

CAPITAL MARKET REVIEW

Second Quarter 2016

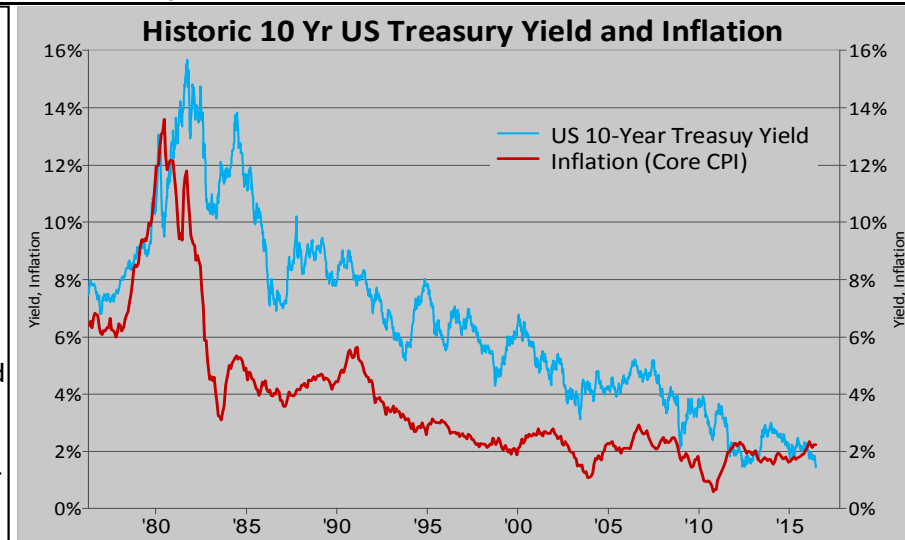


The Economy

If one were to look up the law of diminishing returns he would see something boring like an explanation about why incremental productivity gains of adding an employee get smaller with every employee added. If a company has only one employee then adding a second doubles productivity. Adding a third will increase productivity by a third, etc. These types of explanations, while accurate, are probably why so many don't understand or like economics.

Central bankers have not, however, seemed to learn the law of diminishing returns. The last time any government around the world saw fit to seriously raise rates – to actually slow the rate of growth in the money supply – was when Paul Volcker was appointed Chairman of the Federal Reserve by President Jimmy Carter. Volcker raised interest rates in an effort to combat inflation. Mortgage rates, which today are around 3.5 percent, topped out at 18.5 percent during Volcker's tenure.

His war on inflation did two things. One, it worked in defeating inflation and stabilizing the value of the dollar. Two, it set up an interest rate environment where central bankers could constantly lower rates for more than 35 years. Rates have been dropping ever since and today much of the world actually has negative interest rates. Switzerland's rates actually went negative all the way out to thirty years. People are buying Switzerland's bonds knowing that they will get less money back should they hold on until maturity. This is simply amazing and is probably the biggest market story of our generation, and how it will end no-one knows.



Source: Factset

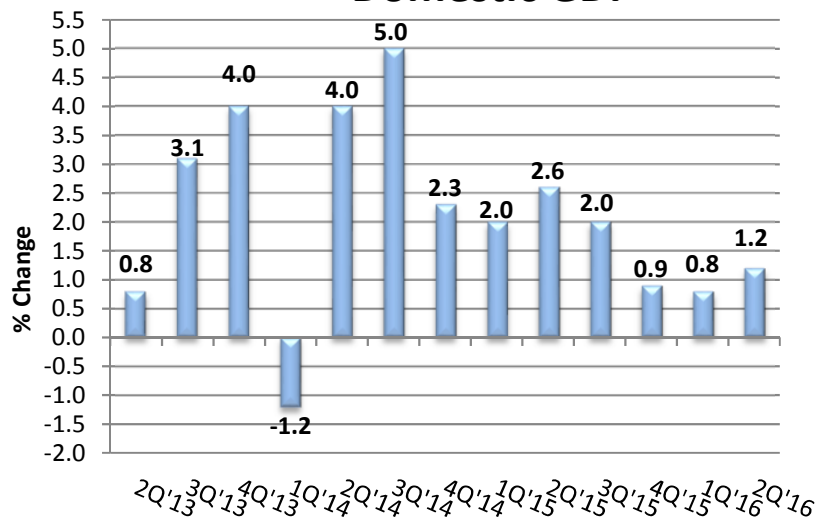
The Economy

While forecasts keep bouncing from overly fearful to overly optimistic the actual economy just slugs along. First quarter GDP was up 0.8 percent. We expected the second quarter number to be higher but it came in at 1.2 percent.

