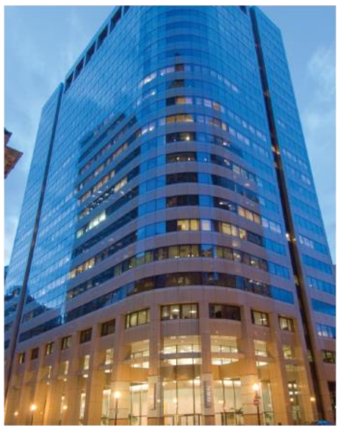
TFC FINANCIAL
The Financial Counselors

COMMENTARY | 2Q
July 13, 2016

OUR VIEW



Volatility May Be Here to Stay

Global equities rose in the second quarter and for the first half of the year, despite some abrupt shifts in momentum along the way. The UK referendum about whether to exit the European Union ("Brexit") was the predominant focus of markets during the latter part of the second quarter, replacing speculation about China as the primary driver of market sentiment. Equity markets were strong in the days leading up to the Brexit vote on June 23, then fell sharply after UK voters elected to leave the EU. The quarter ended with a "relief" rally, attributed in part to expectations that Brexit would be more of a "local" shock than a global cataclysm.

China opted for stimulus over reform during the quarter, stabilizing economic activity and the Chinese currency (RMB). Oil prices remained well above their lows, providing some comfort to struggling oil companies and commodity-producing countries. Current prices are still below break-even levels for many oil producers, so more energy sector turbulence is likely in the months ahead.

Performance: Gold, Long-Term Treasuries and US Value Stocks Led the Way

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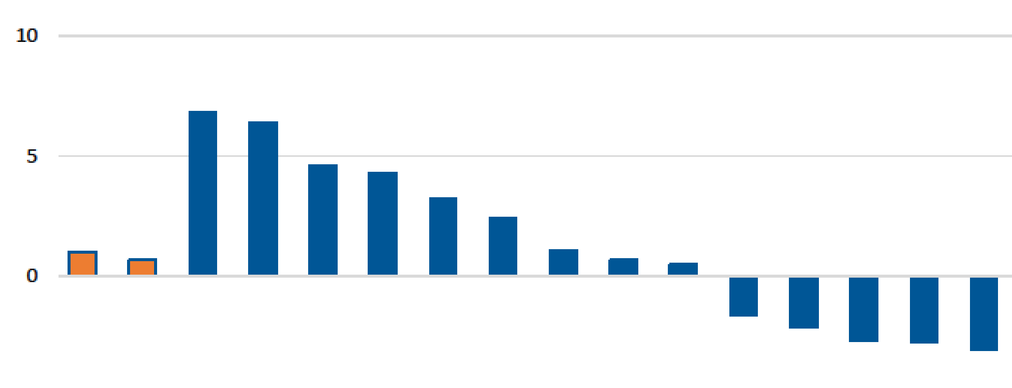
Historical Asset Class Returns



	Short Term Bonds	Short Term Muni Bonds	Gold	Long Term Bonds	US Large Value	US Small Value	US Small Growth	S&P 500	Global Stocks	Emerging Markets	Frontier Markets	Intl. Large Core	Intl. Small Growth	Europe Stocks	Intl. Value	Intl. Small Value
QTD	1.0	0.7	6.9	6.4	4.6	4.3	3.2	2.5	1.1	0.7	0.5	-1.6	-2.1	-2.7	-2.8	-3.1
YTD	2.6	1.4	24.6	15.1	6.3	6.1	-1.6	3.8	1.4	6.4	-0.5	-4.3	-3.1	-5.1	-6.6	-3.2
1 Year	2.6	2.2	12.7	19.3	2.9	-2.6	-10.8	4.0	-3.9	-12.1	-12.1	-9.3	-1.1	-11.2	-15.4	-6.3
Full Cycle*	3.1	2.8	6.1	8.8	4.7	4.9	6.3	6.0	2.1	-1.8	-4.0	-0.8	2.3	-1.7	-2.6	1.6

TFC Chart
Source: FactSet Data
* Full Cycle is the annualized return from October 2007 peak to present.

