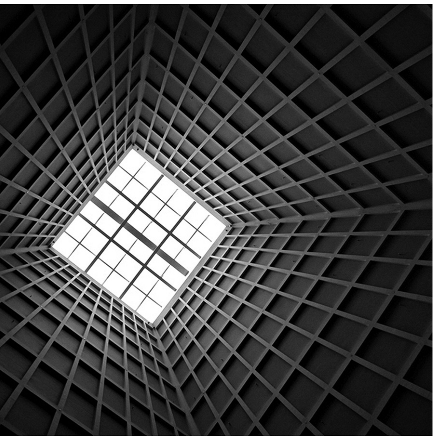
GUIDANCE

POINT OF VIEW

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

JULY 2016



The U.S. equity market staged a substantial turnaround to end the second quarter of 2016 with positive returns of 2.5% for the S&P 500 broad domestic market index. Each month of the quarter was positive even considering the dramatic 5% decline in the aftermath of the decision by the United Kingdom to withdraw from the European Union ("Brexit").

Brexit was the major story of the second quarter, unleashing a sell-off that took most equity markets down 5-7% in the two days following this somewhat-surprising decision. However, most markets quickly rallied to gain most of the losses back in the days following.

Continued uncertain economic growth outside of the U.S. and a slowdown in new job creation overall in the second quarter in the U.S. seemed to postpone further interest rate increases by the Federal Reserve, with the UK's action likely reducing economic activity further. Oil prices gained more than 25% in the quarter, and had almost doubled since their February lows until the Brexit vote. The yield on 10-year U.S. Treasury Notes dropped to 1.47%, a mere seven basis points above its record low of 1.40% in July 2012. The U.S. dollar strengthened slightly against the Euro, while the British Pound lost 5% against the Euro and 7% against the U.S. dollar.

The quarter exhibited a fairly healthy appetite for risk persisting after the mid-February market bottom. Small-cap stocks performed the best during the quarter, with the Russell 2000 Index adding 3.79%. Performance degraded as we moved up the capitalization spectrum—the max-cap Russell Top 200 Index had the weakest return—but still recorded a solid 2.26% gain.

While the first quarter experienced most of the style disparity in the small- and mid-cap region of the market, the second quarter experienced greater disparity among large- and mega-cap stocks. Value stocks outpaced growth stocks by about 4% for each of those groups. Value stocks also outperformed again in the small- and mid-cap groups, but the margin was not as great as the first quarter. Across all major style-based indices, the Russell Midcap Value Index was again the top performer, returning 4.77%; bringing its year-to-date gain to a very solid 8.87%. The largest style-based discrepancy this year is within the Russell 2500, here, the Value Index has outpaced its Growth counterpart by 7.87%, after trailing by nearly 5.7% last year.

Within the broader S&P 500 Index, counter-cyclicals again led the charge. Also, this quarter, Energy stocks roared back to life on the back of recovering oil prices. The Energy sector paced the S&P 500 Index, adding 11.62% and bringing its year-to-date gain to 16.10%. This first-half gain almost pales in comparison to that of the high-yielding Telecom and Utilities sectors, which have surged 24.85% and 23.41%, respectively.

Outlook

Investors around the world were not expecting the British to vote to leave the European Union on June 23, but "Brexit" they did, causing at least a short-term spike in volatility and global economic uncertainty. The Brexit vote wiped out about $3 trillion in value from global equities in the two-day selloff, much of which was recovered in the ensuing three days. The reasons Brits decided to leave the EU are not terribly clear, but suggested culprits included business owners' frustration with growing bureaucratic interference and red tape, and increasing worries relating to the EU's policies of allowing free immigration across all EU borders without limitation. What does seem clear is that most Brits, including those who led the effort to exit, had done little planning in the event that the "Leave" movement prevailed. Prime Minister David Cameron resigned immediately; and more surprisingly, two "Brexit" leaders, former London mayor Boris Johnson and UK Independence Party leader Nigel Farage, stepped away from the effort, removing themselves from consideration as the country's next Prime Minister. This has left a void at the top at a time when strong leadership is needed to chart the future path of the country, both politically and economically. The British Pound hit a 31-year low in early July as the ramifications of Brexit were digested by investors around the world. Our view is that the financial and real estate sectors are most at risk of a slowdown in the UK, as banks and others in London (a global financial center) contemplate their future in the country. Many believe the process of leaving the EU could lead to economic recession, which would put further pressure on banks as loan growth slows and losses rise. Growth in other parts of Europe could also be at risk; the decline in the Pound will make British exports more competitive with those of other EU member countries, while lagging demand from UK consumers would also hurt. Finally, the risk that other EU countries may now also contemplate an exit from the Union exacerbates the uncertainty of the current environment. Scotland is again threatening to leave the UK in order to remain in the EU, while vocal minorities in France, Italy, and others are now advocating for their own departure.

We expect periods of sustained volatility in the next several years (Brexit is at least a two-year process) as negotiations to leave the Union unfold. Perhaps the biggest impact thus far is another downdraft in interest rates around the globe. The U.S. 10-year Treasury broke through its record low of 1.39% in early July. Almost $12 trillion of sovereign government debt now sports a negative yield, a number that has grown by $1.3 trillion in the last 30 days. Japanese government bonds have negative yields out to almost 20 years; those of Germany are negative out past 10 years. One must pay the Swiss government 1.17% to own a 2-year bond, while the 50-year Swiss government bond now yields -0.02%, suggesting that investors are willing to pay the Swiss a small fee every year for a very long time for the privilege of owning Swiss francs.

There is nothing "ordinary" or "normal" about the state of global interest rates; indeed, analysts suggest nothing we see indicates that markets will return to a "normal" state any time soon. It does not stand to reason that U.S. interest rates have to rise in this environment, and in fact, U.S. interest rates may be headed lower.

The case for owning equities in this environment is fragile. We focus on the health of the labor market and levels of corporate investment as primary barometers, as they contribute about 85% to GDP growth and are not related to government spending, which needs to be reined-in if budget deficits are to be controlled. Currently we see mixed signs; employment growth has been solid, with nonfarm payrolls expanding by an average of more than 200,000 jobs per month over the last twelve months. However, wage growth has been very sluggish, and well below the level needed to support more robust U.S. economic growth.

Simultaneously, capital investment has been weaker than expected, even after accounting for the dramatic decline in energy prices in 2015. Capital spending fell by 6.2% in the first quarter, after declining by more than 2% last year. With tepid organic growth prospects, little-to-no pricing power, global economic uncertainty, and a presidential election looming, corporate America is keeping a tight leash on spending. Most surveys we have reviewed forecast little, if any, growth in capital spending for the balance of 2016. Reasonably stable oil prices may result in a modest pickup in spending in the energy sector from the depressed levels of the last 18 months. However, a broader stimulant in investing is also necessary to drive more sustained U.S. economic growth.

Of course, we believe that long-term equity values are determined by the level of corporate earnings, and the alternative (risk-free) return available to investors. If interest rates remain low, equities can trade for a while at values that appear to be well above historical multiples of earnings. However, a substantial increase in the growth of earnings above current rates would be necessary to maintain broad equity market levels if interest rates were to rise. The Federal Reserve is keenly aware of this relationship, and we do not expect to see them raise interest rates until such growth becomes evident.

We continue to seek opportunities to improve our portfolio holdings by owning solid businesses run by good managers whose financial interests are aligned with ours. We are mindful of the potential unintended consequences of investing in this market and are always focused on managing our downside exposure. Over the long term, we are confident that we can generate attractive returns with our investment styles on behalf of our investors.