surge in the Japanese yen, elevating the chances of currency intervention. This type of action could be a coordinated move with other G7 members in the same fashion as it was enacted after the 2011 earthquake. Regardless, Japan is likely to ease further at its next policy meeting. There is very little chance of the FOMC raising rates in July barring better economic data, a monstrous June payroll number, and Britain remaining in its current form. The market is now only pricing in a 50% chance of a rate move by the end of the year. The Fed Chair is cognizant of the fact that the current state of the world is fragile. She also understands that as the world's central banker, for better or for worse, our monetary decisions have monumental ramifications. Central banks are in the business of buying time and the Federal Reserve is no different.

Domestic Equity Strategy

By Allan Carr

Have you ever heard of a "portmanteau"? It's the combination of two words by fusing their sounds and meanings. For example Reaganomics is used to describe President Ronald Reagan's economic policies during the 1980's. In early June, a certain portmanteau became the latest macro event to cause dislocation in global financial markets. "Brexit" is a morph of "British" and "exit" created to succinctly refer to the United Kingdom leaving the European Union (EU). Simply put, UK voters will decide on June 23rd to either stay in the EU or leave. While the date has been known since February, the general consensus and odds have been strongly in favor of the Brits voting to stay in the EU. Suddenly in the second week of June, polls and odds began to shift toward a greater chance they would vote to leave. This caused a massive risk off trade across the globe: the VIX spiked over 50% in one week, 10 year German bond yields went negative for the first time in history, the US 10 year treasury yield fell as low as 1.5% intraday, and gold hit an 18 month high.

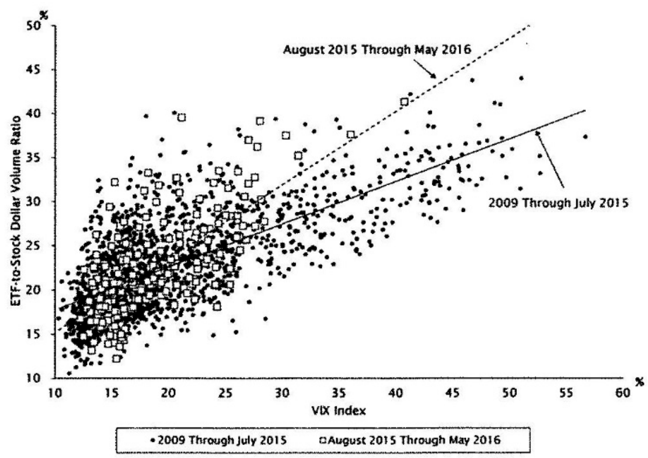
The angst over a possible Brexit is primarily the fear of the unknown as it is a binary event that is unprecedented. ISI's Ed Hyman said it well: it could either be a Lehman event or a Y2K event. If they vote to leave it will be over two years before it takes effect. The general feeling is it will bring risk-off and flight to quality trades, at least initially. Prolonged low/negative rates globally would be bad for the US banks and the much more fragile European banks. A stronger dollar would lead to weaker commodity prices which would pressure China and other emerging markets through a reversal of what propelled the February-June rally. Unfortunately we don't know what the vote will be although sentiment in the days ahead is swinging back in favor of them voting to stay in the EU. If they elect to remain, it seems likely we see a snap back risk-on trade. If they vote to leave, our guess is more volatility and jittery markets as investors, businesses, politicians, and policy makers try to figure out what the ramifications will be.

Brexit is the latest example of the new investing paradigm characterized by quick and violent risk-on/risk-off trades. The all-time closing high was 2131 on the S&P 500 last May 21st. Today, we are less than 2% lower on a price basis, however we have had four moves of over 10% in those 13 months. You probably recall the terrible close to our fiscal 2015 with the market selling off (-11.7%) from the May high through September 28th. From there we rallied 12.1% in a mere five weeks. Then from November 3rd to February 11th we sold off (-13.1%) to 1829 on the S&P. That would mark the bottom for oil, equity markets, high yield, the VIX, and much more as we rallied an impressive 15.8% to close at 2119 on June 8th.

These macro risk-on/risk-off trades make for a tough and frustrating investing environment. The first quarter of 2016 was the worst quarter for mutual fund relative performance on record. Hedge fund performance is similarly poor as they are having a hard time managing these swings. Empirical Research did an interesting piece recently addressing hedge funds. Their work showed that historically hedge funds had their best returns when doubling-down on trades moving against them, with these contrarian plays returning twice as much as all of their other positions. Fifteen years ago, hedge funds were predominantly a vehicle for high net worth individuals seeking outsized returns with little regard to risk. That landscape has changed as more hedge fund assets now come from institutional clients, with the average pension having money in 26 hedge funds, per Empirical. Institutional clients do not have the same goals as high net worth clients; they want risk-adjusted returns with low volatility. The problem is this mandate for low volatility is actually resulting in more volatility for the market as hedge funds are having to manage risk daily. The result is they are increasingly using ETF's to hedge risk as soon as they sense fear in the markets, as they can plow into an ETF instantaneously versus trying to sell baskets of stocks (Exhibit 1).

