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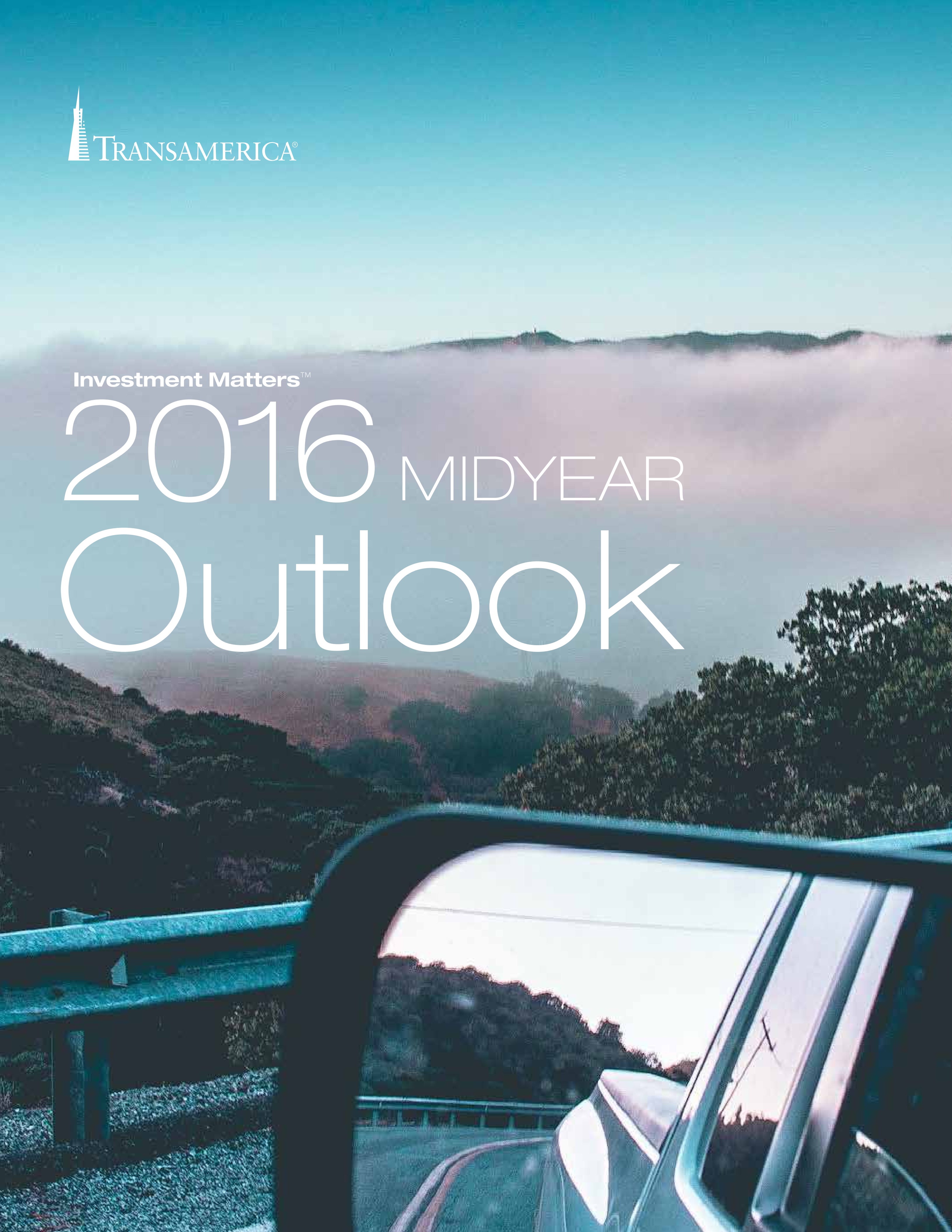
Investment Matters™

2016 MIDYEAR Outlook



About the author

Tom is responsible for overseeing the investment and mutual fund product development functions and sub-adviser selection process. He also actively publicizes Transamerica's investment thought leadership and products to advisors, clients, and the media. Tom has more than 25 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania. He has earned the right to use the Chartered Financial Analyst (CFA) designation.

Tom Wald, *CFA® Chief Investment Officer, Transamerica Asset Management, Inc.*

Looking past the rearview mirror

Executive summary:

- The U.S. economy enters the second half of 2016 having weathered slowing Gross Domestic Product (GDP) expansion, negative corporate earnings growth, and a surprising decision by the United Kingdom to exit the European Union ("Brexit"). As we look forward, we believe the environment for both the macro economy and corporate profits should improve in large part because of consumer spending and more favorable comparisons regarding oil prices and the U.S. dollar.
- U.S. stocks should benefit from a transition back to positive earnings growth in the second half of the year as the net drag created from the battered energy sector and declining net exports begins to mitigate. Early estimates for 2017 earnings growth look encouraging. However, Brexit will add to volatility throughout global markets. We continue to believe high-quality stocks are positioned for mid- to high-single-digit gains.
- Renewed caution at the Fed and the global uncertainties stemming from Brexit has shifted the interest rate environment back to a "lower for longer" profile. This "Tale of Two Feds" has created a change in our monetary policy expectations as we now believe the pace of future rate hikes will be slower and more deliberate than previously anticipated. With longer-term rates down, the quest to achieve income is back on.
- As we expected, high yield bonds have performed well through the first half of the year as default rates outside of energy and mining remain low. We believe this asset class is positioned for continued recovery following last year's selloff and feel that investors can achieve high-single-digit returns or better from coupon payments and modest tightening of credit spreads.
- After falling to their lowest levels in more than a decade, oil prices have recovered and we feel are now in an upward trend. This should provide some welcome breathing room for the better-managed shale producers although we still advise caution within the overall energy sector. Most importantly, we are beginning to see evidence that lower oil prices versus their peak levels of two years ago are finally providing a boost to consumer spending and the overall economy.
- The playing field for international investing has been tilted by Brexit. Britain is at risk of recession, Europe on the whole faces greater uncertainties, and Japan will have to endure a higher yen. While continued monetary accommodation is likely in Europe and Japan, investors will need to brace for more volatility.

Looking past what's behind us

Markets enter the second half of 2016 having been bloodied and bowed through the winter, somewhat rejuvenated in the spring, and amazingly now at all-time highs for the summer. As of mid-July, the S&P 500® now stands at its highest point ever and interest rates on long-term treasury bonds have hit historical lows. Credit spreads and oil prices spiked and cratered, respectively, to start the year yet have recovered to post healthy gains. However, to most investors who lived these past six months in terms of the day-to-day volatility of their portfolios, such favorable moves have probably never seemed quite so treacherous.

A fierce stock market correction, accompanied by a downward spiral in oil prices during the first six weeks of the year, unnerved many and set up a mindset as to a pending U.S. recession being a question not of if, but when. As economic data emerged refuting this assumption, markets rallied strong to challenge the previous historic highs of last year only to fade as the worst employment report in five years caught the market by surprise in early June. Clarity was in short supply during the first half of 2016, and those seeking it from either market trends, corporate earnings reports, credit spreads, commodity prices, or Federal Reserve policymakers were hard-pressed to find any.

From a macro perspective, economic growth in the U.S. through the first half of the year has proved disappointing. While 2Q GDP estimates are still subject to revision, it looks as though the first half of the year will post overall economic growth of only about 1%, and in the seven years since we emerged from the financial crises, we are still yet to achieve a full calendar year of 3% GDP growth. While we believe there are several reasons to expect improving growth in the second half of the year, investors are still left to ponder the legitimacy of stock prices now at historical highs within this sort of economic environment.

Catching markets by surprise in the final week of June was Great Britain's surprising referendum vote in favor of Brexit, departure from the European Union (EU). While polls were clearly signaling a close election was at hand, the markets and the media terribly misinterpreted them, choosing to rely on bookmaking odds instead, which of course turned out to be grossly inaccurate. As a result, the world was caught off guard the morning of June 24 as uncertainty and downside volatility reigned throughout global markets. The true impact of this historic decision by Britain to leave the EU will take at least a couple of years to enact and many more years after that to truly determine its real effects. With this in mind, we do believe there will be time for a rational parting of the ways between the United Kingdom and the EU. As a country, Britain will undoubtedly be facing changes and challenges, and as a region, Europe will experience longer-term uncertainties. However, the overall economic effects to the U.S. and aggregate world markets should be manageable.

Amidst all of this, there has of course been the Federal Reserve, which as of last December seemed to have a clear vision of our economy and how the long-awaited "normalization" of interest rates should be implemented in the year ahead. Fast forwarding six months from then to now, that economic vision is cloudy at best, and any efforts toward normalization, known to the rest of the world as higher interest rates, may not even wind up being on the 2016 docket. Could the Fed really have been so wrong back in December in raising rates for the first time in almost a decade? Or did it simply let short-term events influence its conviction? Or is it now simply exercising the "data dependent" analysis many feel will be necessary for a new era of monetary policy capable of negotiating a global economy unlike any we have seen before? We would answer these three questions with yes, yes, and yes.