The official unemployment rate is 4.9 percent in June. Jobs growth has become lumpy as we had a horrible report in May followed by a very good report in June. Again, expectations move wildly as reality remains stable.

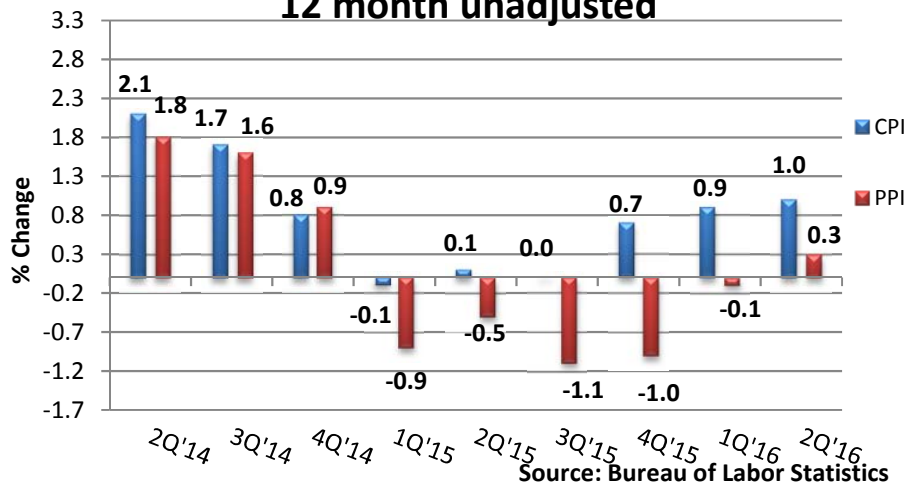
Inflation has been flat with CPI coming in at 0.2 percent in May. The Fed remains on hold after their first interest rate hike last year. After Brexit it is unlikely to see the Fed raise rates this year.

Domestic GDP



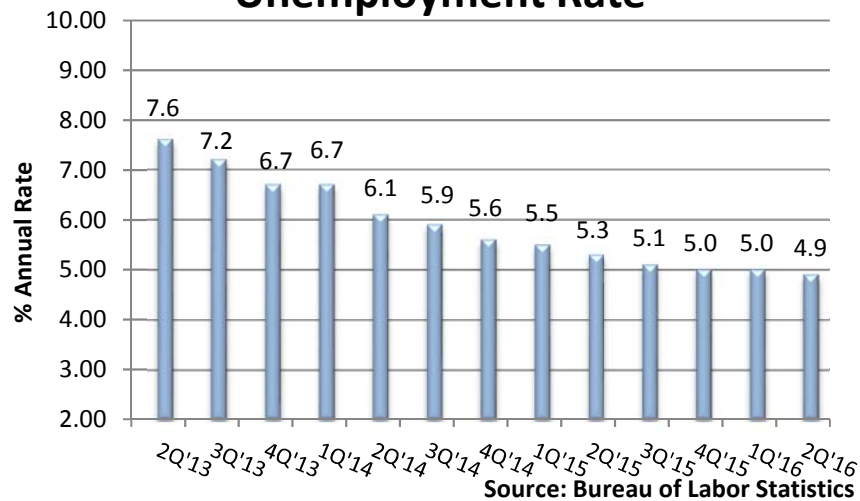
Source: Bureau of Economic Analysis; Forecast from Wall Street Journal

