30 June 2016: Portfolio Review & Outlook

The second quarter began on a positive note as a sense of normalcy returned to global markets and investors seemed to favor fundamentals over central bank decisions. In the U.S., markets continued to stabilize, sustaining a trend witnessed near the end of the first quarter. However, global markets were mixed as investors struggled with slowing growth in China and concern with Britain's potential exit ("Brexit") from the European Union ("E.U"). In early June, signs of negative investor sentiment began to creep into global markets. In the U.S., a weaker-than-expected jobs report shaped investors' uncertainty on the health of the economy and greatly reduced any chance of a rate hike in June. Globally, while headline risk surrounding the Brexit vote dominated global news, volatilities were muted and correlations were stable. As it became clear that the "Leave" party would be victorious, an extreme market reaction proceeded. In the two days following the Brexit, global markets lost an estimated $3 trillion as investors grappled with the potential Brexit implications for the European Union and markets globally. After reeling from the initial spike in volatility, markets rebounded, and in some cases, even surpassed pre-Brexit levels.

For the quarter ended June 30, 2016, domestic equities outperformed global equities as measured by the S&P 500 (+2.5%) and MSCI ACWI ex U.S. (-0.4%) respectively. Fixed income assets continued their upward trend with another strong quarter. Notably, emerging market debt ended the quarter up over 5% as measured by the JPMorgan Emerging Market Bond Index. Elsewhere in fixed income, returns were strong for emerging market sovereign debt, global high-yield, global government bonds, and U.S. bonds. Commodities continued to climb in the second quarter, bolstered by a significant increase in oil prices due primarily to a decrease in global supply. REITs continued their strong performance as fundamentals remained favorable and demand continued to outpace supply in most property sectors and geographic regions, leading to an increase in the sector.

Our portfolios entered the second quarter of 2016 in their most defensive positioning as persistent volatility and global central bank decisions continued to drive investor decisions. As we moved into the latter half of April, our measures began to indicate that a sense of normalcy had returned to global markets and we positioned our portfolios to reflect these conditions. Positive absolute returns during the period were driven by our allocations to all-cap U.S. equities, emerging market equities, and commodities. Partially offsetting these strong returns, were weaker returns from our allocations to developed non-U.S. equities, European equities, and international small-cap equities. Late in the quarter, the Brexit vote led to a sharp increase in our measure of Financial Turbulence. After a period in which asset returns had been driven primarily by fundamentals, the market re-entered an environment in which macro events drove investor decisions. On June 28th, due to unstable correlations and rising volatilities sparked by the Brexit, we reduced our allocation to global equities, global real estate, and commodities, and increased our allocation to global bonds.

Britain's decision to exit the European Union led to a sharp rise in volatility. The Brexit now opens the door for other countries like Spain and Greece to weigh their options and brings into question the long-term viability of the European Union. These macro concerns, coupled with the presidential election in the U.S., should lead to increasing fragility across global markets. Given these uncertainties, we expect that global monetary policy will remain accommodative moving into the third quarter of 2016 as central banks do what they can to support global markets. As a result of the uneasiness and instability in the markets, we maintain an exposure to fixed income assets that is in-line with our benchmark. As of the end of the quarter, within fixed income we maintain an allocation to U.S. and we favor U.S. short-duration debt over intermediate and long-duration debt. We still see heightened levels of long-term interest rate risk and expect increased downside correlations amongst equities, REITs, and commodities. Consequently, based on our measures, we maintain a neutral position.

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