Strategy Newsletter
3rd Quarter 2016

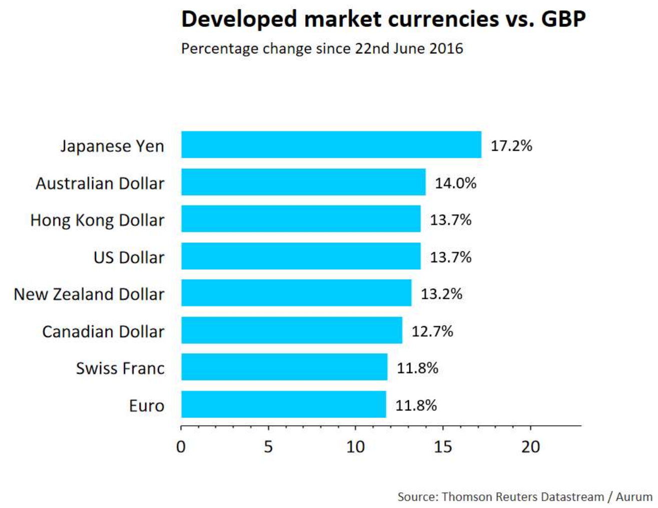
- The Brexit vote stole headlines during the quarter, what does it mean for investors?
- U.S. markets set the pace while earnings pointed higher for emerging markets.
- Negative interest rates around the globe act like a magnet to U.S. bond yields.
- Alternatives with yield exposure did well during the quarter, but some have lofty values.

Economy

The U.K. held a referendum in which its citizens voted to leave the European Union. This was big news across global financial markets. Stocks dropped and then rallied to finish the last week of the quarter.

It is unknown at this point if the U.K. will actually leave or renegotiate terms with the EU. It sets the stage for greater debate about the other 28 countries departing the EU. It also questions the viability of the Euro as a currency.

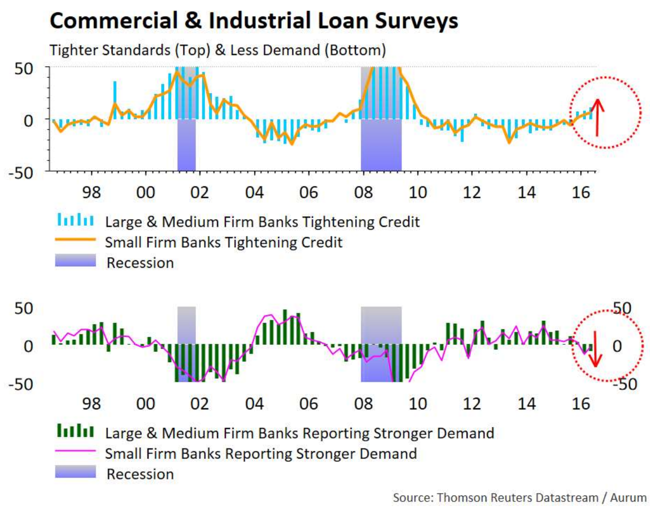
The silver lining for the U.K. is that it never gave up monetary sovereignty. That is, it did not ditch the pound and adopt the Euro in 1999 – which would make this a more problematic situation. This allows its Great British Pound (GBP) to fall against other currencies, increasing exports.



The effects of the referendum vote are likely worse for mainland Europe than the U.K. Since Europe is a net exporter to the U.K., it is more dependent on demand from the British. It is also a negative for Asia. The referendum does not affect the U.S. economy much.

On a secular basis, the U.S. has a great demographic trend compared to Europe and most of Asia. On a cyclical basis, the U.S. continues to print decent economic data. Employment data is still chugging along and wage growth is at its highest rate in seven years. Retail sales also continue to impress, especially restaurant data.

There are a few items of concern. A less constructive lending environment is one of them. The chart below shows surveys of banks with data going back 20 years.



The top bar graphs show tightening credit standards at large and small banks alike. In turn, there is also softening demand for credit. This happens in the latter stages of economic expansions and is one to keep an eye on.

