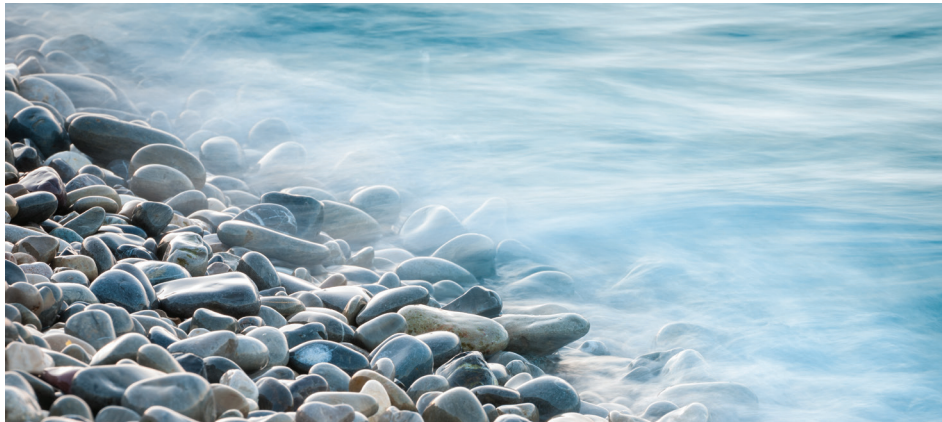


Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



When Emotions Trump Economics

“Leaders of institutions everywhere have lost trust. The global economy is stalled and the world is deeply divided, too unequal, unstable, and unsustainable.”

—Don Tapscott at the World Economic Forum, Davos

BY THE NUMBERS, the global economic landscape changed very little in the second quarter of 2016. Manufacturing and consumer activity bounced back after the first quarter’s opening slowdown, central banks continued their support, and global GDP growth remained on trend—subpar but stable. Yet there exists a rising angst over our economic challenges, challenges that include global inequality and unequal economic development, global poverty and unemployment, the exhaustion of non-renewable resources, depletion of the environment and global warming, and systemic problems associated with inadequate regulation of financial markets. Voters on both the left and the right are unhappy, and are demanding change. In this year’s U.S. primaries, votes were cast in record numbers for those candidates promising to “shake things up” even though the details on how this would happen were vague at best. In the United Kingdom, voters opted for the “unknown” by voting to leave the European Union rather than the “known” dissatisfac-

tion of membership. This frustration and confusion has extended to the markets too, with global investors seeking the relative safety of government bonds, even though interest rates on many of these securities are negative or at all-time lows. It would seem voters and investors alike are casting a vote of no confidence in the policies of the political class, and it is difficult to discern how we will fill the leadership vacuum that exists globally. While central bank policies of low interest rates and quantitative easing have helped, they are not enough and are reaching their limits. Indeed, after an initial surge, Japanese market action has been much more range bound as they await Prime Minister Abe’s third arrow of fiscal stimulus and regulatory relief. U.S. investors have watched cash balances pile up on corporate balance sheets and record numbers of eligible workers leave the work force because of a collective lack of confidence in our slow-growth economy. And, European investors have been forced to watch the 28 governments of the European Union (EU)

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While the global economy stabilized and continued its subpar expansion, the world’s rising angst over economic challenges came into focus in the second quarter, culminating in the shocking vote by the citizens of Great Britain to leave the European Union.

2

U.S. consumer spending improved in the second quarter after a tepid start to the year, though employment gains are slowing. The housing market recovery is picking up steam, with sales and prices back to 2007 levels. U.S. stocks continued their ascent, reaching all-time highs shortly after the close of the quarter.

3

The Eurozone had been making a solid recovery, supported by bold and far-reaching monetary stimulus from the European Central Bank. All bets are off now post-Brexit. Japanese growth remains mired in stagnation, but expectations are rising for more stimulus from President Abe.

4

The slowdown in emerging markets is stabilizing in 2016, supported by growth in consumption and retail sales. Recovering commodities, attractive valuations, and catalysts including a leadership change in Brazil and more reforms in India kept market gains on track.

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At the limits of policy influence

	MEASURE	US	EZ	UK	JP	CN
MONETARY Policy	Policy Rate	0.5%	0%	0.5%	-0.1%	4.4%
	M2 Money Supply	69%	102%	113%	204%	214%
	Central Bank Balance Sheet	25%	29%	21%	93%	49%
	Proximity to Full Employment	0.9%	2.8%	0.2%	0.1%	1.2%
	Inflation	1.1%	-0.1%	0.3%	-0.3%	2.0%
FISCAL Policy	Net Government Debt	82%	70%	81%	130%	36%
	Total Debt	248%	253%	250%	379%	255%
	Government Interest Exchange	3.5%	1.6%	2.3%	1.9%	0.5%
	Old Age Dependency 2050	37%	60%	42%	71%	47%
	Budget Deficit	-4.2%	-3.2%	-5.9%	-8.5%	-1.8%
	Current Account	-2.7%	2%	-4.3%	1.0%	2.1%
	Nominal Growth	3.7%	1.9%	3.6%	1.6%	8.2%

SOURCE: Bloomberg.

squabble to the point where the UK will now leave the economic union altogether.

The world needs smart and inspired fiscal policy from leaders who are mindful of our global economic challenges and have the political fortitude to create solutions. To be sure, we do not mean to imply that our political leaders should unleash “shock and awe” spending programs that would further balloon debt and deficit levels and risk hyperinflation. Rather, the world needs leadership to craft and implement policies designed to lower hurdles to business formation combined with pro-growth tax policies. At the same time we need to accept the realities of poverty, the aging demographics of our global citizenry, and the responsibility we have to our environment, and set a standard of care that will be our legacy.

The politics of indecision and inaction have contributed to stagnant global growth, and risks are rising that this stagnation will foster the kind of extreme nationalism that threatens the promise of our global economy. That is the worst case, of course, but a possibility no longer so remote given Brexit.

BREXIT Stuns the World

On June 23, the UK voted to leave the EU by a majority of 51.9% to 48.1%. Voter turnout was very high at around 72%. While a high turnout was expected to benefit the “remain” camp, the reality appears to have been different.

Global financial markets were caught wrong-footed by the decision — they had been rallying in the days running up to the vote, apparently anticipating that the UK would choose to remain in the EU. However, they gapped down sharply on the news, given the enormous asymmetry in which Brexit risk had been largely priced out going into the vote — polls and betting odds had gotten it wrong. By month-end, markets had largely recovered from their initial dire reactions, but are left facing much economic and political uncertainty ahead.

