Q3 2016 Outlook & Review

A QUARTERLY MARKET PERSPECTIVE FROM QMA'S ASSET ALLOCATION GROUP

KEY POINTS

Economic Outlook

The June 23 Brexit vote in the UK delivered a shock to capital markets and increased downside risks to the global economy. While this may cause a UK recession, it is unlikely to result in a global downturn.

The longer-run political consequences of Brexit could be significant if the UK vote fuels support for referendums on EU membership in France, Italy, and the Netherlands.

The Eurozone economy will likely suffer some economic contagion, but should avoid recession given the reasonable momentum it had before the referendum.

The full economic impact of Brexit will depend on the type of settlement that is reached between Britain and the European Union, and this will not be known for some time. A two-year negotiation period will begin when Britain officially requests to leave the EU.

The United States should be well-insulated from the economic impact of Brexit, but some slowing could occur if the US dollar were to appreciate measurably.

Central banks are likely to maintain or ease monetary policy in order to mitigate the impact of Brexit. The severity of the economic fallout will depend on the strength of the policy response.

Brexit and the rise of populist politics around the world stems from a sustained period of low growth, stagnant real median incomes, increased inequality, and the end of the debt supercycle.

Political efforts to address these problems by boosting median incomes may be beneficial for workers, but should be a headwind for investors.

Investment Outlook

Prior to the Brexit shock, we had been pursuing a cautious investment strategy with benchmark-like exposures across the major asset classes: stocks, bonds, commodities, real estate, and cash.

The higher economic and political risk stemming from Brexit has reinforced our cautious stance.

Longer term, we believe we are in a lower-return environment, and we expect no better than mid single-digit returns for US equities over the next few years. Bond yields in the US are at record lows but look attractive relative to other major bond markets, and Brexit-related risks support a "lower for longer" view on interest rates.

We think fixed-income risk assets are the place to find the best risk-adjusted returns, especially high yield. Hard-currency emerging market sovereign debt is attractive as well.

Our preference for income-oriented asset classes extends to preferred shares, which exhibit yields in the 5-6% range with the potential to rival common shares in terms of expected total returns, but with lower volatility. MLPs are also attractive now that energy prices have stabilized.

China's structural slowdown continued during the quarter, but signs that growth could be perking up caused commodity prices to sharply rebound from very depressed levels. We believe this is a bounce worth playing.

We are also monitoring the direction of corporate earnings as a critical variable to determine whether to adopt a more constructive stance on equities. Earnings growth appears to have troughed in Q1 with the expectation for marginal improvements in Q2, turning positive as we move into the second half of the year.

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Economic Outlook

The global economy was stuck in slow-growth mode even before the UK populace surprised the world and voted to exit the European Union (EU). The result is a macro shock that has increased global downside risks. However, we do not believe this is a "Lehman moment" that will push the global economy into a full-blown recession. The hit to consumer and business confidence in the United Kingdom may push that economy into recession, but a more competitive exchange rate and additional policy support should cushion the blow (Chart 1). The Eurozone economy will suffer some contagion, but should avoid recession given the reasonable momentum it had before the referendum. However, the impact will differ for individual countries, depending on their exposure to the UK (Chart 2).

The full economic impact of Brexit will depend on the type of settlement that is reached between Britain and the European Union, and this will not be known for some time. In fact, the Brexit decision itself is far from final. Britain could remain in the EU. For example, UK voters could decide exit would be too painful once the details of a deal emerge. (Signs of voter remorse were evident anecdotally in the days after the referendum). This would require another referendum, however, which is not currently under consideration.

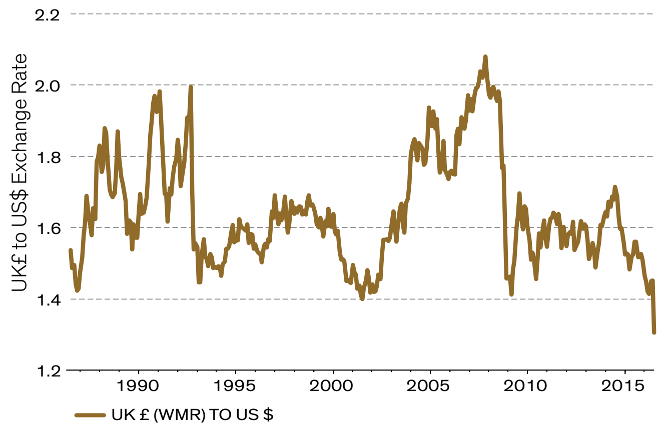
At a minimum, confusion will reign over the next three to six months since politics in the United Kingdom are uncertain. The longer-run political consequences could be far more significant if the UK vote fuels support for referendums on EU membership in France, Italy, and the Netherlands. On the other hand, if the EU holds together, pressure to enact EU reforms could ease, causing reform efforts to stall, including those which may be necessary to maintain the common currency zone.

