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Second Quarter 2016

Mixed Signals

The first half of 2016 has brought us two unsettling global market shocks, one per quarter. The first was a growth and deflation scare that plagued risk assets through the middle of February and the second a reaction to Brexit, in which a majority of the United Kingdom voted on June 23rd to leave the European Union. The table below illustrates the magnitude of selling pressure in each quarter, with drawdowns defined as the maximum loss from any point during the period. Some of the biggest moves occurred over the course of only a few days or weeks as investors dealt with abrupt changes in risk factors that had been fairly stable, or at least deadlocked, for years - namely credit spreads and politics.

Index	Q1 Maximum Drawdown	Q2 Maximum Drawdown
S&P 500	(10.27%)	(5.52%)
MSCI AC World Index ex USA*	(11.96%)	(9.24%)
MSCI EAFE*	(12.95%)	(10.58%)
MSCI Europe*	(13.08%)	(13.46%)
MSCI EMF (Emerging Markets)*	(13.29%)	(8.30%)
S&P GSCI (Commodities)	(14.28%)	(7.05%)
Russell 2000	(15.93%)	(8.28%)
MSCI Japan*	(17.69%)	(7.81%)

**Returns are calculated with net dividends in USD.*

This is not the first time things have come unstuck. The past two years have been especially difficult for active investors to navigate, with large intra-quarter moves and little to no progress made in global equities as central banks have tried, with mixed success, to ease the pain of a generational collapse in commodities and subsequent aftershocks. Economic, political and valuation risks have all risen during this period of peaking profits and modest growth, keeping a lid on stock markets and creating a popular narrative that unconventional monetary strategies such as quantitative easing and negative interest rates have failed. It seems central banks can no longer lower rates (ECB, BOJ) or raise them (U.S. FED) without upsetting market participants, so many investors have simply chosen not to participate and wait for better entry points. Their patience has been tested post-Brexit as global risk assets have rallied considerably.

While economic statistics suggest otherwise, in the U.S. markets, there has been a noticeable “recession rotation” into defensive sectors in the first half of 2016 as savers and investors continue to pay a premium for safety and yield. Longer term interest rates have plummeted to new lows, and bond-like equities within sectors such as Telecommunications, Utilities and REITs, for example, have rallied sharply. Although the U.S. Ten Year Note currently yields below 1.6%, it offers among the highest returns available on sovereign risk in the developed world and a compelling alternative to the one third of all government bonds globally (about $12 trillion) carrying negative yields. Interestingly, commodities have rallied well off their 2015 lows, and U.S. stock indexes are now achieving record highs while the bond markets are predicting long term secular stagnation. Bank equity, on the other hand, has suffered terribly amid margin compression, soured loans to commodity producers, and unaddressed credit issues in Europe. In the wake of the Brexit vote, many banks and diversified financial firms across Europe are trading at valuations last seen during the European debt crisis of 2011. In general, ultra-low rates have encouraged public debt issuance more than bank lending, which is now highly risk averse, more regulated and much less profitable with a flat yield curve. In typical fashion, the last crisis is still being solved while other imbalances are growing unattended.

Index (as of 06/30/2016)	**Second Quarter 2016**	**Year to Date 2016**	**12 Months Trailing**
S&P GSCI (Commodities)	12.67%	9.86%	(25.91%)
S&P Telecommunication Services	7.06%	24.85%	24.93%
MSCI U.S. REIT INDEX - Gross Return	6.81%	13.56%	23.89%
S&P Utilities	6.79%	23.41%	31.19%
Barclays U.S. Treasury (20+ Y)(USD Unhedged)	6.76%	15.82%	20.13%
iBoxx USD Liquid High Yield Index	4.77%	8.25%	1.17%
Russell 2000	3.79%	2.22%	(6.68%)
S&P 500	2.46%	3.84%	3.96%
Barclays U.S. Aggregate (USD Unhedged)	2.21%	5.31%	5.95%
MSCI Japan*	1.01%	(5.58%)	(8.87%)
MSCI EMF (Emerging Markets)*	0.66%	6.41%	(11.97%)
MSCI AC World Index ex USA*	(0.64%)	(1.02%)	(10.17%)
MSCI Europe*	(2.69%)	(5.13%)	(11.14%)
MSCI Europe Financials Index*	(10.91%)	(21.51%)	28.61%