It clearly has not been the year anyone has expected. Markets have round-tripped and then some, yet despite the recent rally, many investors don't necessarily feel a whole lot better off and are all the more weary in the process. As a result, the quandary facing investors is attempting to determine whether the economic and corporate earnings backdrop of the past six months has in reality not been as weak as it may have seemed, or if perhaps the upcoming six months might be much better than most anticipate. (Spoiler alert, we believe the answer lays somewhere in between).

So is there sense that can be made of this past half year, and can it be applied looking forward? To sum up the answer to this question in three words: We think so.

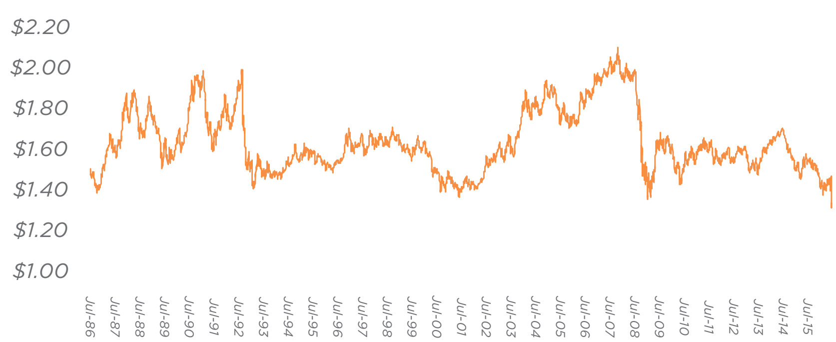
Brexit: Keeping the risks and realities in perspective following the shock to markets

A 1970s college philosophy professor once asked his class, “Tell me why this chair sitting in front of you is not really there?” After students spent most of the class posing theories of molecules, combined matter, visual interpretations, and social definitions, one of them finally stumbled upon the response the professor was looking for: “What chair?”

This is probably as good an explanation for the Brexit surprise as any. In summary, it never should have been a surprise. All indications pointed in the direction of a close vote, a true toss-up if there ever was one. Unfortunately, the markets and the media gravitated toward a narrative that the polling was irrelevant and bookmakers identifying betting trends should be the real focus of forecast. As much as some like to draw analogies, gambling and investing are two very different things, and their respective predictive measures should never cross paths. Enough said on the surprise, what are the implications of Brexit as we can define them at this early stage.

In looking first at the risks, the most obvious one is a slower rate of economic growth and possible recession in Great Britain. We believe this risk rises front and center for no other reason than the future uncertainties this decision has created. Global firms with operations based in the U.K. will most likely be curbing their presence with U.S. banks probably being among the first to do this. Countless trade negotiations will have to be renegotiated and redesigned. This will take years to play out. Unfortunately, ongoing uncertainty and economic growth rarely sit at the same table.

Currency is also a risk. Even before global equity markets began declining about midway into the Brexit vote count, the British Pound Sterling began falling, an indication that the home currency of a Great Britain outside of the EU would be the first to feel pain. By the morning of June 24, the pound had declined more than 10% to 1.37 versus the dollar, its lowest level in more than 30 years. While a home currency in decline can have many implications, one of them is inflation as commodities and imported goods instantly become more expensive. This could put Britain at risk of “stagflation,” the historically uncommon but still economically painful combination of recession and inflation, which last gripped the U.S. in the late 1970s and early 1980s. It is, however, also worth noting that currency can be a double-edged coin, in that a cheaper pound could also help exports and overseas investment within U.K. home markets. There will definitely be a fine line to be walked by the British government, the Bank of England, and investors in general pertaining to the new Brexit world.



The British Pound Falls to 30-Year Lows on Brexit Vote

U.S./U.K. Foreign Exchange Rate (July 1, 1986 - June 30, 2016)
U.S. Dollars, to One British Pound, Daily, Not Seasonally Adjusted

With all of this in mind, we do not currently see a potential British recession of the magnitude experienced in 2008–2009. We believe this for a variety of reasons, the first being that the terms and timing of the EU departure are within the control of both Britain and the EU, as there is expected to be at least about a two-year process regarding Britain's exit. Certainly much will be determined and negotiated during this time. However, England as we know it is not stopping on a dime and going a different direction tomorrow. The referendum itself is nonbinding, and while we believe the U.K. will accept the will of its people and begin the process of leaving the Union, there will be ample time for rational paths taking economic and market conditions into account.

There is also a degree of risk that emotional sentiment in Britain could remain high for some time as those who advocated hard to stay in the Union ("Remain" supporters) took a hardline in their campaigning as to how bad the outcome of an EU departure would be. While much of this was probably campaign rhetoric, Britain's leadership must deal with the other side of it now. The "Remain" contingent of the British political hierarchy will need to make the case as to why the future will not be as bleak as it predicted. In addition, there could be more volatility as leadership is transitioned between the nation's prime ministers.

Perhaps the greatest systemic fear regarding Brexit would be the risk of other nations, such as Italy, France, or Spain, taking up the notion of also separating from the EU. This will likely create a good bit of noise in the future as the question will often be raised as to whether Britain's departure was unique in nature, or if it might trigger a domino effect that ultimately unravels the EU over the course of the next few years. In this regard, we would caution EU doomsayers to recognize that while Britain was a Union member, it was not a member nation of the Euro currency. Departure for currency members will be far more problematic in that they will have to re-establish their own currency markets, which quite possibly could render future exits by these member countries unrealistic. In addition, the leadership of these nations is probably far less likely to go the referendum route given the result Britain has just experienced.

We believe the overall economic impact to the U.S. from Brexit is likely to be minimal as we do not see the business models of most American companies being materially impacted. Probably the biggest risk to the U.S. is short- to intermediate-term currency fluctuations and its effect on corporate profits. However, bear in mind the dollar against most currencies is still below beginning-of-the-year levels. It is also important to recognize that Britain only accounts for approximately 4% of the global economy. Therefore, the risk of a ripple effect moving overseas is unlikely in our opinion, and we continue to believe that the U.S. is positioned for 2H16 improvement in both GDP and corporate earnings.

Most importantly, we feel it is vital to keep Brexit in perspective as comparisons of this event to those of the Lehman Brothers bankruptcy of 2008, the Asian Crises of 1998, or European debt crises of 2010, in our opinion are not fair at this point. The biggest difference being those events were immediate in their economic impact with an unavoidable chain of events set in motion at their onset. In this case, the EU and British government still control a large degree of the eventual outcome.

On balance, we view Brexit as a political and cultural shock event and one that will in all likelihood be viewed as a historical turning point in intra-European relations. We also view it as ultimately having a less-than-shocking impact upon the global markets and world economic landscape.

The referendum itself is nonbinding, and while we believe the U.K. will accept the will of its people and begin the process of leaving the Union, there will be ample time for rational paths taking economic and market conditions into account.

U.S. economy and the road forward

We believe there are several key elements making a strong case for a second half recovery for both the U.S. economy and corporate earnings. As these developments play out, they should create a favorable environment for both the equity and credit markets. They include:

1. The dollar and oil prices
2. Renewed wage growth
3. Potential Inflation
4. Pent-up demand in the economy

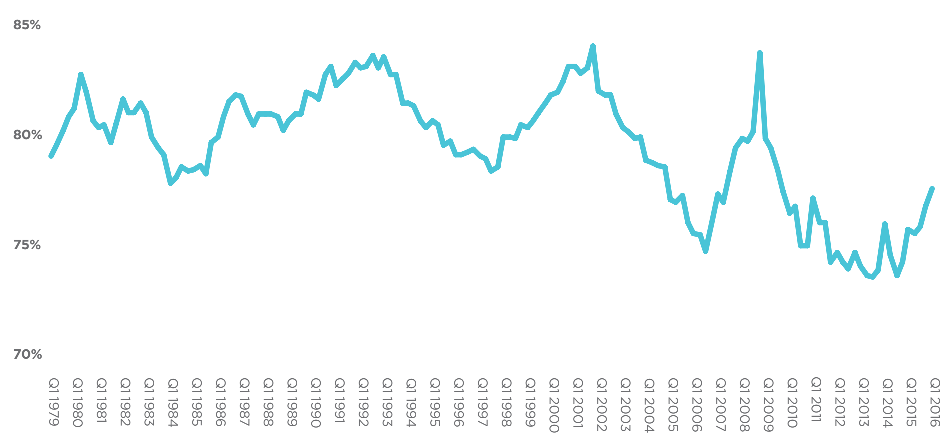
As we have mentioned in previous outlooks, the precipitous decline in crude oil prices, and the rapid ascent of the U.S. dollar, both occurring during the time frame of mid-2014 through the end of 2015, has had a negative impact on both the overall U.S. economy and corporate profits. For the 18 months ending at the start of 2016, crude oil declined more than 60%, and the dollar rose by more than 25% against a basket of developed-nation currencies. These two trends directly led to declining net exports throughout the economy as well as massive job losses and capital expenditure curtailment in the energy sector. It is our opinion that for these negative factors to mitigate in 2H16, the dollar and oil prices need not necessarily reverse themselves but only need to stop rising and falling, respectively. As we enter 2H16, the dollar has declined approximately 3% since the beginning of the year, and oil prices have increased more than 30%. This heavily implies that the net drag on growth created by these two phenomena will likely dissipate.

