Beacon Trust

Guiding you forward.

Second Quarter Summary

On Thursday, June 23rd, citizens of the United Kingdom voted to exit the European Union free trade zone ("Brexit"). The decision, unlikely to be reversed, sent shock waves throughout global equity markets, with the S&P 500 falling 3.7% on June 24th. However, by the end of June most of the losses were recovered and the S&P 500 ended up 2.5% for the quarter and 3.8% for the first half of the year. By mid-July the S&P 500 was in record territory. The emerging consensus, cheered by the markets, is that the Federal Reserve will not raise interest rates in the near term, and perhaps at least through the end of the year. Central banks around the world from Europe to China to Japan are in accommodative modes.

Speaking of interest rates, bonds were among the best performing asset classes this year, with the Barclays Aggregate Bond Index up about 5% through the end of June. Many of our clients own municipal bonds, so the Barclays Municipal 5-Year Index is perhaps a more appropriate measure of fixed income performance. This index increased 1.2% for the quarter and 2.3% on a year-to-date basis, still quite respectable for a fairly low risk asset class. More importantly, the diversification benefits of investment grade fixed income securities were demonstrated during the stock market turmoil following the Brexit vote. In short, investment grade bonds continue to serve as ballast for diversified portfolios, despite their low yields.

Market Outlook

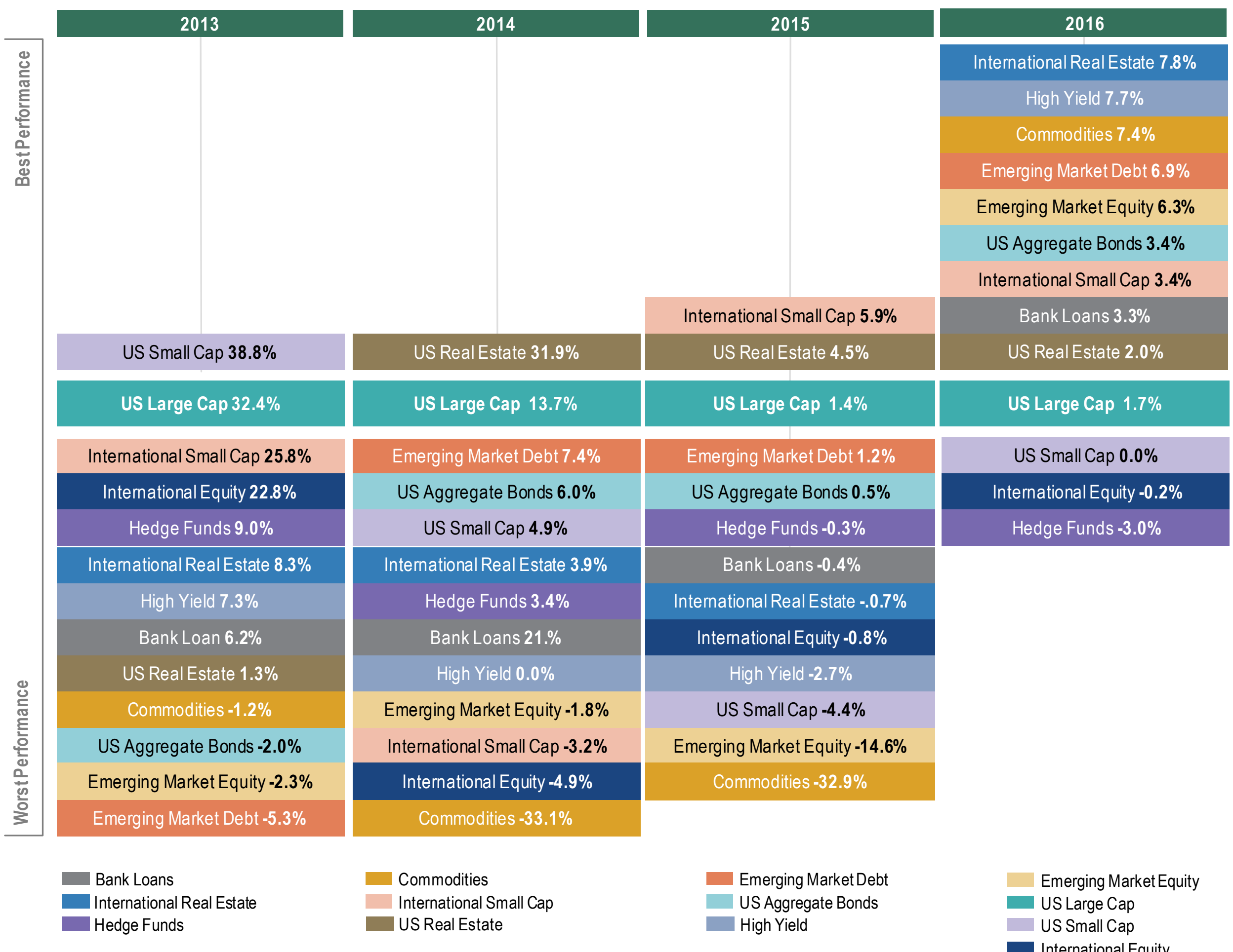
Our market outlook for equities remains one of modest returns and heightened volatility in the months ahead, similar in character to what we have experienced over the past twelve months. The main points supporting our view are heightened valuations and the likelihood of sluggish economic growth. For example, the trailing Price to Earnings (P/E) ratio for the S&P 500 is 19, excluding certain one-time items. On a forward looking basis, the P/E ratio is 17. Both of these numbers are higher than the market's historical P/E of 15. However, in our view, the exceptionally low level of interest rates should be able to support a higher P/E than the market's historical average, resulting in performance being driven by earnings growth. The decline in corporate credit spreads is also supportive of higher P/E valuations.

GDP for the first quarter came in at 1.1% and estimates for the second quarter are slightly better, with the consensus estimate at 2.4%. GDP estimates for the remainder of the year are approximately 2.5%, supporting modest, but not robust, growth. Yields on investment grade bonds remain exceptionally low, with the 10 Year U.S. Treasury Note at approximately 1.4%. While our 1.25% optimistic target for the 10 Year Treasury Note yield has come close to realization, we believe the downside is about 1.0%, based on the negative sovereign debt yield throughout much of Europe and Japan. The more than 5% return experienced by the Barclays Aggregate Index though June is unlikely to be repeated during the second half of the year. A reasonable expectation is for investment grade bonds to earn their coupons on a forward looking basis, plus potentially modest capital gains, if rates do indeed fall to the 1% range.

Relative Performance of Various Asset Classes

We believe that diversification lies at the heart of constructing intelligent portfolios. However, in recent years, investors with diversified portfolios have been penalized, at least relative to the performance large cap U.S. equities. An additional part of our market outlook is that investors will likely realize improved benefits from diversification going forward. **Figure 1** provides a nice visual representation of the returns of various asset classes, such as domestic equities, international equities, real estate and hedge funds. Over the 2013-2015 time periods, few asset classes kept up with the performance of U.S. Large Cap stocks (shown in the light green or teal color in **Figure 1**). However, on a 2016 YTD period, it appears that the traditional benefits of diversification have resumed. As shown on the right hand part of **Figure 1**, on a year to date basis, other classes are adding value, in addition to large cap U.S. equities. With U.S. equity valuations heightened and investment grade fixed income yields near historic low levels, investors may rely on other asset classes to drive portfolio returns in the future.

Figure 1: Relative Performance of Various Asset Classes (2013-2016 YTD)



Source: Goldman Sachs

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