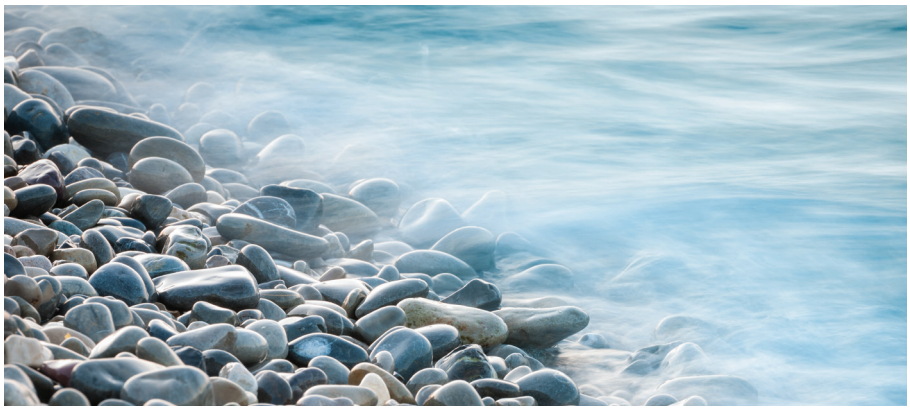
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



The Opportunity in Uncertainty

"The isles of Greece, the isles of Greece! / Where burning Sappho loved and sung, / Where grew the arts of war and peace, / where Delos rose, and Phoebus sprung! / Eternal summer gilds them yet, / But all, except their sun, is set."

— Lord Byron, *Don Juan, Canto the Third*

TRUE TO FORM, WE FACE YET ANOTHER SUMMER OF DISCONTENT, with Greece at a crossroads, stocks in China nose diving, and rising uncertainty about the timing and impact of a U.S. interest rate hike. Against this backdrop, global markets wobbled into the end of the second quarter, as the latest developments in Greece's debt drama spurred higher volatility and volumes than we have experienced in some time. Investors are understandably questioning whether these events mark a potential "Lehman" moment, heralding a financial market crisis and global economic slowdown. We think not, and while markets are sure to be roiled and repriced to some extent by the news flow, we are cautiously looking for opportunity amidst the uncertainty, with the expectation that broader impacts will be short-lived.

As a review, on June 27, Greek Prime Minister Alexis Tsipras announced that the Greek government would not repay loans due to the International Monetary Fund (IMF) on June 30, and called for a referendum on July 5 to decide whether Greece should accept the aid package offered to it by the European Commission, IMF, and European Central Bank (ECB), including austerity and other unpopular economic reforms. In response to Greece's refusal to pay, the ECB decided to cease making new Emergency Liquidity Assistance (ELA) loans to Greek commercial banks, which effectively shut down the banking system. As the rhetoric following the surprise announcement intensified over the course of the week, it became clear that the referendum vote was being cast as more than a vote on the terms of austerity: it was a vote about the future of Greek membership in the Eurozone.

As it turns out, Greek voters have apparently had enough of austerity, and

IN THIS ISSUE

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We face yet another summer of discontent, with Greece at a crossroads, stocks in China nose diving, and rising uncertainty about the timing and impact of a U.S. interest rate hike. Even so, we are cautiously looking for opportunity amidst the uncertainty, with the expectation that broader impacts will be short-lived.

2

The U.S. economy rebounded in Q2 from bad weather, but high absolute valuations of U.S. equities made them vulnerable to overseas headlines and the Fed's timetable for returning interest rates to more historically normal levels.

3

Data in Europe and Japan showed early signs that the ECB's quantitative easing program and President Abe's reforms are helping reboot growth; unfortunately, uncertainty caused by the potential for a Greek exit from the eurozone eroded year-to-date market gains.

4

Concerns over Russia-Ukraine gave way to angst over China, as the overheating mainland stock market crashed back down to earth and raised doubts over the stability of the financial markets. Even so, emerging market equities offer compelling valuations for long-term investors at current levels.

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voted a resounding "no" to the terms of the original bailout, risking their Eurozone membership and seemingly accepting of a fate of even more dire economic hardship, but at least a fate on their own terms.

That said, at press time, more negotiations were in the works, as there is a great deal of hesitation about a Greek exit from the single currency union despite the recognition that more austerity may be unbearable.

As developments continue to unfold, we are mindful of the impact of uncertainty on the markets, but feel it is equally important to provide perspective. The Greek economy represents only a small percentage of the eurozone's gross domestic product (less than 2%) and many firewalls exist to minimize contagion among other euro area countries. European banks are significantly less exposed to Greek debt than they were a few years ago, and periphery countries are much healthier at this point in time.

Importantly, the European Central Bank remains committed to "doing whatever it takes," to stabilize the European financial system, including flooding it with its €1 trillion monetary war chest, using all instruments available, including quantitative easing (QE), outright monetary transactions (OMT), and unconditional long-term refinancing operations (LTROs). Should they occur, bank runs in other high debt-to-GDP countries like Portugal, Spain, or Italy are likely to be dealt with forcefully and expeditiously, in a way that makes clear Greece's issues can be contained. While risk premia on European sovereign paper may rise near term, reflecting the higher uncertainty associated with a Greek default, sovereign rates are likely to head lower longer term once the Greece situation plays out and the ECB and other central banks unleash QE and other monetary tools to calm global investors.

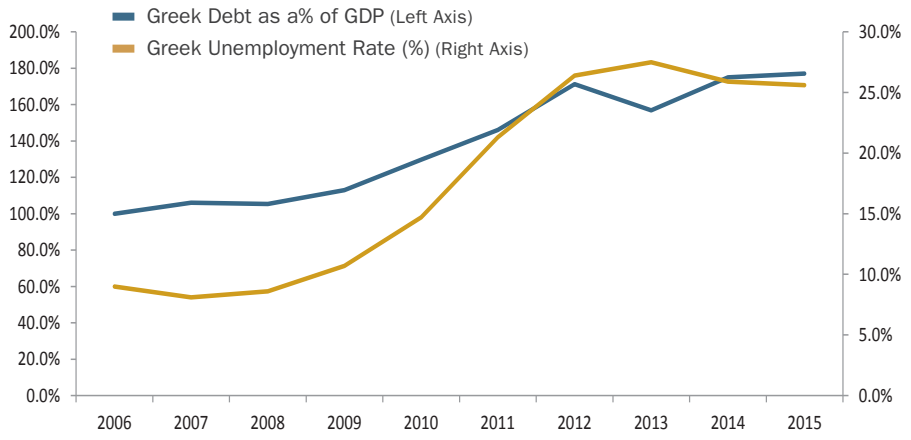
Furthermore, the overall fundamentals in Europe haven't changed, and remain positive in our eyes. Additionally, structural reforms in peripheral Eurozone economies such as Spain and Italy are sending encouraging signals. Over the long term, we believe opportunities should continue to emerge from Europe no matter how the Greek situation finally plays out.