It is also important to note that while job creation has been strong over the past seven years, perhaps the greatest single component missing in the overall economic recovery since the financial crises has been wage growth. While more than 10 million jobs have been added to our economy since the end of 2009, for those people who have managed to stay consistently employed since that time, their financial situations have not noticeably improved. Prior to the economy's decline back in 2007, wage increases were tracking at approximately 4%, consistent with the upper range of historical averages and indicative of a growing economy. Following the subsequent downturn, average hourly earnings growth dropped considerably, bottoming out at 1.5% in 2012 and has been clawing its way back since. Three times over this past half year, monthly annualized growth rates for hourly earnings has hit 2.5%, and we believe there is a strong possibility it could break above 3% in the year or so ahead based on the cumulative job growth over the past two years and the emerging demographics within the labor force. One dynamic potentially accounting for lower relative wages has been younger workers from the Millennial generation replacing higher-priced Baby Boomer retirees, and this trend could well be in the later innings. Should we see an acceleration in wages, the widespread impact may well prove quite meaningful.

Similar to wages, inflation on the whole has failed to play a role in economic growth over the past seven years. While the Fed continues to target a 2% rate for Personal Consumption Expenditures (PCE), efforts going into 2016 to reach this goal have almost seemed futile. However, as oil has rebounded and the seeds of higher wages may finally now be taking root, this too could be turning the corner. As of the end of May, Core CPI (excluding food and energy) had reached a year-over-year rate of 2.2%. While PCE was still lagging this level at 1.6%, the directional trend seems somewhat encouraging.

So as we size up the economic playing field for 2H16 and beyond, we believe there exists a strong potential for pent-up demand playing out in the form of stronger consumer spending throughout the economy. Over the past two years, more than 5 million jobs have been added to the economy, and with that we have not only been seeing a pick-up in personal income, but also in household savings. Gasoline and fuel costs, while higher than a few months ago, are still only about half their peak levels of two summers ago, which in our opinion can still provide a catalyst for increasing discretionary spending. When combined with potential higher wages and inflation, we believe a favorable set up could well be taking shape.

With the whirlwind of developments we have witnessed since the calendar turned to 2016, let's now look at the market themes we defined back in January as being most important to investors.



Labor's Share of Corporate Income

Q1 1979 - Q1 2016// Source: Economic Policy Institute's Nominal Wage Tracker Using Bureau of Economic Analysis National Income and Product Account data (Tables 1.14 and 6.16D)

U.S. equities continue to battle a "Wall of Worry." However, we believe earnings are setting up to recover in the second half of the year.

We continue to see potential for mid- to high-single-digit gains for stocks.

As the year began, we expressed that equities as an asset class were positioned for mid- to high-single-digit appreciation based on earnings growth and dividends but not multiple expansion. Despite the volatile behavior of stocks through the first half of the year, we still believe there is a strong case for the right types of companies to generate positive returns in line with earnings growth. This remains consistent with our view that equities are returning to an "old-school" market and that stock selection would play a much larger role than it had over the past seven years since the financial crises. With this return to old-school equity investing, we feel investors will need a very keen sense of the macro surroundings and what will drive some companies to achieve or exceed earnings expectations as well as why others will fail. Simply put, there will be no more rising tides to lift all stocks, or even most of them.

It has now been almost two years since the golden age of easy money equity investing came to a halt. When the Federal Reserve officially ended Quantitative Easing (QE) in October of 2014, concluding more than six years and $4 trillion dollars of freshly printed money, approximately half of which ultimately found its way into the stock market, we felt that earnings rather than liquidity would once again become the predominant catalyst for equity returns. For the six full calendar quarters reported since QE ended, corporate earnings growth (ex-energy) has been basically flat, and even when taking into account the recent move to historical highs, stock returns have not been much better.

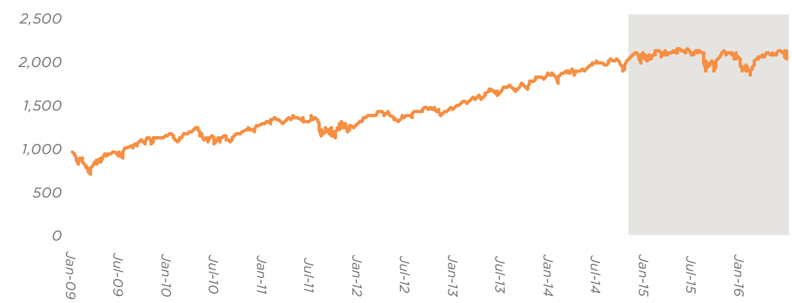
Dovetailing with this end to Fed-induced liquidity in the autumn of 2014 was of course the double-punch combination of lower oil prices and the higher dollar, both of which took a toll on relative economic growth and corporate income statements. As stocks bounced through 2015 with higher volatility and basically stagnant returns, investors struggled to determine how much of the muted performance was ultimately attributable to these transient factors, which, if not destined to immediately reverse themselves, would eventually normalize.

It has often been said that the stock market "climbs a wall of worry" and if that is indeed the case, this past year alone has provided no shortage of worries to be climbed. Over the past 12 months, bears have certainly had a full menu to feast on in regard to potentially market-deflating trends or events, which have included everything from renewed debt concerns in Europe, to a market crash in China, to recessionary scares here in the U.S., to the latest news of Brexit and what that could mean for global markets. Along the way, there have been two double-digit corrections (both of which have been followed by near-complete recoveries) and a downward trend in overall earnings growth that looks as though it will last four consecutive quarters (from 2Q15 to 2Q16). The calendar year of 2015 was also the first year of negative S&P 500® earnings growth since 2009. As the first two quarters of this year are forecast to come in below those of last year, calendar year 2016 will likely finish up with flat to slightly negative growth, even when taking into account the expected second-half profits recovery. Despite all of this, the S&P 500®, as previously mentioned, now stands taller than ever before.

Given this profile, one might be inclined to say the wall has only become higher and stocks are at risk of a tumble. While we would not disagree with the rationale behind that premise, we believe there are several points worth noting, both in terms of the macro economy itself and the equity markets specifically, pointing toward the assertion that the worst of these most recent worries is behind us. At the core of our optimism for stocks over the next year or so is the combination of an economy that could well be seeing upward momentum in consumer spending and earnings trends in corporate America that will be shifting from negative to positive. Points worth noting include:

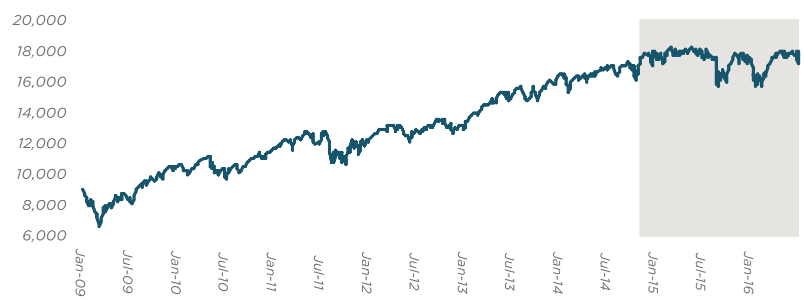
First, we believe there could be some macro tailwinds at work in regard to equities during 2H16 mostly surrounding consumer spending. As we anxiously await signs of a breakout in wage growth, the uptick in personal income is showing signs of filtering through the economy. In April, consumer spending (which ultimately accounts for approximately 2/3 of GDP growth) experienced a 1% monthly rise, its highest in almost seven years, and this was followed by a solid 0.4% increase in May. Retail sales are also showing an improving trend as gains for June came in well above expectations at 0.6% on a monthly basis and 2.7% annualized. Even within the disappointing first estimate of 1.2% 2Q GDP growth, consumer spending still expanded at a strong 4.2% pace, its highest rate since 4Q14. Finally, inflation—as measured by both Personal Consumption Expenditures and Consumer Price Index (Core)—is tracking at 1.6% and 2.2%, respectively. While these numbers have proved volatile on a monthly basis, we would view sustained levels approaching 3% for retail sales and 2% for Core CPI as helping to create a beneficial environment for equities

Second, we believe that 2Q16 will likely represent the low point in negative earnings growth for the year. For 2Q16, we believe S&P 500® earnings growth on an operating basis will shake out somewhere in the area of -5%. Almost all of that will likely be attributable to declining profits in the energy sector where bottom-line results are anticipated to decline by more than 70%. Overall S&P 500® operating earnings should turn positive in 3Q and 4Q to finish out the year only slightly negative on an aggregate basis and slightly positive when not taking the energy sector into account.



