September 2016

# Quiet Trading Results in Positive Returns

## Overview

On the heels of strong returns during the month of July, U.S. and international stock markets continued to trade higher in August. Volatility declined during the month, as investors felt more at ease with slowly improving economic data and better-than-expected earnings reports from U.S. companies. Although the S&P 500 Index was up just 0.14% during the month, it hit an all-time high of 2,190 on August 15. International equities posted the strongest returns, as economic data showed continued resiliency in the face of the Brexit referendum. The MSCI ACWI Ex US Index returned 0.63% during the month, while the MSCI Emerging Markets Index jumped 2.49%.

The Federal Reserve held its annual conference at Jackson Hole in August and noted that the economy continues to improve, which may allow the Fed to hike rates again this year. The central bank's focus remains on global risks and the potential for a jump in market volatility. However, the calm trading in August, combined with continued strength in the U.S. labor market, may encourage the Fed to hike rates at its September meeting.

## Performance

Stocks moved higher while bonds declined slightly in August.

| Index Name | Aug | 2016 YTD | 5-Year Annlzd | 10-Year Annlzd | Category |
|---|---|---|---|---|---|
| BarCap Municipal TR USD | 0.13 | 4.54 | 4.80 | 4.87 | US Muni Bonds |
| BarCap US Agg Bond TR USD | -0.11 | 5.86 | 3.24 | 4.89 | US Taxable Bonds |
| BarCap US Corporate High Yield TR USD | 2.09 | 14.35 | 7.48 | 7.79 | US Corporate HY Bonds |
| JPM EMBI Global Diversified TR USD | 1.79 | 14.31 | 6.71 | 7.75 | Int'l/Emerging Bonds (USD) |
| JPM GBI EM Global Diversified TR USD | 0.04 | 14.75 | -2.38 | 5.23 | Int'l/Emerging Bonds (Local) |
| | | | | | |
| HFRX Equity Hedge USD | -0.18 | -2.18 | 1.26 | -0.77 | Hybrid/Hedged Equity |
| | | | | | |
| DJ Industrial Average TR USD | 0.26 | 7.65 | 12.48 | 7.72 | US Equity -- Large |
| S&P 500 TR | 0.14 | 7.82 | 14.69 | 7.51 | US Equity -- Large |
| NASDAQ Composite TR USD | 1.18 | 5.04 | 16.55 | 10.24 | US Equity -- Large |
| | | | | | |
| Russell 1000 TR USD | 0.13 | 7.83 | 14.60 | 7.64 | US Equity -- Large |
| Russell Mid Cap TR USD | -0.25 | 10.04 | 14.29 | 8.49 | US Equity -- Mid-sized |
| Russell 2000 TR USD | 1.77 | 10.23 | 12.85 | 7.04 | US Equity -- Small |
| | | | | | |
| MSCI All Country World Index ex-USA NR USD | 0.63 | 4.53 | 3.31 | 2.04 | Int'l Equity -- Comprehensive |
| MSCI EM NR USD | 2.49 | 14.55 | -0.42 | 3.90 | Int'l Equity -- Emerging |
| | | | | | |
| Bloomberg Commodity TR USD | -1.76 | 5.57 | -12.75 | -6.20 | Commodities |
| HFRX Global Hedge Fund USD | 0.16 | 0.78 | 0.59 | -0.19 | Multi-Asset Alternative Invm't |

*Source: Morningstar Direct. Data through 8/31/2016*

The S&P 500 Index is now up 7.82% in 2016, and the MSCI ACWI Ex US Index has returned 4.53%. Emerging market equities are one of the best-performing investments; the MSCI EM Index has returned 14.55% for the year through August. U.S. small cap stocks performed very well last month, returning 1.77% and increasing their YTD return to 10.23%.

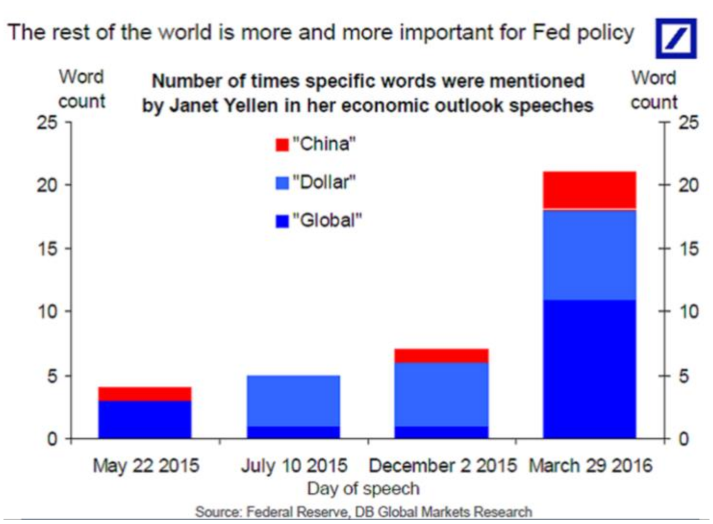
The Barclays US Aggregate Bond Index declined slightly during the month as investors perceived increasing risks of a Fed rate hike. Corporate bonds continue to perform well, with the BarCap US Corporate High Yield Index returning 2.09% during the month of August. High yield bonds are now up 14.35% for 2016.