Equity

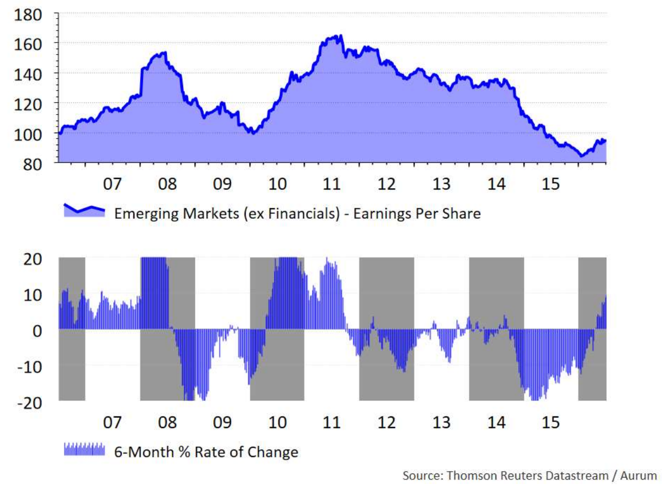
Even with the Brexit vote, the U.K. equity market fell only 0.7% during the quarter while Europe (excluding the U.K.) lost 3%. Both were behind the U.S. and emerging market stocks.

US Equity	2Q 2016
Large Cap Stock	
Dow Jones Industrial Average	2.07%
S&P 500	2.46%
Small & Mid Cap Stock	
Russell Mid Cap	3.18%
Russell 2000	3.79%
Style Indices	
Russell 3000 Value	4.57%
Russell 3000 Growth	0.80%
International Equity	**2Q 2016**
MSCI EAFE	-1.19%
MSCI EAFE Value	-2.44%
MSCI EAFE Growth	0.05%
MSCI Europe	-2.29%
MSCI Japan	1.03%
MSCI Emerging Markets	0.80%

The chase for yield by investors pushed up more defensive sectors such as utilities, telecom, and consumer staples. Financials were punished with interest rates falling and technology also lagged. Energy continued its rise from the first quarter as commodities cooperated with higher prices.

Many investors are asking if now is the time to go bargain hunting in Europe. The continent is cheaper than it was two years ago. Compared to the last 20 years, Europe's valuation discount to the U.S. and emerging markets is close to the average. Despite this, U.S. investors poured money into the international blend category of mutual funds and ETFs. This category has about 60% of assets held in Europe. In the twelve months ending in May, it was the top category with $110 billion in net new inflows.

We maintain conviction that emerging markets are coming out of a trough in earnings. Currencies stopped depreciating against the U.S. dollar and stabilized the last few quarters. The following chart shows the earnings per share (excluding financials) for emerging markets. Earnings bottomed at the start of 2016. This coincided with the trough in many commodities as well. Since many emerging markets are net exporters of oil, this is not a surprise.



The bottom graph shows the six-month rate of change. It is at the fastest pace of growth since mid-2011. Emerging markets already had cheap values and now have better earnings. The outperformance of emerging versus developed markets has tailwinds.

Within equities, we maintain an underweight to developed markets in favor of emerging markets.

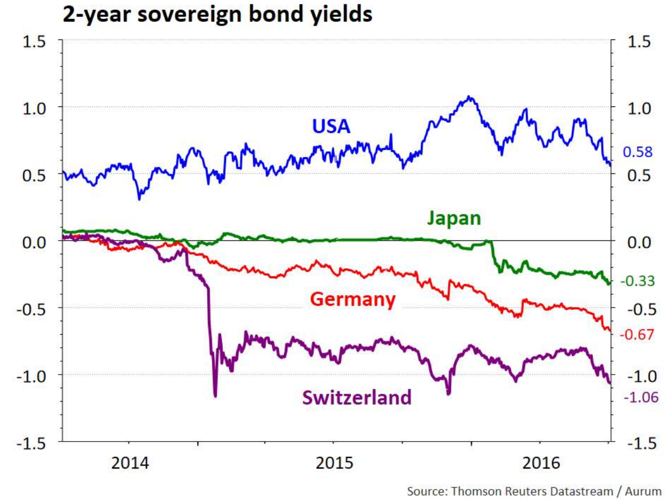
Fixed Income

The 10-year Treasury is down from starting the year at 2.27% and ended the second quarter at 1.49%. Credit spreads tightened during the quarter, even with some weakness the last two weeks. This boosted returns of high yield and structured credit assets.