<u>Exhibit 1</u>

U.S. Stocks
ETF-to-Stock Dollar Volume Ratio Versus VIX Index
2009 Through May 2016

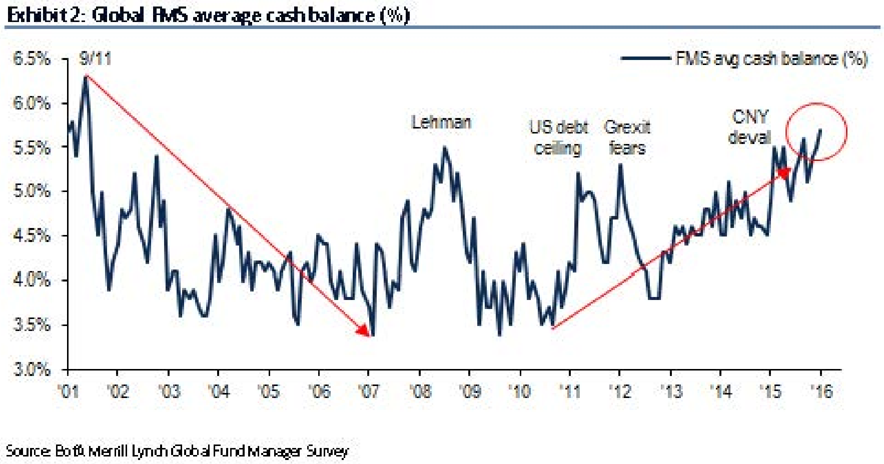


Source: Empirical Research Partners Analysis.

The consequence of pouring into ETF's is extremely high stock correlations, which makes stock selection more difficult. As a result, assets are fleeing hedge funds and asset managers for low-cost indexed funds, adding further to stock correlations. Through the first 21 weeks of the year we saw record domestic equity outflows from mutual funds to the tune of $64 billion.

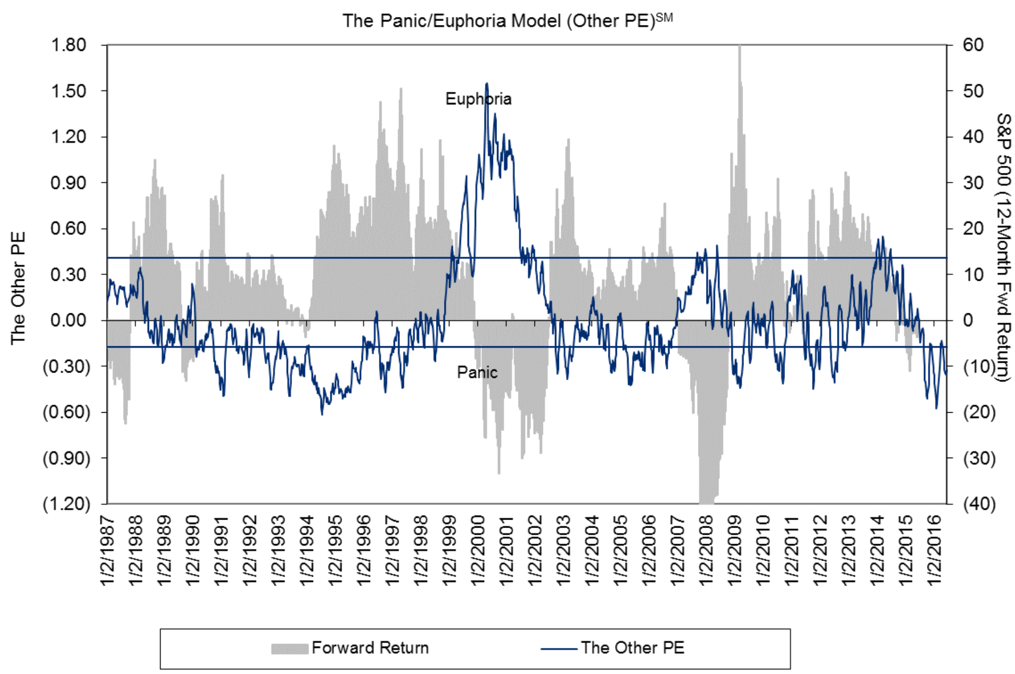
Wall Street strategists who constantly talk to investors say people are almost exclusively focused on the negatives. Simply put, tons of pessimism and lack of conviction abound. The market is testing all-time highs while the American Association of Individual Investors survey shows all-time lows for bullishness: very odd times. Bank of America does a monthly survey in which they ask over 200 fund managers managing upwards of $650Bln in assets how they are positioned (stocks/bonds/cash, etc). The most recent survey in early June revealed fund managers maintain their highest cash balance since 9/11 and higher than at any point in the financial crisis. (Exhibit 2)

Exhibit 2



Citigroup's "Panic/Euphoria Model (the Other P/E)" is a multi-factor model that includes things such as put/call ratios, option prices, and short interest to capture how investors are actually positioned in addition to what they say in surveys. As you can see in Exhibit 3 below, the latest reading shows a surprising amount of risk aversion. Historically, similar readings on this model have preceded higher equity prices over the next 12 months.

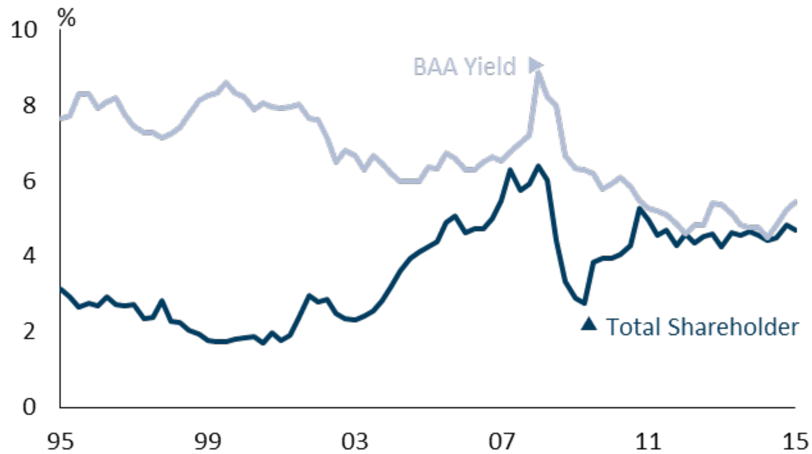
Exhibit 3



As has been the case since exiting the financial crisis, there are plenty of potential bearish scenarios and the media covers them well. Brexit, the presidential election, China hard landing, ISIS, European bank failures, negative rates, market P/E above long term averages…the list goes on. We recognize these risks and do not dismiss them. However there is a base case and a bull case to be considered.