Various scenarios could unfold in the coming weeks, in terms of the direction of the UK’s political leadership, the markets’ response and ripple effects in other European countries.

We see the major risks in the aftermath of the vote to be surrounding growth — in the UK, the EU and globally. We believe the resulting uncertainty is likely to put a damper on investment, especially in the UK, but in the EU as well, and perhaps elsewhere, until the outcome of the complicated exit negotiations can clarify the overall trade and business landscape of the separated blocs.

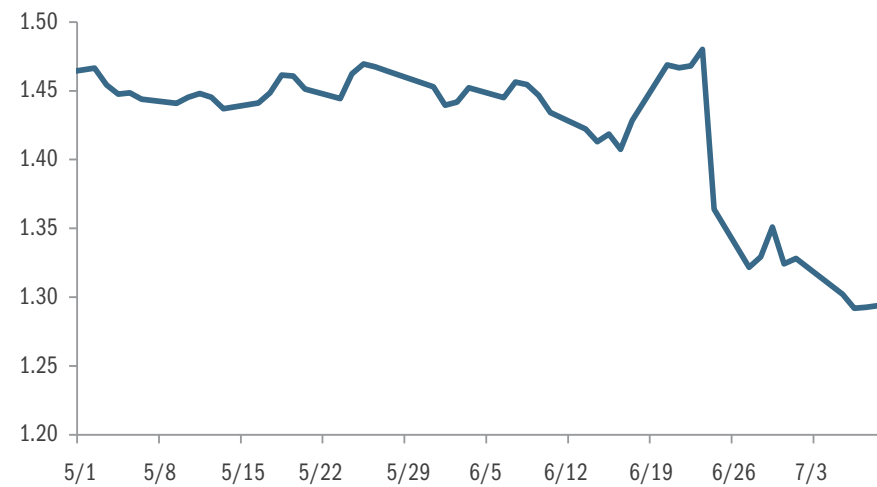
While at least political uncertainty was swiftly resolved with the appointment of Theresa May to succeed David Cameron, the new prime minister has her hands full not just with the EU but also with the

integrity of the UK itself. Scotland voted overwhelmingly to remain in the EU by a margin of 24%, whereas England and Wales voted to leave by 6.8% and 5.1% respectively. This contradiction has already prompted calls for a second Scottish independence referendum. Northern Ireland voted by an 11.5% margin to remain, also significantly more than the overall UK 2.8% margin for leave. Senior Northern Ireland politicians are now calling for a referendum on the reunification of Ireland.

Beyond Great Britain, the EU and eurozone will need to address the risks of copycat exit referenda in other member states as other countries within Europe potentially consider their EU membership. A potential eventual course of action is to try to “federalize,” or more closely join,

While financial markets recovered quickly from Brexit, the Pound is another story

Value of the British Pound in U.S. Dollars (\$)



SOURCE: Bloomberg.

the eurozone, but this would likely take a lot of time and negotiation, during which euroskeptic countries may well wish to exit based on their own referenda. The countries that should be most closely watched on this front are Finland, Netherlands and Denmark. National elections in France and Germany (2017-2018), as well as mayoral elections in Italy (ongoing), will also provide useful political signals.

Amid all of this uncertainty, financial market reaction, while initially very negative, had a surprising turnaround in just a short time period. Credibility around central bank support may be an underpinning. Bank of England (BoE) Governor Mark Carney, for example, announced that the BoE stands ready to provide GBP250 billion of extra funds and won't hesitate to take additional measures, if necessary. And while not a coordinated measure, the Federal Reserve (Fed) will very likely hold rates steady in July; in fact the markets have almost completely priced out a Fed hike for the rest of this year.

The coming weeks will pave the way for months of national political decisions and years of international negotiations. We believe the UK's decision could unfold into two possible scenarios: positive Brexit or negative Brexit. It will be critical to monitor political signals as much or even more than the economic data and behavior of financial markets, which may now be as much or more influenced by prominent politicians as by central banks.

In a negative Brexit scenario, UK growth could slow significantly; recession would be a distinct possibility. Lower UK-EU trade could cause a new deflationary demand shock in Europe, where peripheral European countries could bear the brunt of such a slowdown. The EU's new emerging market member-states, such as Poland and Hungary, are also likely to suffer weaker growth, in our view. By threatening their catch-up in terms of prosperity and living standards compared with richer EU neighbors, the risk of social and political tensions could rise.

A positive Brexit scenario could involve the UK and EU engaging in constructive negotiations about exit and about maintaining open borders to trade and investment. Such a scenario could also entail the post-Brexit UK stepping up to the plate as an independent trading force and voice apart from the EU. In this scenario, we believe the UK's recent growth slowdown would likely continue, but downside risks would be contained by constructive engagement among the UK, EU and global trading partners, including the United States.

For all of our sakes, we hope that the part of the Brexit campaign that was about opening up further to the rest of the world helps render a positive Brexit. Correspondingly, that hope would be supported by a Europe that remains open to the UK and the wider world, despite its need to integrate to sustain the euro and despite the challenge of political forces that are skeptical to that integration.

GLOBAL ECONOMIC OVERVIEW: Shuffling Along

The global economy has yet to emerge from 2015's moderate growth path with real GDP forecast to rise by just 3.1% this year. Low energy prices and interest rates created the conditions for most advanced economies to accelerate in 2016 and were it not for the wavering in confidence early in the year that dampened activity, growth forecasts would be higher. With central banks committed to maintaining accommodative policy and governments no longer implementing fiscal policy restraint, we see the easing in financial market volatility as a precursor to firmer growth in the advanced economies as the year progresses, though Brexit impacts remain a wildcard.

Emerging market economies, conversely, are likely to remain on a slower growth trajectory in 2016. As the rebalancing in China's economy continues, the slowing in investment and industrial production will weigh against firmer consumption and service sector activity. Chinese GDP is forecast to expand by only 6.5% this year, slower than 2015's 6.9% pace. The rebalancing saw Chinese import demand slump in 2015 and continue to fall at a double-digit clip in early 2016. This pullback in demand is acting as a headwind to other emerging economies that rely on China to purchase their exports. Combined with lower revenues earned by commodity exporters and rising financing costs, 2016 will mark a year of subdued economic activity in many emerging economies.