**Outlook**

With earnings season in the rearview mirror and markets shifting further into the back half of the year, greater attention will be paid to the direction of Federal Reserve policy. Indeed, global central banks have been a focal point in the current economic expansion. This occurred first as they laid heavy monetary easing onto the markets to help stave off the effects of the global financial crisis. The second phase unfolded as the European Central Bank and Bank of Japan pushed rates into negative territory to encourage risk taking, and now as the Federal Reserve tries to find ways to push interest rates higher without disrupting economic growth and investment markets.

After the Federal Reserve raised rates last December, it forecasted 4 additional rate hikes for the full year of 2016, which meant that the official Fed Funds rate was projected (at that point in time) to end 2016 in a range of 1.25% to 1.50%. Despite the hawkish forecasts, the central bank has yet to move rates *at all* this year for several reasons. One was the sharp drawdown in global equity markets during the first quarter, and second was the anemic pace of U.S. economic growth during the first and second quarter, which gave the Fed wiggle room to keep policy loose. Finally, the uncertainty caused by the Brexit referendum gave them further reason to keep rate hikes on hold. As all of these developments occurred, inflation remained tame by historical standards, and labor markets continued to improve, which gave the Fed cover for keeping rates flat.

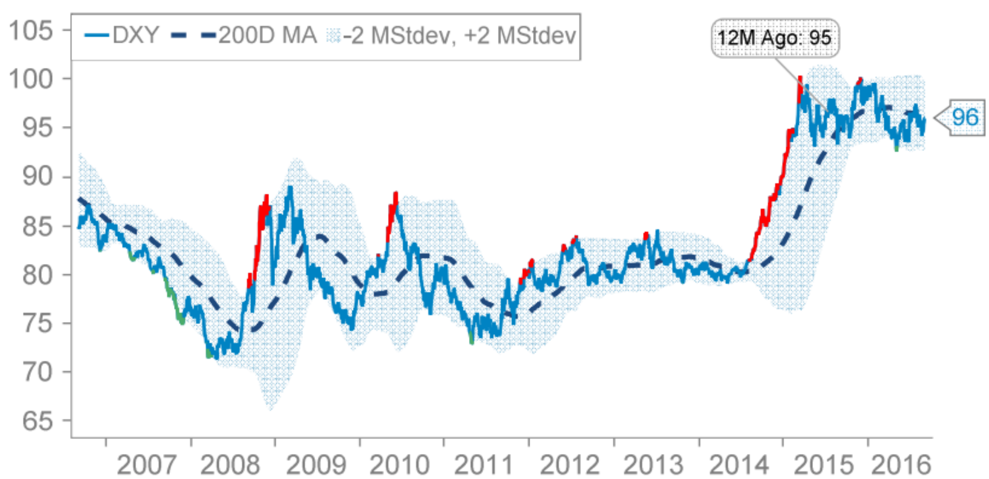
Although the Federal Reserve has historically focused solely on U.S. labor markets and inflation with respect to setting their interest rate policy, it has recently taken a greater interest in global issues. The following table highlights the increased references to global elements in Janet Yellen's speeches, which underscores just how important global risks are to the Fed.



In one sense, this is not surprising given the interconnectedness of global trade and investment markets. However, there is only so much the Fed can do with interest rate policy to affect, for instance, whether China is back on a pathway to growth or whether Europe has stabilized its economic situation. The Fed's reach only goes so far abroad. The fact that global markets have stabilized and volatility has subsided after the Brexit referendum increases the likelihood that the Federal Reserve will raise rates again this year, perhaps as soon as its meeting on September 21.

If the Fed raises rates in September, its benchmark policy would have an official range of 0.50% to 0.75%. As we have noted previously, the absolute level of interest rates is unlikely to have negative real world economic ramifications. Borrowing costs are still very favorable, and a bump up in short-term interest rates may actually help savers more than they hurt borrowers. The major concern that the market would have over the Fed's moving forward with tighter interest rate policy is the effect it would have on the dollar.