The base case has been and continues to be that the US economy forges ahead, earnings continue to grow, and a recession is not likely. The consumer remains in great shape as does Corporate America. US equities remain attractive given negative rates in Japan and Europe, the 10 year treasury coming within 10 bps of all-time lows, and stability in the US economy. The TINA (there is no alternative) mantra is still alive as the combination of earnings growth, dividends and buybacks gets investors mid to high single digit returns. In Exhibit 4 from RBC, the "shareholder yield" of buybacks plus dividends is roughly the same as corporate bond yields, as well as the kicker of possible growth.

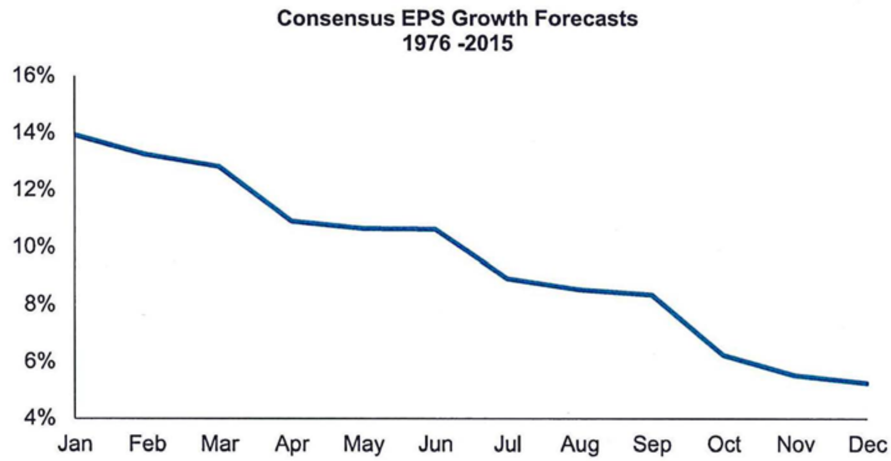
Exhibit 4



Market skeptics are quick to point out how all the return in the markets in the last two years has been from multiple expansion. This is true as earnings have been flat and the weak commodity/strong dollar trade was a huge headwind for earnings in 2014 and 2015. On energy in particular, Morgan Stanley wrote that energy earnings went from $15 in 2014 to $2 in 2015. This explains all of the "earnings recession" as earnings grew roughly 6% last year ex-energy. Lower energy prices hit the energy companies immediately, while they have a lagged effect filtering through to the consumer.

In regards to earnings, we've addressed in prior updates the calendar effect of earnings revisions. In most cases, analysts start the year with overly ambitious earnings projections and have to whittle them down as the years goes on, as shown in Exhibit 5 (from Morgan Stanley).

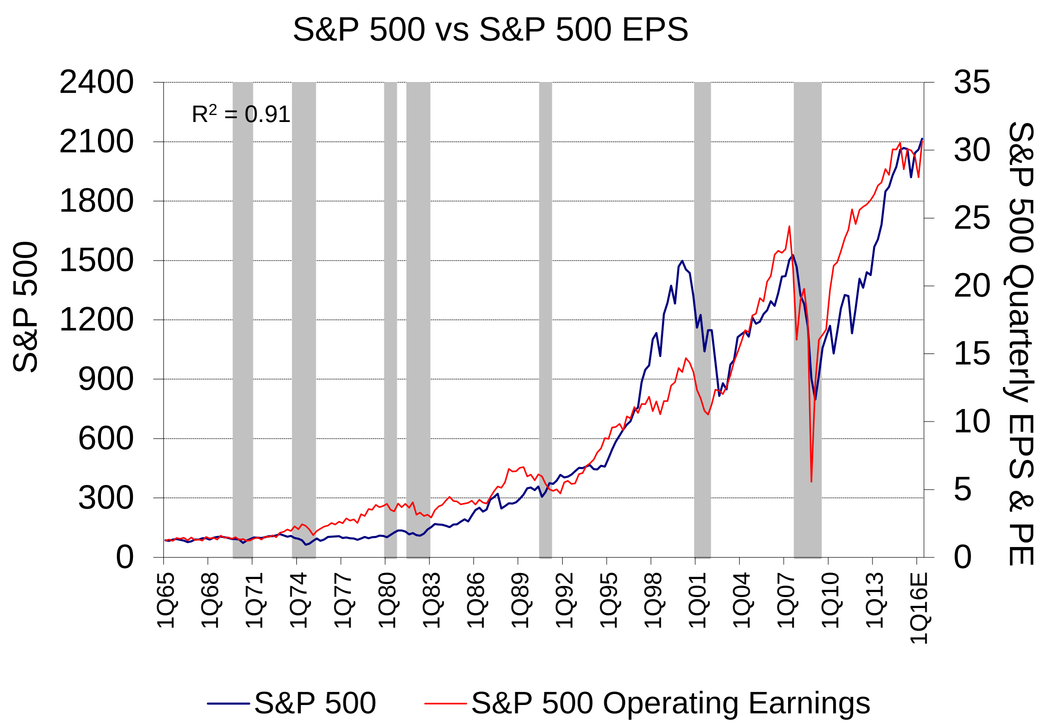
Exhibit 5



However, on occasions when dynamics have been trending against earnings (as energy prices and dollar strength have been), analysts tend to assume these dynamics continue. This year it appears that analysts cut their estimates much more quickly and sharply, extrapolating the low oil prices seen in January/February as lasting throughout the year. The result was bottoms-up estimates calling for flat earnings again for 2016, while top-down estimates from strategists at both Citigroup and Morgan Stanley have them up roughly 4%.