Safe haven asset classes such as Gold and long-term Treasury Bonds were also among the best-performing asset classes. A slow-growth economic environment, fear of deflation, and limits of traditional monetary policy has led central bankers to take extreme measures to stimulate economies. Consequently, the bond market is in uncharted territory, with more than one-third of sovereign debt trading at negative yields and nearly three-quarters with yields below 1%!

Value stocks in the US rebounded, helping TFC performance. Emerging market equities, possibly the least-loved asset class after a difficult 2015, were in line with global stocks for the quarter. Developed International markets were down for the quarter, despite rallying from the lows after the Brexit vote. UK Large Cap equities recovered nicely in local currency terms, but the fall in the pound made the UK a poor market for unhedged investors.

The US is viewed as a "safe haven" from Brexit risk, as only 4% of US exports and under 5% of S&P 500 Company's revenue are affiliated with the UK.

Currencies continued to be on center stage, creating volatility for company earnings and investors around the globe. A depreciating Chinese RMB is creating competitive concerns for Asian exporting countries. The weak pound is welcomed by UK exporters, but creates challenges for importers and investors. The strength of the yen, a safe haven in the aftermath of the Brexit vote, continues to torment Japanese policymakers.

Economic Outlook: Market Focus on Geopolitics and Central Banks

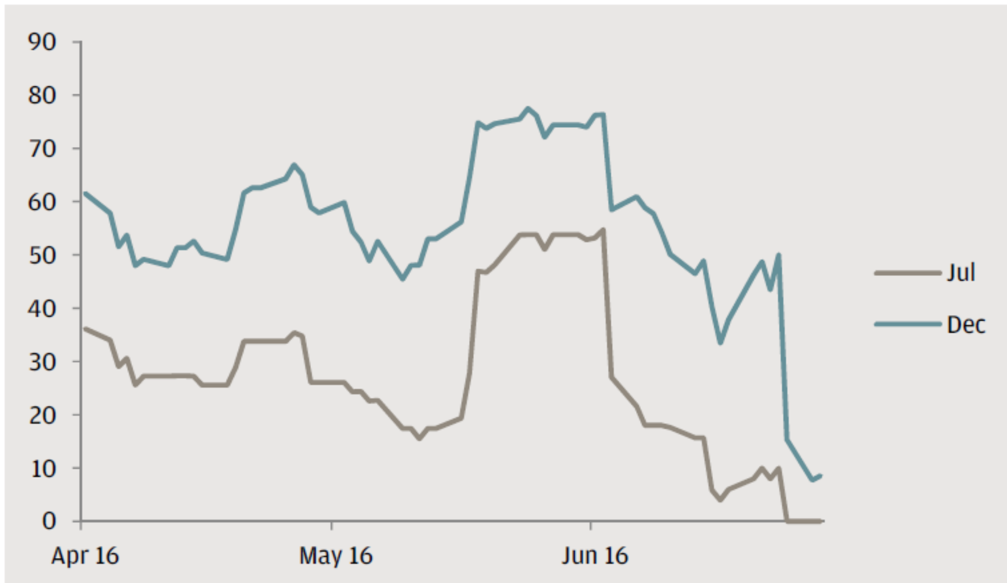
The US economy continued the less-than-robust recent pace, with employment, wage growth, consumer spending, and manufacturing all delivering positive, but tepid growth. Housing is a notable bright spot for the US, rebounding from the depths of the financial crisis. Companies that struggled the most in 2015--commodities producers and exporters hurt by the rising dollar--start the third quarter facing considerably easier earnings comparisons. The US is viewed as a "safe haven" from Brexit risk, as only 4% of US exports and under 5% of S&P 500 Company's revenue are affiliated with the UK.

Europe had positive economic momentum in the first half of the year, but further geopolitical uncertainty clouds forward expectations. Analysts expect, if not fiscal, monetary policy actions to offset some of the near-term economic impact of the Brexit vote, while hopes are rising that the UK will ultimately change its mind and remain in the EU. The most optimistic observers say that Brexit will become more political crisis than economic crisis.

Politicians replaced central bankers in the spotlight during the second quarter, but central bank policies will still influence markets over the coming months. Expectations of Fed rate increases have been lowered yet again, with analyst consensus pointing in the direction of the Fed staying on hold at least until December (Exhibit 1). For context, at the start of this year, the Federal Open Market Committee (FOMC) year-end estimate for 2016 was multiple rate hikes ending 1.0% higher. Some analysts think a rate cut might be in the cards before year-end. While TFC isn't in this rate cut camp at this point, market speculation about a rate cut shows how far we've come from the fears of rate hikes that dominated debate in recent years.

