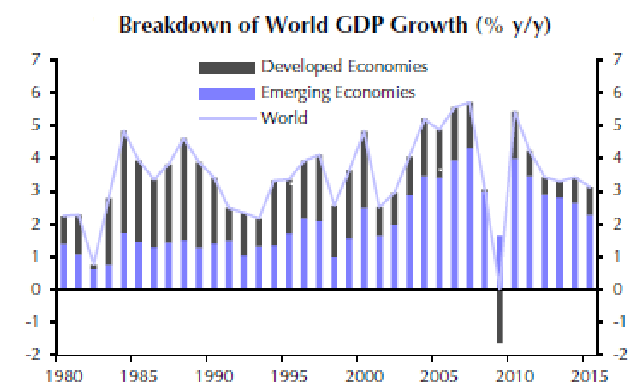
PATHSTONE
FEDERAL STREET

Economic & Market Commentary
Q2-2016

The second quarter of 2016 started off with strong positive returns across the global equity markets. Upbeat investor sentiment quickly changed course in June, as the U.K. referendum to leave the European Union, combined with the Federal Reserve's decision to *not* raise short term interest rates, produced dramatic price swings over the last three weeks of the quarter. The modestly positive quarterly return of the MSCI All-Country World Index masked the intra-quarter volatility as the index declined almost 7% in the two days following the U.K. referendum, followed by a recovery.

In contrast, most segments of the U.S. bond market performed well. The best performance came from U.S. government bonds as interest rates continued to decline with the 10 year Treasury yield falling 0.30% during the quarter, hitting lows not seen since the peak of the Euro crisis in 2012, as investors sought the safety of U.S. debt in the uncertain aftermath of the post-U.K. referendum. U.S. high yield bonds, with their U.S.-centric revenue base, also posted strong returns, as oil prices climbed another 32%, further relieving investor fear of defaults in the oil and oil-related sectors. Echoing the increased demand for fixed income, the highest dividend sectors of the equity market also proved popular with investors hungry for yield amidst low and plummeting interest rates.

Leadership changes in the market have been notable this year, as investors focused their capital on areas of the market that were previously oversold. For example, stocks in emerging markets are now leading equity markets year-to-date. Even with declining growth rates, growth across the emerging economies still far outpaces that of the developed markets. Emerging market stocks did not bear the brunt of the more recent market decline, as their relatively attractive valuations and their reduced reliance on demand from developed countries helped cushion the downdraft. Conversely, pricier growth stocks declined more precipitously, with small cap biotech stocks, for example, losing more than a quarter of their value in the first half of 2016. This style shift is translating into outperformance for many exceptional active managers that focus on value, as the margin of safety built into their portfolios is becoming more appreciated in an environment of uncertainty.



As we look ahead, we are mindful of the additional complexity and uncertainty that accompany the recent U.K. referendum. It will become clearer as to which companies gain an advantage and which are disadvantaged by the U.K.'s shift in relations with the E.U., and volatility will increase as investors adjust their portfolios accordingly. Interest rates may stay lower for a longer period of time, and these lower rates also mean increased risks in the U.S. Treasury market. For example, despite the flight to Treasuries in June, the quarter witnessed daily price moves of the 10 year U.S. Treasury bond that were 40% more volatile than those of the below investment-grade Barclays High Yield Bond index.

Market volatility and uncertainty are accompanied by opportunity. In the aftermath of Brexit, we have already seen investment managers embrace opportunities to purchase securities at prices that are below their assessment of fair value. With the capital markets in general lacking the tailwind of robust economic growth, successful security selection and active portfolio management become even more valuable to a portfolio's total return.