MARKET PERSPECTIVES

STC Investment Committee

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For once, things pretty much went according to plan in the second quarter. Better economic growth data delivered sharply higher interest rates; expectations grew that the Federal Reserve (Fed) would raise rates much sooner than expected; international equity markets continued their 2015 outperformance; and hedge funds were the right place to be.

Some investors' near-term deflationary concerns were misplaced, as prospects for overall world growth remained upbeat, particularly for developed economies. Europe's consumer confidence and job creation hit multi-year highs and Japan's economy beat expectations with strong wage growth, as the weaker Yen helped offset a growth slowdown in China. After strong gains last year and in early 2015, the US dollar lost 3%, principally against the Euro (3.9%) and the British pound (6.0%); while the greenback gained against the Yen and most emerging market currencies.

US equities declined 1.7% in June on concerns over China growth and Greece, leaving the Russell 3000 benchmark little changed at +0.1% for the quarter. Returns were widely dispersed: small-cap growth outperformed small-cap value by 3.3% over the quarter and 7.9% on the year; health care stocks outperformed utility stocks by nearly 9.4% (21.8% year-to-date). REITs and MLPs were hit by rising interest rates, with US REITs falling 9.1% for the quarter and 5.4% on the year while MLPs fell 6.1% and 11%. Commodities bounced back 4.7% in the quarter, led by a 25% increase in crude oil prices, which were up 11.6% year-to-date.

Despite a setback in June on "Grexit" (Greece exit from the Euro) fears, international developed equities gained 0.6%, as Euro, pound and Swiss franc currency gains offset modest local market losses. For the year, foreign developed market equities have returned 5.5% versus a 1.2% gain for the S&P 500. International developed market small caps again outperformed in the quarter, bringing their year-to-date gains to over 10%. Emerging market equities returned 0.7% for the quarter, beating both developed market and US benchmarks, led by 7-8% recoveries in Brazil and Russia. The year-to-date 2.9% gain was boosted by a 14.7% gain in China (although the narrower local mainland market was up 33%, even after June's decline).

High quality government and corporate bonds were the biggest losers over the quarter, with the Barclays Aggregate Index down 1.7% for the quarter. They now are negative for the year. Longer term Treasury and corporate bonds fell 8% for the quarter and 5% for the year. In contrast, high-yield bonds were little changed, as interest income was able to offset the effects of higher benchmark rates. The yield curve steepened over the second quarter as longer term rates increased more than 50 basis points after 15 months of falling yields, while two-year yields were little changed, up only 8 basis points.

Portfolio Positioning

While our headline portfolio changes reflect only an incremental boost to municipal bonds as interest rates have increased, our current positioning reflects a number of other changes across and within asset classes that incorporate new developments in July. Hedge funds remain near maximum levels, while our cash overweight is modestly reduced to fund higher fixed income exposure. The tactical increase in high quality municipal bonds to 88% of strategic target would have been larger were it not for its recent relative outperformance versus Treasuries. We have seen excellent relative value (at least 110% of Treasury yields) in 15-18 year maturities and are offsetting that added interest rate risk with a large amount of very short term bonds. Opportunistic fixed income targets have been raised, but only up to 85% of strategic levels, owing to my concerns about Chicago's potential loss of an investment grade rating (it is now split-rated) and a likely default in Puerto Rico. While the timing is hard to predict, a perfect storm

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would also feature a September Fed rate increase. While that view has gained some followers, the market judges that potential event at possible, but not probable. While we would expect our managers to aggressively add to their sizeable Chicago, Illinois and Puerto Rican exposure, prices may be vulnerable near-term.

Moving on to equity markets, domestic stocks remain unattractive and we are maintaining current exposure at only 82% of normal levels after a 1% gain thus far in July, coupled with negative earnings growth (trailing earnings down 5% from peak), a resumption of strength of the dollar against the Euro and in smaller, more speculative stocks (biotech up another 3.5%). Within domestic equities, we are once again boosting energy exposure and commodity equity exposure more broadly on double digit price declines this month. International equities remain close to target levels, but emerging markets have been upgraded, following the 4% Eurozone gain thus far in July, coupled with a 6.4% loss in emerging markets and residual concerns over the broader political fall-out from Greece. Finally, while not yet a full-blown tactical call, we are about to fund a new manager with a portfolio heavily skewed to the mining and resource sector, following a 25% fall in precious metals stocks this month. This allocation also reflects our desire to fund managers after bad recent performance but with strong long-term records. This will initially be sized as a small toehold position, given downside risks from an early Fed rate hike and an unexpected fall-out from the crash in mainland Chinese equities.