U.S. ECONOMY: A Giant Awakes

The U.S. economy is poised to emerge from its recent weak patch. After growth averaged just 1.1% in the six months ended March, recent data points to a sharp acceleration in activity with expectations building for a 3.1% annualized increase in real GDP in the second quarter. The easing in financial market volatility underpinned a recovery in business sentiment as indicated by an improving ISM purchasing managers' index. Likewise, consumer spending has picked back up to its 2015 pace of 3%, supported by low gasoline prices, low interest rates, and solid employment growth. We expect this stronger momentum to persist throughout the

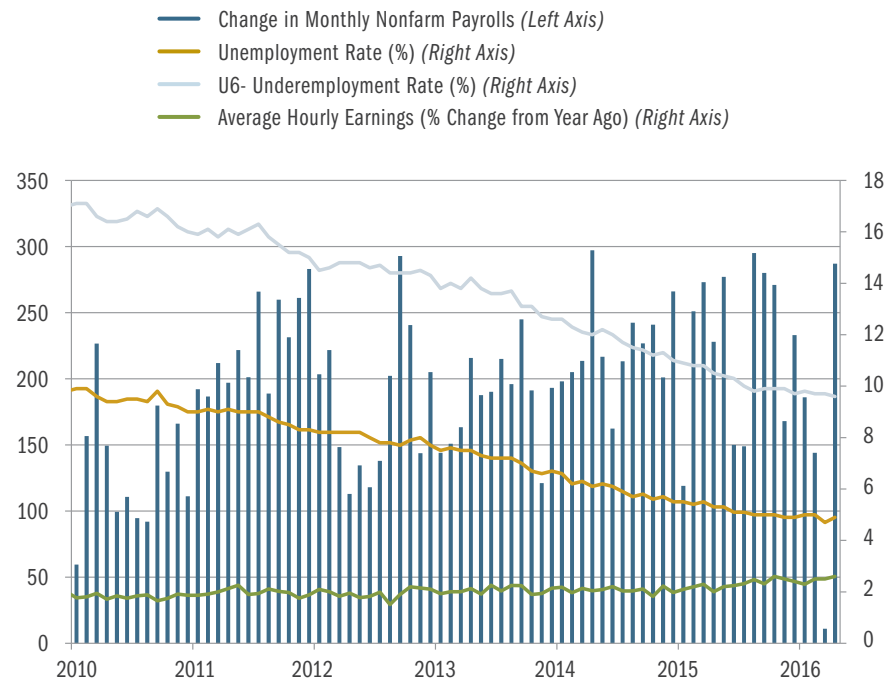
remainder of this year and next. Although the recovery in domestic demand will likely result in import growth reaccelerating as the quarter wears on, the April and May increase in exports tees up for growth in the second quarter, a marked improvement following declines or slow growth in the previous three quarters. All that said, the soft start to the year sets up for real GDP growth to average 2.0%, slower than 2015's 2.4% gain.

If there is a potential for upside, it will come from the U.S. consumer. The persistent tightening in labor market conditions is finally filtering into a strengthening in the pace of wage increases. At the same time, household net worth ended 2015 at \$86.8 trillion and homeowners' equity in real estate stood at a post-recession high of 57%. These firm underpinnings may provide consumers with the fire-power to spend with motor vehicle sales forecast to rise above the 17 million mark in 2016 and the upward trend in home sales, now annualizing at a 5.53 million pace last witnessed in 2007, to continue.

With all of this relatively strong economic data, it was disheartening to see employment growth, a prior bright spot for the U.S. economy, falter as it did in the second quarter. Breaking the trend, gains in nonfarm payroll employment averaged just 147,000 in Q2, the slowest pace of increase since 2010. That said, the unemployment rate in May fell to 4.7% and broader measures of unemployment showed a further reduction in labor market slack. Looking forward, we see the abrupt weakening in job gains as likely to reverse (and acknowledge there may have been some noise in the numbers given the Verizon strike), though the pace of job creation is likely to run closer to 150,000 per month rather than the 223,000 average posted over the prior three year period. We believe that both the reduction in excess capacity in the labor market as well as the demographically driven weakening in growth in the working age population are becoming a factor. However, on balance, these conditions will support the unemployment rate holding around the Fed's assumed full employment level of 4.8%.

Turning to inflation, as of May, the core CPI rate was at or above the Fed's 2% objective for seven months running, the longest such streak since 2012. Based on the inflation and labor market readings, the

U.S. job growth starts to slow



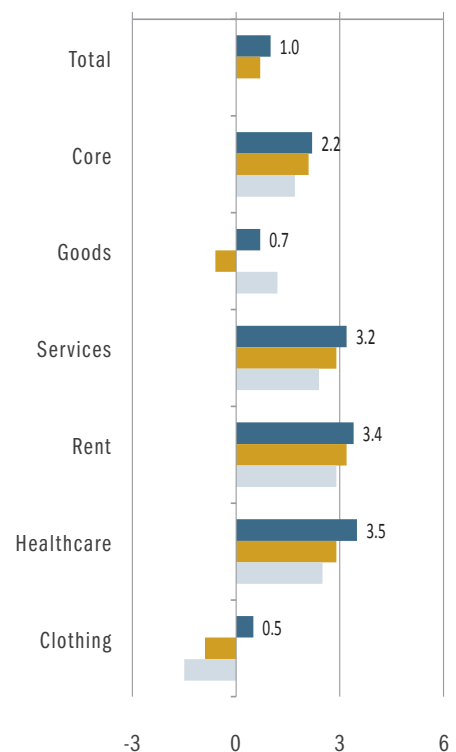
SOURCE: Bloomberg.

Fed would have little hesitation following up the December 2015 rate hike with another 25 basis point increase. However, as the risks from global economic and financial developments increased early in the year, policymakers assumed a cautious stance about the pace of further tightening. The minutes of the June FOMC meeting suggested that members increasingly viewed the downside risks to the outlook as becoming less intense and that the labor market and inflation data support a gradual withdrawal of policy stimulus. That said, they were mindful of the UK referendum and the negotiations regarding Greece's upcoming debt repayment and deferred for now. We predict the markets may be too complacent about the Fed's path forward, and expect Fed Chairwoman Janet Yellen to begin to guide markets to a recognition that one or two more increases in the interest rate is warranted in 2016, regardless of the fact that it is an election year. The elections themselves will prove an inflection point for the U.S. economy, one way or another, given the relatively bold agendas of both candidates. At this time, our biggest worry is the uncertainty shock they may wreak upon U.S. growth that continues to strive to get out of first gear.

