Market Commentary

Equity markets were relatively calm during the second quarter until the final week of trading when Britain shocked global markets with a decision to leave the Eurozone in what has been termed "Brexit." Despite the impending Brexit, most major stock indices ended the quarter close to where they started. The S&P 500 ended the quarter with a small gain of 2.5% while small cap stocks outperformed and returned 3.5%. International stocks continued to lag and were down 0.6% this quarter.

Brexit fears caused a flight to safety for investors who in turn rushed to buy high quality bonds, which lowered bond yields. The expectation of continually declining interest rates is causing many European bonds to trade at negative interest rates. For example, the 10-year German government bond is yielding an all-time low of negative 0.1%. Futures traders have cut the probability of a Fed rate hike this year to 10%, down from 50% prior to the Brexit vote. Shifting expectations that interest rates will remain near historically low levels, coupled with the Federal Reserve waiting longer than expected to raise interest rates, pushed the Aggregate U.S. Bond Index up 2.4% this quarter (yield and price are inversely related). Declining interest rates also helped publicly traded real estate to be one of the best performing asset classes in the second quarter with a rise of 6.8%.

Brexit - Britain Surprises the World and Votes to Leave the Eurozone

In an historic June 23rd decision, Britain's populous voted 52% to 48% to end its 43-year membership in the European Union (EU). Most market participants expected Britain to vote to remain in the European Union, making the outcome a surprise to global financial markets. Britain will be navigating uncharted waters since no country has left the EU in its 59-year history. To proceed with the exit, Britain must notify the European Council under Article 50 of the Lisbon Treaty, which likely will not occur until a new prime minister is chosen several months from now. The official exit process will be a lengthy one, and may take up to two years of negotiations to complete. Until the exit process is finalized, all trade and border agreements will remain in place. While there are scenarios where Britain may change course and stay in the Eurozone, Parliament will likely follow the wishes of the people and vote to leave.

The surprise result of the vote roiled global markets and caused a 10% drop in the British pound, 5% declines in many major stock markets, and a 2% increase in high quality bonds. As markets digested the ramifications of Brexit over the subsequent week, they quickly stabilized and stocks regained most of their decline. Shocks like Brexit are a common occurrence (we have experienced two others recently including substantial market declines last August and January) and a timely reminder that investments always carry uncertainty and volatility. Market volatility often creates opportunities for smart investors to profit, not by clever trading or market timing, but by activities such as tax loss harvesting and portfolio rebalancing. In addition, Brexit has pushed interest rates near all-time lows making mortgage refinancing an attractive option for many. Although heightened volatility may endure, Brexit will likely have very little impact on diversified long-term oriented investors.

Comparative Returns

	Q2 2016 Returns	Annualized Performance			
		1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks(1)	2.5%	4.0%	11.5%	12.0%	7.3%
Small Cap U.S. Stocks(2)	3.5%	-5.1%	7.3%	8.1%	6.0%
International Stocks(3)	-0.6%	-10.2%	1.2%	0.1%	1.9%
Real Estate(4)	6.8%	23.9%	13.4%	12.4%	7.6%
U.S. Bonds(5)	2.4%	6.1%	4.0%	3.7%	5.1%

1. *Measured by the S&P 500 index, which includes 500 of the largest U.S. companies in all sectors of the economy.*
2. *Measured by the MSCI U.S. Small Cap Index.*
3. *Measured by the MSCI ACWI ex-U.S. index, which includes large and mid-capitalization stocks from developed and emerging international markets.*
4. *Measured by the MSCI U.S. REIT index, which includes domestic publicly traded real estate stocks.*
5. *Measured by the Barclays Aggregate Bond index, which includes a representation of the performance of the entire U.S. investment grade bond market.*

Matt Goette, CFA, CFP®, AIF®
President & Chief Investment Officer
Black Diamond Financial, LLC
www.blackdf.com