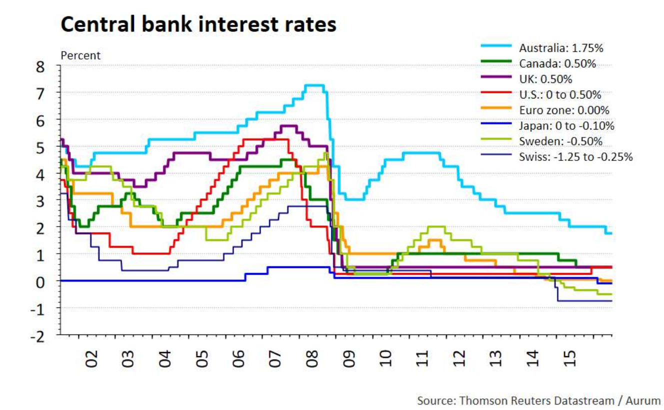
Fixed Income	2Q 2016
Barclays U.S. Aggregate Bond	2.21%
Barclays Corporate Inv. Grade	3.57%
Barclays High Yield Bond	5.52%
Barclays Global ex. U.S. Tres.	4.78%
Barclays Municipal Bond	2.61%

The next chart is of 2-year government bond yields. It includes the U.S.A., Japan, Germany, and

Switzerland. Note that for almost two years, the European countries traded below zero percent.



Except for the U.S., these countries are essentially being paid to borrow. You know the phrase, you have to spend money to make money? It applies here. The private sector has too much debt. Banks have high capital requirements and greater regulation. That leaves no one to spend except countries. Bond markets are saying there is no worry about inflation when the yields are negative. Many investors believe the sharp rise in government bond prices is due to scarcity of safe bonds. Quantitative easing programs purchased several trillion dollars worth and took them out of circulation. There is $13 trillion worth of negative yielding debt now, according to Bank of America. The lack of understanding of the situation by politicians and economists within the EU and Japan is astounding.



The chart at the bottom left is the policy rate for central banks around the world. It is the same as the fed funds rate that the Fed sets in the U.S.

Every single country that raised interest rates since 2008 began lowering shortly thereafter.   The hiking cycle in the U.S. is just seven months old now. There was only one move higher in the fed funds rate, the least number of moves ever at this point. The Fed is stuck in a difficult position given that inflation is starting to trend higher.   Yet it does not want to raise interest rates higher because this pushes the value of the U.S. dollar higher. This hurts exports and economies around the world.

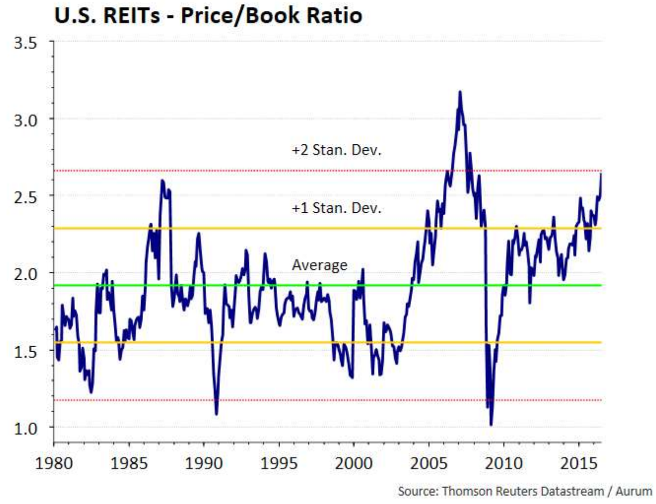
The Aurum Asset Allocation Frameworks maintain fixed income allocations at the strategic targets. We continue to prefer cash flowing structured credit assets.   These are backed by real assets such as residential houses, aircrafts, and railcars. These bonds typically are investment grade, have a modest interest rate risk, and acceptable yields.