**U.S. Dollar Index**




*After strengthening in 2014 and 2015, the U.S. dollar index has leveled off, which has provided relief to investment markets.*

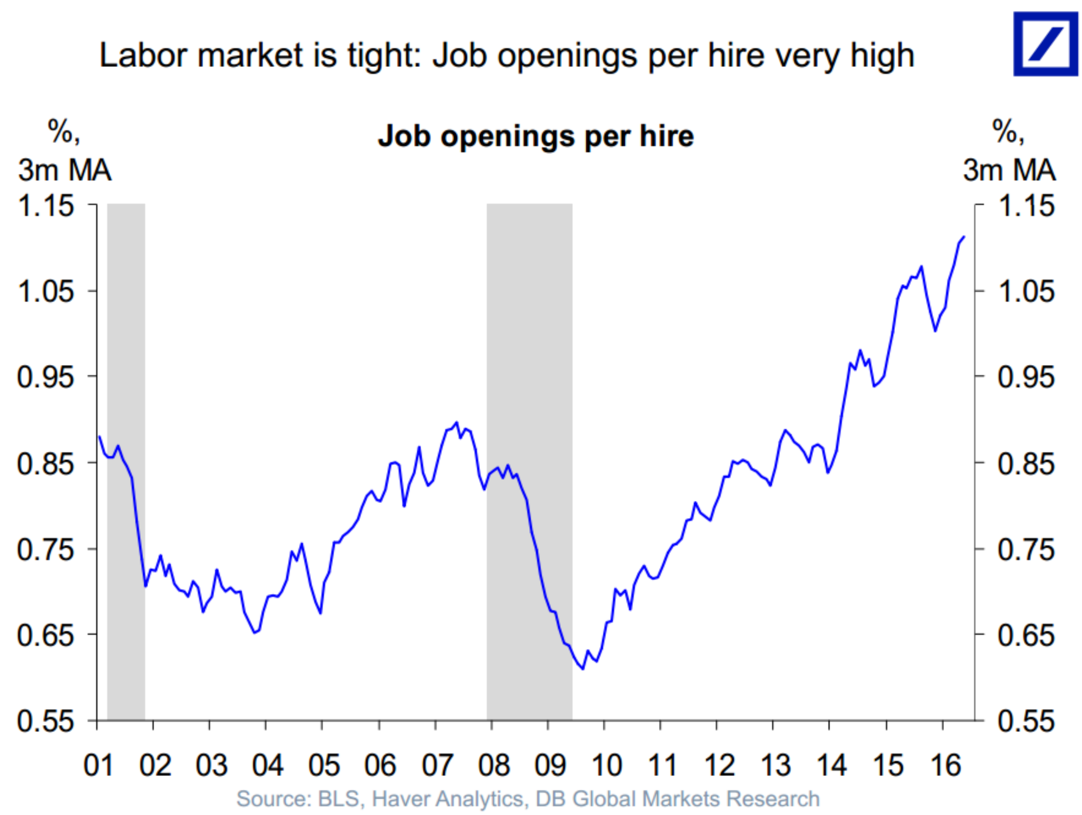
Source: Bloomberg, Macrobond, Morgan Stanley Research

From 2009 to early 2014, the U.S. Dollar Index was in a holding pattern. Then, in the middle of 2014, the U.S. dollar accelerated sharply to the upside as the Federal Reserve indicated that it would be ending quantitative easing and look to raise interest rates in the coming year. This jump in the dollar significantly disrupted commodity markets, along with international stock and bond markets. As the dollar has leveled off in 2016, mostly as a result of the Federal Reserve's becoming less aggressive in its policy projections, other markets have performed very well. It is no mere coincidence that emerging market equities are one of the strongest-performing investment classes this year when the Fed has softened its rate-hiking policy path.