With oil prices having nearly doubled and remaining there, analysts are raising estimates for the first time in nearly two years. In fact, Morgan Stanley estimates there is another $3-$5 of possible energy earnings still not yet reflected. Positive earnings revisions bode well for stock prices. In addition, leading indicators are looking positive for the second half of the year which could suggest further strength in the economy. A better economy along with the dollar/energy trade switching from a headwind to a tailwind could result in estimates continuing to move higher. This would be the bull case for equities, as the correlation between earnings and the market is extremely tight (exhibit 6).

Exhibit 6



Having laid out all three and not knowing as of deadline the outcome of the Brexit vote, we still feel the base case is the most likely, as we have for quite some time. With the dollar/energy trade having eased concerns in credit and emerging markets, we feel the bear case is less likely versus our prior update. While the earnings revision tailwind is easily plausible, we do not see outsized gains as highly likely given elevated multiples. Dividends plus buybacks plus 4-5% earnings growth would give investors 8-9% returns if multiples hold. We view the market's resiliency in the face of such widespread skepticism as encouraging. Unfortunately, we do not expect the choppiness and risk-on/risk-off environment to change anytime soon.

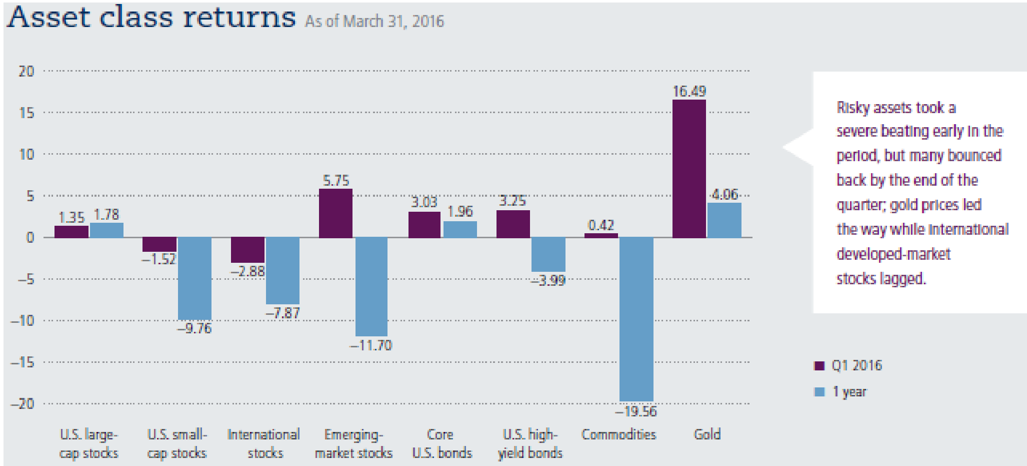
Our longstanding policy of managing all of our equity in-house results in extremely low fees in a time when individual and institutional investors alike are scrambling to move assets in-house or to low-cost index products. Vanguard, the low-cost fund pioneer, now manages $3.5 trillion and is growing assets by over a billion dollars every day per a Morningstar report. According to the same report, Vanguard's average expense ratio is 18 bps versus the industry average of 101 bps. At RSA, we are a fraction of even Vanguard with expenses under 3 bps.

Finally in regards to activity, we took advantage of the market strength and spike in volatility in the last month to layer on more protection with hedges. We extended some protection out to December to allow for more upside, as well as stagger the maturities. Given the whipsaws we've seen and we likely will continue to see, we feel these hedges are prudent and appropriate in managing downside risk while still allowing for solid upside potential.

International Equity Strategy

By Steve Lambdin

Equity markets around the globe started out 2016 in a tailspin as macro events completely dominated investor minds. Worries about a slowing U.S. economy, further growth concerns in China, interest rates continuing to fall around the globe, currency volatility, and fears of "Brexit" in the U.K. all came together to push many international equity indices to fresh lows. However, about midway through the first quarter saw a complete reversal of fortunes for equity investors. Commodity prices staged a good rally as the Bank of Japan (BOJ), the European Central Bank (ECB), and the U.S. Federal Reserve (FED) all reiterated their respective stance on supportive policies which helped fuel a nice equity market rally. The surprising dovish FED statements in March seemed to reduce investor expectations on future interest rate increases, causing the U.S. dollar to fall significantly and a rally in oil and other commodities. Needless to say, this was very favorable for the emerging markets. As mentioned above, the biggest issue for most investors over the last couple of months is the upcoming June 23 referendum in the U.K. to withdraw from the European Union (EU). The potential fallout from a "yes" vote could have many short term and a few long term implications. Over the short term, most disruptions will be within the Eurozone and U.K. economies themselves, and probably not too much beyond these borders. The longer term issue is whether the EU eventually unravels and falls apart as a U.K. exit provides a model for others to follow. At this time, the projected vote is just too close to call. In Japan, the central bank surprised many of us by setting a negative interest policy in another attempt to ignite more economic growth in the region and push inflation toward its target. We just don't know if this will ultimately work. Meanwhile, China's continued economic slowdown remained very concerning for most in the quarter. The Peoples Bank of China (PBOC) continued to provide support to the growth outlook and cut the required reserve rate in the quarter as well as taking other stimulative actions. However, investors still pushed equity markets downward as this was not enough to mask a slowing outlook. As we look out through the summer, equity markets remain very nervous as investors have a lot of issues on their minds. The Brexit vote, a seemingly slowing global economy, a growing number of countries supporting a negative interest policy, a host of geo-political concerns, and corporate earnings are just a few of these issues. As we add up the so-called "scorecard," sentiment seems fairly negative at the moment and could make for some heightened volatility in the equity markets as we move through the summer.