The further one moves from Britain, the less the impact of the Brexit vote. The United States and emerging markets should be comparatively well-insulated, as exports to the UK are relatively limited. Prior to the referendum, we expected US growth to hover around 2%, in line with its average since the financial crisis. That said, the impact of Brexit could drag it below that level, especially if the US dollar were to appreciate measurably from here.

In addition, Brexit could negatively affect the global economy through tighter financial conditions, though we expect that policymakers will lean against this. The Bank of England will likely cut rates and could restart quantitative easing if conditions require it. We expect more easing from the Bank of Japan and the European Central Bank, and rate hikes by the Federal Reserve may be off the table for the rest of the year. The strength of the policy response in addressing any tightening in financial conditions will be the key to the severity of the economic fallout.

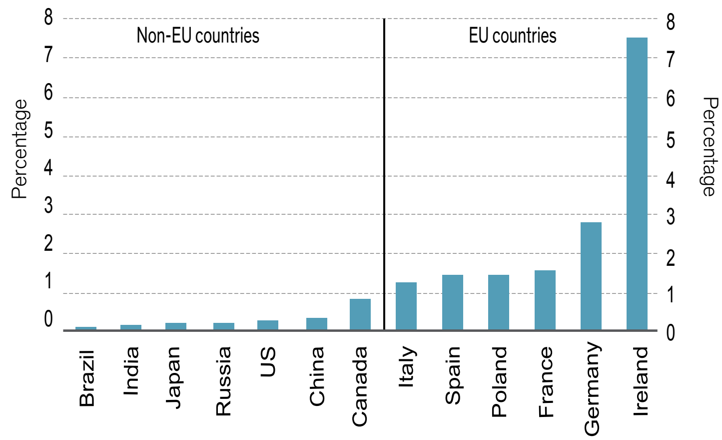
Brexit and the rise of populist politics around the world is the consequence of a sustained period of low growth, stagnant real median incomes, increased inequality, and the end of the debt supercycle. We see this fueling a shift to the left among voters in some major countries. Regardless of the outcome of the US presidential election in November, we expect to see greater public pressure for more regulation and government economic involvement. We also expect a greater push against globalization and against cuts to entitlement spending. Political efforts to respond to populist pressures by boosting median incomes could benefit economic performance on the margin; lower-income households have higher marginal propensities to consume, and a major problem facing the global economy is a lack of aggregate demand. But this is likely to further pressure the rebalancing of national income in favor of labor compensation at a time when corporate profits are already struggling (Chart 3). What is good for workers, may be a headwind for investors.

BREXIT SPARKS PLUNGE IN POUND
1 / UK POUND STERLING vs US DOLLAR
Breaching 30 Year Lows



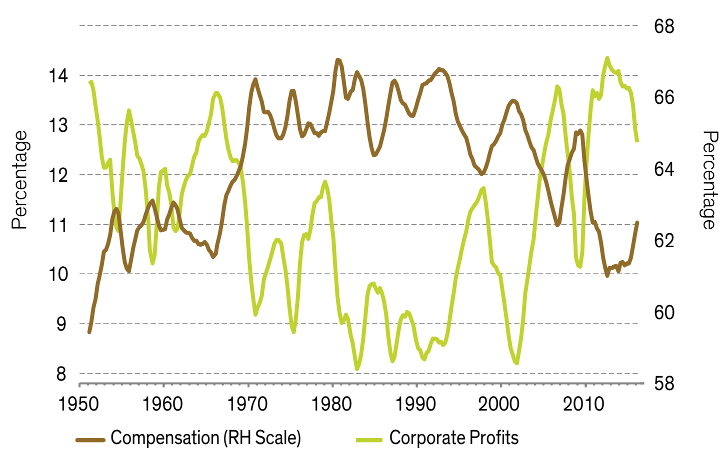
As of 7/5/2016.
Source: Thomson Reuters Datastream, QMA.

IMPACT FROM BREXIT WILL VARY
2 / MERCHANDISE EXPORTS TO THE UK
(2014, % of GDP)



As of 12/31/2014.
Source: Capital Economics.

THE RETURN OF WORKERS OVER CAPITAL
3 / SELECTED COMPONENT SHARES OF NATIONAL INCOME Percent of National Income (Smoothed)



As of 3/31/2016.
Source: Thomson Reuters Datastream, QMA .

