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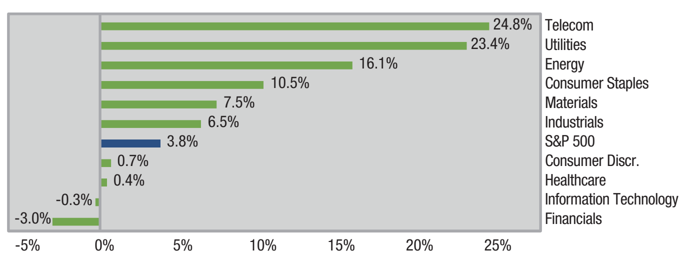
During the quarter, equity markets experienced volatility but ended at a slightly higher level. The United Kingdom's unexpected vote to leave the European Union (Brexit) drove most of the volatility, although the long-term effects of this decision are unclear for now. Continued aggressive monetary policy on the part of foreign central banks has driven $11.7 trillion of global debt into negative-yield territory. Expectations for the Federal Reserve's next interest rate increase have been pushed into 2018. Global investors' focus on yield has driven returns this year. The U.S. economy continues to expand at a slower pace than last year, but stabilization in the industrial segment of the economy may improve this outlook. Housing remains a bright spot. Low interest rates and healthy employment statistics should support further improvement and, by extension, greater consumer spending. Volatility is likely to stay elevated as investors closely watch Brexit, China, the Fed, the U.S. presidential election cycle, and commodity prices. For now, we position portfolios for modest economic growth.

The S&P 500 Index gained 2.5% on a total return basis for the quarter. Energy led the way and has been a leader for the year. The higher-dividend-yielding and defensive Telecom, Utilities, and Consumer Staples sectors are all up double digits for the year. The interest-rate-sensitive Financials sector continues to struggle.

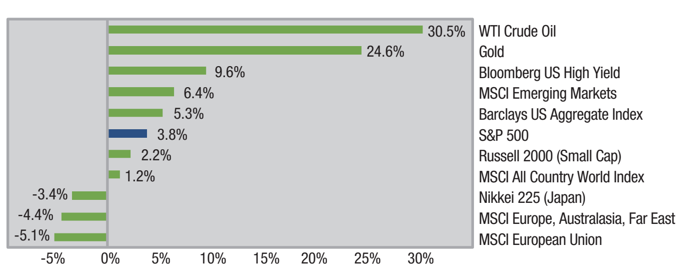
Figure 1: 2Q16 Performance by Sector



Source: Bloomberg. Data as of 06/30/2016.

From a global perspective, the S&P 500 outperformed most other developed markets this quarter and for the year. The Japanese Nikkei is down 3.4% for the year, and the MSCI European Union Index fell 5.1%. Gold continues to be viewed as a safe haven and was one of the best-performing categories.

Figure 2: 2Q16 Performance by Category



Source: Bloomberg. Data as of 06/30/2016. All returns in U.S. dollars.

The U.S. Remains a Bright Spot

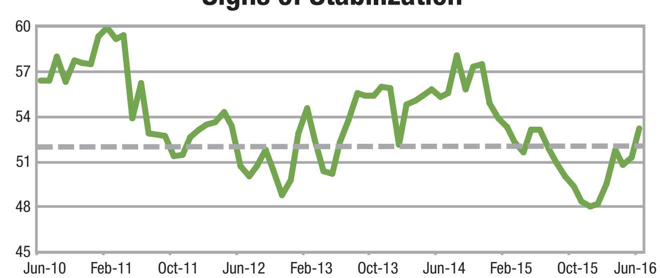
The U.S. economy, as defined by Gross Domestic Product (GDP), continues to expand. Forecasts for annualized growth have been reduced to 1.7% for the next two quarters—down from 2.7% at this time last year—but the fear of a recession that we saw earlier in the year has subsided. Residential investment and consumer spending are key drivers.

Fundamentals for housing are still favorable. Home prices are rising at a 5% annual rate, a pace that has held since the start of 2015. After several years of job growth, household formations are increasing, and this trend is driving construction of new single-family homes. Nonetheless, U.S. housing starts still look depressed compared to long-term averages. The combination of moderately increasing home prices, low mortgage rates, and rising incomes should help support current trends.

Retail sales, excluding gasoline, are expected to grow about 4% this year. Nine out of 13 sales categories tracked by the U.S. Census Bureau posted gains in May. Unemployment fell to an eight-year low of 4.7% in May, although non-farm payrolls failed to meet consensus estimates. This situation is something to watch over the next few months, as the economy is running near "full employment." Wage growth, at 2.5% year-on-year, continues to increase at a faster rate than inflation. The Conference Board Consumer Confidence Index improved to 98.0 in June, well above the consensus of 93.1 and the highest level since last September.

After a prolonged period of weakness in the industrial part of the economy, we are now seeing some signs of stabilization. Capital spending has been depressed due to lower oil prices and the impact on exports of the stronger dollar. The ISM Manufacturing Index—which monitors employment, production inventories, new orders, and supply deliveries—has now been above 50, signaling growth, for the last four months (see Figure 3). It is still early, but if oil prices and the U.S. dollar continue to stabilize, we will look for further improvement in this index.

Figure 3: U.S. Industrial Segment Showing Signs of Stabilization



Source: Bloomberg. Data as of 06/30/2016.