Source: John Hancock Investments; Morningstar Direct

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -3.01% and +5.71%, respectively during the first quarter of 2016 vs. +1.35% for the S&P 500 Index. The emerging markets responded very favorably to reduced expectations for rising U.S. interest rates going forward. The U.S. dollar was a significant factor in returns in the quarter, as it fell -4.3% against the Euro and -6.6% vs. the Japanese yen, and rose +2.7% against the British Pound. In all, currency provided about a +3.3% benefit to unhedged U.S. investors in the MSCI EAFE Index. The European region was a bit stronger than the Pacific basin, as Japanese equities were very weak in the quarter. From an economic sector standpoint, the defensive sectors of healthcare and utilities were relatively stronger, while industrials and telecom were the weakest. The commodity markets did manage to stage a nice rally late in the quarter, as oil rallied off a multi-year low of $26/barrel in mid-February and finished over $38/barrel at the end of March.

Inflationary risks remain absent throughout much of the world

Inflation forecast (annual % change)

Inflation rates	2016	2017	2018	2019	2020	5-year average 2016–2020
United States	0.8	1.4	1.8	1.9	2.0	**1.6**
Canada	1.5	1.9	1.5	1.7	1.8	**1.7**
Eurozone	0.3	1.3	1.5	1.6	1.6	**1.2**
Germany	0.4	1.5	1.4	1.6	1.5	**1.3**
France	0.1	1.0	1.4	1.5	1.5	**1.1**
United Kingdom	0.5	1.3	1.4	1.5	1.6	**1.3**
Asia-Pacific	1.6	2.3	2.2	2.5	2.7	**2.2**
Japan	0.0	0.9	1.3	1.2	1.3	**0.9**
China	1.3	1.7	1.7	2.4	2.8	**2.0**
India	5.2	5.0	5.0	5.0	4.6	**5.0**

With few exceptions, we foresee anemic inflation rates over the next few years.

Source: John Hancock Asset Management, 3/8/16.

Thus far into the second quarter of 2016, the global equity markets have recently turned negative, especially just recently. Negative sentiment toward the upcoming Brexit vote in the U.K. and falling economic growth concerns in many parts of the world seem to have alarmed most investors. This has pushed the MSCI EAFE Index and the MSCI Emerging Markets Index down -2.5% and -3.0%, respectively through mid-June in the second quarter. On the other hand, the S&P 500 Index is still managing to hold onto a very slight gain at the moment, as U.S. stocks are faring a bit better in the marketplace at the present time. At this point, growth seems to be slowing more than many have estimated and this is putting a lot of pressure on the markets. This will keep the central banks in the forefront as investors look for leadership from these groups to get more positive toward equities.

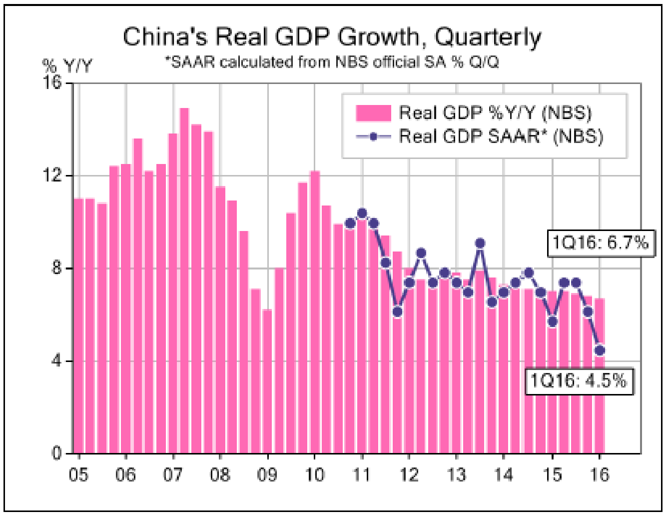
Source: Fidelity Quarterly Market Update 2Q 2016

Asia Update

The MSCI Pacific region finished as the worst performing region within the MSCI EAFE Index during the first quarter of 2016. The main thrust for this was the -6.38% return for the MSCI Japan Index during the period. The equity markets here responded very harshly to the adoption of the country's first negative interest policy by the BOJ. As one would expect, the banking sector got hit the worst with many banks selling off -15% to -20% in the period. This is an attempt to re-ignite growth in the region and push inflation rates higher. At this point, we have to wonder whether the BOJ can really help the economy, as weak demand for capital spending is hurting the region. Chinese equities also struggled in the quarter as the MSCI China Index was down -4.8% in the period. Continued stimulus measures by the PBOC did not seem to give investors much comfort in the period. China seems to be stuck in a perpetual slowing of the economy and investors seem to fade in and out with what the future looks like here. Perhaps sentiment will flow the other way at some point.