Investment Outlook

Gold has been the big winner so far in 2016, as negative interest rates on government bonds have become more widespread and investors pondered increased geopolitical risks and Brexit, in particular (Chart 4). China's structural slowdown continued during the quarter, but signs that growth could be perking up on the margin in response to policy measures caused commodity prices to sharply rebound from depressed levels. Disappointing economic growth and expectations of more dovishness from central banks drove surprisingly strong returns on long-term government bonds. In contrast, global equity markets continued their lackluster performance in the context of declines in corporate profits (Chart 5).

Prior to the Brexit shock, we had been pursuing a cautious investment strategy with benchmark-like exposures across the major asset classes: stocks, bonds, commodities, real estate, and cash. Anticipating that higher economic and political risks stemming from Brexit will drive heightened volatility across markets, we have become a bit more defensive on the margin. In general, we have been trimming equity exposure and holding more bonds and cash.

We are also watching the performance of corporate earnings as a critical variable in determining whether the US equity market outlook will improve. The consensus forecast for S&P 500 earnings implied an end to the profit recession in the second half of 2016, as the negative impact from low oil prices and a strong US dollar disappeared. But the Brexit shock could spark another rally in the dollar, which could hurt S&P profits. This would present another hurdle to corporate earnings in addition to the political headwinds discussed above.

Longer term, we believe we are in a lower-return environment, and we expect no better than mid single-digit returns for US equities over the next few years. Record-low government bond yields should lead to scant returns, so we still foresee a normal-sized risk premium for investing in stocks over bonds. Yet bond yields in the US look attractive relative to other major bond markets, and Brexit-related risks support a "lower for longer" view on interest rates. Therefore, we don't expect a big spike in rates anytime soon.

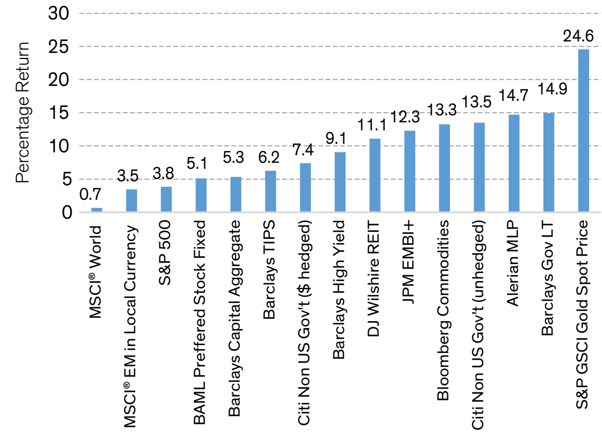
We think fixed-income risk assets are the place to find the best risk-adjusted returns. High-yield bonds have outperformed stocks this year by a substantial margin, and we believe this could continue. While there is no denying the broad deterioration in credit quality that has been fueled by debt issued to buy back equity, we still believe that high-yield spreads are at attractive levels, given expected default rates (Chart 6). We also look favorably on hard-currency emerging market sovereign debt, where we expect attractive yields, and solid momentum, despite challenging macro fundamentals among many countries in this space.

Preferred stocks also remain an attractive area. These instruments are essentially fixed-income securities that are lower in the capital structure. This asset class is dominated by financials (primarily banks and insurers), which we believe have healthy balance sheets and low risk regulated business models. In addition, preferred stocks exhibit yields in the 5-6% range with the potential to rival stocks in terms of expected total returns, but with lower volatility.

In oil markets, we expect prices to settle into a new range around current levels. Given strong productivity and efficiency gains among US shale producers, we believe long-term growth in North American oil and natural gas production can continue even in a "lower for longer" scenario for energy prices. Master Limited Partnerships (MLPs) should be solid long-term investments in this environment. We have been adding to MLPs in portfolios where we hold them, on the basis of cheap valuation, attractive yields, falling volatility, and stabilizing energy prices.

4 / FIRST HALF PERFORMANCE

YTD Index Returns as of 6/30/2016



As of 6/30/2016.

Source: Factset, QMA. An investment cannot be made in an index.
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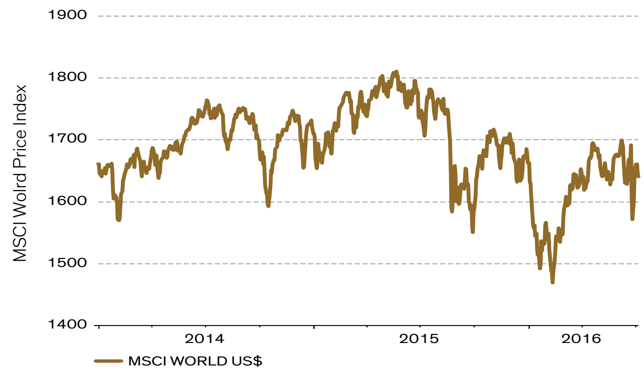
STOCKS ARE RANGE BOUND FOR 2 1/2 YEARS
5 / MSCI WORLD INDEX



As of 7/6/2016.