Another Wave of Volatility

In a dramatic move on June 23, the United Kingdom voted to leave the European Union (EU)—a decision commonly known as Brexit. The investment community was clearly surprised at the outcome of the referendum, and global markets declined by $3 trillion over the next few days. The British pound fell to a 30-year low versus the dollar.

The long-term implications of Brexit are unclear. No country has ever left the EU before. The rules provide a two-year window for the EU to determine how to treat commerce after the exit. Trade relations with the rest of the EU must be renegotiated; this process will take some time, but it will not begin until formal notification by the U.K.'s new prime minister, sometime after the summer. Some analysts predict a very positive outcome for the U.K., while others warn of dire consequences for the U.K. and the beginning of the end for the EU and the euro. Given the level of uncertainty, growth is likely to be weaker in the U.K. and Europe in the near term.

Since May 2015, we have had four significant corrections in the S&P 500. At this point, it is hard to tell whether Brexit will drive a fifth one. The U.K. is the fifth-largest economy in the world, but American trade with the U.K. makes up less than 1% of U.S. economic activity. Weaker growth in Europe could have an effect on the U.S. economy. A stronger U.S. dollar versus the euro could also have an effect. Similar to what we saw in 2015, currency translation from a strong U.S. dollar negatively impacted earnings for large multinational companies and led to minimal growth in earnings for the S&P 500 as a whole. In addition, a negative political environment overseas could affect the election cycle in the U.S. if the demand for deglobalization continues to spread.

In recent corrections, concerns about China have played a role. The trajectory of China's economic expansion remains in question, although the country has shown signs of improvement in the last few months. If the U.S. dollar strengthens, China may look to depreciate its currency again, and such a move could rekindle many of the worries we saw last summer and earlier this year.

The Federal Reserve Staying on Hold

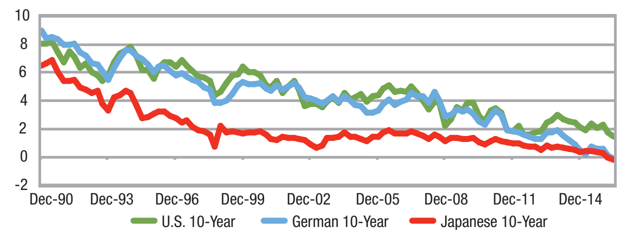
After numerous false starts in 2015, the Fed raised the federal funds rate to 0.25% in December and indicated that four more increases in 2016 would bring the rate to a level of 1.375% by year-end. Since then, the March and June meetings have come and gone with no increases. With unemployment low and wage inflation picking up, the Fed would like to see higher interest rates, but factors overseas have kept those increases on hold.

Outside of the U.S., growth continues to be anemic. The International Monetary Fund cut its global growth forecast for the fourth time in the past year, citing China's slowdown, persistently low oil prices, and chronic weakness in advanced economies. To combat these forces, the European Central Bank and the Bank of Japan have expanded the use of negative interest rates, which means they are actually charging depositors to hold their money.

During the second quarter, we saw negative rates extend all the way out to bonds with 10-year maturities in Germany, following levels already seen in Japan (see Figure 4). According to Morgan Stanley's economics team, the first Japanese government bond with a positive yield will mature in 2034. In safe havens such as Switzerland, there are only two bonds with positive yields, maturing in 2048 and 2064.

If the Fed increased interest rates against this backdrop, the dollar would likely strengthen considerably, and this result could have a negative effect on growth, as was the case in 2015. The chances of an increase in July were 10% before Brexit, but sentiment has reversed, and traders are now pricing in a greater probability that the Federal Reserve will cut rates in upcoming meetings rather than raise them. Traders assign less than a 50% chance of an increase until the beginning of 2018.

Figure 4: Global Bond Yields Continue to Decline



Source: Bloomberg. Data as of 06/30/2016.

Course of Action

We continue to have significant exposure in the Technology and Consumer Discretionary sectors, which offer attractive earnings growth relative to other sectors. We still have meaningful exposure to Health Care, although we did decrease exposure during the quarter, primarily in pharmaceuticals. We increased exposure to the Energy and Industrials sectors, which are showing signs of stabilization.

Overall, the best-performing stocks in the S&P 500 this year have higher-than-average dividend yields. This trend is reflected in the strength of the Utility, Telecommunications, and Consumer Staples sectors. These sectors make up only 15% of the index but represent over 60% of the performance this year. Given the decrease in interest rates, we understand the level of investment in these names, but our focus remains on top-line revenue growth as an important driver of cash flow and earnings. For comparison purposes, the Nasdaq Composite—where the growth-focused Technology, Consumer, and Health Care sectors make up 75% of the index—is down 2.6% for the year, while the S&P 500 has seen a 3.8% increase.

Since the financial crisis, banks have been required to hold significant capital to cushion against losses from a recession or market shock. All but one of the nation's largest banks earned an unconditional passing grade from federal regulators on their annual stress tests, which measure their preparedness for a financial crisis. While tougher rules may be helping to stabilize the banks, they are hampering profitability. The stock prices of many large banks have languished as investors question whether these companies can meaningfully increase their earnings in such a stringent new regulatory environment. As a result, we have pared back on exposure to the banks.

We expect volatility to remain elevated in 2016, and we continue to focus on high-quality, large, domestic companies with strong balance sheets. Brexit has now been added to the list of concerns, which includes central banks moving in different directions, an aging economic recovery in the U.S., a slowdown in China, and a U.S. presidential election cycle.

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