Inflation Indicator 12 month unadjusted



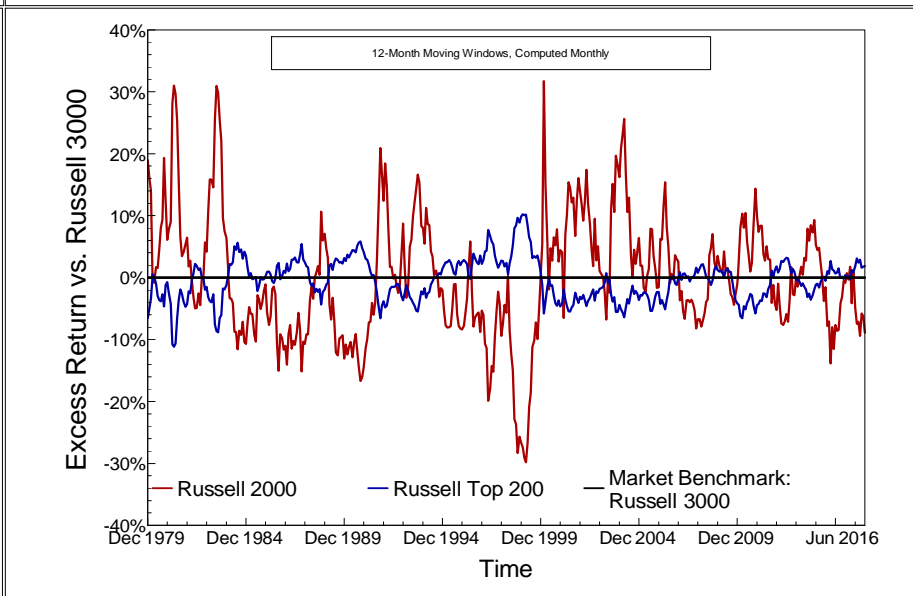
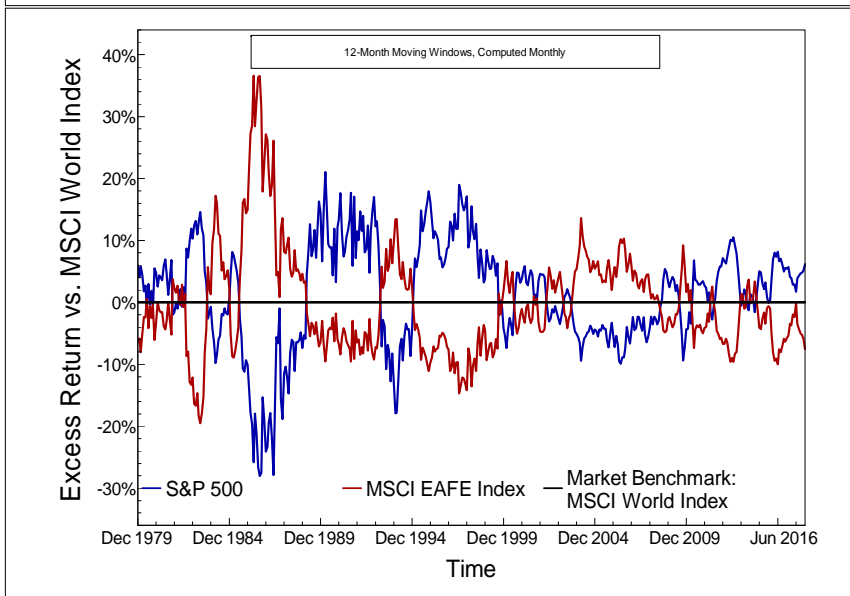
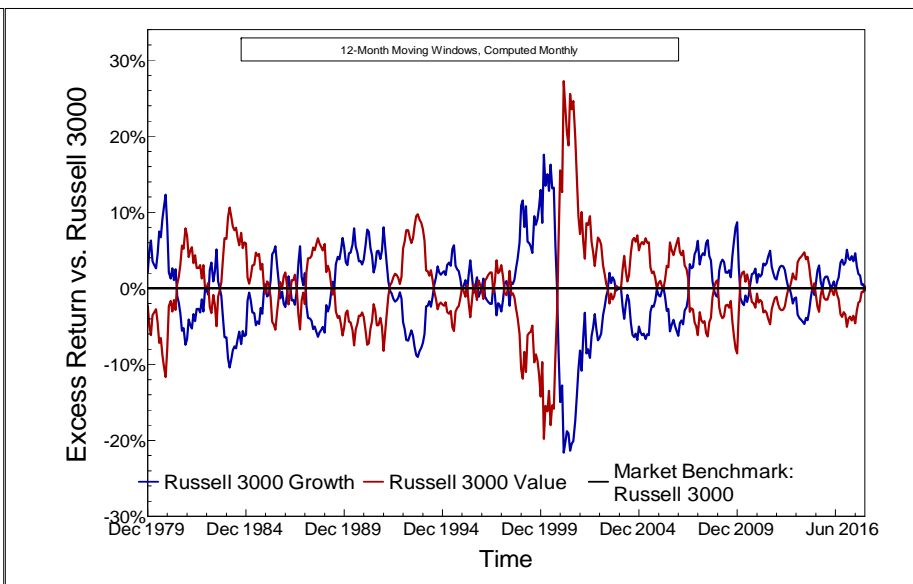
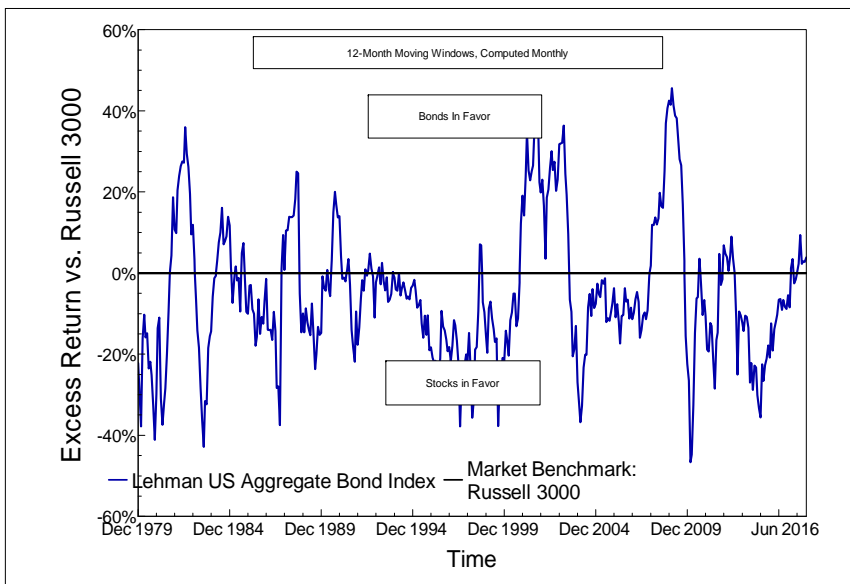
Source: Bureau of Labor Statistics