As for the bear market correction in Chinese equities, it is important to consider the context of this decline, namely that the affected mainland Shanghai Composite had risen over 100% in the last year against a backdrop of lackluster fundamentals, making a pullback not at all surprising. Reassuringly, the People's Bank of China (PboC) has provided support for the economy in a dramatic fashion. Indeed, the PboC moved quickly to cut benchmark interest rates and reserve requirement ratios for certain banks in an effort to lower borrowing costs and improve the distribution of credit. When the selling continued, government officials further intervened to stabilize markets, halting IPOs, encouraging public displays of long-term investment by brokerage firms and state-linked and sovereign wealth funds, and placing restrictions on trading, including limits on short-selling.

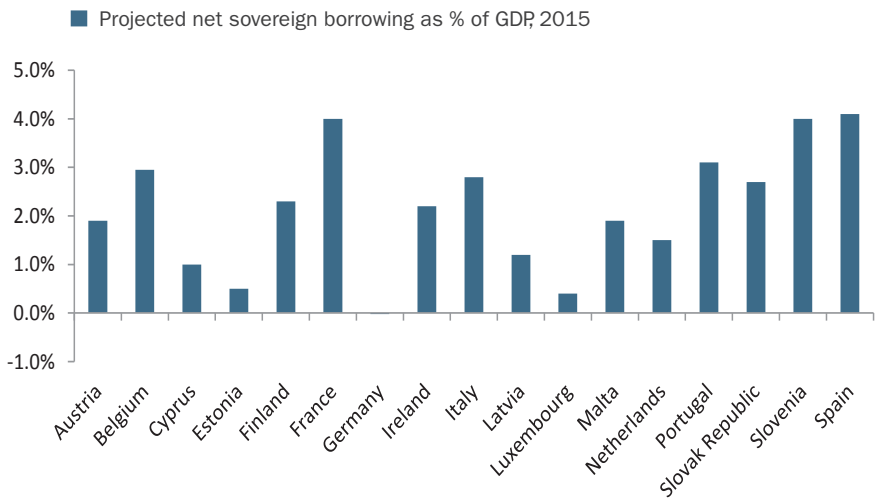
While circumstances in China and Greece are hardly encouraging, it is important to acknowledge that leaders from Brussels to Beijing have taken lessons from the crisis in 2008 in trying to limit global fallout, and appear more committed than in the past to extinguishing uncertainty as an equally important goal to protecting and promoting political agendas.

For all of these reasons, we are cautiously optimistic that our most recent dose of summer turmoil will yield more opportunity than uncertainty for long-term investors, though we stress that fundamentals must always come first in any bargain-hunting and prudence dictates maintaining balance in a broadly diversified portfolio for best long-term results.

Greece's Debt Burden & Unemployment Rate Unsustainable



ECB Will Purchase 4.75% of GDP in Bonds from Member States in 2015, More Than Any Government is Expected to Issue on Net This Year



Global Economic Overview: Differentiating the Disappointments

The global economy has been buffeted this year by the after-effects of a plunge in oil prices, QE in Europe and Japan and an associated jump in the dollar, and record cold weather in portions of the U.S. The IMF has forecasted 3.3% growth in the world's GDP, down from last year and the weakest clip since the world economy contracted in 2009. Furthermore, there is likely downside risk to that growth rate given the potential for fallout from Greece and China and the Fed.

While global growth is expected to pick up again next year, these bouts of turmoil underscore the fragility in the world's economy, where anemic output in one region risks dragging down others across the globe. This condition is exacerbated by the fact that policymakers have few options left to respond to downside surprises. Indeed, governments have pushed debt to dangerously high levels and central banks are constrained by the lower limits of rate reductions. Together with aging workforces and deteriorating productivity levels around the world, the global economy overall likely faces a low-growth outlook through the rest of the decade.

While the global economic outlook overall may be subpar in the short- and intermediate-term, there is divergence and differentiation among regions and individual countries worth noting. We strive to understand these divergences in our creation of our asset allocation frameworks, allocating capital in reflection of our views of economic outlooks but, more importantly, based on our judgment of the valuations underscoring the markets.

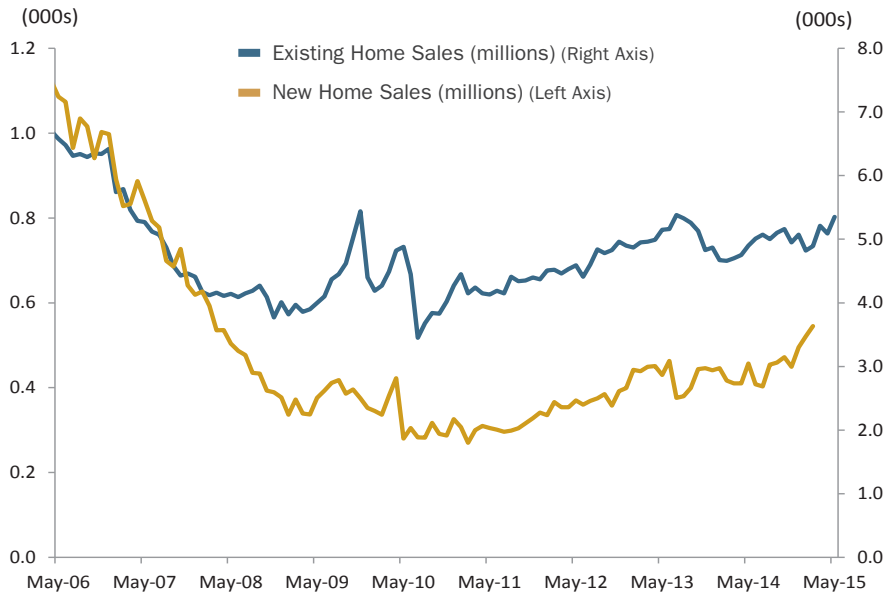
U.S. Economy: Poised to Rebound

Half-way through 2015, and now six years into recovery, the U.S. economy remains in strange territory. Real GDP growth has proceeded on a narrow path, averaging just a 2.2% pace. Even this modest pace, however, has been sufficient to pull the unemployment rate down to levels near most conventional measures of full employment. Despite the low unemployment rate, the economy and labor market are anything but a picture of health. In fact, the feeble gait of this expansion has kept the economy vulnerable to the slightest misstep, be that bad weather, labor strife, or foreign events.