While our hedge fund performance has been quite strong, we are likely to continue to trim winning positions, as it is difficult to expect exceptional performance to continue in India, biotech and the Chinese loan/convertible market. In contrast, Japanese exposure will be maintained in the belief that the governance changes in corporate Japan will bring continued benefits. Our investments there are now largely unhedged, after benefitting from hedging Yen exposure through its multi-year decline against the dollar. Despite already being heavily weighted in Europe, we recently added a dedicated European peripheral bank strategy, focusing on some specific opportunities generated by recent legislation in Italy. Otherwise, positioning may be relatively unchanged as we wait an important unemployment number in early August with implications for a possible September rate increase. We would look to boost emerging market exposure on any further resulting weakness.

On the private equity and real estate side, while enjoying the capital gains and portfolio liquidity brought about as our managers monetize their positions by selling into strong market rallies, our attention turns toward the profitable redeployment of those proceeds. This is a challenge, as across most private investment areas I would rather be a seller than a buyer. One new potential area is the emerging market distressed corporate debt market. While we have yet to fund any managers, attractive distressed opportunities are likely to arise as emerging market corporations have binged on low-cost debt made possible through quantitative easing at the same time as Fed rate increases and commodity price weakness may create future funding difficulties for them. Our investments would be in such places as Mexico, Brazil, Ukraine and Venezuela and be accessed through a private investment structure due to their long-term, illiquid and activist nature. The timing could be fortuitous as emerging market currencies are somewhat undervalued already and there has been little money raised relative to the scale of the opportunity.

In response to questions from clients, I hope the following thoughts will be of interest to you:

The Federal Reserve

While all eyes are on the Federal Reserve for a potential September rate increase, attention has properly shifted to the more important questions of the speed and extent of subsequent rate increases. While my prediction of a September rate increase is less of an outlier today (it was judged only a 5% possibility back in the first quarter) and survey odds are 50/50 today, market prices tell us that the people who count (those who vote with money) are still skeptical that this Fed is ready to act. I remain convinced that unless the August 7th unemployment number is shockingly weak, the Fed will act in September. Potential barriers to a September increase, such as international concerns over Grexit and the China stock market crash, have been suspended (if not exactly solved). Plus, Vice-Chairman Stanley Fischer has highlighted the financial stability threats from continued very low interest rates.

Although a September move is not priced in the market today, it is unlikely to be destabilizing if it occurs. Wall Street has been proven correct over the entire post-Lehman period since internal Fed interest rate forecasts have continued (every year) to come down to Fed funds/Wall Street expectations. Renewed dollar strength, June retail sales weakness, international monetary accommodation and the plunge in the China/commodities complex have increased market confidence that Fed Chair Yellen will raise rates only gradually and that the Fed is ahead of the curve. Near-term, the September rate increase likely would result in a continuation of the bullish curve flattening (shorter-end flat while longer-end yields decline) that we have seen thus far in July.

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While the market's complacency is understandable, it is misplaced as there is a good chance that the Fed is actually behind the curve in raising interest rates. By one important measure of unemployment (the unemployment rate for the short-term unemployed), the economy is already past the point of full employment, a portent of inflationary wage pressures to come. At a minimum, the Fed is likely to hike at a pace in line with its own forecasts - a development that would represent an unwelcome surprise to markets.

China

The recent plunge in China's mainland "A-share" market is of concern only for its implications on China's actual economy. On that score, I see only a limited direct effect. However, the heavy-handed policy response not only represents a multi-year set-back to their inclusion in global equity indices, but it also gives rise to suspicions that while reported growth figures are reliable over time, downturns such as this have a tendency to be statistically "smoothed."

The economy going forward will lose the boost from financial sector activity directly related to the stock market. However, the wealth effect from the market plunge should be small. While financial assets have overtaken real estate as the biggest store of wealth, equities are still up 70-100% from mid-2014 levels. Admittedly, near-term adverse impacts could center on copper or other metals used as collateral for stock market speculation and on the luxury goods sector as the market plunge piles on to the economic drag from the anti-corruption campaign.

Beyond these short-term effects, the real question is that of China's underlying growth rate. The economy must navigate the difficult transition towards a consumer-led economy at the same time as it copes with a hangover from a massive debt-fueled stimulus binge that propped up the global economy in the post-Lehman aftermath. The surprising policy response to effectively suspend a functioning equity market, both with outright share suspensions and direct interference to prop up shares, seems a bit desperate. These actions fuel further concerns about the extent to which the reported 7% growth rate is overstated when growth in electricity consumption has fallen to 30-year lows at 1.5%.

Without question, China's export economy has been hit by its strong currency. The Renminbi's quasi-tie to the strong US dollar comes at a time when the Japanese Yen is undervalued by 20%. Since China's international political considerations mandate a strong currency, the current slow-down in growth is much greater than reported and represents bad news for commodities and commodity exporting countries. Deprived of a potential weaker currency, monetary easing in the form of lower rates and reserve requirements will continue to be the principal policy response to this growth falloff. Looking forward, while the more accommodative monetary policy appears to be stabilizing the property market, a recovery to a 5-6% growth is a more realistic near-term target than the double-digit rates of years past.

