Greece, China, Puerto Rico and the Federal Reserve take center stage: Despite an increase in intra-day volatility, the U.S. markets end the quarter essentially unchanged.

Even as the bad weather, the West Coast port strike and other negative events from the first quarter dissipated, markets were faced with new challenges that increased uncertainty. The major headlines for the quarter included concerns about a Greek exit from the Eurozone, declines in commodity prices, increased anxiety about Fed action and most recently concerns about China and Puerto Rico. But despite these on-going risks, the underlying fundamentals of the U.S. economy and financial markets remained solid.

The situation in Greece seemed to garner most of the news coverage over the last few months. As we sit here today, it appears that the Greek prime minister and the Greek Parliament have agreed to a bailout deal with the ECB, EU and IMF. As part of the deal, if implemented, the Greeks would need to step up pension reforms, broaden the tax base and sell government assets. While the back- and-forth of these negotiations weighed on global markets, we believe that no matter the outcome, Greece will not have a major impact on the European economies, or more importantly, the U.S. economy and financial markets. However, a finalized deal would certainly remove one major source of angst from the market.

The recent sharp sell-off in the Chinese equity market has led to concerns about the Chinese economy and its effect on global growth. The Chinese stock market had risen nearly 150% through mid-June as more and more investors borrowed money to buy shares. The market began to decline, which led to forced selling to cover margin calls, which then led to further price declines. The Chinese government stepped in and tightened regulations in an effort to stop the decline. At this point, the major selling appear to have abated and some stability has returned to the market; however, many trading restrictions still remain in place. So far, this seems to be more of a local market event and not something that will hurt global markets over the longer term. The Chinese economy has been growing at a slower pace over the last few years but is still expected to expand between 6-7% this year. Closer to home, Puerto Rico recently announced that it does not have the ability to repay the large debt owed to creditors. Unlike U.S. cities, Puerto Rico does not have the ability to file for bankruptcy, so it will need to work with creditors to seek a solution. Again, much like Greece, these issues have generated headline risk and bear watching, but so far do not change the underlying fundamentals of our economic or market outlook.

After another slow start to the year, in which the U.S. economy contracted by 0.2%, we are seeing signs of better economic growth as the improving labor market and rising disposable incomes are generating increasing levels of consumer spending. Consumer confidence readings have been trending higher as people feel more upbeat about the future. The unemployment rate fell to 5.3%, the lowest level since June of 2008. While the level of long-term unemployed and underemployed remains elevated, we continue to see improvement here as well. Household formation increased by a total of 3.2 million over the prior two quarters. While the increases have been primarily driven by renters rather than home purchasers, the trend of more people moving out on their own is a further sign of confidence in the future. While it is still early, the housing market

appears to be gaining some momentum as well. Recently, we have seen positive trends in new and existing home sales. Home prices are up just under 5% year-over-year, which is increasing consumer net worth. Overall, we continue to believe that U.S. economic growth has improved from the 1st quarter, and we expect to see continued moderate growth throughout the rest of the year.

While increased geo-political risks led to a lot of intraday volatility in the equity market, the U.S. markets ended the quarter almost exactly where they started. However, returns across the various sectors of the market have varied greatly. The more cyclical and consumer related sectors have been outperforming, while the more defensive market sectors have lagged. Additionally, some sectors, such as health care have been boosted by increased merger and acquisition activity. We have also seen increased volatility in interest rates, both domestically and overseas. Some of this has been driven by the expectation of Federal Reserve action, but rates also moved higher along with those in Europe, as the Greek crisis unfolded. European sovereign debt yields declined early in the year due to the purchase program enacted by the European Central Bank. The yield on 10-year German debt was as low as 0.07% earlier in the year but has since risen to 0.98%. The yield of the 10-year U.S. Treasury reached a low of 1.64% in January and traded as high as 2.49% in early June. While these rates are still low by historical standards, expectations are for them to trend higher over time. Along with equity markets, volatility in fixed income markets will also likely remain high.

The Federal Reserve is still expected to raise rates in the fall, but the pace and magnitude of any moves will likely be more muted than in previous cycles. The Fed is not expected to raise rates at every meeting, and the fed funds rate will not likely approach its longer term average of 1.6% until well after 2017. The Fed is not looking to tighten monetary policy but rather to move away from the overly accommodative stance that has been in place since December of 2008. Given the progress made toward the Fed's goals of full employment and stable inflation, zero bound interest rates are no longer needed. It would take a significant increase in economic growth, along with a sustained acceleration in inflation to push the fed to raise rates more substantially or at a faster pace.

Oil prices remained range bound for most of the quarter, but have since begun to decline on worries about over supply. Rig counts are down nearly 50% in the U.S. but due to efficiency gains, total production has actually risen. OPEC countries are maintaining production near peak capacity in order to protect market share. In addition, the prospect of Iranian oil coming to market this year has risen with the just announced nuclear deal. While global demand is expected to increase over the next few years, concerns that supply will outpace demand are likely to keep prices from returning to last year's high levels. While lower prices are a challenge for the energy industry, it is important to note that the positive benefits that accrue to U.S. and global economic growth from low energy prices far outweighs the negative to the energy industry.

Despite all of the shorter-term headwinds, we remain focused on the longer-term view for the U.S. and global markets. Our belief is that moderate growth led by a healthy consumer should support continued longer-term earnings and revenue gains, which will move equity prices higher. We continue to favor consumer related sectors of the market and have been reducing our exposure to more interest rate sensitive sectors such as Utilities. In the Fixed Income allocation, we remain focused on generating incremental yield while keeping the duration of the assets short, in anticipation of higher rates. We will continue to monitor the events both here and overseas and remain ready to make adjustments as needed. In the meantime, while near-term volatility will likely remain high, we believe that the solid fundamentals of the U.S. economy and the increasing earnings of U.S. companies will drive returns over the longer term.

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