Inflation continues to climb; Fed must take notice

Percent Change Year-over-Year

- Latest
- 6 months ago
- 1 year ago



DEVELOPED INTERNATIONAL ECONOMIES: All Bets Are Off

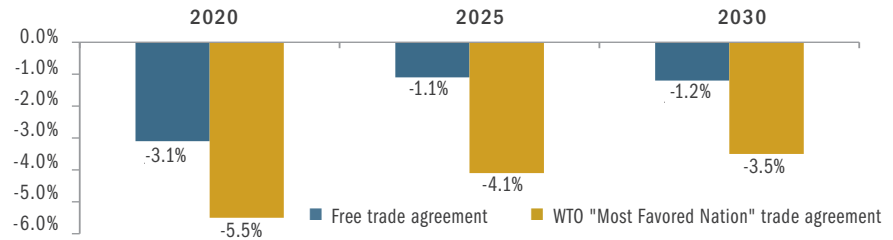
In contrast to the U.S., the Eurozone economy picked-up pace in the first quarter of the year, recording the largest expansion in one year with annualized GDP growth of 1.7%. Robust growth in the domestic economy, particularly Germany and Spain, drove the recovery, as an improving labor market boosted private consumption growth to an over one-year high. Even more promising were positive trends such as employment and manufacturing. For example, the unemployment rate in the Eurozone fell to 10.1%, its lowest level since the height of the sovereign debt crisis in the summer of 2011. Manufacturing, too, has continued to improve, with the Markit Manufacturing PMI jumping significantly in May to 52.8 from 51.5. Inflation was even showing some signs of life, as the flash estimate for Eurozone inflation for June swung from -0.1% to +0.1%.

Without a doubt, the UK's vote to leave the European Union casts a shadow on the Eurozone's outlook. Negotiations will likely drag out as European rules set a two-year period for negotiating an exit—with a possibility for an extension—once formal notice from a member country has been given. While a country leaving the EU is uncharted territory with huge uncertainties in terms of economic consequences in the long term, in the near term, the Eurozone economy is likely to feel the effects of the vote through heightened volatility in financial markets along with pressure on the euro and reduced confidence.

While the European Central Bank's March stimulus package of negative interest rates and extended quantitative easing was bold and far-reaching, additional calls for accommodation have emerged in the wake of Brexit. ECB President Mario Draghi described a potential drag of -0.5% on European GDP growth, and reiterated his commitment to secure price stability and coordination with other central banks. And while European Union leaders face the immediate question of how best to move forward with the United Kingdom, the biggest risk, of course, is that pockets of populism and discontent appear and create even greater pressure on the bloc in the near term.

The economic impact of Brexit depends on exit type

% Difference in real UK GDP compared to 'remain,' by Brexit type



SOURCE: Bloomberg.

Across the Channel, a deeply divided population has been left reeling by the decision to leave the European Union. With 51% of the U.K.'s exports ending up in Europe, the worst current account deficit in the G7, and a London-based financial industry predicated on free capital flow with the EU, the economic implications of Brexit imply a recession, with the only question really the magnitude based on the nature of the trade agreements that ultimately get put into place.

Prior to the Brexit vote, the U.K. economy grew by +0.4% in the first quarter versus +0.6% in the first quarter of 2015, its slowest growth in three years. Construction, agriculture, and production all declined

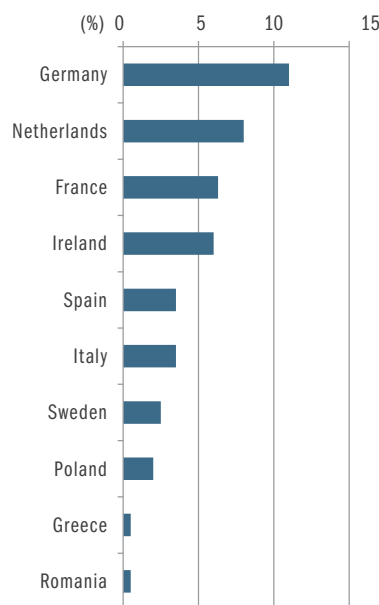
in the quarter, while the services sector expanded. Inflation remains subdued based on lower transportation costs, and grew only +0.3% in May – unchanged from April. The most positive indicator was industrial production in April, which grew by +2% versus a +0.3% gain in March.

Looking ahead, the IMF estimates that the Brexit could cost the U.K. anywhere between 1.5% and 4.5% in negative GDP impact between now and 2019. The magnitude of the impact on the economy is contingent in large part on the political, fiscal, and monetary response to come over the next several quarters.

As for Japan, first quarter GDP grew at a +1.9% annualized pace, much better than the +0.3% expected. This was led in part by increased consumption as citizens took heart about the news that the sales tax hike slated for April of 2017 would be delayed, and enjoyed the benefits of a January central bank decision to enact a negative interest rate policy. However, as the quarter wore on, economic data weakened. Industrial production in May fell by a whopping -2.3%, after a measly +0.5% gain in April. And, despite efforts by both the Japanese government and the Bank of Japan, core consumer prices for May fell by -0.4%, back to levels not seen since April 2013, when Japan embarked on its current stimulus program. By quarter's end, the soaring yen had reignited fears of a full-fledged return to deflation. It was with great relief to the markets, then, that Prime Minister Shinzo Abe and his ruling coalition rang up a stronger-than-expected victory in Upper House elections in early July, giving Abe the platform to announce a new round of stimulus spending.

Despite deep economic ties, Brexit wins

51.4% of British goods exports go to the EU



SOURCE: Bloomberg.

CHINA & EMERGING ECONOMIES: Seeking Stabilization

The first quarter was dominated by fears of a deepening Chinese economic slowdown, fears which seemed to be warranted as economic data displaying a weakening trend. For example, in April and May, factory output grew by just +6%, while fixed asset investment grew by +9.6% year-over-year, a sharp decline from April's +10.5% year-over-year pace. While still strong in an absolute sense, retail sales have continued to slow, growing by +10% in May and 10.6% in June—well off 2015 highs. Prices, too, remain under pressure, as CPI rose +2.0% in May year-over-year; this is below the People's Bank of China's +3% target for 2016. Perhaps most concerning, however, is the persistent weakness in manufacturing. Both the Caixin and official PMI readings have continued to soften, and June's readings were weaker than May, coming in at 48.6 and 50, respectively.

Despite the data, there is a growing feeling that China's rapid deceleration has stabilized, due in large part to well calibrated fiscal

and monetary policy efforts. China's central bank has flushed funds through the financial system, ramped up infrastructure spending and reduced red tape and corporate taxes. Indeed, government spending rose some 19.9% year-over-year in June compared with a 17.6% increase in May. China will need this support, as there are significant potential trade impacts from a weaker Europe for China. However, perhaps offsetting the potential effects of Brexit in the near term for China—and emerging markets as a whole—is the fact that the Federal Reserve remains on hold. While the dollar could modestly strengthen against the backdrop of market volatility, coupled with continued accommodation from the European Central Bank and the Bank of Japan, the anticipated flight of capital from emerging markets as yields rise in the U.S. is for now delayed.