We are still reasonably optimistic about the long-term prospects for Europe and the UK and retain meaningful investments, but we have reduced our exposure given the potential slowdown in growth and heightened risk of an event that would jeopardize the Euro.

Exhibit 1 – Market-Implied Probabilities for Fed Rate Hikes



Source: Bloomberg; data as of June 28, 2016. For illustrative purposes only. Past performance is not indicative of future results.

The feedback loop between Fed policy and financial conditions continues to act as an equity market constraint, in that the more policy in the US diverges from the rest of the world, the more the dollar as a perceived "safe haven" rises. A rising dollar tightens US economic conditions, which in turn makes it more likely for the Fed to delay rate increases. A cautious Fed and the expanding US trade deficit may signal the end of the rapid rise in the dollar.

Market Outlook: Moderately Positive, but Risks Are Visible on the Horizon

US stock market valuations continue to be high relative to Europe, Japan and Emerging markets. Given high relative valuations, slowing revenue growth and margins at peak levels, we expect US equity markets to struggle to provide the returns earned in recent years.

We started 2016 enthusiastic about the prospects for Europe, with an investment outlook shaped by improving economic momentum, attractive valuations and profit margins with room to rise after the severe downturn following the European debt crisis. European markets struggled to build momentum this year, hampered in the first quarter by the refugee crisis and in the second quarter by Brexit fears. Brexit creates two sets of challenges for Europe: the likely decline in economic activity during a protracted negotiation process, as well as the elevated risk that one or more additional countries decide to exit from the Euro. We are still reasonably optimistic about the long-term prospects for Europe and the UK and retain meaningful investments, but we have reduced

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The Japanese market is also inexpensive, but Japan's economic momentum, demographics and fiscal dynamics are far from confidence-inspiring. We are watching policy trends in Japan carefully, however, as the odds are rising for Prime Minister Abe to attempt a "game-changing" policy move to end the country's slow-growth and deflationary mindset.

There is no doubt that Emerging and Frontier markets will continue to be volatile, but our long-term outlook is positive, given favorable demographics, stock valuations and growth prospects.

Low interest rates are a positive in many ways, supporting stock market valuations, economic activity and helping consumers and companies keep debt servicing costs low. Our expectation of rates being lower for longer provides a generally constructive backdrop for equities and fixed income investments, though the delay in interest rate "normalization" makes it tough for income-oriented investors. We also worry about imbalances that may be created with rates kept artificially low and fixed income markets distorted by central bank intervention.

Risks: The Highest Profile Risks Present Considerable Uncertainty and Will Contribute to Market Volatility