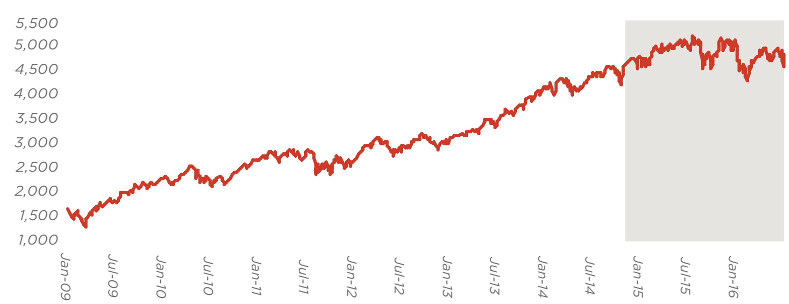
S&P 500®

January 1, 2009–June 30, 2016



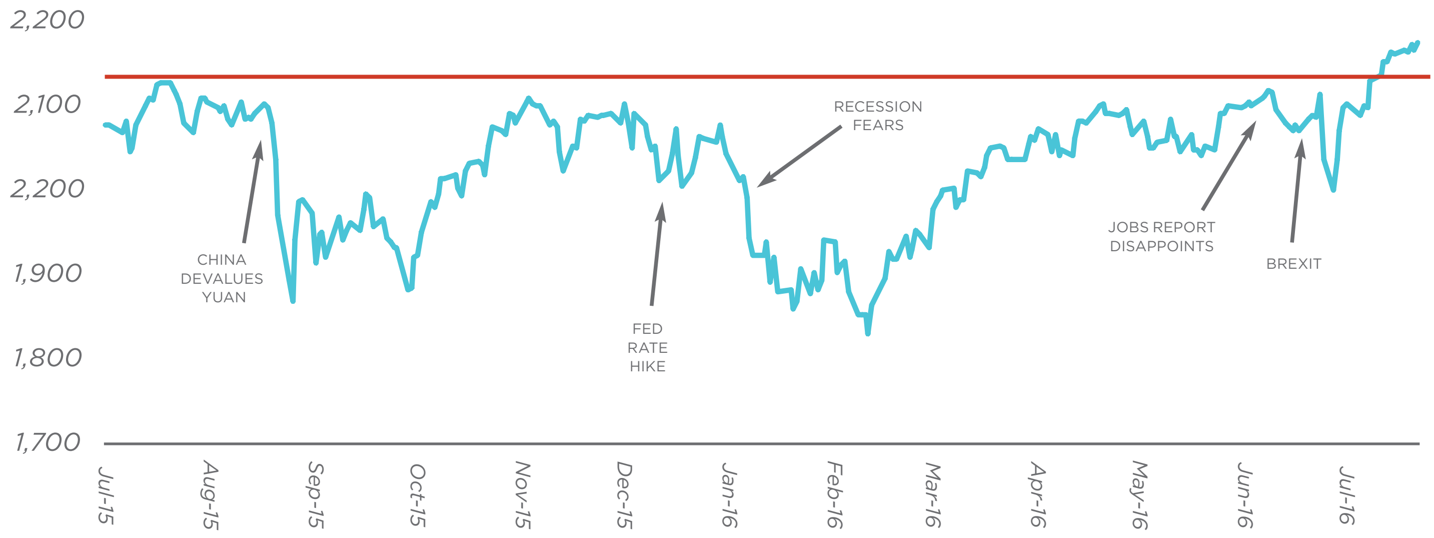
Dow Jones Industrial Average

January 1, 2009–June 30, 2016



NASDAQ

January 1, 2009–June 30, 2016



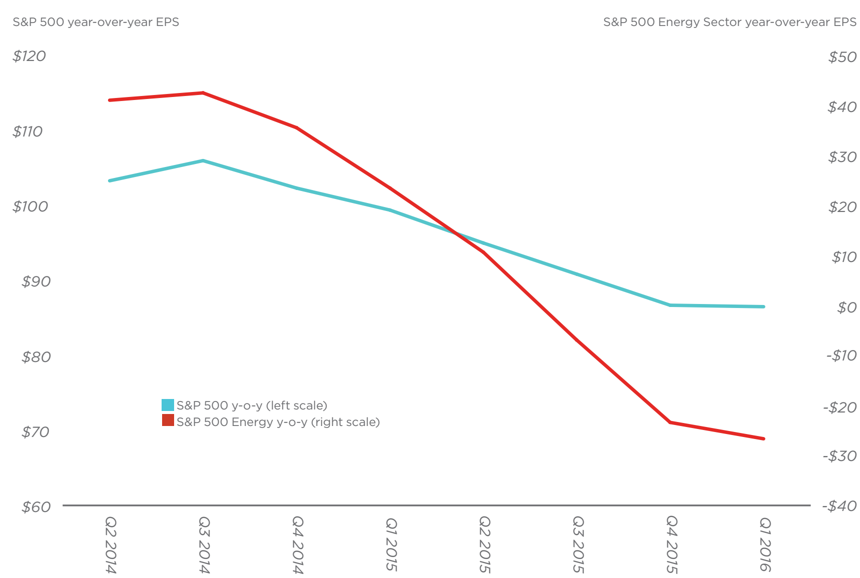
S&P 500®

June 30, 2015–July 22, 2016

Third, when earnings growth does turn positive, perhaps in the neighborhood of about 3% in 3Q and 8% in 4Q, we believe the market could take a more forward-looking view and discount the likelihood of a much stronger year in 2017. With oil having bottomed in February and now approximately $20 higher per barrel, there is a real probability the energy sector itself will contribute to next year's earnings growth. While much can transpire between now and year end, we do not think it would be unreasonable to estimate 2017 earnings growth at 10% or better before taking into account the energy sector's recovery, which could add another 2 to 3%, assuming oil prices remain somewhat stable from here on out.

However, it is also important for equity investors to realize that old man volatility is back in the house and has made himself quite comfortable in the living room rocking chair. While stocks managed to ascend for four years during 2011–2015 without a single correction of 10% or more, that vacation ended quite harshly over this past year with fast and steep double-digit declines during both last summer and this past winter, as well as a very quick 6% selloff in the days immediately following Brexit. Over the past 50 years, the market has averaged about one double-digit correction in stocks every year and a half, and we feel this is a more realistic schedule looking forward.

So in summary, we believe U.S. stocks stand to benefit from a modestly improving consumer segment of the economy and quarterly earnings trends once again turning positive. Individual stock selection will continue to play a much larger role than it has over the past seven years, and investors will need to brace for more market volatility like we have seen over the past year. All considered, making money in stocks from here on out will require not only more judgment but also more patience.



S&P 500® Earnings Growth vs. Energy Sector Earnings Growth

Q2 2014 - Q1 2016// S&P Dow Jones Indices

Renewed caution at the Fed and the aftermath of Brexit now point once again to a “Lower-for-Longer” environment for interest rates.

The quest for income is back on.

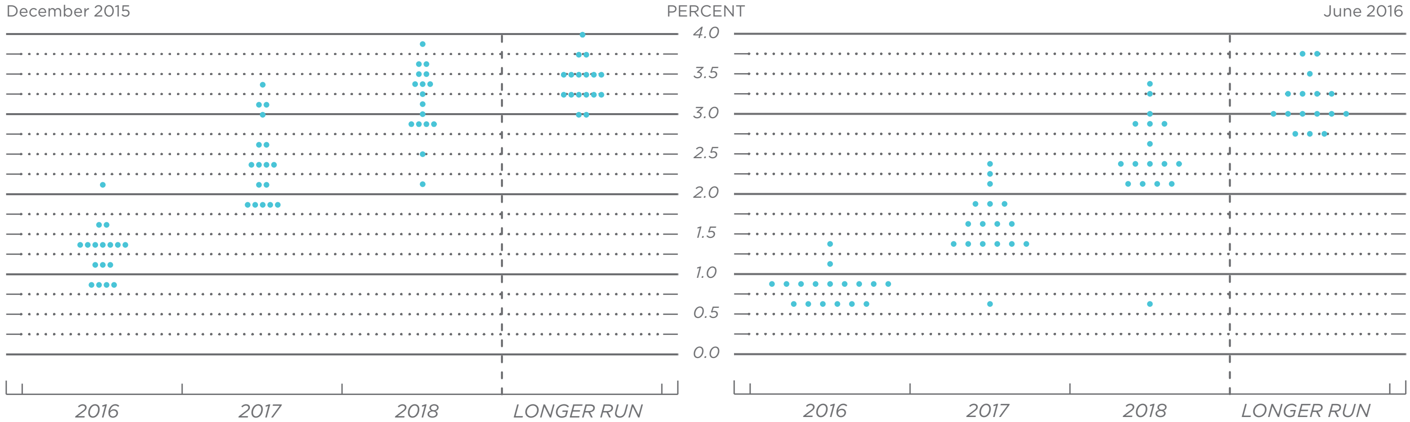
If Charles Dickens had written a summary of the interest rate environment during the first half of 2016, he may have penned the first paragraph something like: “It was higher rates, it was lower rates, it was a time of Fed clarity, it was a time of Fed confusion, it was fear of Brexit, it was the reality of Brexit, it was a season of four expected rate hikes, it was a season of no expected rate hikes.”

This “Tale of Two Feds” was certainly not the novel fixed income investors had anticipated reading during the months of January through July. While in some ways it seems like another age, it was only last December when the Federal Open Market Committee (FOMC) raised the fed funds rate for the first time since 2006. In its statement following that meeting, the FOMC referenced a “considerable improvement in labor market conditions” and said it was “confident inflation would rise.” So after seven years of zero rates, we finally had a liftoff into positive territory and the rationale of a growing economy appeared in place. The markets seemed to have clarity on monetary policy and most forecasts converged around either three or four rate hikes for the year.