A paused Fed is not the only positive as it relates to emerging markets. India and Brazil delivered positive macroeconomic news in

the second quarter, sparking hope that the worst may be behind us for the developing world. India's first quarter GDP came in at a whopping +7.5%, based in part by positive reforms implemented by Prime Minister Modi. While concerns remain about India's data and regulations, the pace of growth in the economy and the Reserve Bank of India's diligence as it relates to inflation are both positive in the minds of investors. While Brazil remains challenged by ongoing political strife, the country managed to post a first quarter GDP contraction of only -0.3%. With oil prices stabilizing and interim President Michael Temer at the helm during Dilma Rousseff's impeachment trial, the Brazilian economy could be poised for a modest rebound in the coming months. Of course, the emerging markets are never without their troubles, and now the focus is on Turkey in the aftermath of a failed coup against Turkish President Recep Erdogan, who has been criticized as an autocratic leader intolerant of dissent.

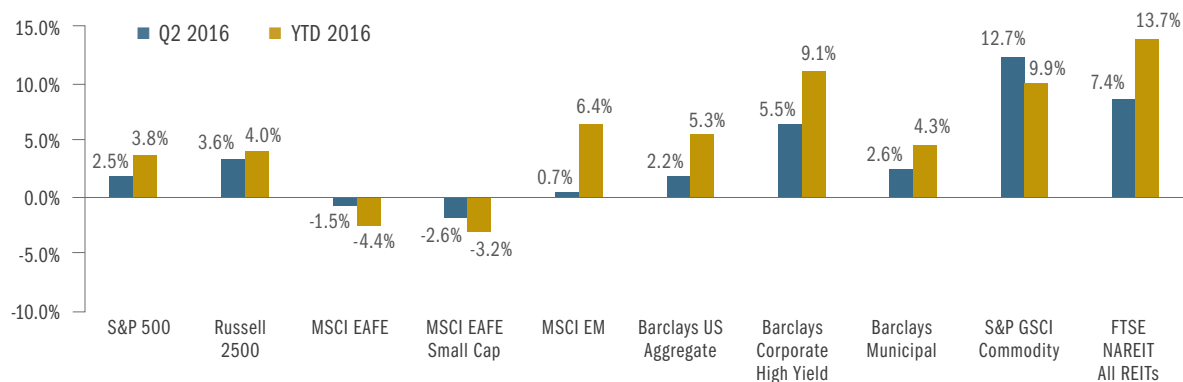
GLOBAL MARKET OUTLOOK: Strength in Safety

With the exception of the period immediately following the Brexit outcome, the second quarter of 2016 was fairly uneventful for equity prices. Broad market indices were confined to a relatively narrow trading range during most of the quarter, with the Brexit result surprising the market and sparking a short-lived sell-off. However, stocks regained their footing very quickly following the Brexit volatility, ending June back within the trading range they roamed

throughout the quarter. The S&P 500 Index was among the best performing market segments, though domestic small and mid-capitalization companies bested their large cap brethren. In terms of style, value stocks materially outperformed growth, with dividend-focused equities particularly strong. International and emerging market stocks generally underperformed U.S. equities in the quarter, as slowing growth in China and Brexit concerns in Europe

had an adverse impact on results. Bond yields globally continued to plummet on a flight to safety, though credit spreads were remarkably resilient despite the volatility. As for alternatives, real estate investment trusts (REITs) delivered solid gains for the second consecutive quarter, largely as a result of continued low interest rates. Commodities also performed very well with the rebound in oil prices, though gold has been 2016's shining star. Currency markets saw the

Commodities, yield, and domestic market investments carry the quarter



SOURCE: Bloomberg.

biggest reaction after Brexit results, as the British pound and euro suffered substantial declines while the U.S. dollar and yen rallied. Finally, hedge funds performed reasonably well in the quarter, as they were generally positioned conservatively and defensively for the uncertain outcome of the Brexit vote.

U.S. stocks soldier on, with yield-focused sectors leading the way

The S&P 500 has rallied since bottoming in mid-February and by June 30 was back within a few points of its all-time high. Yet the fears that had gripped investors early in the year haven't exactly gone away: economic growth is still sluggish to nonexistent around the world, corporate earnings are moving in the wrong direction, and valuations remain well above historic

norms. However, with other investment alternatives so unappetizing, U.S. stocks still found reason to run.

This quarter saw eight of the ten S&P sectors post positive returns. Energy, health care and utilities were the top performing sectors. Energy shares rallied 11.6% in the quarter as crude oil gained 26%, ending its historic two-year rout. Health care stocks rose 6.3% bouncing back after being among the worst performing sector in the first quarter. Investors continue to flock to utility stocks, which rose 6.8% in the quarter and 23.4% for the year, thanks to their steady, bond like cash flows. Technology stocks (-2.8%) and consumer discretionary (-0.9%) stocks were the weakest performers.

Small cap outperformed large, likely be-

cause the knee-jerk reaction to global tumult is to seek safety in companies that derive more of their revenue in the U.S. Value dominated growth in both large and small capitalization markets, no surprise given the market's bias toward more dividend-focused equities.

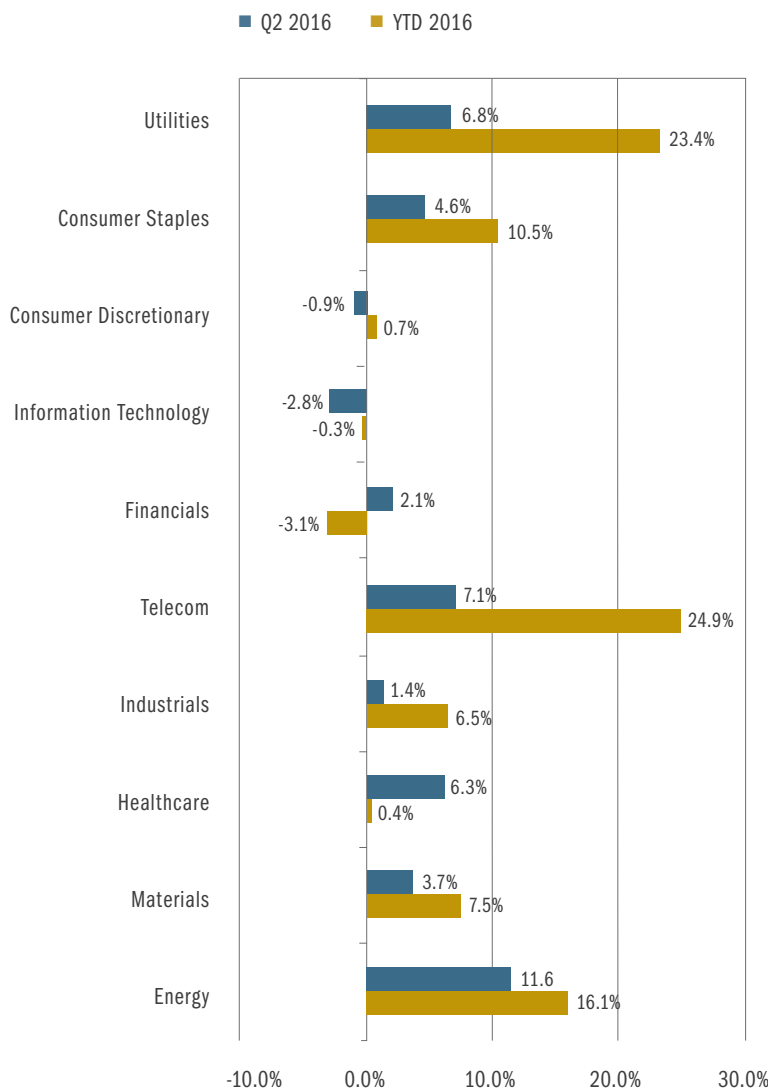
Developed international equities struggle with macro overhangs