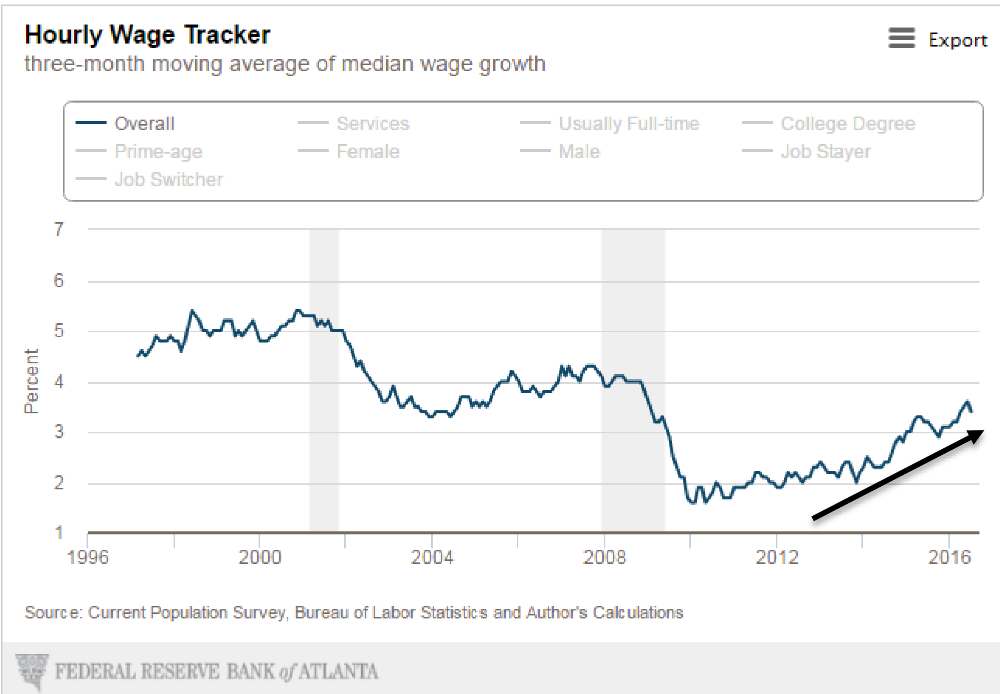
As we look toward the remainder of 2016 and the possibility that Federal Reserve policy may again start to tighten, we think it is important to acknowledge that there could be renewed volatility in investment markets. At present, the Federal Funds futures markets are only forecasting a 27% chance that the Fed will hike rates in September. Most forecasters anticipate that the Fed will raise interest rates only once this year; they assign a 56% probability that the central bank will increase before the end of December. If the Fed raises rates earlier than expected and surprises the markets, there may be additional volatility in store. To be clear, we do not think that a rate hike would derail the economy. But it is worth mentioning that more aggressive Fed policy is something to be cognizant of as we head into year-end.

We have highlighted a Federal Reserve policy move as one potential reason for an increase in market volatility. It then raises the question what are some reasons why the market may continue higher from its present levels? One is that the back half of the year has been favorable to both the economy and the equity markets from a seasonal perspective. Given that the United States has a service-oriented, consumer economy, the second half of the year typically sees momentum build within the various service sectors as summer ends, the school year starts, and the holidays approach. Another advantage for stock markets is that earnings over the past year have been sluggish. This may seem like a negative headwind, but it actually provides lower hurdles for companies to overcome and makes it easier for them to hit their targets heading forward. Poor earnings in the rearview mirror can lead to favorable comparisons in the future. The two major detractors to earnings at the start of the year -- a strong dollar and a weak commodity market -- have abated and are not weighing on corporate income statements to the same degree that they were in 2015.

A third positive factor is the labor market in the U.S. We often refer to the job market as one of the key economic indicators. This is because it offers a frequently updated, easy-to-interpret gauge on the health of the economy. We continue to see signs of stability in U.S. employment. Moreover, current data points often accompany an economic expansion. Put differently, there have been no warning signs from the labor market that a recession is on the horizon. For instance, the following chart shows the number of available job openings per worker in the U.S. A high number indicates robust hiring by employers.



A low number shows very few jobs available for the workforce and often coincides with a recession. Also, a deterioration in the data typically coincides with an economic slowdown. At present, we are at levels that generally reflect a strong expansion and high demand for workers. A tight labor market such as the one we are in often is accompanied by rising wages. We can see in the following chart that income growth in the U.S. has begun to improve and should keep moving higher as the labor market continues to strengthen.




*Wage growth has been improving and should increase further as the labor market continues to strengthen.*

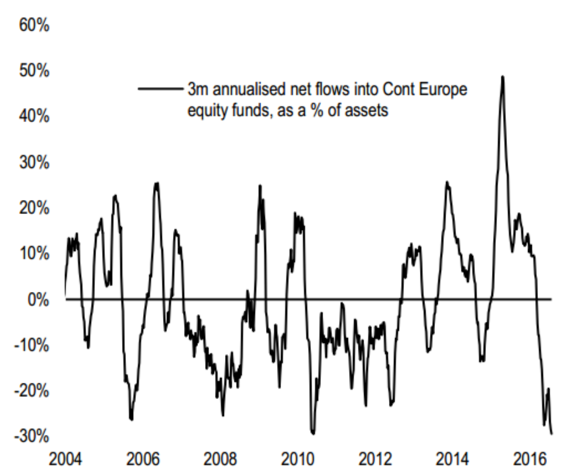
While wage gains in the current expansion have been lackluster compared to previous expansions (due to the fact that we came out of a financial crisis in 2008), the signs of growth in this data point have been encouraging for future consumption, which is good for the overall economy.