Now at the halfway point of 2016, the path could not have diverged more. In fact, one might say there is no more path. Last December’s rate hike has now seen the Super Bowl, NCAA March Madness, Stanley Cup, and NBA Playoffs with no company. In all likelihood, it will watch the Olympics and World Series by itself as well.

Since last December, the FOMC seemed often to find cover in a single sentence, which is now a mainstay in all its statements and quickly becoming the legacy of this Janet Yellen-chaired Fed: “*However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.*” It is these words that are behind this Federal Reserve’s perception as the “data dependent Fed.” One could even go so far as to interpret such data dependence to mean something like, *don’t hold us too much to what we’ve said in the past or might be saying at the moment, because data can always change.* (While perhaps a touch cynical, there does seem to be at least a quarter-point of truth here).

Staying true to this decree, the Fed watched data change as 2016 began, with the biggest data point being the stock market correction in January and early February. Falling stocks at that time were mostly being attributed to economic slowing in China and oil price declines stemming from international demand concerns. Thus, in January the FOMC held off on further raising rates. Despite citing improving labor market conditions and increasing household and business spending, the January statement cited that over just one month since the December hike “economic growth slowed” as the committee further added language saying it would be “closely monitoring global and economic developments and assessing their implications,” which in our opinion was a not-so-indirect reference to the ongoing weakness in stocks. While this helped the markets to calm somewhat, clarity took a hit.



Dot Plots

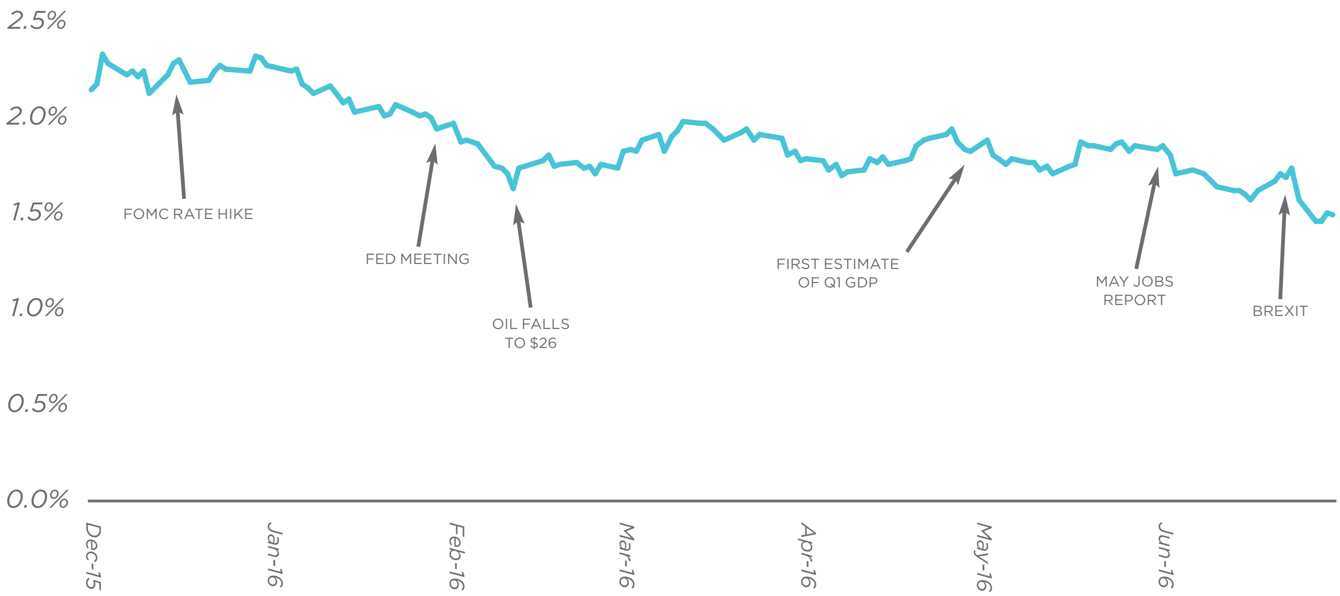
Left to Right, December 2015 and June 2016 // Source: Board of Governors of the Federal Reserve System

Despite favorable employment data, rebounding oil prices, and strengthening personal income numbers during the months of February through April, the consensus was emerging that weak exports and business spending would hurt overall economic growth for 1Q. After the initial 1Q GDP estimate came in at only 0.5% (later revised to 0.8%), the goalposts seemed to be moved back a bit. This was evidenced not only by no change in rates during the March and April meetings but also the Fed's own expectations as seen in the latest and greatest means to track the FOMC's expected path of monetary policy, the "Dot Plot."

The Fed "Dot Plot" is an anonymous but publicly disclosed survey of all 17 participating FOMC members as to where they forecast the fed funds rate to be at various dates in the future (each of these 17 forecasts are portrayed as a dot on a scale). As of last December, this survey was dictating a consensus fed funds rate of 1.16% by the end of 2016 or as it could also be interpreted, either three or four rate hikes of 25 basis points. By March, this had dropped to a 0.90% fed funds rate, or either two or three hikes. The markets quickly took a more trend-based interpretation at this time, as futures contracts priced in only a one or two rate-hike scenario for the remainder of the year.

This sentiment took a turn in May when minutes were released from the April FOMC meeting, another in which no action was taken, when the concept of a rate hike at that April meeting had apparently been discussed in much greater consideration than most had assumed. Language in the minutes also stated that the committee was "leaving open the possibility of an increase in the federal funds rate at the June FOMC meeting." The market quickly interpreted this to mean the Fed was indeed seeing a recovery in 2H16 and that a midyear rate hike was pretty much a forgone conclusion, with the timing of June or July being about a fifty-fifty proposition. Chair Yellen for the most part confirmed this interpretation in late May by commenting that an interest rate hike would be "appropriate in the coming months." For a brief moment, clarity seemed to be restored.

This of course was short-lived as the May nonfarm payroll report released during the first week in June provided the unexpected news that only 38,000 jobs had been added to the economy over the month (later revised lower to 11,000), well below the 160,000 consensus forecast and the monthly average of approximately 200,000 over the past two years. Despite the fact that this was only one month of data and that various other trends—such as housing, retail sales, and inflation—may have been suggesting this May jobs number was a one-off, the Fed reversed course at its June meeting, for the most part backing off its stance from the April minutes and Chair Yellen's public comments. In the post-meeting press conference, Chair Yellen announced that the committee would be "proceeding cautiously in raising our interest rate target" and that "Caution is all the more appropriate given that short-term interest rates are still near zero." Clarity was again put back on the shelf.



10-Year U.S. Treasury Yield

December 1, 2015-June 30, 2016 //Federal Reserve Bank of St. Louis

Then came Brexit. Having been specifically asked about the impact of Great Britain potentially leaving the EU during the press conference following the June Fed meeting, Chair Yellen commented "It is a decision that could have consequences for economic and financial conditions in global financial markets … it is certainly one of the uncertainties that we discussed and that factors into today's decision." So the dots (pardon the pun) can be easily connected here, fear of Brexit played a role in not raising rates at the June meeting. Real-life Brexit will make the Fed more apprehensive about raising rates during the remainder of 2016.

So where does all of this leave fixed income investors?

In summary, when combining Brexit with the Fed's renewed expressions of caution and their inherent reticence to disrupt equity markets, we now believe any path of future rate hikes will be considerably slower and more measured than originally anticipated by the markets at the year's onset. While 4Q16 is not out of the question, we would not be at all surprised to see the Fed wait until 2017 for their next move, particularly if the equity markets fail to maintain current levels or we experience another weak employment report. This in our opinion will sustain lower longer-term yields as well. As we saw in early July, the 10 year treasury hit its lowest yield ever at 1.37%, some 90 basis points below where it began the year. December seems a long time ago indeed.

The quest for income will likely intensify again as the ensemble cast of "Lower-for-Longer" once more takes over the stage. However, this is not necessarily a negative development in that pursuit of income over the next year or so could lead to some interesting asset classes given we believe the economy is better positioned than the Fed is giving it credit for. Specifically, we would recommend high yield bonds, select areas of the municipal bond market, and higher dividend paying common stocks to achieve income in the year ahead.

Finally, we are still of the belief that higher rates, whenever they do occur, will prove additive to the economy as well as the overall equity and credit markets. It's just going to take longer.

High yield bonds continue to recover from last year's sell off and remain positioned for high-single-digit returns or better.

Credit spreads and default rate trends should be viewed outside of energy and mining sectors where investors should remain cautious.

Back in January, we expressed our belief that high yield bonds, after suffering negative total returns in 2015, were entering 2016 attractively priced and that opportunities existed for this asset class within diversified portfolios focused outside of the energy and mining sectors. This conclusion was based in large part on the following:

- While default rates in the troubled energy and mining sectors were being negatively impacted by lower oil and overall commodity prices, we did not see credit contagion spilling into the remaining sectors of the high yield market.
- Default rates outside of energy and mining issuance would continue to remain below overall historical averages.
- The high yield credit spread widening that occurred in the second half of 2015 was mostly energy and mining related. Therefore, higher yields were being offered throughout most of the market without corresponding credit deterioration.
- From a historical standpoint, negative years within high yield have been typically followed by strong returns the following year, provided there is not recession or serious inflationary concerns.