Such was the case in the first quarter, as U.S. GDP contracted at an annualized rate of -0.2%, as lower oil prices, the strong dollar, and a shutdown of West Coast ports weighed on growth. However, there were signs throughout the second quarter that the economy bounced back as the weather improved. Consumer spending has clearly ramped up, with motor vehicle sales humming along at a 17.1 million unit pace during the quarter. Strong retail sales reports and the strongest consumer spending growth since August 2009 also bode well for consumption.

While heretofore housing had been making fairly modest gains, the pace of recovery in this segment appears to be accelerating. Existing and new home sales hit multi-year highs in May, and the return of first-time buyers to the markets may mark a major shift for housing and the broader economy. Home sales and new home construction provide significant spillover effects to the broader economy, supporting not only manufacturers of building products, furniture and home furnishings, but a whole host of services ranging from mortgages and insurance to lawn care and pest control.

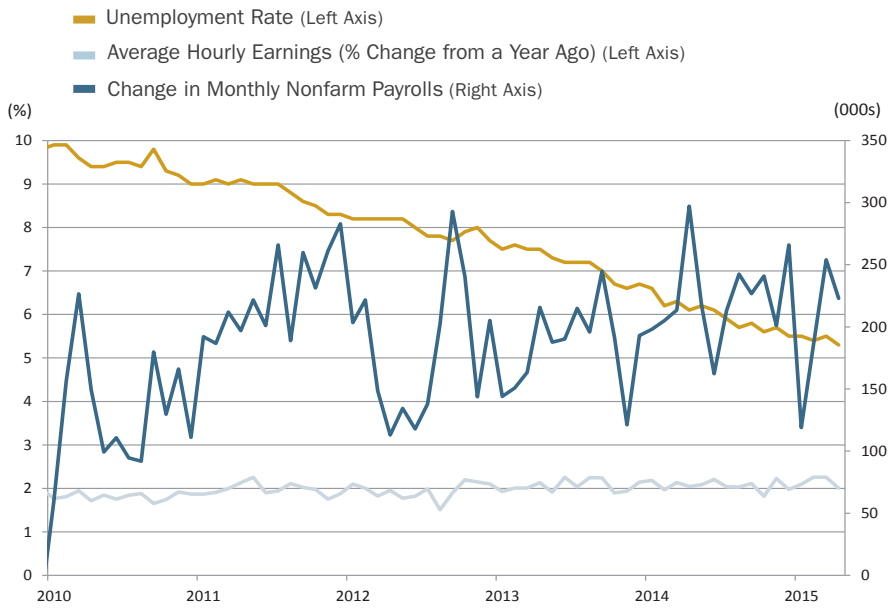
U.S. Housing Market Recovery Accelerating



These improvements are being offset by slower growth overseas, which is restraining exports, and continuing cutbacks in energy exploration. Business fixed investment is also growing less rapidly, although nonresidential construction has shown signs of strengthening more recently. Manufacturing has continued to be a weak spot: excluding the automotive sector, manufacturing output has risen only once since November 2014, as manufacturers have taken a one-two punch from slumping oil prices and the surging dollar.

As for the labor markets, the good news is that nonfarm payrolls have risen by an average of 233,000 jobs over the past two years, weekly jobless claims reached their lowest levels in 15 years in June, and the unemployment rate has fallen to just 5.3%. The bad news is that wage increases still appear to be lagging, with the year-over-year change in average hourly earnings stuck at around 2% for the past six years. At least inflation remains contained, at 1.7% year-over-year for the core CPI as of the last reading.

Job Market Accelerates But Wages Still Stagnant



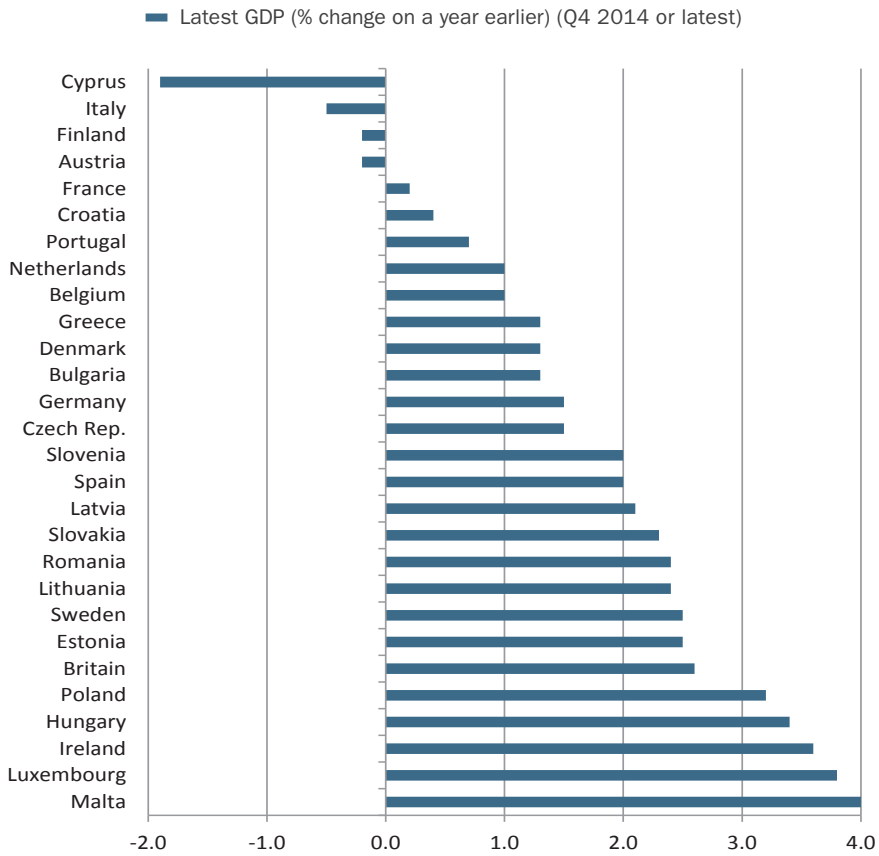
Although at one point it appeared that the Fed may raise short-term interest rates as early as June, the weak data in the first part of the year made that date unrealistic even as the central bank removed the language from their statement about being "patient" in when it would boost rates. At the June meeting, the Fed made clear that it was planning on the first rate increase sometime this year but also said that the pace of increases may be slower than many had initially anticipated. Expectations are converging around the September meeting, and while many forecasters have scaled back their expectations to just one move or pushed liftoff altogether into 2016, we could see increases in both September and December. The economy feels stronger than the numbers show and all signs point to a Fed that is anxious to get started, even against a backdrop of global uncertainty.