Turning to foreign markets, patience with emerging markets investments is beginning to bear fruit. After their recent weakness, emerging market bonds and stocks have been some of the best-performing parts of a diversified portfolio this year. For instance, the MSCI Emerging Market Equity Index has returned 14.55% in 2016, after being one of the worst performers last year. Emerging markets have rewarded disciplined investors because of cheap valuations to start the year, combined with a turnaround in China's domestic economic policy. Investors were caught off guard last year by questionable moves by the Chinese government that did not instill confidence in stock market investors. The Chinese government this year has shown a steadier hand, which has prompted renewed investor interest. Given China's heavy involvement in its market infrastructure, combined with the lack of transparency offered by the government, it is hard to say what Chinese policymakers will do next and how this will affect Chinese (and emerging market) stocks. However, valuations and demographics still favor sticking with emerging market investments even after the strong run that they have experienced YTD.

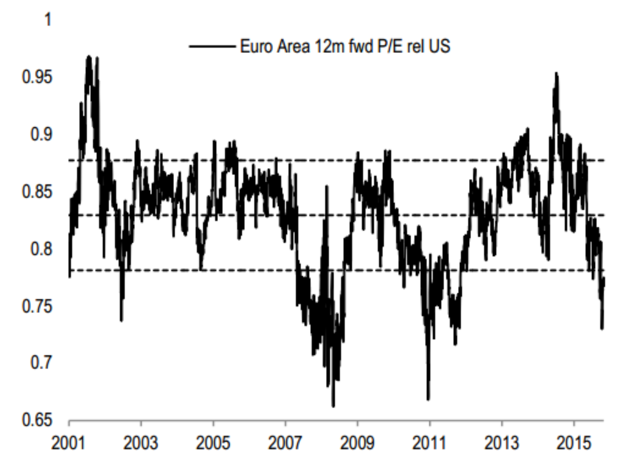
Within Europe, the economic effects of Brexit have yet to be realized and may linger for some time within the United Kingdom. Despite little in the way of formal discussions on how trade agreements between the EU and Britain may look if the UK formally leaves the bloc, outflows from European equities have been significant.

Credit Suisse has called it "total capitulation" in spite of the fact that recent data shows a continuing economic recovery in the Eurozone.

**Outflows from Europe signal capitulation... …while valuations relative to U.S. stocks are increasingly attractive**




Source: EPFR, Credit Suisse




Source: Thomson Reuters Datastream, Credit Suisse

European valuations, relative to the U.S., are at levels last seen during the Greek debt crisis in 2011. Outflows are at also at extreme levels similar to those of the 2011 Greek crisis as well as the 2008 financial crisis. When valuations and outflows were at these levels in the past, subsequent returns from international stocks were very strong. The MSCI ACWI Ex US Index returned 16.83% in 2012. Yet while many investors have panicked and exited their European equity positions, economic growth has continued to move higher. Eurozone GDP growth in the first half of the year came in at a 1.5% annualized rate, higher than the 0.95% annualized rate experienced in the U.S. JP Morgan has revised its second half growth forecasts higher, noting a smaller than expected impact from the Brexit referendum, combined with stronger than expected retail sales results.


Source: Eurostat, J.P. Morgan

Though some have capitulated with respect to their international equity investments, we believe that those who are patient will be rewarded. Relative valuations to the U.S. are at levels similar to past crises, yet the data on the ground shows continued growth rather than an imminent recession. The European Central Bank continues to be incredibly supportive of investment markets and may further expand their asset purchase programs in the next year.

In closing, despite significant geo-political disruption this year, investment markets have provided strong returns through August, and we are encouraged by the fact that the stock market rally is supported by improving economic and corporate earnings data, both in the U.S. and abroad. Although volatility may rise as the Fed signals increased willingness to hike rates, or as the U.S. presidential election draws near, we think investors will be well-served by sticking with a diversified mix of investments. Many parts of the portfolio -- whether government and corporate bonds, emerging market assets, or stocks -- have generated strong returns this year. That fact has underscored the benefits of maintaining disciplined exposure to a wide variety of assets.