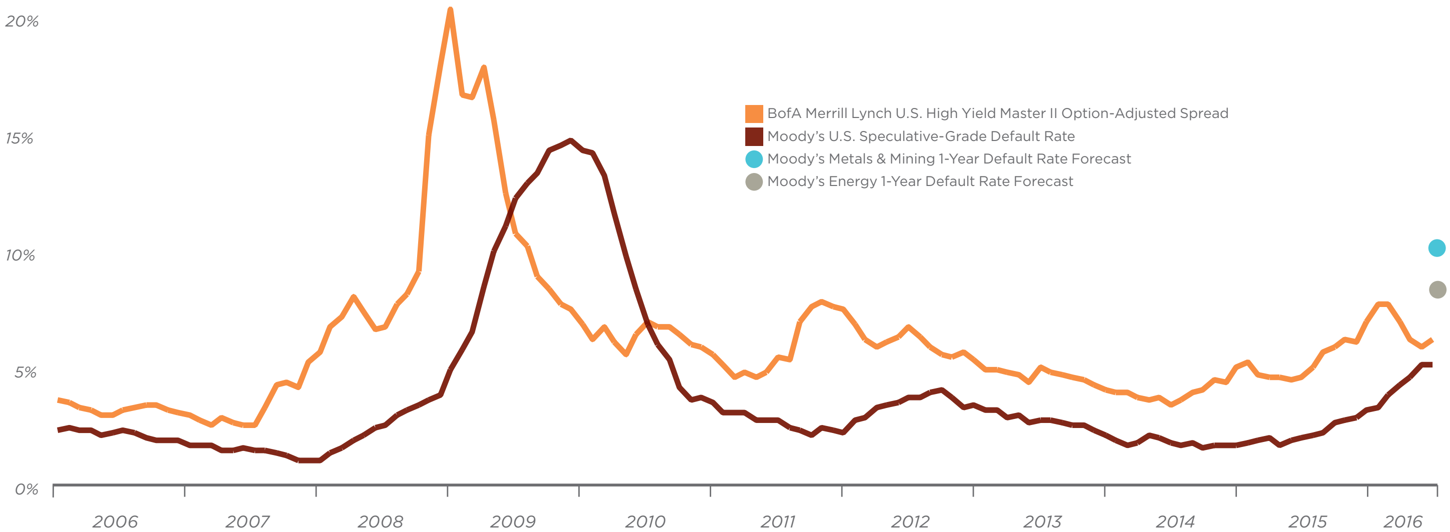
This thesis has played out through the midpoint of 2016, as most high yield indexes have posted total returns of approximately 10% through mid-July. However, that result has not come without a fair dose of volatility along the way.

Commensurate with the correction in stocks, the high yield market took some serious lumps during the first six weeks of the year as credit spreads versus comparable maturity treasuries widened considerably. In total, this yield margin expanded to almost 9% as of the second week in February, representing a near 200 basis point increase from the year's onset and more than 400 basis points above mid-2015 levels. At that time, these spreads were at their highest since 2011 as the market clearly appeared to be pricing high yield for a pending recession.

In the months to follow, as the probabilities of recession dropped and oil prices began to recover, spreads materially narrowed, falling more than 1.5% below beginning of 2016 levels and at about 5.4% as of July's midpoint, are now at their lowest level since 3Q15 (Bank of America Merrill Lynch High Yield Master II Index). In our opinion, this rapid recovery reflects not only a better economic environment than the market had been discounting during the winter months but also continued evidence that rising default rates and overall credit deterioration within the energy and mining sectors of high yield (approximately 15% of total issuance) is not spilling over into the rest of the market.

The current environment within high yield is a somewhat anomalous one as we enter 2H16, in that we believe opportunities will continue to exist despite what will likely be continuously rising aggregate default rates. In fact, in the year ahead, overall default rates will likely increase above high yield's historical average. However, we feel this math will be more a result of the financial strain originating from energy and mining bonds but not the rest of the market.

It is important to break down the components of current high yield default trends as headline numbers could become confusing in the year ahead. It is quite likely that the aggregate default rate in high yield will conclude 2016 at a level above its historical average of approximately 4.2%. While this will undoubtedly unnerve some investors, the essential point to realize is that this overall number is probably going to be driven by a double-digit default rate in energy and mining bonds. Should that rate within these two sectors reach as high as 15 to 20% as some forecasts are calling for, that could drive overall defaults to approximately 6%. However, under this scenario non-energy and mining bonds would still likely maintain default rates in the neighborhood of 3.5 to 4%, which would remain below historical averages.



High-Yield Spreads vs. High-Yield Default Rates

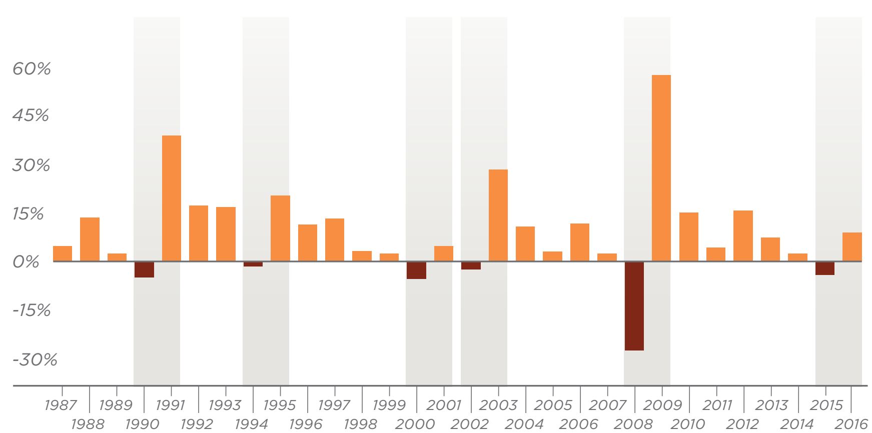
December 31, 2005–June 30, 2016 // Source: Spread data from Federal Reserve Bank of St. Louis; Default rate data and forecasts from Moody's

In looking at spreads to comparable treasuries, it is interesting to note that since the summer of 2014 when oil prices began their precipitous decline of more than 70%, overall high yield spreads widened approximately 220 basis points to 5.4% as of July 15, 2016. This included about a 4% rise in energy and mining bond spreads, which represent approximately 15% of high yield issuance. Therefore, approximately 0.60% of the 2.2% increase over that time was attributable to the energy and mining sectors implying that investors are now receiving incremental yields of about 1.9% on the remaining areas of high yield where default rates have remained below historical averages.

The unfortunate reality for energy bonds is that the hardship endured from the crash in oil prices during the year and a half preceding this past February will almost certainly take more time to play out. Even if oil prices continue to bounce higher and the overall economy and corporate earnings recover in 2H16, it will still likely prove too late for many of these bonds. In the process, the headline high yield math could get a little wacky. Over the next 12 months, we could see rising default rates and tightening spreads, which is basically what we have witnessed through the first half of this year. This would be due to the fact that energy bonds would be experiencing high default rates but their overall composition of the market would still be low. If 2H16 does see an improvement in the broader economy, we expect the energy and mining sectors to remain isolated in their default trends allowing the remaining sectors to not only meet their coupon payments without stress but possibly trade at tighter spreads. The key point for investors amidst all of this, is to maintain high yield exposure within diversified portfolios that avoid or are underweight energy and mining issues. It is simply best to let the dust settle and then some before returning to index weights in these sectors.

As we also mentioned in our 2016 Market Outlook published back in January, on only six occasions over the past 28 years (1990, 1994, 2000, 2002, 2008, and 2015) have high yield bonds suffered aggregate losses for the calendar year, and in each of those cases, the following year was a strong one. The common theme in all of these occurrences was either a recession in the year of, before, or after that negative year, or in the case of 1994, inflationary fears leading to a material rise in overall interest rates. Hence, should 2016 not be a year of recession or inflationary concerns, as we do not expect it to be, it would imply that last year's sell off in high yield was an overreaction similar to the other five times since 1990.

In summary, we continue to favor high yield opportunities through 2H16 and beyond. However, we feel it is important to invest through diversified portfolios that continue to avoid or underweight the energy and mining sectors.



Buying the High-Yield Dip

Bank of America Merrill Lynch High-Yield Master II Index Returns 1987–Q2 2016
Source: Morningstar Direct // Note: You cannot invest directly in an index. Past performance does not guarantee future results.

Oil prices have improved considerably. However, they remain at low enough levels to finally start creating some economic tailwinds.