Developed International Economies: Greece Threatens Growth Reboot

Data in Europe showed early signs that the European Central Bank's quantitative easing program was helping reboot growth in the eurozone. Consumer prices rose modestly in the second quarter, arresting concerns about deflation. The jobless rate has fallen—albeit very slowly—to a three-year low of 11.1%. A substantial rebound in Spain and Italy's activity indicators has contributed to this year's recovery, and is likely to persist, barring a shock. The quantitative easing program that kicked off in March appears to be having a positive impact despite the dramatic slide in oil prices since mid-2014. ECB President Mario Draghi indicated he was pleased with the eurozone's consistent policy response and predicted that "the weak and uneven recovery experienced in 2014 will turn into a more robust, sustainable upturn." Draghi confirmed that the ECB intends to continue its quantitative easing program until September 2016 or when the eurozone achieves its inflation target of 2%.

Certainly, though, the big story out of Europe has been the ongoing Greek saga. The drama has had many acts thus

Eurozone Grows 0.3% in Q4 2014, Expected to Reach as High as 1.5% in 2015



far, including a missed payment to the IMF, the imposition of capital controls, a shutdown of the banking system and stock market, and a referendum in which Greek voters issued a resounding "No" to the European Union's terms of austerity. Now, Tsipras is back at the negotiating table, trying to balance even more hardened resolve from European leaders with the desperation of his people.

Regardless of the outcome, we remain confident in the recovery trajectory of Europe, and believe Greece may slow, but will not stop, the pace of gains. For these reasons, we are also positive on the outlook for the U.K., where policy uncertainty earlier in 2015 was resolved given the Conservatives' surprisingly solid election win. Similar to the U.S., the output gap is closing in the U.K., as the unemployment rate has sunk to 5.5%. Wage growth is showing up more clearly with average weekly earning earnings up 3.3% in the private sector in April. The implications for household disposable income are particularly positive considering that inflation hit a 55-year low of -0.1% in the month. These data offer solid support for consumer spending, and indeed May's 4.6% year-on-year increase in retail sales marked over two years of interrupted growth.

Likewise, the Japanese government's efforts to pull the country out of its multidecade pattern of deflation and stagnating economic growth appear to be working. Japan's first-quarter economic growth was revised sharply higher to an annualized rate of 3.9% to reflect stronger-than-estimated capital expenditures. Japanese consumers increased spending for the first time in more than a year in May. The weak yen provided a boost to Japan's large export sector, spurring sales for automakers and other industries. However, consumer prices rose a scant 0.1% for the year through May, well shy of the Bank of Japan's 2% target. President Abe's reform agenda continues to make progress though, with publicity mostly recently focused around efforts to liberalize agricultural policy to allow for Japan's participation in the proposed Trans-Pacific Partnership trade agreement between the U.S. and the Pacific rim.

China & Emerging Economies: The "Good" in the Bad News

China had a tumultuous quarter, from an economic and market perspective. The economy continued to slow, growing 7% in the first quarter, the slowest rate in six years. Year-to-date activity across a wide range of indicators has been disappointing, reflecting excess capacity, slowing investment, weak inflation, and a property market downturn. The HSBC Purchasing Managers Index for June recorded its fourth straight month of contraction in the manufacturing sector. Exports performance remained patchy, continuing the weakening trend from 2014, due to slower demand within Asia.

The prognosis is not all grim, however. Household spending is holding up, supported by close-to-full employment and decent wage growth. The pace of credit growth has cooled, allaying some of our more immediate concerns about risks to the financial sector, and particularly shadow banking. Also, as one of the world's largest importers of oil, China has been the beneficiary of lower energy costs.

Chinese GDP and Manufacturing Continues to Slow

Critical to our optimism is how Beijing is ramping up policy response. Leadership has recently announced monetary and fiscal stimulus measures designed to both support growth and limit the risk of turbulence for the Chinese financial system. Some of their initiatives include reform of state-owned enterprises to create national champions, measures to stimulate housing sector demand, and an infrastructure investment plan totaling RMB 10 trillion focused on new railways, internet infrastructure, and affordable housing. Financial market liberalization is also high on the agenda, and demonstrated by recent steps taken by the PBoC. They have dropped the reserve ratio requirement for banks twice in 2015, and in June it cut interest rates for the fourth time since November. The PBoC has also increased lending to banks by RMB 1.76 trillion, and offered debt swaps that allow local governments to convert loans into lower-interest bond issues.

As for other emerging markets, growth prospects vary. India is now growing faster than China, and has the benefit of weakening inflation that may provide the central bank scope for additional interest rate cuts. Additionally, Prime Minister Narendra Modi's government has set a course for steady economic reforms, focusing most recently on the labor market. Meanwhile, in Turkey, economic momentum is slowing, with GDP growth likely to fall below 2.5% this year. The central bank eased its policy rate lower in February in an effort to stimulate growth. Russia entered into recession in the first quarter, and recent data points to an economic contraction for the full year. Sanctions remain in place amid risks from potential reescalation of tensions with Ukraine. Yet fiscal conservatism has allowed the central bank to loosen monetary policy in a bid to limit their economic fallout. In Latin America, Brazil continues to face multiple challenges. Its central bank is near the end of a series of rate hikes designed to cut inflation from over 8%-the highest level in more than 10 years. President Dilma Rousseff's government appears committed to fiscal adjustments, but slow growth remains the forecast. For sure, prospects for emerging markets vary more widely than ever in these slow growth times and given difficult overall conditions for the world's economy.