Source: Evercore/ISI

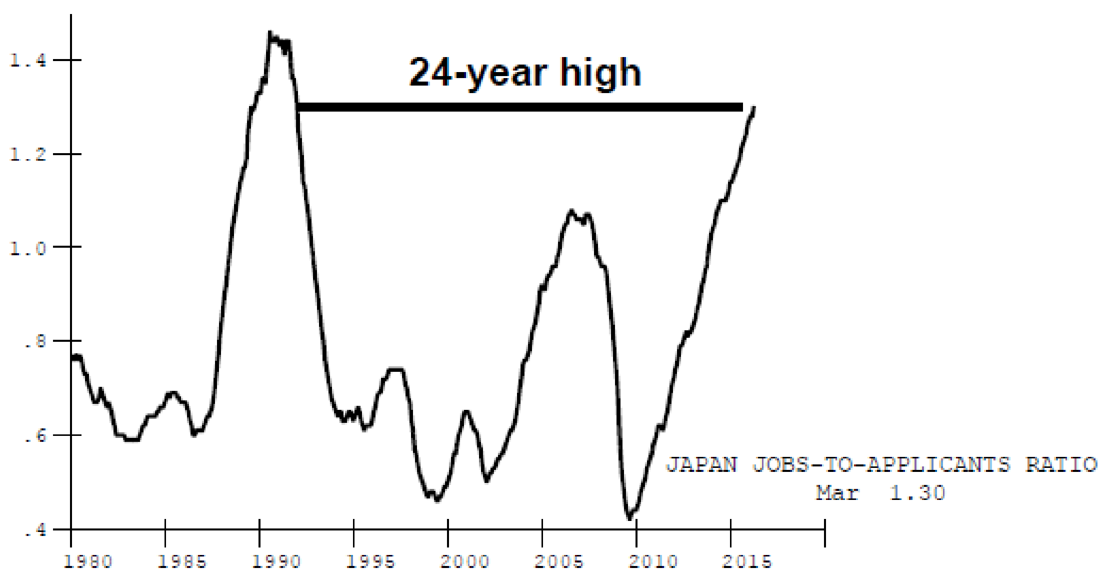
The Chinese economy performed about what investors were expecting in the first quarter of 2016, as GDP rose +6.7% in the quarter, which was right in line with government projections. The quarter was helped by a robust March, which saw improvements in fixed asset investment, retail sales, and exports. In addition, we saw a reacceleration in lending, as outstanding credit gained nicely in March. The property sector has recently seen a small revival as new construction has been robust. Automobile production and sales has been very strong as recent tax cuts targeted toward this sector have been well received. However, this growth comes at the expense of lending, as outstanding credit rose to 215% of GDP. This is not sustainable in the long run. No doubt, it will be an enormous challenge to rebalance this economy over the long run without a hard landing. We remain concerned about the ability to manage capital flows over the long term. We also still believe growth is a major priority over the short term as officials here attempt to meet growth targets established for 2016. While the services sector continues to expand, many are concerned that much of this expansion has been in low-skill areas, not doing much for the economy in the long run. Industrial production rose +6.0% in May, while fixed asset growth continued to slow to +9.6% for the first five months of 2016, which again is the slowest pace of growth since 2000. Exports remain in a slump, rising only +1.2% in May from the year earlier period, which came as little surprise. Retail sales continue their recent trajectory, rising +10.0% in May, slowing just slightly from the pace of a few months back. Inflation remains not much of an issue as consumer prices rose +2.0% in May from a year earlier, falling slightly from April levels. Food inflation has been running ahead of non-food inflation lately, but should fall going forward to more normal levels and could push the overall CPI below +2.0%. At this point, we would expect another cut in the required reserve ratio over the near term in an effort to keep stimulus actions flowing. However, even with these actions, we now expect GDP growth in 2016 to come in at the +6.5% area vs. our earlier expectation of the +6.5% to +7.0% range. Most expectations remain tilted toward the downside as global growth estimates continue to be cut by the International Monetary Fund (IMF) and others.



Source: Evercore ISI

The economy in Japan was a little more resilient in the first quarter than many had anticipated, as GDP rose +1.9% in the quarter from a year earlier period. This was slightly better than the previous estimate, as upward revisions to private consumption and business investment helped on the margin. This could put off the need for further monetary and fiscal stimulus over the near term, but should not be perceived as a long term decision, as we believe much stimulus will be needed further out. Also, Prime Minister Shinzo Abe recently delayed the planned increase in the national sales tax from April 2017 to October 2019, just ahead of national elections scheduled for this July. This probably gives just temporary support to the economy until further fixes can be orchestrated. Abe continues to have aggressive policy targets over the next few years which will require a lot of monetary stimulus actions to raise asset prices and depreciate the yen. Most don't believe this will happen to the degree he is aiming for. Exports continue to trend downward and fell for the seventh consecutive month in April to -10.1% from a year earlier. However, Japan is running a trade surplus as imports fell -23.3%, much more than exports. Shipments are getting hammered from not only a strengthening currency, but also an overall weak overseas demand environment. Industrial production continued to struggle in the quarter as April's output fell -3.5%

from a year earlier. We are optimistic that we should expect to see this improve as we move through 2016. Small business confidence continues to struggle, falling to 45.6 in May, which is the low of year, as many businesses are citing a nervous consumer and heightened foreign exchange (forex) pressures in the marketplace. We would also expect to see some recovery in this key statistic if the economy is to improve going forward. Consumer confidence is also weak lately, falling to 40.9 in May, which is well off levels of late 2015. The consumer is simply in not much of a position to help the economy at this point. The deflation debate is alive and well in this economy as core prices fell -.5% in May from the year earlier. This is the third consecutive month of falling core prices and many businesses simply have no pricing power at this time. The labor market remains very stable as the May unemployment rate remained at 3.2%, right at multi-decade lows. Also, the jobs-to-applicant ratio continues to improve, rising to 1.34, which is a multi-year high. However, this has not transpired into higher wages thus far, but we feel these readings are planting the seeds for higher wages sometime in 2016. As we look out for the next few months, the strengthening yen is putting a lot of pressure on growth levels in this economy and should continue to do so for the next few months. With this in mind, we see 2Q 2016 growth at levels below that of the first quarter. We expect to see more monetary stimulus measures over the next several months in an effort to grow this economy. Perhaps this can bring some strength to the equity markets.