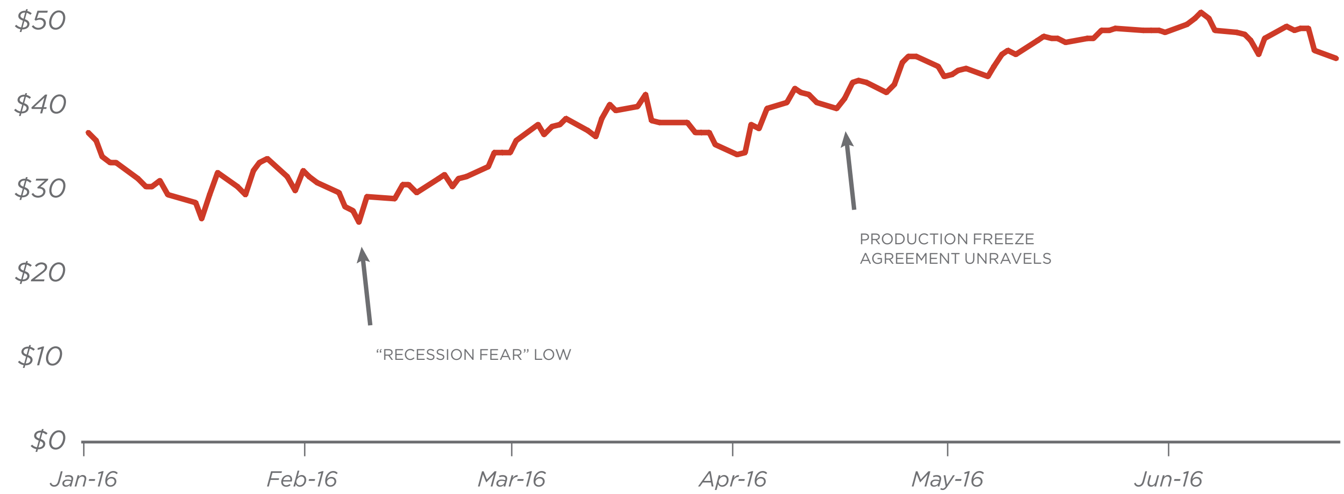
While there will be survival benefits for some U.S. producers, energy investors should remain cautious and long-term focused.

It has now been two years since crude oil peaked north of $100 per barrel, and as we look back over this time, it has clearly been a humbling experience for many who proclaimed themselves to be experts of this commodity.

As we mentioned back in January, when all is said and done, oil prices are subject to commodity-based valuation, which of course is nothing more than short to intermediate term supply and demand dynamics and how they may or may not be manipulated by market players. Fair value is an elusive determinant for oil, and if pressed to gauge a target over the next year, we would probably say in the $60 - $65 range although such a level would be subject to volatility and the path there would be far from linear.

With this in mind, we would still like to offer the following points regarding our perspective of the oil market and its impact on the broader economy.

- While oil prices cratered without mercy for more than a year and a half, we believe there is logical rationale to suggest that the worst is over and that a more positive trend has been established.
- The North American shale industry has certainly incurred widespread damage. However, those who survive should be positioned for higher profitability.
- From a macro economic standpoint, lower oil prices are beginning to play a role in enhanced consumer spending, and this is evolving into an economic tailwind.



Oil Prices: West Texas Intermediate

January 1, 2016-June 30, 2016 // Source: Federal Reserve Bank of St. Louis

It was our opinion that the bulk of the first leg down in oil during the summer of 2014 was demand related as slowing global rates of growth likely accounted for the original move from over $100 to the $80 range. However, thereafter we felt that the majority of the second leg, from $80 to the mid-$50 level during 4Q14 was supply related as OPEC strategically let production run in order to directly challenge market share of the North American shale industry. Following what may be viewed in retrospect as a fool's rally in the spring of 2015 back to $60, summer fears of a slowdown in China combined with crashing stock prices of that region, as well as our own equity market correction here in the U.S., sent crude prices to the painful point of $37 to close out the year. Then as more concerns in China emerged along with fears of a U.S. recession, oil prices essentially hit free fall in the early winter months of 2016, bottoming out at $26 per barrel the second week in February. By this time, U.S. production was down about 5% from peak levels.

Sentiment had turned pretty negative at this point and from a pure technical perspective, $26 per barrel corresponded with the 15-year low for crude oil during the height of the tech bubble sell off in 2002. The next level of support was around $16 which dated back to the Asian crises of 1998. While it's never good to be looking at support levels 18 years old, this was perhaps the first indicator that oil was either going to drop another $10 (40%) or at the very least get one heck of a dead cat bounce. Of course we know now the answer turned out to be the latter of these two scenarios, but at the time, more than a few pundits were forecasting the former.

As oil recovered with equities through the end of March, $40 seemed to be an important milestone for three reasons. First, it was a nice round number. Second, it represented the level at which the November 2015 "more of the same" OPEC meeting had begun sending prices to multiyear lows. Third, it seemed within reach of the January 2009 mark of $47, which had been the previous recessionary low. So oil was at this $40 price on April 17, when 18 OPEC and non-OPEC oil-producing nations met in Doha, Qatar to officially reach and enact a production freeze agreement.

That agreement, some 11 months in the making, fell apart in about 11 hours when Iran backed off and surprisingly Saudi Arabia refused to participate without them. As this news hit the markets the following morning, bearish sentiment seemed to be all consuming and forecasts of $20 oil were back in vogue. Then a funny thing happened, after dropping about $2 (5%) that morning, crude oil rallied hard and finished 2Q16 only slightly below $50. To us, this was an indication that price levels had become washed out and crude oil was likely in at least an intermediate term favorable trend.

Our view on the energy sector has been that investors should brace for volatility, have a long-term time horizon and own companies less susceptible to direct moves in oil prices themselves. We have also warned against exposure to energy bonds within the high yield market where we believe more collateral damage is likely to play out. With all of that in mind, we do feel that some of the stronger shale producers will emerge from these past couple of years leaner and better positioned for profitability.

The potential for such industry Darwinism can be seen in the fact that total U.S. rig counts as of the end of 2Q16 are down approximately 80% from 4Q14 highs with the weekly downward trend finally reversing itself during the month of May. Word is break even on existing facilities is somewhere around $45 and should we see a sustained move above $50, profitability ratios will probably be higher than the last go round. As smart firms have found ways to survive with lower costs, such belt tightening should result in higher margins as prices improve. While living through the oil price crash of these past two years is obviously not the road most would have chosen, survival does have its benefits.

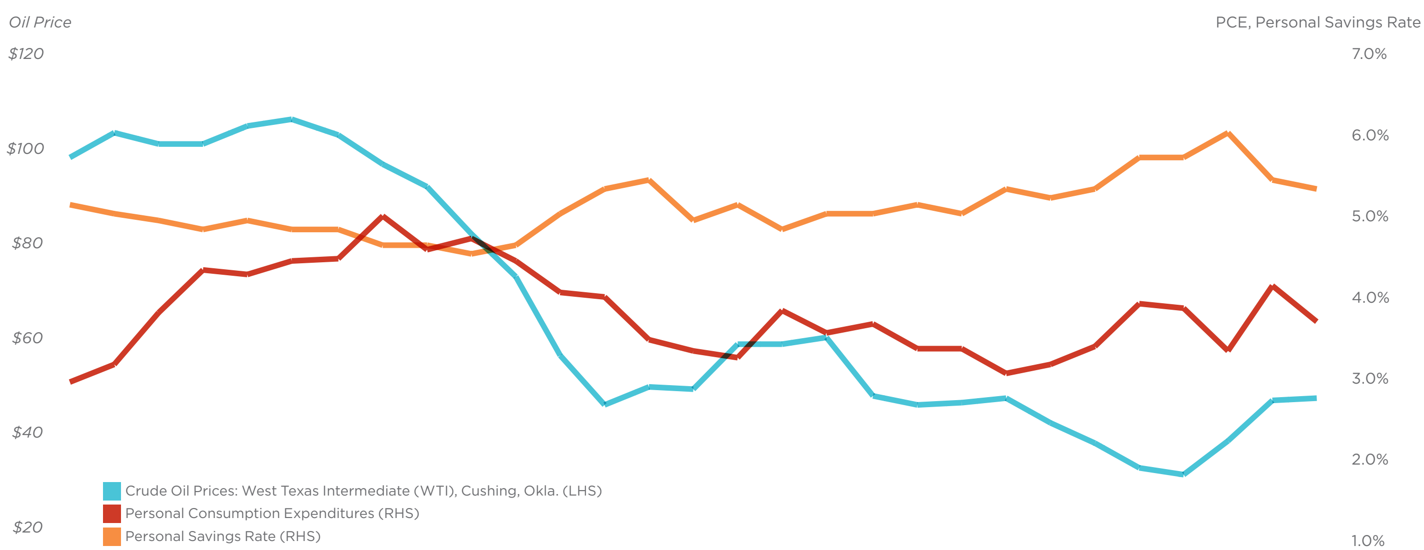
As we also mentioned at the year's onset, the free fall in oil prices wreaked havoc on the U.S. economy throughout 2015, and this continued through 1Q16 as massive job losses and the curtailment of business spending in the energy sector created a net drag on overall growth. Corporate profits also took a hit because of oil as the energy sector witnessed earnings declines in the 70 to 80% range, representing the predominant cause behind negative earnings growth for the S&P 500® in 2015 and forecasts of basically flat growth in 2016.