Global Market Outlook: Changing of the Guard

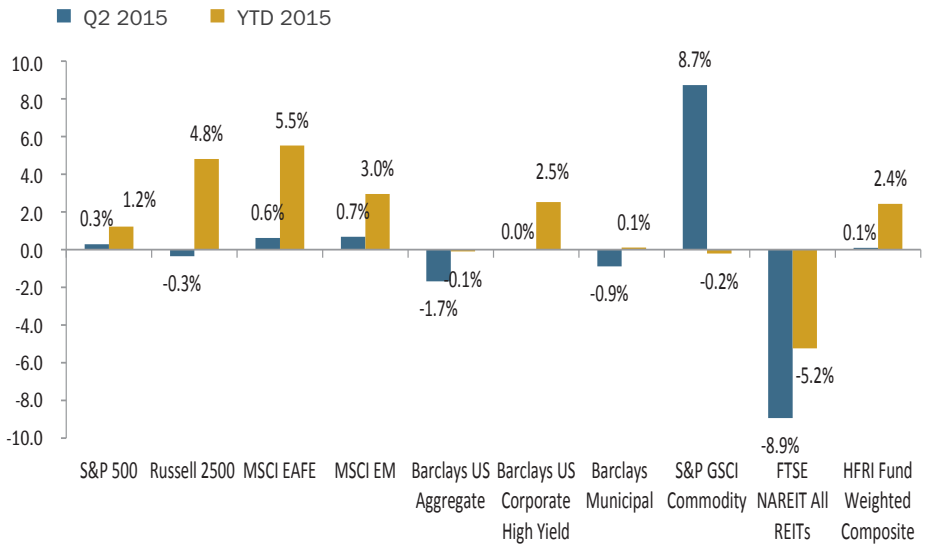
With the first half of 2015 now in the books, there has clearly been a changing of the guard in the global markets. After several years of double-digit returns, the S&P 500 is lagging other equity markets as the effect of lower oil prices and a stronger U.S. dollar have been too much for an improving economy to offset. On the other hand, U.S. small caps have benefitted from their domestic orientation, returning 4.8% year-to-date. Outside the U.S., both emerging and developed equity markets have regained some ground this year, rising 3.1% and 5.9%, respectively, with Europe and Japan benefitting from quantitative easing and emerging markets seeing signs of stabilization. That being said, interest rate sensitive asset classes such as fixed income and REITs have suffered at the hand of higher and more volatile interest rates, but high yield has returned almost 2% as spreads tightened against a backdrop of rising rates. Finally, commodities continue to struggle, falling 0.2% in the first half of 2015. The stark difference in returns so far this year should not only remind investors of the importance of time horizon, but also of the need for balance and diversification.

U.S. stocks were flat in Q2 as earnings and growth optimism give way to Greek worries

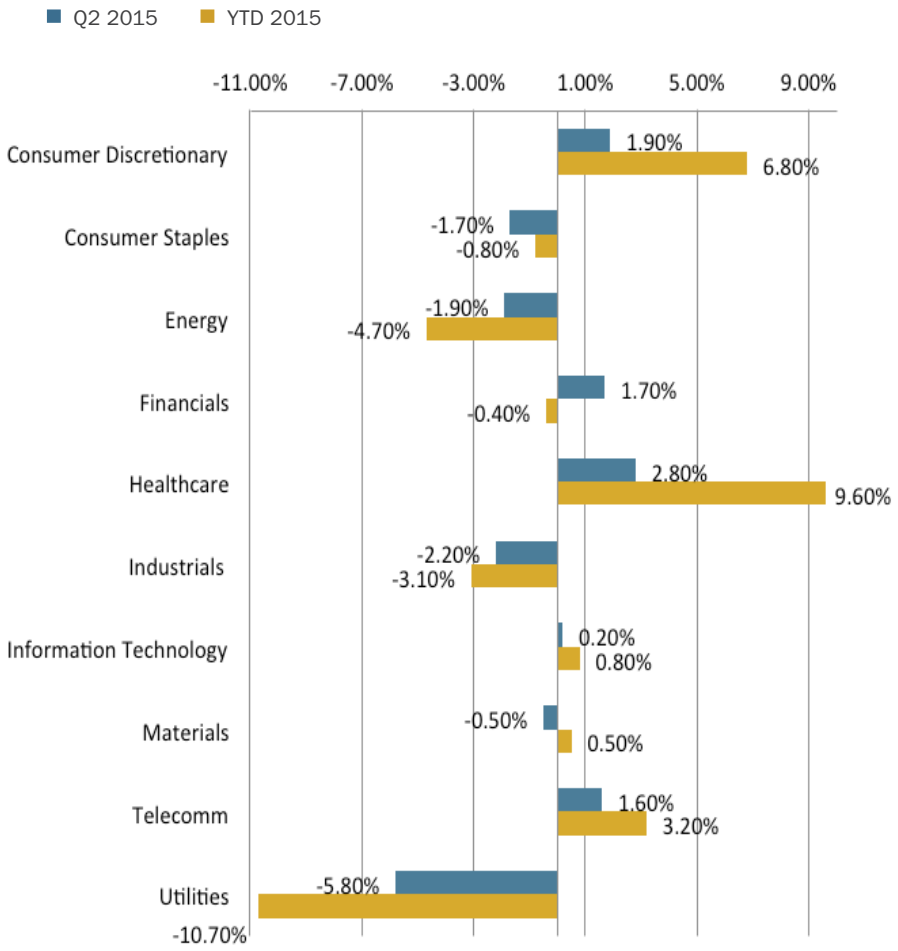
The S&P 500 was roughly flat for the second quarter, as relief over resilient corporate earnings growth and enthusiasm about a reaccelerating U.S. economy gave way to worries over the ongoing Greek debt crisis. The Nasdaq Composite performed better, helped in part by merger and acquisition activity, and managed to breach the record high it established in 2000 before pulling back a bit. The Russell 2000 small cap index performed well, benefitting from the combination of greater exposure to the strengthening domestic economy and lesser exposure to the currency translation effects in a strong dollar environment. Utilities and industrials shares underperformed within the S&P 500 Index, while health care and consumer discretionary shares outperformed.

Investors braced themselves at the start of April for the arrival of the previous quarter's earnings reports, which appeared

Q2 and YTD Market Returns: International and Emerging Markets Still On Top Despite Quarter-End Fireworks



S&P 500 Sector Returns: Energy & Interest Rate Sensitive Sectors Languish While Healthcare & Discretionary Surge



likely to reflect the negative effects of both falling energy prices and the strong U.S. dollar. While these headwinds did have an impact, markets rose as many companies reported that profits had not declined as much as analysts expected. In fact, when final results were tallied, earnings had in fact risen by 0.8%. While this was the slowest rate of growth in over two years, earnings would have grown 8.5% if not for the plunge in energy sector profits.