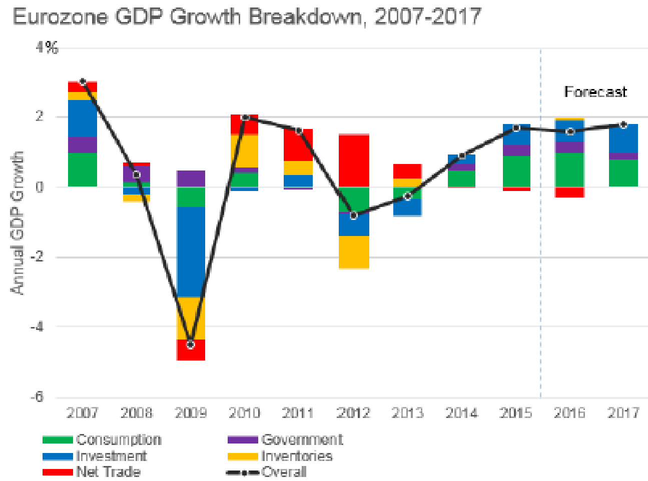


Source: Evercore ISI

Europe Update

The driving force behind the continued recovery in the Eurozone economy continued to be the ECB in the first quarter. The ECB essentially upped the ante in March by taking the deposit rate deeper into negative territory, expanding the monthly asset purchase program to 80 billion euros a month, and introducing a series of targeted long-term refinancing operations starting in June 2016. This leaves no doubt to us that the ECB has become more aggressive than what many had been thinking about its monetary easing program. These actions should allow banks to cut interest rates on new loans in a continuing effort to stimulate the economy. On the margin, we are seeing signs this is working as some economic data points are turning, indicating better things ahead. However, investors are still wrestling with a host of issues such as the upcoming Brexit vote, the influx of refugees into the EU, the continuing saga of many of the European banks, reduced expectations for corporate earnings, and falling inflation expectations that keep the threat of deflation alive and well. The MSCI European Index (ex. U.K.) struggled in the first quarter and posted a loss of -2.54% in USD. This would have been even worse had it not been for a weak U.S. dollar helping returns. As we look out into the summer, the number one issue at the moment is the upcoming brexit vote. This could be a short term disruption event with some longer term issues to work out if a yes vote passes. Beyond this, we need to see more economic growth from all of the monetary and fiscal stimulus that has transpired in this region.

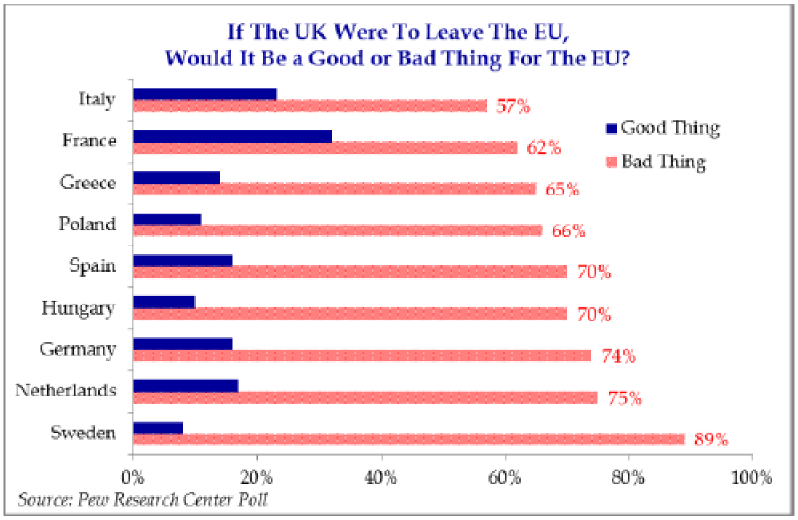
First quarter GDP rose +.6% from the previous quarter, or +1.7% from the year earlier period, which was a bit better than most were expecting and is a good start to the year. The German economy provided a significant boost to the Eurozone economy as it expanded by +.7% in the quarter, which is the fastest pace in two years. This economy is benefitting from good consumer demand and record low unemployment. In addition, the economy in Spain was very good as first quarter GDP rose by +.8%, the fastest pace for this economy in quite some time. As mentioned above, the ECB continues to provide massive support to the Eurozone economy and should continue so for most of 2016. This should provide a decent backdrop for growth over this time frame. Second quarter industrial production is off to a good start as April was reported up +2.0% from the year earlier, as production gains were broad based across most major industrial goods. This comes on the heels of a decent first quarter for industrial production, which was the sixth consecutive quarter of growth. The index of executive and consumer sentiment continues to move in the right direction and was reported at 104.7 in May. This is the highest level for this key indicator since January 2015. Rising disposal incomes and better prospects for business investment seem to be fueling higher sentiment levels. Retail sales were up about +2.2% in the first quarter from a year earlier, which is a slight acceleration from the previous quarter and another positive indicator for the region. Inflation remains non-existent at the moment as core consumer prices only rose +.8% in May from a year earlier period. At this point, we do not see much inflation in this economy over the near term. The employment situation continues to improve ever so slightly as the April unemployment rate was reported at 10.2%, the best rate thus far in 2016. At this point, we should see the unemployment rate tick below the 10% threshold at some point over the next several months.



Source: BlackRock Investment Institute, Eurostat and European Commission (EC), May 2016.
Note: 2016 and 2017 numbers are EC forecasts.