Unemployment Rate



Source: Bureau of Labor Statistics

Market Comparison



Domestic Equity Markets

We are in a global bear market. One wouldn't know it looking at the S&P 500 which finished up 2.5 percent for the quarter. But the rest of the world continues to struggle.

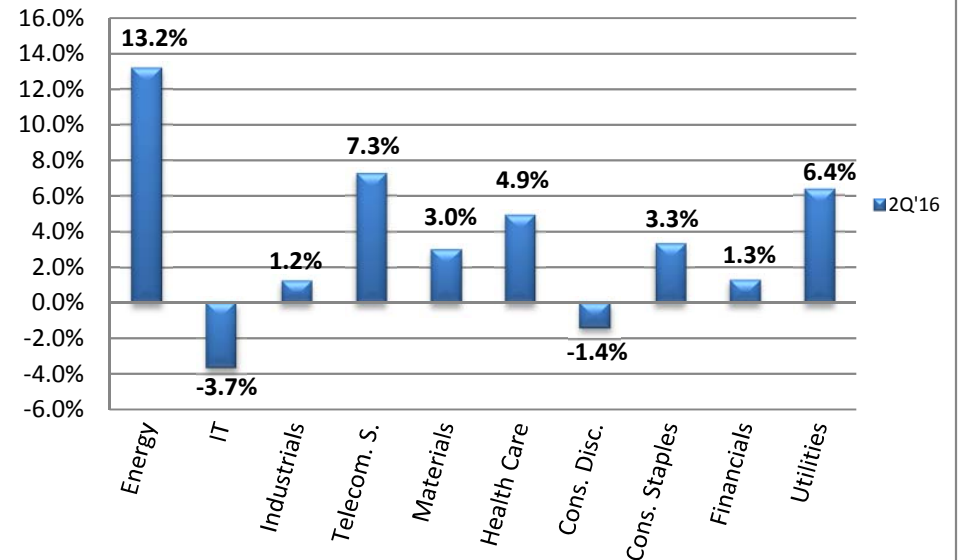
We were waiting for the market momentum to broaden and include more than the FANG stocks. Instead we got a rotation out of FANG and into dividends, especially in utilities and telecom. At the same time, many of the beaten up energy companies rebounded as oil prices stabilized.

We are still in an environment where the spread between the most expensive stocks and the least expensive stocks is larger than it has been since the tech bubble. We are also stuck in an environment where companies move on news flow regardless of valuation. In other words, the market seems to be ignoring valuation at the moment. This cannot last forever, but it is very frustrating for managers.