Greece

As the post-mortem details are released, it is clear just how close Greece came to being unable to remain in the Eurozone. My sense is that Greece is still on the exit path for 2016, but that the proposed new bailout plan gives leaders in Greece and the rest of Europe the breathing room to work out the details of an orderly exit that will leave Greece with a realistic opportunity to rejoin the Eurozone at a later date.

A plausible alternative case can be made that European Union (EU) leaders have circled the political wagons and put in place the blueprint for a third bailout that, if successfully implemented, could stabilize the banks and revive the economy, particularly if political pressure is brought upon the European Central Bank to protect depositor confidence. In Greece, Prime Minister Tsipras has been able to separate himself from fringe elements of his party as he realizes that the only way he can continue to lead is to implement the series of reforms/actions required to obtain the ongoing bailout support. Finally, from the pure "numbers" point of view, while Greece's debt-to-gross domestic product ratio is 150% and increasing, to assume that it is totally unsustainable is to miss the point that this overstates the true economic burden. Most of the debt has been already restructured with lower rates and longer maturities that equate to a 40% haircut in a net present value sense.

The less optimistic, and to my mind more realistic, outcome is to focus on the current trajectory of the Greek economy and the damage done to it by its political leaders. After all, the economy had been recovering nicely and Greek borrowing costs were low until SYRIZA came to power. Can the damage done to the banks and the economy be reversed? Will Greeks keep deposits in banks that are certain to be recapitalized, knowing that their deposits are potentially at risk? Will tax compliance improve and/or will the wealthy sail to friendlier tax regimes? While budget deficits have been reduced largely through higher taxes, will leaders be able to implement the more difficult supply-side reforms that directly target protected clienteles in the Greek economy? Ultimately, will Greece elect new leaders able to commit to the admittedly orthodox economic views of the Eurozone?

My best guess is that EU leaders simply could not bring themselves to leave the Greek people on their own in a disorderly overnight "Grexit," no how much they may have thought Tsipras' behavior made that

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the only logical outcome. Beyond the usual logistical needs to enforce capital controls and print new Drachma currency, a more orderly Grexit would require coordination with the European leaders as well as the International Monetary Fund (IMF). Ultimately, I think 2016 will see Greece leave the Eurozone in a controlled manner where everybody appears to win: the IMF will lead the bailout/restructuring/ monitoring effort and will determine what level of debt is indeed sustainable; Greece will get what it wants in terms of a debt haircut and greater sovereign freedom; and Germany and other European creditors will agree to these terms, in exchange for Greece's withdrawal from the Eurozone. There is no reason that Greece could not at a later date negotiate a path back to Eurozone membership.

Black Swans

Black Swan events (sudden and dramatic change in market prices) are by nature notoriously hard to anticipate. The huge intra-day drop in the Treasury market last October was a classic example. Accordingly, a realistic goal for us should not be to attempt to profit from one, but to at least not be on the wrong side of one. Black swans are most likely to occur when many of these conditions are prevalent: an extended unidirectional trend with one-sided market sentiment and speculative positioning; market pricing far away from long-term equilibrium value; fundamentally-based investors either exhausted or out of business; and either high degrees of leverage or a mismatch between the liquidity of the asset and the mechanism for accessing it. Finally, the asset price distortions brought about by unorthodox central banks' policies have encouraged trend-following and a short-term "data-dependent" mindset. This momentum-based, low-conviction investment climate is an ideal breeding ground for future black swan events.

After black swans last year in Treasury bonds and the Swiss Franc, expected volatility in those markets remains elevated. I could envision two specific potential black swan events in the fixed income and currency markets that have a low probability of occurrence, but are probably 10 times more likely than the market expects.

First, the Japanese Yen could suddenly strengthen 10% against the dollar, particularly at the worst possible time- when global asset prices are falling. The situation has most of the Black Swan pre-conditions as, despite the Yen being 25% undervalued against the dollar: investors view the Yen as an ideal short or even funding source given the weak trend that has seen the Yen fall 37% in three years, the government has targeted a weaker Yen in an effort to rekindle inflation, and Japan's government-debt situation is quite precarious.

A much more significant black swan event could occur if financial markets learn that not only is the Federal Reserve not ahead of the inflation curve, but that it is actually behind it. For the reasons discussed previously, investors are quite complacent with respect to the future path of Fed rate rises, confident that once again Fed rate increases will fall short of the Fed's own forecast. The black swan event could occur if the Fed is forced to consider raising rates even faster or beyond its forecast.

A spike over the next year in wage gains and related core service-sector inflation would put the Fed in an impossible situation: fight inflation with aggressive rate increases and risk recession, or tolerate a period of above-trend inflation and lose control of the bond market.

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