**Returns are calculated with net dividends in USD.*

In Brexit we have seen a stark divergence between the corporate, political and investor class, who wish to operate and diversify globally, and a sizeable, disenfranchised voting bloc which does not. Immediately following the vote, politicians were struggling to cope with this tension, either fighting amongst themselves or resigning in large numbers. As we mentioned in a previous communication to you a few weeks ago, one of our partners traveled to London for manager meetings immediately after the Brexit vote. While London was likely a bubble of establishment, pro-remain voters, most managers noted the uncertainty and potential for slower economic growth in both the U.K. and Europe as consumers and businesses postponed spending. A random sampling of ordinary wage earners indicated much less concern – many were more interested in the upcoming U.S. election than their status within the European Union. It made us wonder if Brexit was simply a vote for change without a full understanding of the ramifications. Three weeks on, however, there is a new Prime Minister and a new cabinet is forming. As in the U.S., the U.K. system is designed to facilitate change when desired, and politicians will actually embrace it when pushed. In our view, recent stock market gains may be discounting a welcome regime change from monetary to fiscal policy solutions. We can only hope the more rigid, unelected bureaucrats who run the European Union will choose to adapt and survive.

While regime changes can be hugely positive and rewarding for investors, they are usually volatile and certainly not guaranteed to succeed. We therefore don't want our clients' portfolios to be positioned for one particular outcome or even overly dependent on historical relationships among asset classes. When attempting to diversify portfolios, we expect some assets will respond differently than others in various market environments, so when conditions change suddenly our clients have assets that will help moderate these fluctuations. While it's difficult to forecast the timing of stressful market periods, we are satisfied with how most of these portfolio stabilizer positions have performed year to date. Early in the first quarter, for example, we added positions with higher sensitivity to interest rates to our overall fixed income allocations. These helped offset some of the extreme volatility in global equity markets during the first half of the year, while active and passive positions in lower volatility stocks within our international developed markets allocation also helped limit some of the drawdowns experienced in widely held market capitalization weighted indices in Europe and Asia. We have also been pleased to see many of our internally selected stocks, which tend to have a quality bias, hold up well in the second quarter. Like others, we question the mixed signals equity and fixed income markets are sending amid the fog of unconventional monetary policy actions. In recent weeks we have watched stocks and sovereign bonds move higher in tandem. This is a somewhat unusual occurrence that is unlikely to persist, and we are currently focused on making sure our asset allocation remains as balanced as possible.

Thank you for being a valued client of North American Management. Please contact your relationship manager or either of us directly with any questions.

Robert G. Scott
Chairman & CEO

Fraser J. McLean, CFA, CFP®
Chief Investment Officer

Source of data not specifically cited: Fact Set.

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Special Note to Clients

Our Partner, Susan Tangney, has retired from the investment advisory business in order to pursue other interests, both charitable and personal, and so begins a new phase of her life. We have no doubt that others in the community will benefit immensely from her attention and focus, just as we have at North American Management. Susan has enjoyed a long and successful career in senior roles in banking and asset management, and we will miss her daily presence and support, kindness and good humor, sharp analytical skills and tireless efforts on behalf of clients and fellow employees. It means a great deal to all of us that Susan has been a mentor to many younger people at the Firm over the past eight years, giving generously of her time and knowledge to help them grow professionally. That is a very special quality indeed. We wish Susan the very best in the years ahead.

The Firm's research team previously led by Susan now reports to Fraser McLean, our Chief Investment Officer.

Quarterly Reporting Note:

We recently performed a review of the income strategy benchmark provided on our clients' quarterly reports. For this strategy we have been using a blended benchmark comprised of an equity component, the S&P High Yield Dividend Aristocrats Index (90%), and a fixed income component, the Barclays U.S. Aggregate Total Return Index (10%). Considering the positioning of this strategy, we decided to make two changes:

1) To more accurately reflect the equity percentage in the strategy, the benchmark equity allocation has been reduced to 80%, with the fixed income allocation moved to 20%.
2) To more accurately reflect the universe from which we select securities, the benchmark equity index has been changed to the S&P 500 index.

This new S&P 500 Index (80%) / Barclays U.S. Aggregate Total Return Index (20%) blend will replace the historical blend. It's important to note that the purpose of our benchmarks is not to be proxies for our clients' portfolios, but rather to provide a general measure of comparison. Please refer to the disclosures near the back of the quarterly performance reports for more details and let us know if you have any questions.