Domestic Indices Three Months Ending June 30, 2016

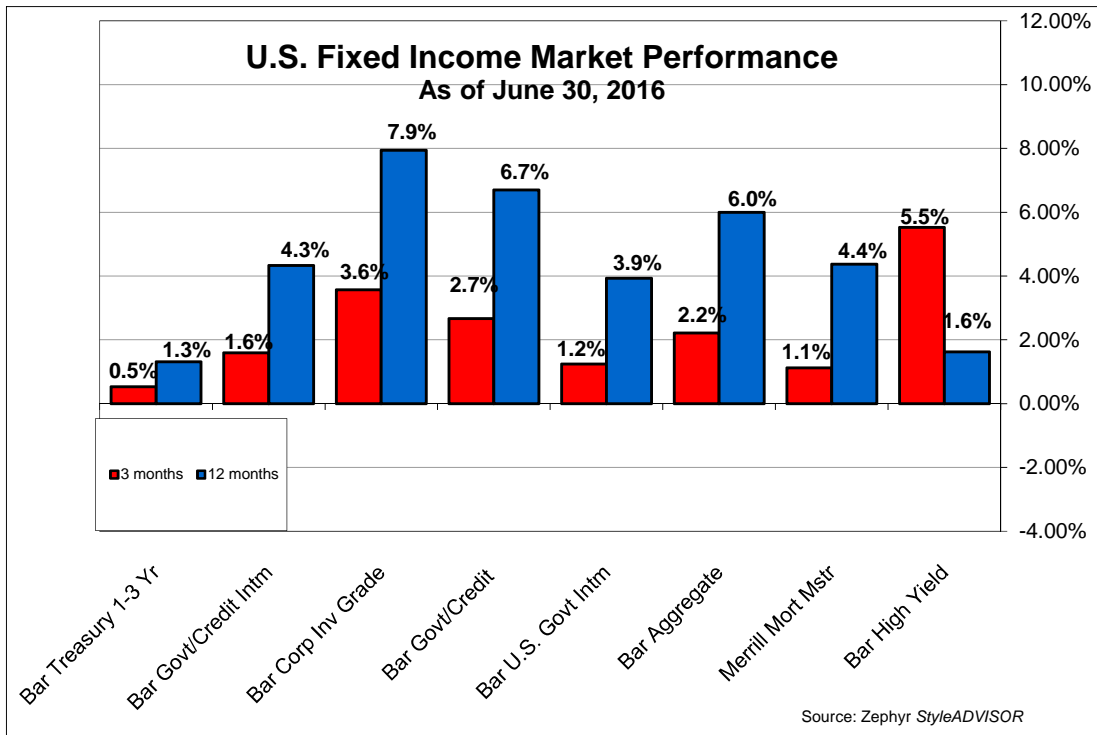
	Yield	Price/Earnings	Price/Book
S&P 500	2.16%	22.4	3.70
Russell 1000 Gr	1.57%	24.5	5.68
Russell 1000 Val	2.61%	19.2	1.85
Russell Midcap	1.81%	25.6	2.59
Russell 2000 Gr	0.84%	44.8	3.78
Russell 2000 Va	2.32%	25.3	1.39