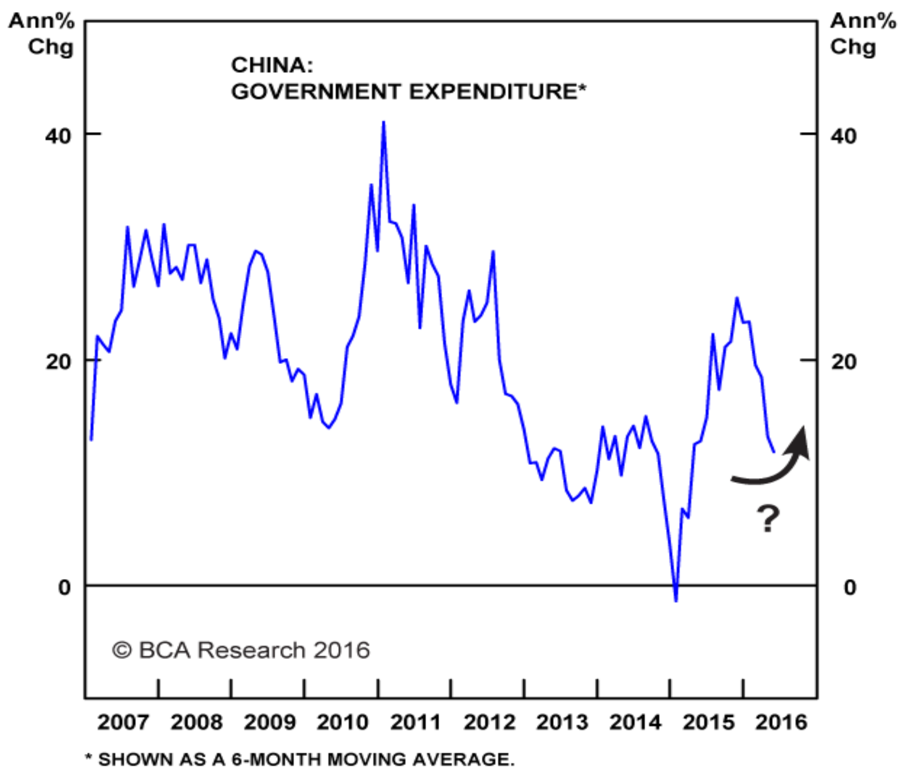
China: China has a difficult balancing act, trying to stabilize growth while taking steps to address structural problems such as poor credit allocation, an overleveraged corporate sector, and "zombie" state-owned companies that need to be restructured. To address slowing growth and potential social unrest, China has announced stimulus plans for the northeast provinces that include infrastructure such as airports (500 by 2020!) and rails (Exhibit 2). This stimulus is likely to boost growth near-term, but the longer-term outlook depends on whether China takes steps to address their structural challenges.

Fed Policy: The primary risk to our interest rate outlook is an acceleration of inflation. Wages are slowly drifting higher, but to date such growth has been far from levels that would force Fed action. Technology continues to be a disruptive force, increasing productivity in many industries while decreasing the bargaining power of workers. The slow wage growth environment continues, though at some point a declining labor pool may create wage pressures.

Recession: Improvement in manufacturing indicators and generally constructive employment, consumer and housing momentum reduce the likelihood of steep recession in the US; the apparent stabilization in China also helps to reduce the risk of a global recession. The UK faces heightened risk of recession, which as noted above is likely to be more of a local shock than a global shock.

Oil Prices: Despite the recent rebound in oil prices, the energy sector is likely to remain under siege until inventories are reduced and supply is constrained. We expect more energy companies to fail, creating ripple effects for oil prices, stocks and credit markets. However, if prices rise much

Exhibit 2 – China: Government Spending to Re-Accelerate



from current levels, additional shale oil supply may come back into production, delaying the long-term "balancing" of supply and demand needed to stabilize oil prices.

Political Shocks, Including Brexit Aftershocks: The potentially messy "divorce" between the UK and the EU heads the list of political concerns for markets. Following a wave of redemption requests from shareholders concerned about the UK property market post-Brexit, seven open-end UK funds that invest in commercial real estate have suspended redemptions. We think the move to suspend redemptions, while unfortunate, isn't a material development or early indication of systemic stress. As with the Third Avenue distressed debt mutual fund that suspended redemptions late last year, the liquidity crunch experienced by UK real estate funds illustrates the challenges that can result when illiquid assets such as commercial property are purchased by a fund that promises daily liquidity.

The US presidential election will be in the headlines non-stop until Election Day, and is likely to have a consequential impact on the markets. Italy will also be in the news, with solvency concerns about Italian banks in the headlines now and headlines sure to increase as the country gears up for an October referendum on constitutional reforms. Russian President Vladimir Putin, possibly the happiest political leader after the Brexit vote, continues to be a potential source of global unrest that could spill over into markets.

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Concluding Thoughts: Our View

Although we realize how difficult it is to forecast a steep market downturn, we don't see the sort of imbalances in the global economy that would signal a recession or a steep bear market. The US is in relatively strong position, European unemployment has declined significantly, and China is demonstrating its commitment to financial stability.

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It seems there is always a global concern arguing for defensive portfolio posturing. Today's headlines certainly point to the UK and we have corrected our position sizes as a result. We continue to monitor all of the risks outlined above and will adjust the portfolio based on new information. That being said, we remain cautiously optimistic. We think the pessimistic mood in the market is influenced by the recent memories of the Great Recession of 2008-9 and by a mental adjustment to a lower return and slower growth world.

As always, we welcome your comments and questions.

Sincerely,

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