International stock markets generated mixed performance in the second quarter, which was punctuated by a steep sell-off stemming from Brexit. Before the Brexit vote, eurozone stocks were volatile as conflicting economic data, central bank moves, and energy price swings whipsawed investors. In April, European equities logged gains, benefiting from the region's large exposure to emerging markets. Weak economic data in May, including a stubbornly low inflation rate and a stagnant employment rate, resulted in modest declines for equities. Those declines reversed toward the eve of the Brexit vote as manufacturing output strengthened, especially in Germany, and consumer purchases of durable goods began to tick upward. But the unexpected outcome of the referendum roiled markets in Europe, sparking uncertainty and diverging opinions about the long-term ramifications. Stock markets were further unmoored after the announcement that UK Prime Minister David Cameron would resign and allow his successor to steer the U.K.'s official exit from the EU.

At press time, European equity markets have recovered many of their losses, though the pound sterling remains at a multi-decade low, reflecting the formidable task ahead for new Prime Minister Theresa May and the UK and the EU. Also supporting stock markets and weakening the pound was Bank of England Governor Mark Carney's signal that the central bank may lower interest rates to support the economy.

Within the MSCI EAFE Index, growth stocks outperformed value and large-caps outperformed small-caps. Energy stocks outshone all sectors with an 11.5% gain, followed by a 4.9% advance for the health care sector. Consumer discretionary stocks fell the farthest, with an -8.2% decline, and financials dropped more than -6%. Besides Brexit-related concerns, banks and financials were in the spotlight earlier in the quarter over concerns about billions in nonperforming loans and Italy's financial stability. Spain's banks were also dragged down in May after

U.S. stocks play defense



SOURCE: Bloomberg.

a surprise announcement by Spain's Banco Popular Español SA's plan for a €2.5 billion rights issue to raise money to cover bad loans.

As for Japan, equities rose just 1% in the quarter, and that was thanks only to the strong yen. Unfortunately, the Bank of Japan's aggressive monetary policies have yet to meaningfully stimulate economic growth or inflation. While the Japanese economy avoided recession in the first quarter, it was only because gains in government spending outweighed a decline in business investment. And yet, given reasonable valuations and active monetary and fiscal stimulus, Japanese equities look relatively compelling among the options, especially if emerging market growth has indeed stabilized.

Emerging markets continue their comeback

Emerging markets stocks advanced in the second quarter of 2016 as the Brexit vote raised expectations that the Fed would pause its monetary tightening cycle, spurring demand for riskier assets. Assurances from the Bank of England and the European Central Bank that they would loosen monetary policy to cushion markets from post-Brexit turmoil also supported risk sentiment. Commodity prices surged, brightening the outlook for resource-driven economies. Most emerging markets currencies rose against the dollar over the quarter, lifted by gains in June, as risk appetite returned and attractive relative market valuations drew investor demand.

Three sectors in the MSCI EM Index rose and seven declined. Consumer staples

stocks performed the best with a roughly 4% gain, while industrials fell the most, shedding about -3%.

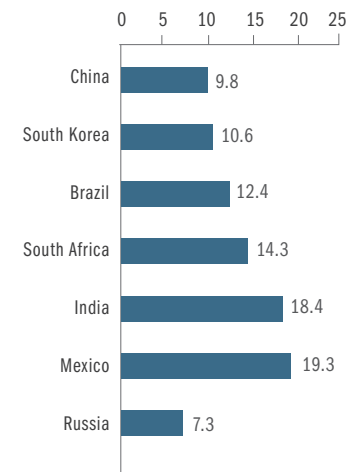
Latin American equities were the strongest within the index. Peru was bolstered by confirmation of the country's status in the MSCI EM index and a successful presidential election. Brazilian equities were also sharply higher, as President Dilma Rousseff was formally suspended on impeachment charges. Vice President Michel Temer took charge and announced a series of policy measures which were well received by the market. Temer also appointed a new cabinet and changed the head of the central bank. Returns were magnified by an 11.8% rally in the real. Mexico was the only Latin American market to finish in negative territory with a -5.5% depreciation in the Mexican peso weighing on returns.

In emerging Asia, Chinese stocks edged higher, though recent data suggested that China's economy slowed in the second quarter from the first quarter's 6.7% pace. Concerns about China's currency resurfaced at the end of June as the yuan sank to its lowest level versus the dollar in five years after Beijing guided the currency sharply lower in response to Brexit-induced currency volatility. Indian stocks also advanced, thanks to another fantastic GDP report showing 7.9% annualized growth in the first quarter, cementing the country's stature as Asia's fastest-growing economy. Furthermore, in June, India's government unveiled sweeping changes to the country's foreign investment rules, signaling that it was following through on a long-promised plan to create a more business-friendly climate.