S&P Sector Returns



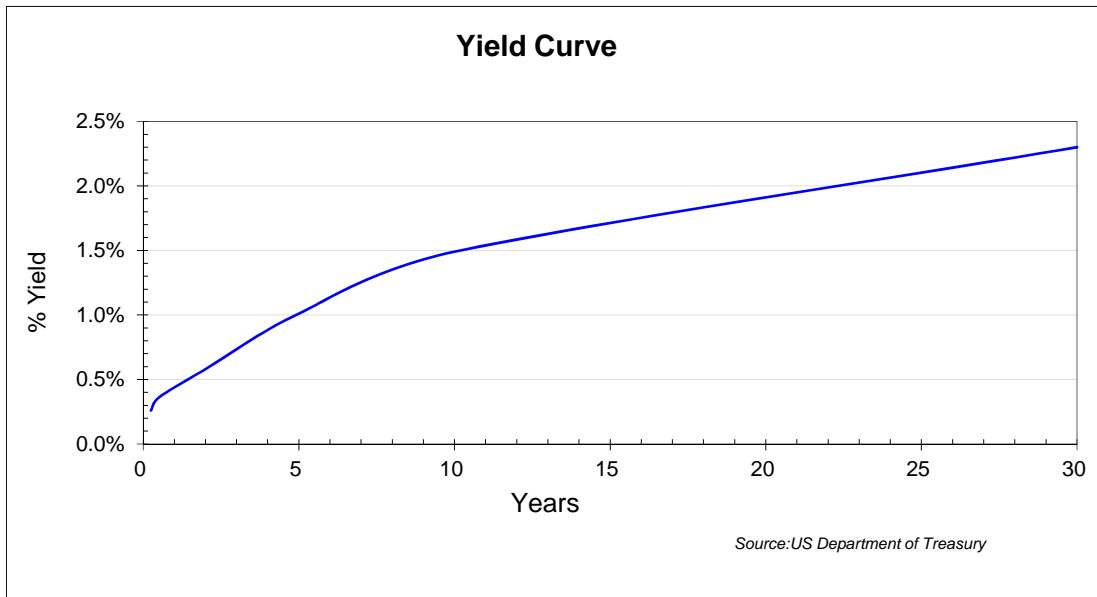
Source: Telemet Orion

DOMESTIC FIXED INCOME MARKET



Bonds rallied during the quarter up 2.21 percent. High yield bonds ended the quarter up 5.78 percent.

There has been a strange combination of a flight to safety and a flight for yield. Much of the developed world now has negative interest rates on government debt. It is hard to know what that means but it is likely that it will not end well.



Yield Curve as of June 30, 2016

Time to Maturity	Interest Rate
3 Month	0.26%
6 Month	0.36%
2 Year	0.58%
5 Year	1.01%
10 Year	1.49%
30 Year	2.30%

INTERNATIONAL MARKETS

Brexit, what else do we need to say? We were wrong. Last quarter we said that the Brexit wouldn't happen, but it did. This caused an initial shock, and thus far the biggest loser has been the Pound as UK's currency sold off quickly.

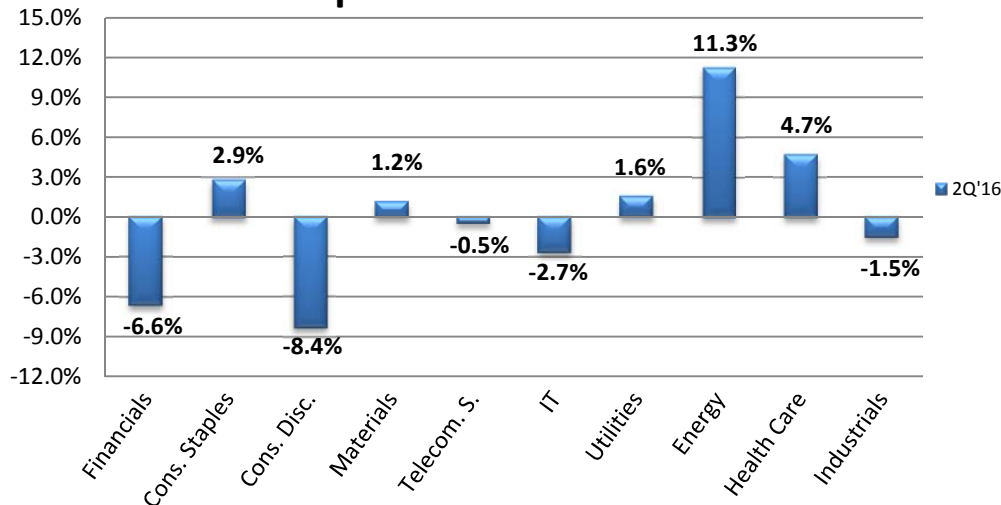
After the initial shock things have pretty much gotten back to normal. The UK was particularly well positioned to pull this off, and could even end up benefitting. It will all depend on the two plus years of negotiations which will determine Britain's ongoing relationship with the rest of Europe.

Globally it has not been good for stocks over the last year. The BRIC countries (Brazil, Russia, India, China) are down 18.6 percent over the last year, even after rallying this quarter. The Eurozone is down 15 percent. Italy is down 28 percent. The world equity markets excluding the USA are down 12.35 percent and that is after a strong rally the last week of the quarter. The rest of the world has seen a bear market. The question is, has it bottomed?