However, as we also stated, we believe low oil prices have likely been a case of bad news right away and good news later. The good news could occur on two fronts over the next six months. The first is the simple math of better macroeconomic and earnings comparisons as oil sustains itself at these higher levels. This will likely begin to play out between now and year end, assuming we don't have a downward reversal of these more recent prices. The second is that we believe we are beginning to see encouraging trends regarding consumer spending and retail sales as a result of lower gas prices and fuel costs.

Consumer behavior often dictates that lower everyday costs, such as gas and fuel expenses in this case, need to be internalized psychologically and saved financially before they are disseminated back into the economy. The everyday people at the malls, shops, restaurants, and their computers, typically need to feel that such lower costs will be sustained before they are comfortable spending more.

We believe there is evidence of this now as seen in stronger retail sales in 2Q16. Annualized gains for retail sales closed out June at 2.7% and core retail sales (excluding autos and gas) also rose above expectations for the month at 0.7%. In our opinion, these recent trends are important ones in that they are being driven by real live everyday people whose spending habits, when all the numbers are tallied, still represent about two-thirds of our economy's overall growth.

Clearly the path of lower oil prices has been somewhat painful both in terms of the energy sector and the net drag it has created on the broader economy. However, as we anniversary their lowest levels in the months ahead, we believe price trends may well have turned and consumer spending habits are finally beginning to reflect lower gas and fuel costs. Should these trends continue, the current price of oil—even with an upside range of perhaps another $10 to $20—will likely shift to a tailwind for the economy.



Oil Prices, Spending and Savings

January 2014–May 2016 // Source: Federal Reserve Bank of St. Louis

Brexit has impacted the international playing field as uncertainties could slow Europe and a rising yen will challenge Japan.

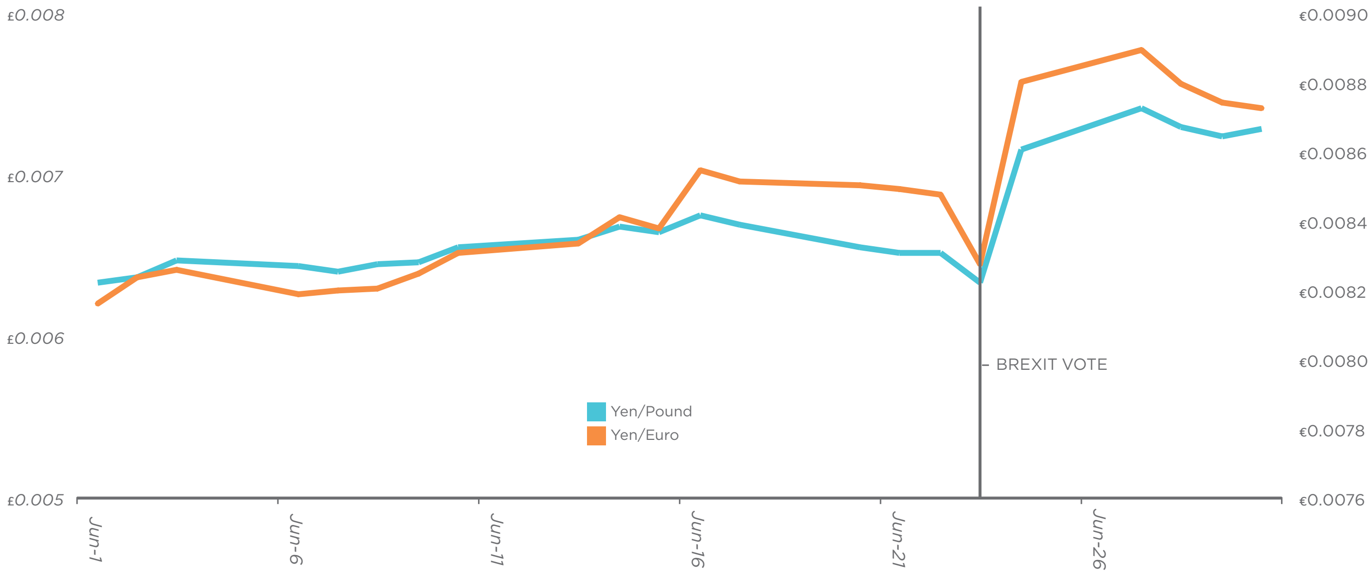
While opportunities still exist in these regions, fundamental security selection will be imperative to find them.

The new post-Brexit world has complicated international investing. In Europe, long-term opportunities have turned to intermediate-term uncertainties, and in Japan, investors are paying a steep price for being a safe harbor. The world just isn't a fair place sometimes.

When the year began, these two regions were well-positioned in our opinion based, on accommodative monetary policy and the potential for modestly improving economies. The central banks in both Europe and Japan had aggressively increased Quantitative Easing (QE) and moved to negative short-term interest rates, which presented an enhanced opportunity for their equity markets, provided there was some evidence of incremental economic growth. It did not have to be rapid growth, simply improving perhaps in the neighborhood of 2% for Europe and north of 1% in Japan. Enough so that when combined with the liquidity induced by the European Central Bank (ECB) and Bank of Japan (BOJ), stock market investors in these regions could have the wind at their sails.

Unfortunately, Brexit has thrown cold water on this. While we believe that markets overreacted in the days immediately following the referendum vote in Great Britain, there can be no question that the uncertainties now thrust upon Europe's economic landscape became considerably greater on the morning of June 24 than they had been the day before. No country has ever left the EU before, and in its strictest definition, few things are more uncertain than those that have never happened before.

Economically, politically, and socially there is no precedent. This is truly uncharted waters. Nobody can text their parents or grandparents to ask them how things worked out the last time someone left the EU. There could be a few silver linings in this of course. First, the lack of any history here will probably mean that the divorce proceedings between Britain and the Union will be more prolonged and deliberate, which ultimately could mean a smoother and more cautionary transition. Second, given the complexities certain to be involved, other nations witnessing this separation may well become more hesitant to follow Britain's lead. Finally, if the British pound continues to take a beating, this could be a boost to exports.



British Pound and Euro vs. Japanese Yen

June 1, 2016-June 30, 2016 // Source: Bloomberg

Even with potential silver linings, the balance of these uncertainties will cloud the economic horizon in Europe. Risk of recession in the U.K. has increased considerably as British consumers will become less confident and overseas companies will be reticent to commit capital. Trade between Britain and the other EU members will invariably suffer. Populist movements in the other member nations, if not capable of inspiring another departure, can certainly make enough noise to warrant concern. Clearly perspective is important; this is not a Lehman bankruptcy, or an Asian Crises, or a sovereign debt default, but it is not good.

Japan is also an unfortunate recipient of Brexit pain for among the most ironic of reasons. As a strong exporting nation with low debt and high consumer wealth, the Japanese yen has typically been viewed as safe haven currency, in some ways even more so than the dollar. As a result, the yen surged amidst the pound and euro's decline immediately following the referendum and closed out the 2Q some 15% higher against the euro and 17% against the dollar than its year-end 2015 levels. If the pound and euro continue to drift lower, this higher yen level will persist.

A higher yen is problematic for the Japanese economy since so much of that nation's monetary policy has been aimed at creating a weaker home currency and, therefore, a more growth-oriented export environment. The BOJ's decision to venture into negative interest rates over the past year was also aimed at currency devaluation and the quest to avoid longer-term trade imbalances. The BOJ will likely intervene to fight this trend, but that will probably entail more QE and more negative rates, two monetary strategies that can increase overall economic risk if they are kept in force too long. Fighting a rising currency can be a difficult balancing act.

Finally, the rising yen will create an extremely challenging environment for Japan to reach its longer-term target of 2% inflation, or achieve any inflation at all for that matter. Just as the falling pound could encourage an inflationary impact in Britain, the rising yen could prove deflationary in Japan, which could certainly hamper growth. In summary, the voting electorate in Britain has unfortunately put Japan on a more difficult path to growth.

This is not to say that opportunities on the international front—and in particular Europe and Japan—have gone into hibernation. There are good companies in both of these regions, and skilled investors will still be able to find them at attractive valuations. However, in the post Brexit world, economic uncertainties and less-than-favorable currency pricing will likely be making that task more challenging.

How to position for the second half of 2016

- Continue to modestly overweight equities versus bonds in balanced portfolios as we believe the second half of the year should see improving economic growth and a corporate earnings recovery.
- We believe a combination of high yield bonds, preferred stocks, and higher dividend-paying common stocks in a diversified income strategy may achieve yields in what looks to once again be a "lower for longer" interest rate environment.
- We believe in moving portions of investment grade bond portfolios with lower yields and higher durations into high yield bonds, which may offer total returns of high single digits or better. In doing so, we also believe underweighting or avoiding the energy and mining sectors where credit risk still remains.
- There will likely be opportunities for total return and tax free income in select areas of the municipal bond market as local economies should benefit from improving trends in the second half of the year.
- In regard to international investing, we believe value-based strategies will be most prudent given that Brexit has created a more challenging growth environment in Europe and Japan. Fundamental security selection will be absolutely crucial for international strategies.

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