As for other Asian economies, the Philippines were by far the strongest market with gains primarily attributable to the presidential election victory of populist Rodrigo Duterte. Indonesian stocks strengthened after the

EM stocks gain as commodities rise and investors look for value

Current P/E ratios of Selected Countries

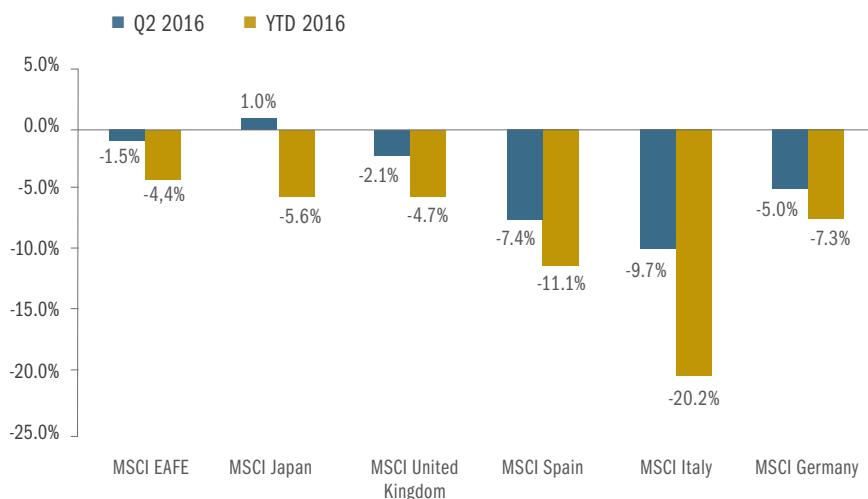


SOURCE: Bloomberg.

central bank cut interest rates in June for the fourth time this year and the government announced a tax amnesty program. Malaysian stocks declined as a corruption scandal involving a controversial state investment fund showed no sign of abating.

Turning to emerging Europe and Africa, Russia outperformed thanks to rising oil prices and the Russian central bank's move to cut interest rates by 50 basis points to 10.5% as inflation eased. The central European markets of Hungary, Czech Republic and Poland all underperformed amid uncertainty over the impact of Brexit. Poland lagged by a wide margin, with domestic politics weighing heavily on sentiment, in particular the prospect for pension reform. Greece and Turkey, where the prime minister resigned and was replaced by a minister loyal to President Erdogan, also lagged. South African stocks rose slightly, driven by gains in June after S&P and Fitch separately affirmed the country's investment-grade credit ratings. However, S&P kept its negative outlook and warned that it would cut its rating to junk if South Africa's economy failed to recover. Separately, South Africa reported that its GDP shrank a worse-than-expected annualized -1.2% in the first quarter due to declines in mining and farming output.

Developed international equities slump on Brexit



SOURCE: Bloomberg.

How low can yields go in fixed income?

The UK’s late-June vote to leave the European Union triggered elevated volatility in financial markets and selling pressure in riskier asset classes such as equities, cementing investor expectations that the Fed would likely hold off on rate hikes for several months and possibly until 2017. Bonds performed well in this environment, as investor demand for safe havens from the volatility in stocks boosted the prices of high-quality government bonds from developed markets. At the same time, the Fed’s perceived dovishness supported fixed income securities with credit risk. In addition, the price of Brent crude oil, the worldwide benchmark, climbed above \$50 per barrel after starting the quarter at about \$36, benefiting high yield and emerging markets bonds.

By quarter’s end, the yield on 10-year UK sovereign notes fell below 1.0% for the first time ever. The German 10-year government note’s yield also decreased into uncharted terrain after the UK referendum, joining 10-year Japanese sovereign debt in negative territory. The U.S. Treasury yield curve flattened as short-term rates were little changed and longer-term yields decreased, closing the quarter at 1.49% on the 10-year and 2.30% for the 30-year. Despite being at generational lows, Treasury rates remained meaningfully higher than yields on other high-quality global sovereign debt, drawing more investors into the U.S. government bond market in search of yield.

Even with all of the macroeconomic volatility, high yield bonds surpassed government market performance, as they benefitted from the rebound in oil prices and strength in energy-sector issuers, which make up a large proportion of U.S. high yield indexes. Though investment-grade corporate bonds lagged their high yield cousins, they still posted healthy returns, benefiting from both narrowing credit spreads and their correlation with rallying Treasuries. New issuance was very heavy, with over \$160 billion in new U.S. investment-grade corporate debt reaching the market in May, the highest monthly amount on record. Outside the U.S., the European Central Bank announced the criteria for its purchases of investment-grade corporate debt in April and started buying the bonds in June, helping extend the biggest rally in European corporate bonds in over three years.

The market’s perception that the Fed would wait to hike interest rates supported emerging markets debt. Bonds from emerging markets rebounded quickly from selling pressure immediately following the UK referendum and extended their gains. In April, Argentina sold \$16.5 billion of new sovereign bonds in the largest-ever issue of emerging markets debt. Argentina had not issued bonds in almost 15 years and had spent much of that time battling holdout creditors following its default on over \$80 billion in debt in 2001.

Municipal bonds recorded solid gains, supported by their generally strong credit quality and seemingly insatiable investor demand for tax-free income. Municipal resilience is impressive given the daily headlines around Puerto Rico, as the territory’s struggles to service its \$70 billion in debt continued to grab headlines. By quarter’s end, President Barack Obama had signed legislation that will set up an oversight board to help Puerto Rico restructure its debt.

The one loser in the fixed income market was the mortgage-backed sector, as decreasing Treasury yields and the resulting concerns about faster prepayments held back returns. Faster prepayments on the mortgages backing these securities generally hurt their value.