MSCI Country Returns Three Months Ending June 30, 2016

	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Austria	-9.66	-7.33	-2.33
Belgium	2.81	5.45	-2.64
Denmark	-0.49	1.93	-2.42
Finland	-1.00	1.55	-2.55
France	-3.53	-1.05	-2.48
Germany	-4.98	-2.53	-2.45
Ireland	-9.85	-7.53	-2.32
Italy	-9.67	-7.35	-2.32
Netherlands	-4.79	-2.44	-2.35
Norway	3.12	4.33	-1.21
Portugal	-1.94	0.59	-2.53
Spain	-7.44	-5.05	-2.39
Sweden	-4.61	-0.31	-4.30
Switzerland	2.47	4.24	-1.77
UK	-0.72	6.74	-7.46
Europe Total	-2.99	1.65	-4.64
Australia	0.53	3.86	-3.33
Hong Kong	0.94	0.96	-0.02
Japan	1.03	-7.78	8.81
New Zealand	5.86	3.20	2.66
Singapore	0.36	0.30	0.06
Pacific Total	0.90	-4.26	5.16
Brazil	13.93	3.00	10.93
Canada	3.61	4.03	-0.42
China	0.28	0.31	-0.03
Greece	-13.89	-11.68	-2.21
Hungary	-4.67	-1.76	-2.91
India	3.72	5.72	-2.00
Indonesia	4.45	4.08	0.37
Korea	-1.21	-0.50	-0.71
Mexico	-6.94	0.18	-7.12
Poland	-17.32	-12.00	-5.32
Russia	4.19	0.46	3.73
Thailand	2.92	2.80	0.12
Emerging Markets	0.80	0.83	-0.03

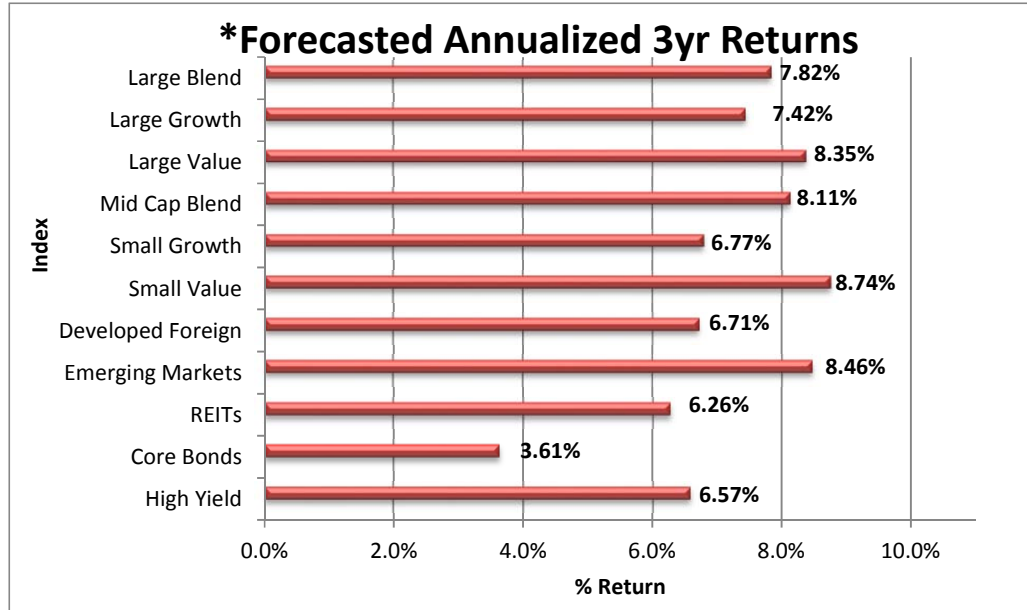
Developed Int'l Sector Returns*



Source: Harbor Capital

* MSCI EAFE Index

Market Forecast



Volatility is likely here to stay for a while. As frustrating as that is, we remain confident in the longer term. Valuations on equities are attractive on the whole and the economy is still chugging along. It is a rough ride but we still believe it will end in a positive direction.

Emerging markets have real economic issues but valuations have become very attractive. Small company stocks are finally getting back into normal valuation bands. Caution is in order but that is a good long term sign.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down.

**Indices Three Months Ending
June 30, 2016**

	Yield	Earnings Yield	**Hist. Return	***Hist. Risk Prem. + RF Rate
Large Blend	2.16%	7.59%	9.95%	5.99%
Large Growth	1.57%	6.83%	9.64%	5.99%
Large Value	2.61%	8.82%	10.09%	5.99%
Mid Cap Blend	1.81%	7.27%	11.36%	5.99%
Small Growth	0.84%	6.08%	7.49%	6.99%
Small Value	2.32%	8.90%	10.27%	6.99%
Developed Foreign	3.37%	9.95%	4.97%	4.12%
Emerging Markets	2.55%	9.80%	9.52%	5.62%
REITs	3.37%	5.45%	9.03%	4.56%
Core Bonds	1.91%	1.91%	6.61%	2.89%
High Yield	7.27%	7.27%	8.13%	4.06%

* Weighted average using 40% earnings yield, 30% historic return and 30% historic risk premium + RF rate

**Annualized 28 Yr return

***Hist. risk premium of domestic and international equity as defined by Zyphyr Style Advisor's GFD Long Term Index database except for REITs and High Yield which are based on average 20 year rolling returns of the NAREIT Equity REIT Index and the Barclays Corporate High Yield Index minus the average 20 year rolling returns of the 3-month T-Bill and scaled using proprietary data. The Current 3-month T-Bill yield (as of 06-30-2016) is added back to each risk premium.