A worsening of the Greek debt situation caused the quarter to end on a down note, however. U.S. markets followed their European counterparts lower at the start of the month, and endured their largest daily decline since last October on June 29, following news that Greece had shut down its stock market and banks and instituted capital controls in preparation for a default.

Despite the risks Greece and China pose to the markets, the U.S. economy is on solid enough footing to withstand the fallout. The outlook for U.S. equities remains generally positive, but after a six-year bull run that has seen the S&P 500 rise more than 200%, investors should not be too complacent about the risk of short-term market volatility. U.S. equities still appear quite attractive, especially when measured against very low Treasury yields, but their somewhat high absolute valuations make them vulnerable to the Fed's timetable for returning interest rates to more historically normal levels. A mature economic cycle also implies that companies will have a harder time expanding margins by cutting costs, and that only companies that are executing well will be able to see solid profit growth. For these reasons, we are also starting to see a market bias toward growth over value stocks.

International equities cooled as Greece reached a tipping point

A strong stock market rally early in the second quarter reversed in June amid renewed concerns over the fate of Greece and uneven economic data. Developed markets ended the second quarter with small gains of just 0.6% as measured by the MSCI EAFE Index. The local-currency return for the EAFE index was -1.8%. The euro and British pound strengthened versus the U.S. dollar, but the yen declined. U.S. dollar strength, which had been a significant factor in returns over the last several quarters, moderated in the past three months.

Similar to the U.S., international small-cap stocks handily outperformed large-caps, while growth stocks outperformed value shares. From a sector perspective, energy, telecommunication services, and utilities performed best. The worst-performing sectors in the index were materials, health care, and information technology.

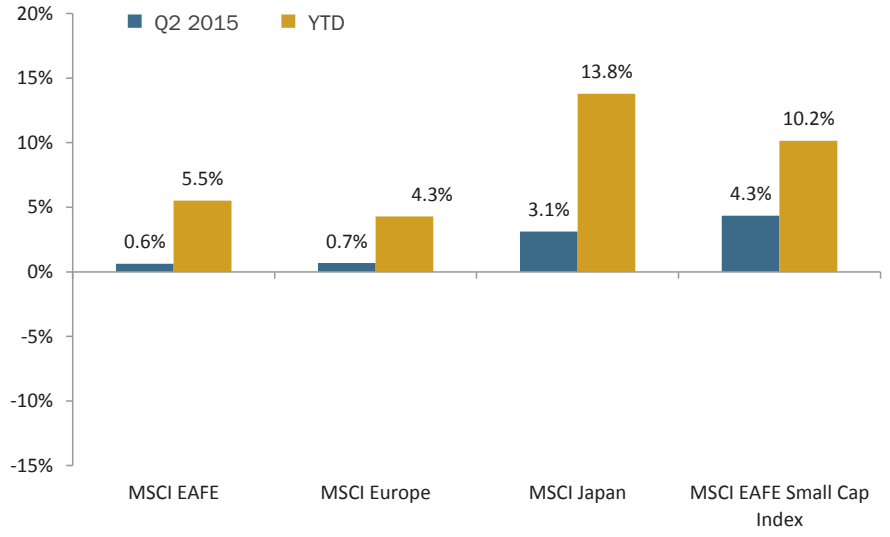
Non-U.S. stocks should continue to benefit from quantitative easing initiatives, even with the headlines and volatility from Greece. While valuations are no longer particularly cheap, they remain generally appealing on a relative basis. European firms are in good financial shape, which should support growth in capital expenditures, healthy M&A activity, and revenues and earnings gains. In general, we are also encouraged by the changes taking place at the corporate level in Japan, including the newfound focus on return on equity, improvements in corporate governance, and generally improving returns for shareholders.

Emerging markets stocks edge higher on hopes for Fed inaction

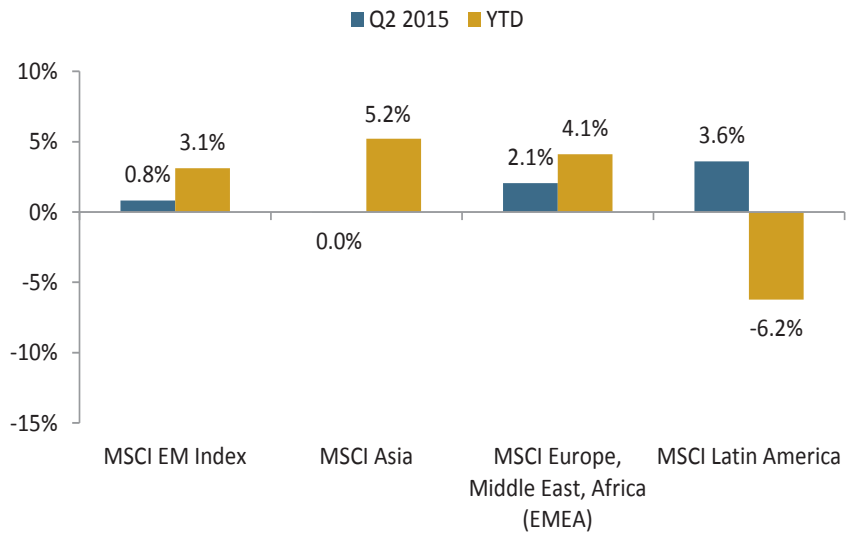
Emerging markets stocks rose in the second quarter, lifted by an April rally on speculation that the Federal Reserve would delay a widely expected interest rate hike until this year's second half. Rising U.S. rates reduce the relative attractiveness of assets in emerging markets, where yields are currently higher than those in developed markets, and raise the risk of capital outflows from the developing world. The MSCI Emerging Markets Index rose to a seven-month high in late April but pared most of its gains over the rest of the quarter as talks between Greece and its creditors failed to produce an agreement on its debt. The index tumbled on June 29 after negotiations broke down and Greece shut down its banks, raising fears of a disorderly exit from the euro. Greece's imposition of capital controls coincided with a one-day plunge in Chinese stock markets in Shanghai and Shenzhen that, after several days of losses, pushed China's benchmark index into a bear market—a drop of more than 20%. Six of 10 sectors in the MSCI Emerging Markets Index rose, three declined, and the utilities sector ended almost flat. Energy stocks performed the best, while health care stocks fell the most.