The U.K. economy continued to churn along with another quarter of decent growth in the first quarter of 2016, as this economy has now posted a record 13 straight quarters of economic growth. We find this even more remarkable in the face of the Brexit referendum taking place shortly. GDP grew by +.4% in the quarter from the previous quarter, or +1.9% from the year earlier period. This rate of growth is just a hair below that of the previous quarter. This growth appears broad based as household consumption, fixed investment, and government expenditures all contributed rather nicely to output. Retail sales continue to surprise to the upside as May sales were up +.9% from the previous month, or +6.0% from the year ago period. We find this very surprising, especially in the face of the upcoming referendum vote. Many now believe this just might not be much of an issue for the consumer regardless of the outcome. Inflation remained very stable lately as May core CPI was up +1.2% year over year and remains well below policy levels. As we have seen from other parts of the world, we have seen nothing in the way of inflation at the moment. At its recent June meeting, the Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds, just as it has for an extended period of time. We see nothing on the horizon over the near term that would indicate to us any expectation for higher interest rates any time soon. The employment situation continued its pattern of gradual improvement lately as the April unemployment rate fell to 5.0%, which is an 11-year low. Also, employment rose by 55,000 in April to a record employment of 31.6 million workers. Wages are beginning to accelerate in response to these stellar employment readings as recent wage increases have been in the +2.5% area, which has surprised a few economists. This continues to be a shot in the arm for the consumer going forward. As we look out for the next few months, we do expect some weaker growth on the margin as anxiety over the upcoming referendum vote remains at high levels. This vote remains too close to call and we have no basis as to what will happen with a yes vote. Therefore, with this in mind, we would expect a weak and contentious equity market over the near term.

EU COUNTRIES OVERWHELMINGLY BELIEVE
A "BREXIT" WOULD BE BAD FOR THE EU…



Source: Strategas

Emerging Markets

The emerging markets staged quite a rebound in the first quarter of 2016. Surprisingly dovish statements from the U.S. FED led to a declining U.S. dollar, rising price of oil and other commodities, and a marginally better currency outlook going forward. This led to significant strength in the commodity related regions of South America and Africa, even as China continues to flounder around fighting a slowing growth outlook. The MSCI Emerging Markets Index (net) did post a very healthy +5.7% gain in U.S. dollar terms in the first quarter of 2016, the second consecutive quarter of gains in this index. Whether this is the beginning of a new cycle in the emerging markets or just a quick upward bounce in a continuing saga remains to be seen. The biggest issue still remains with China, as investors need to gain comfort that a hard landing will not transpire with this economy. However, we are beginning to get the feeling that we may have seen the worst and perhaps better performance lies ahead with this index. At least this index remains a good hedge to falling interest rates in the U.S. We are also becoming more comfortable that we have seen the lows in most commodities in this cycle and perhaps this will help the sentiment here as well. Valuations still remain attractive, but not to the degree of a few months back. We are still looking to add to our emerging markets exposure on downward movements as we could see some rebound in this asset class at some point as we keep a long term perspective in mind.

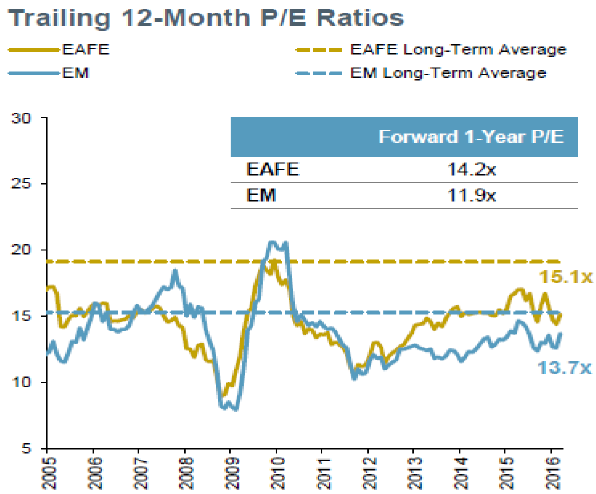
Earnings Growth Expectations		
Region	Next 12M	Last 4-Yr Average
Developed	7.5%	9.8%
Europe	6.5%	8.4%
Japan	10.7%	20.7%
Emerging	6.6%	13.3%

Source: Fidelity Investments Q2 2016 Market Update

International Equity Activity/Strategy

As we enter the summer of 2016, there remains a multitude of issues facing investors. First and foremost is the upcoming Brexit referendum in the U.K. At this point, it's just too close to call. A yes vote could have some far reaching implications over time. But again, this is unchartered waters as we have not experienced this before, so naturally investors are very nervous toward risk-on type assets, such as equities. A no vote could bring a relief rally to the global markets, but to what degree we just do not know. With all of the central bank actions over the last few years, one would have thought the global growth environment would be much better. However, it's clearly not and interest rates keep getting pushed downward and inflation rates are moving down as well. The bias toward global growth has declined as fresh concerns are also hitting the U.S. economy. Central banks continue to pump massive amounts of stimulus into the various regions around the globe, pushing ten-year government bond rates into negative territory in several countries. Some estimates have put nearly ten trillion of global debt securities into negative territory at the moment. This is unprecedented in history. Perhaps over time this will spur investment and spending over savings. With all of this in mind, we expect markets to be uneasy and quite volatile over the next few weeks. Perhaps all will not be perceived negatively and investors gain some measure of clarity and comfort at some point.

We have taken advantage of the recent volatility in the global markets to remain active in the emerging markets index (EEM). After recently adding approximately $44 million to our emerging markets index in January, which we mentioned in our previous quarterly report, we did sell approximately $34 million of this index in March as the index did rally nearly +13% over a two month period. Subsequently, we did add back approximately $23 million of EEM in May as the price of EEM moved back below our exercise price on our puts as the EEM has been quite volatile lately. We are taking advantage of the whipsaw market action lately to do these actions and expect to continue to sell some call options on EEM at strike prices well above the current price of EEM and 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 these strategies still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.50% of total assets and approximately 10.3% for MSCI EAFE equities, which still remains below peer group averages. *(Credit is given to the following entities for charts provided: Strategas, Fidelity Investments, John Hancock Investments, Evercore ISI, Blackrock Investment Institute, European Commission, and Eurostat)*



Source: Fidelity Investments Q2 2016 Market Update