SELECTED INDEX RETURNS - PERIODS ENDING June 30, 2016

	Quarter	Year-to-Date	One Year	Three Years	Five Years	Ten Years
US EQUITIES						
Broad Stock Market - Russell 3000	2.63%	3.62%	2.14%	11.13%	11.60%	7.40%
Large Stocks - S&P 500	2.46%	3.84%	3.99%	11.66%	12.10%	7.42%
Dow Jones Industrial Average	2.07%	4.31%	4.50%	8.99%	10.41%	7.66%
Medium-Size Stocks - Russell Mid-Cap	3.18%	5.50%	0.56%	10.80%	10.90%	8.07%
Small Stocks - Russell 2000	3.79%	2.22%	-6.73%	7.09%	8.35%	6.20%
Small Value Stocks- Russell 2000 Value	4.31%	6.08%	-2.58%	6.36%	8.15%	5.15%
Small Growth Stocks- Russell 2000 Growth	3.24%	-1.59%	-10.75%	7.74%	8.51%	7.14%
Large Value Stocks - Russell 1000 Value	4.58%	6.30%	2.86%	9.87%	11.35%	6.13%
Large Growth Stocks - Russell 1000 Growth	0.61%	1.36%	3.02%	13.07%	12.35%	8.78%
US FIXED INCOME						
1-3 Yr Treasury (Gov't) Bonds - Barclays Capital	0.53%	1.44%	1.31%	0.99%	0.82%	2.48%
US Government Bonds Int - Barclays Capital	1.24%	3.55%	3.93%	2.41%	2.31%	4.07%
US Corporate Inv Grade Bonds - Barclays Capital	3.57%	7.68%	7.94%	5.42%	5.43%	6.24%
Government/Credit (Corp) Bonds - Barclays Capital	2.67%	6.23%	6.70%	4.20%	4.11%	5.22%
Int Govt/Credit (Corp) Bond - Barclays Capital	1.59%	4.07%	4.33%	2.95%	2.90%	4.48%
US Aggregate Bond Market - Barclays Capital	2.21%	5.31%	6.00%	4.06%	3.76%	5.13%
Mortgage Master - Merrill Lynch	1.12%	3.09%	4.37%	3.73%	2.98%	4.98%
US Corp High Yield Bonds - Barclays Capital	5.52%	9.06%	1.62%	4.18%	5.84%	7.56%
INTERNATIONAL (Measured in US Dollars)						
Non-US Stocks - MSCI EAFE	-1.19%	-4.04%	-9.72%	2.52%	2.15%	2.05%
World Stocks (includes US) - MSCI World	1.21%	1.02%	-2.19%	7.54%	7.23%	5.02%
European Stocks - MSCI Europe	-2.29%	-4.61%	-10.67%	2.52%	1.62%	2.13%
Japanese Stocks - MSCI Japan	1.03%	-5.41%	-8.64%	3.00%	4.45%	0.33%
Asian Stocks (Ex-Japan) - MSCI Pacific ex-Japan	0.70%	2.55%	-6.62%	1.22%	0.99%	5.76%
Chinese Stocks - MSCI China	0.28%	-4.53%	-23.20%	3.62%	-0.24%	7.48%
Indian Stocks - MSCI India	3.72%	1.13%	-6.54%	7.13%	-0.44%	6.32%
Emerging Markets - MSCI EM	0.80%	6.60%	-11.71%	-1.21%	-3.44%	3.88%
Int'l Gov't Bonds -Citi World Gov't Bond (Non USD)	4.04%	13.50%	13.85%	2.36%	0.31%	3.97%
REAL ESTATE						
FTSE NAREIT Equity-Reits Index	6.96%	13.38%	24.04%	13.58%	12.60%	7.45%
SHORT TERM INTEREST RATES						
T-Bills	0.06%	0.12%	0.14%	0.07%	0.06%	0.96%

Note: Returns for periods longer than 12 months are annualized.