Alternative Investments

With the fall in yields, TIPS again performed well. Hedge funds disappointed given the risk rally. Managed futures were a bright spot, profitably trading the uptrend in commodities and bonds.

Alternative Assets	2Q 2016
HFRI Fund of Funds Index	0.66%
Dow Jones Global Select REIT	4.02%
Barclays U.S. TIPS	1.71%

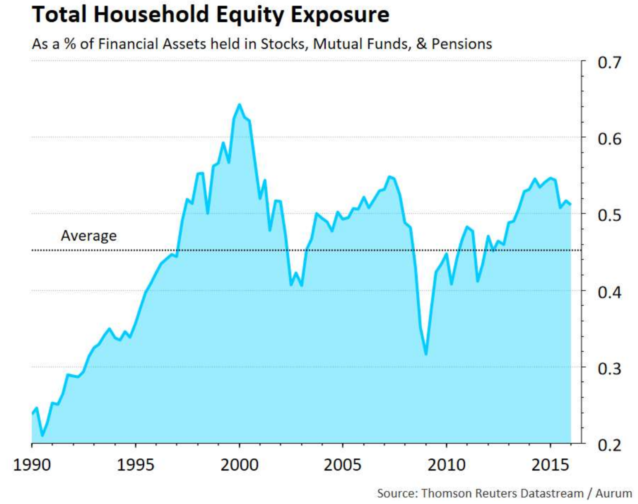
Thanks to low interest rates and a chase for yield, REITs continued ascending higher. There are many metrics to value REITs. Some prefer relative metrics like spreads versus Treasuries or BBB-corporate bonds. Many analysts prefer making adjustments to the net asset values. We keep it simple and look at it on a price to book basis since we have data that goes back to 1980. On this metric, REITs are as overvalued as they were ten years ago and 38% above the historical average.



We maintain a slight underweight to the alternative asset class broadly. Alternative strategies are essentially in line with the strategic targets. REITs and TIPS are excluded from the tactical weights.

Conclusion

Equities make up 51% of financial assets for households. This is across direct stock holdings, mutual funds, and pensions. It is near the average of the last twenty years and down from the recent high of 55% in 2015. It has the potential to move higher based either on net flows or asset valuations pushing up.



The other side of the coin is that the 51% held in equities is much higher than average compared to the last 28 years. Stocks as a percent of financial assets were lower in the early 1990s and the two bear markets in the 2000's. As we mentioned last quarter, election years tend to be choppy leading up to November. With the uncertainty today and political environment globally, this expectation seems appropriate again.

Aurum Asset Allocation Frameworks

	Income		Conservative		Moderate		Growth		Aggressive	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	21%	35%	37%	50%	52%	70%	74%
U.S. Equity	0%	0%	12%	10%	20%	17%	30%	25%	42%	38%
Int'l - Develop. Markets	0%	0%	6%	5%	12%	11%	16%	15%	21%	20%
Int'l - Emerg. Markets	0%	0%	2%	6%	3%	9%	4%	12%	7%	16%
Fixed Income	65%	63%	45%	42%	30%	30%	17%	19%	10%	10%
U.S. Fixed Income	56%	62%	39%	41%	26%	29%	15%	18%	7%	9%
Global Fixed Income	9%	1%	6%	1%	4%	1%	2%	1%	3%	1%
Alternative Invest.	25%	23%	28%	23%	30%	23%	30%	23%	19%	15%
Diversified Strategies	19%	23%	22%	23%	24%	23%	24%	23%	15%	15%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	14%	7%	14%	5%	10%	3%	6%	1%	1%
U.S. Dollar	10%	14%	7%	14%	5%	10%	3%	6%	1%	1%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

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