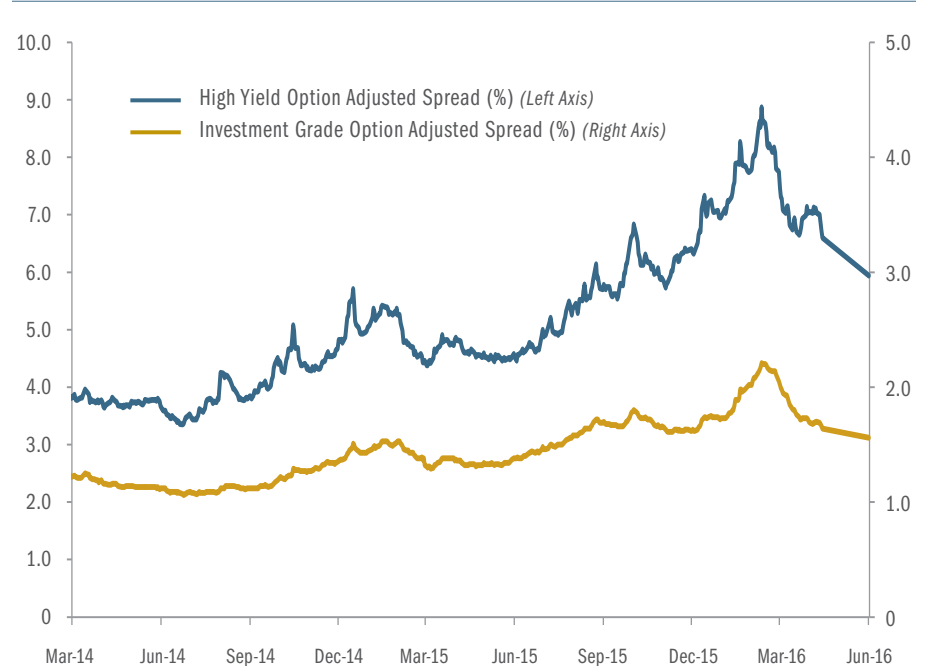
Hedged strategies hang in

Against a backdrop dominated by political and policy risk, hedged strategies managed in aggregate to produce positive performance for the quarter. Because the binary nature of the Brexit vote drove most managers to reduce risk exposure, the shock of the leave campaign victory did not cause huge losses for traders initially, and most portfolios benefited from the rebound into month-end. Event driven strategies were the best quarterly performer, as despite the strong volume of corporate announcements and catalysts, most event traders were defensively positioned based on macro concerns and the overhang of an uptrend in redemption requests beginning late last year. Event driven should continue to see opportunities given the high level of corporate events as well as a growing opportunity in stressed and distressed positions, including commodity-related investments that did well in the quarter. Other hedged strategies, including global macro and long/short hedged equity strategies, delivered more mixed results, whipsawed as they were by the violent market moves.

A golden age for commodities

After epic losses in recent years, the commodity complex has posted widespread profits in 2016 on hopes that stabilizing

Even as Treasury yields reached generational lows, corporate bond spreads rip tighter



SOURCE: Bloomberg.

demand and curtailed production may correct market imbalances. Indeed, oil and gas are up dramatically year to date and even more so from February's lows. Precious metals have also seen huge gains brought on in large part by market volatility, with gold up close to 25% year-to-date, while silver has gained almost 50% since the end of 2015. Agricultural commodities are more mixed. While the technical picture suggests a return to "bull market" territory, it is important to remember that this year's comeback merely brings broadly diversified commodity indices back to fourth quarter 2015 levels. Indeed, even with recent gains, crude oil remains down over -18% for the trailing one-year period.

Real estate rises to the top

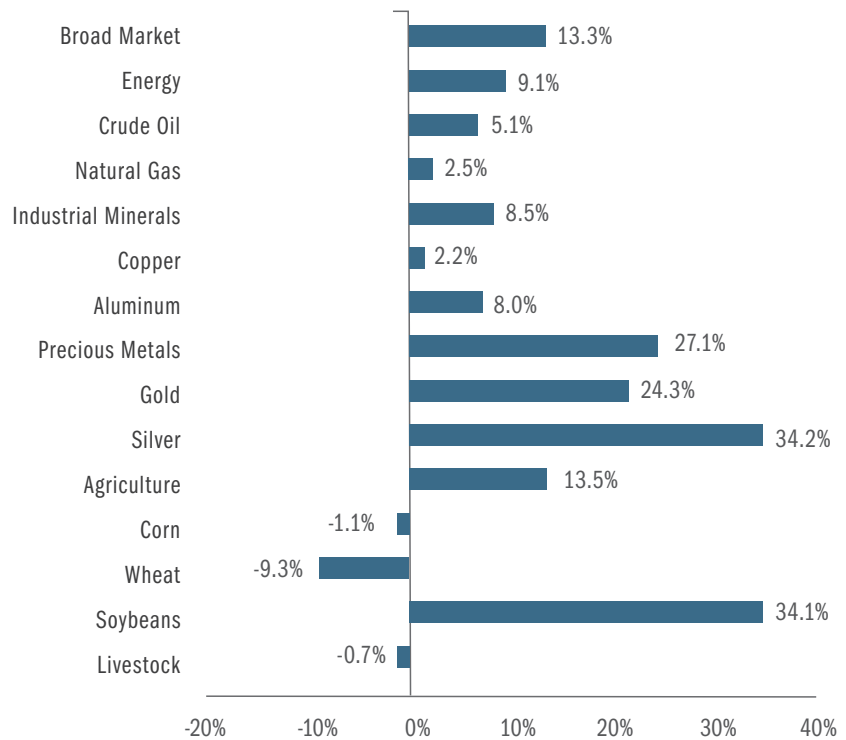
REITs outperformed the broader market in the second quarter and the first half of the year, as sector fundamentals remained healthy and a flight to yield drove investor demand and thus returns for the asset class. REITs have also benefitted from an upsurge of interest from generalist investors ahead of the elevation of real estate to a new headline sector under the Global Industry Classification Standard (GICS).

In terms of the fundamentals, demand continues to exceed supply in real estate markets, leading to lower vacancies, rising rents, and accelerating net operating income. Indeed, net absorption over the past four quarters was 60% above completions in the office and retail property markets, and 33% in the industrial space. Apartment vacancies, which had moved up a bit last year due to increasing supply, edged down and stand at a very low 4% level. While construction is rising, at current trends REIT fundamentals still seem very firm.

LOOKING AHEAD

2016 has certainly been one of the most volatile years since the beginning of the global financial crisis. Multiple examples of sharp equity market drawdowns followed by rapid recoveries would seem to be the theme. This volatility is unlikely to recede in the near term, as the current macroeconomic environment is setting up for more excitement going forward. Geopolitical

Commodities surge higher but still have a long way to go



SOURCE: Bloomberg.

issues such as Brexit, the ongoing threat posed by ISIS, the pace of the slowdown in the Chinese economy, and the upcoming U.S. presidential election are just some examples of current uncertainty. As each of these potential fault lines unfolds, it will likely lead to increased volatility.

Since the onset of the global financial crisis, central bank involvement in the capital markets has been a significant factor in asset performance. While the narrative had been framed that the Fed would become less accommodative than it has been, there has been little progress toward that goal and very few signals indicating a significant shift in policy in the near term. It appears likely that global central bank policies related to both interest rates and currencies could continue to be meaningful drivers of investment performance. The risks associated with policy errors are high, which we believe will lead to continuing elevated volatility.

Volatile markets can be uncomfortable and we anticipate there could be further periods

of steep declines in the coming year, as well as rapidly rising markets. However, we do not believe increased volatility should lead to dramatic changes to investment programs. Rather, it should lead to greater focus on the long-term, and discipline to withstand the market volatility by avoiding the potential pitfalls caused by overreaction.

Maintaining a long-term perspective, rebalancing the program when the opportunity arises, and avoiding mistakes are always top priorities that become even more acute in volatile periods. Investors with a long-term investment horizon and the discipline to remain diversified significantly increase their probability of achieving their investments goals, which is a goal we all share.

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SOURCE ON ALL GRAPHS: Bloomberg.