By region, emerging markets stocks in Latin America and the Europe, Middle East, and Africa region recorded solid gains, while Asian emerging markets posted a modest loss. In a sign of market bottoming, Brazilian stocks advanced despite data showing the economy is falling into a recession this year and news of a widening bribery scandal involving

International Markets Still Deliver Despite Fears of a Grexit



EM Ekes Out a Gain Even As Chinese Mainland Shares Collapse



Petrobras, the state oil producer. Meanwhile, Mexican stocks rose slightly as Mexico's central bank kept its benchmark interest rate at a record low after the government cut its full-year GDP growth forecast during the quarter. Andean markets were mixed; stocks rose in Colombia and Peru but retreated in Chile. Central banks in all three countries kept their respective interest rates unchanged over the quarter as they grappled with commodity weakness, rising inflation, and sagging currencies against the U.S. dollar.

Russian stocks added almost 8% on increased risk appetite. Russia's central bank cut its key rate twice during the quarter, and officials deemed that the worst of the economic crisis due to Western sanctions and slumping oil prices is over. But in June, the European Union extended sanctions on Russia until January, and most analysts think the country will be in a recession into 2016. Turkish stocks strengthened despite greater political uncertainty after the ruling AK Party lost its majority in parliamentary elections in June. The majority loss means that the AKP must form a coalition government and raises the possibility of another election if a new government cannot be formed. The lira sank to a record low against the dollar and the domestic benchmark plunged the day after the elections. Turning to South Africa, stocks declined as unemployment rose to a 10-year high even as South Africa's central bank prepares to raise interest rates to stem rising inflation due to currency weakness and rising electricity prices.

Within Asia, the white-hot Chinese market got doused with cold water at the end of the second quarter, when China's restricted A-shares market fell about 20% in two weeks after rising more than 100% in the past twelve months. The correction was sparked by a move by regulators to clamp down on margin financing, a favorite tool of retail investors in these mainland stock markets. As the downslide in prices accelerated, China's central bank unexpectedly reduced its benchmark interest rates and the required level of reserves for certain banks on June 27, a move that was seen as a sign that the government wants to support the market without fueling more speculative trading. At press time, volatility in the Chinese markets continues, but Beijing leaders have taken further steps to stem the declines by suspending IPOs, halting trading in some names, encouraging long-term purchases by sovereign wealth funds and "private" brokerages, and displays of supportive rhetoric.

While it is difficult to draw a line under this volatility in the near term, we still see merits in selectively investing China for the long term, based on key investment themes such as middle-class consumerism, the One Belt, One Road infrastructure initiative and the policy drive for environment protection and renewable energy. In addition, the real estate market is stabilizing after an 18-month correction, which is good news for developers. Despite the recent volatility, we still believe Chinese onshore equities are on track for inclusion in global emerging market benchmarks (MSCI in particular) in the next few years, which would stimulate international capital flows.

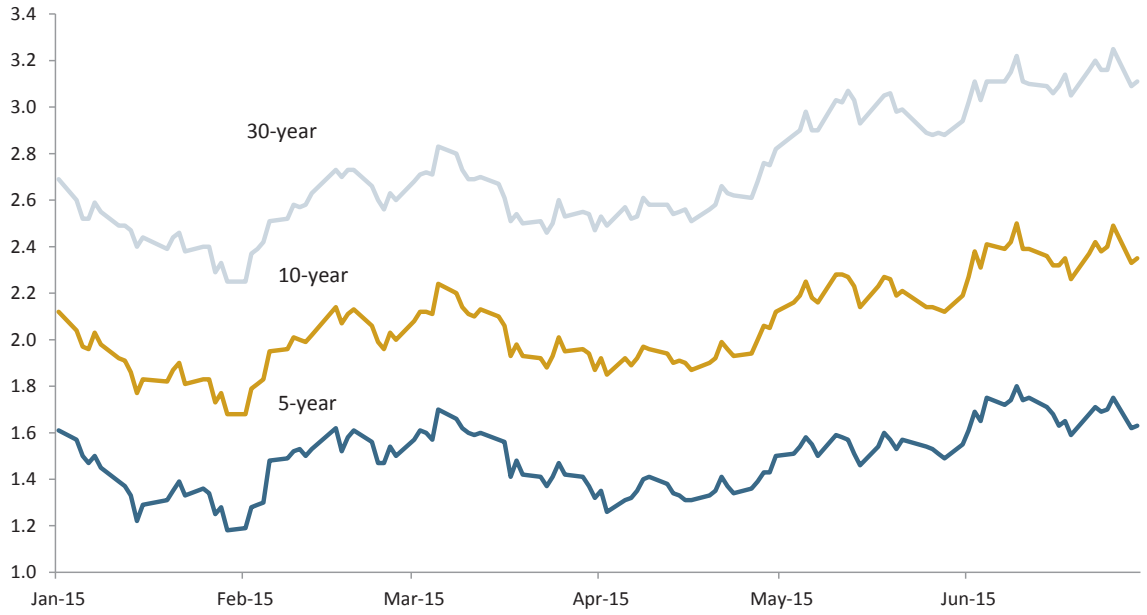
For their part, Indian stocks also declined in the second quarter as some investors opted to lock in profits after the Sensex benchmark rose to a record in January. India's central bank cut its key rate in June for the third time this year, days after the government reported that GDP grew at a better-than-expected 7.5% annual pace in the first quarter. In contrast, Southeast Asian markets were in decline as most countries in reported first-quarter GDP growth that missed forecasts. Indonesian stocks were hit particularly hard, losing roughly 14%, as economic growth slowed to a five-year low, raising expectations of a shake-up in the newly elected president's cabinet.

We are optimistic about the long-term outlook for emerging markets as we see solid fundamentals offsetting near-term risks. Rising consumption, an expanding middle class, and real wage growth are the drivers of huge economic potential in the developing world. Emerging markets are trading at a significant discount on an absolute and relative basis, making current valuations compelling for long-term investors. Most emerging markets have stronger financial positions, larger currency reserves, and more flexible foreign exchange policies than they did a decade ago. Finally, most emerging markets are still expanding faster than developed ones and offer solid growth opportunities for long-term investors.

Fed liftoff fears create losses in most fixed income markets

U.S. Treasuries posted their first quarterly loss since 2013 as fears of an imminent Federal Reserve rate increase outweighed

Bond Yields Rise In Front of the Fed



demand for safe-haven assets as Greece moved toward default. The yield on the 10-year Treasury note increased from under 1.85% in early April to nearly 2.50%—the highest level in 2015—in June before falling in 2.30% by the end of the quarter on a flight-to-quality thanks to Greece. The Treasury yield curve steepened as longer-term yields climbed more than shorter-term rates, with the 30-year Treasury's yield increasing more than 50 basis points.