Source: Thomson Reuters Datastream, QMA. An investment cannot be made in an index. Past performance is not a guarantee or a reliable indicator of future results.

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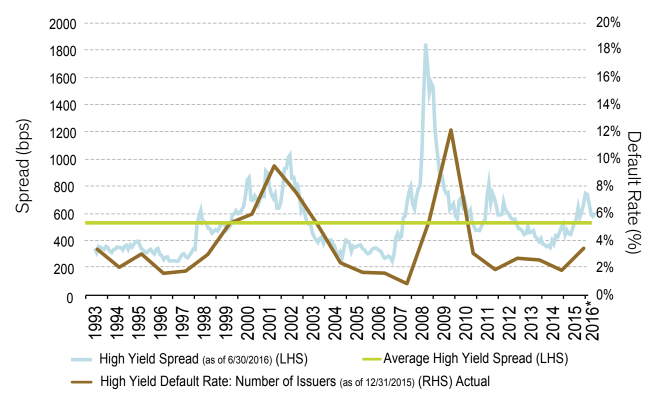
VALUE IS STILL ATTRACTIVE FOR HIGH YIELD BONDS
6 / HISTORICAL HIGH YIELD SPREADS AND DEFAULT RATES



As of 6/30/2016.

Source: Moody's, FactSet, QMA.

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*As of 3/31/2016.

Special Risks

Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic uncertainties. Emerging and developing market investments may be especially volatile. Investments in securities of growth companies may be especially volatile. Due to the recent global economic crisis that caused financial difficulties for many European Union countries, Eurozone investments may be subject to volatility and liquidity issues. Value investing involves the risk that undervalued securities may not appreciate as anticipated. Small and mid-sized company stock is typically more volatile than that of larger, more established businesses, as these stocks tend to be more sensitive to changes in earnings expectations and tend to have lower trading volumes than large-cap securities, creating potential for more erratic price movements. It may take a substantial period of time to realize a gain on an investment in a small or mid-sized company, if any gain is realized at all. Diversification does not guarantee profit or protect against loss.

Emerging markets are countries that are beginning to emerge with increased consumer potential driven by rapid industrial expansion and economic growth. Investing in emerging markets is very risky due to the additional political, economic and currency risks associated with these underdeveloped geographic areas. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio's income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.

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IMPORTANT INFORMATION

Source of Outlook: QMA, Thomson Reuters Datastream, Federal Reserve, Bloomberg, FactSet Research Systems.

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The Barclays US Aggregate Bond Index is composed of US investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities, and commercial mortgage-based securities. Source: Barclays. Barclays US TIPS Index includes all publicly issued, US Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value. Barclays Intermediate Government/Credit Index is comprised of US-dollar denominated fixed-income securities that are rated investment grade (BBB or higher by Standard and Poor's), including US government, corporate, and sovereign debt, which have 5-7 years to final maturity. The Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. The US Treasury Index is a component of the US Aggregate, US Universal, Global Aggregate and Global Treasury Indices. The US Treasury Index was launched on January 1, 1973. Source: Barclays. Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities.

Citi World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. Dow Jones Wilshire REIT Index- Measures US publicly traded Real Estate Investment Trusts. The index is a subset of the Dow Jones Wilshire Real Estate Securities Index (WRESI). The indexes are weighted by both full market capitalization and float-adjusted market capitalization.

J.P. Morgan Emerging Market Bond Index (EMBI) - a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries (Brady Bonds).

The S&P 500 Index is an unmanaged index of 500 common stocks, weighted by market capitalization, representing approximately 75% of the New York Stock Exchange. The value-weighted index represents about 75% of the NYSE market capitalization and 30% of the NYSE issues.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US. The MSCI World Index is a free-float adjusted market capitalization index that is designed to measure global developed market equity performance. The index is net of foreign withholding tax using the Luxembourg tax rate. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global emerging markets. The index is net of foreign withholding tax using the Luxembourg tax rate. The MSCI EAFE (Net) Index is invested in Europe, Australasia, and the Far East. Dividends are reinvested monthly, weighted by each country's aggregate market capitalization. The 10-Year US Treasury note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

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