Investment-grade corporate bonds underperformed Treasuries to post considerable losses as credit spreads widened. Heavy issuance continued to weigh on the investment-grade corporate bond market, with the supply of new bonds largely driven by merger and acquisition funding needs. In April, AT&T sold $17.5 billion of bonds—the third-largest corporate bond issue on record—to help fund its acquisition of DirecTV. Late in the quarter, food giant H.J. Heinz issued $10 billion of bonds to finance its previously announced merger with Kraft Foods.

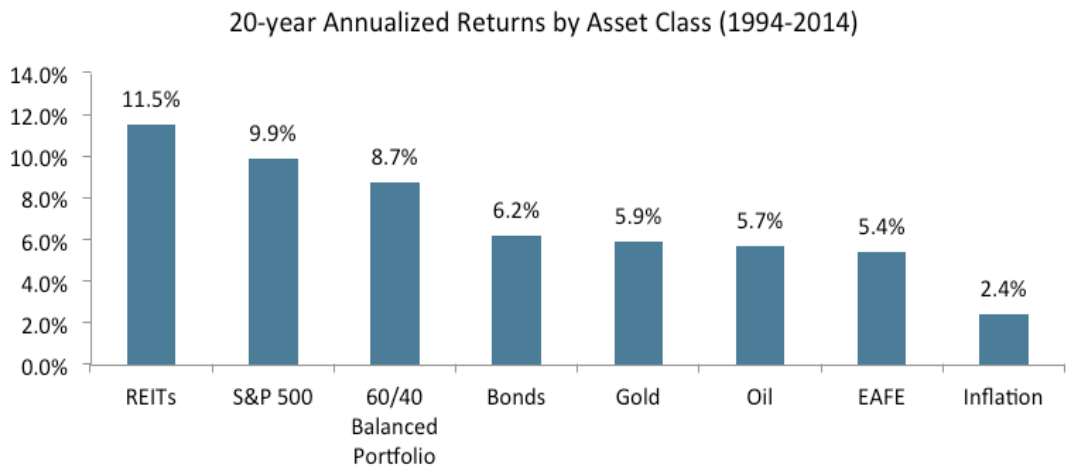
In contrast, bank loans and high yield corporate bonds were among the few fixed income sectors that avoided posting losses for the quarter, benefited from their relatively low sensitivity to interest rate changes. Oil prices steadied at higher levels than at the beginning of the year, providing support for the asset class. Bonds from oil-related issuers account for a large proportion of most high yield indexes.

Tax-free municipal bonds moved lower in the second quarter but broadly held up better than investment grade taxable bonds. Late in the quarter, bonds issued by the commonwealth of Puerto Rico, a major muni issuer, fell sharply after the highly indebted U.S. territory's governor announced that it will not be able to repay its debt obligations.

Prices of mortgage-backed securities declined less than Treasuries as light volumes of new mortgage origination and securitization provided support. Asset-backed securities produced slightly positive returns as the market easily absorbed an uptick in new supply. Although they are also generally less sensitive to changes in Treasury yields than debt with lower credit risk, emerging markets bonds declined nevertheless, with locally denominated debt prices falling more than dollar-denominated bonds. Likewise volatile were non-U.S. sovereigns, including and especially debt issued by Germany. Early in the quarter, the European Central Bank's quantitative easing program helped support the prices of high-quality eurozone sovereign debt, as did worries about Greece's ability to meet its debt obligations. The 10-year German government note's yield reached an all-time low of 0.05% in April before a rapid sell-off later in the quarter drove it above 1.00%. However, prices of Germany's sovereign debt gained toward the end of the quarter as the impasse between Greece and its creditors continued.

The monetary policies of the world's major central banks will continue to dominate the global interest rate environment. While the central banks of the eurozone and Japan aggressively purchase assets in an effort to stimulate economic growth, the Fed's move toward tightening monetary policy should eventually create an upward bias for U.S. interest rates. This divergence in central bank policies, along with the uncertainty inherent in the Greece situation, could

Diversification Provides for Strong Risk-Adjusted Returns Over Time



lead to increased volatility in global fixed income markets as well as more relative value opportunities.

Within alternatives, commodities have a turnaround

Commodities came up big in the second quarter, with the exception of metals, as prices bounced off the bottom after months of declines. The best performing sector in the quarter was energy, which soared by 13.8%. The biggest winner in energy was NYMEX crude oil, which posted gains of 25%. Brent crude and gasoline were both up more than 15%, heating oil was up almost 11%, and natural gas added 7%. Coming in second place was grains, which appreciated by 8.3%, thanks to big increases in wheat, corn, and soybeans. Soft commodity prices were also higher, thanks to a 21% surge in the price of cocoa as supply worries over West African output added to bullish sentiment caused by a continuation of rising demand for chocolate confectionery products in Asia.

Looking ahead, while cheap valuations may drive prices higher, we are cautious about the potential for volatility in the asset class given the prospects for an interest rate rise and likely increase in the dollar, which has tended to depress commodity prices.

For their part, REITs experienced significant struggles in Q2, snapping a long stretch of double-digit returns as fears of rising interest rates and concerns over valuations weighed on the asset class. While we expect jitters over interest rates to continue, the fundamentals for the asset class remain solid. Indeed, vacancies are improving across the board in different property sectors, while new supply remains in check. We believe global real estate offers some interesting prospects, as the category is less sensitive to U.S. interest rates and offers more attractive valuations relative to U.S. REITs.

Within hedged strategies, returns were mixed, with global/macro strategies falling down after a period of strength in 2014. In contrast, event driven funds were supported by increased merger and acquisition activity, while equity long-short strategies outperformed as managers used fundamental stock selection and the ability to short to their advantage. Among the categories of hedged strategies, we favor using flexible, tactical strategies as a substitute for some of our fixed income exposure, as these types of investments benefit from sophisticated, non-directional and low-beta exposure to markets mired in uncertainty and fears over rising U.S. interest rates.

To be sure, 2015 has been a year when global diversification has been appreciated more than in the past, though unfolding events in Greece and China remind us that all investing entails risks and being patient. We believe the balance of 2015 may require some fortitude as market volatility increases, not just because of macroeconomic events and diverging central bank policy, but because valuations are higher. Yet we still see opportunity for solid returns for the diversified investor, and embrace the opportunity to be your guide in navigating the markets to find them.

Source of all chart and graph data: Bloomberg.