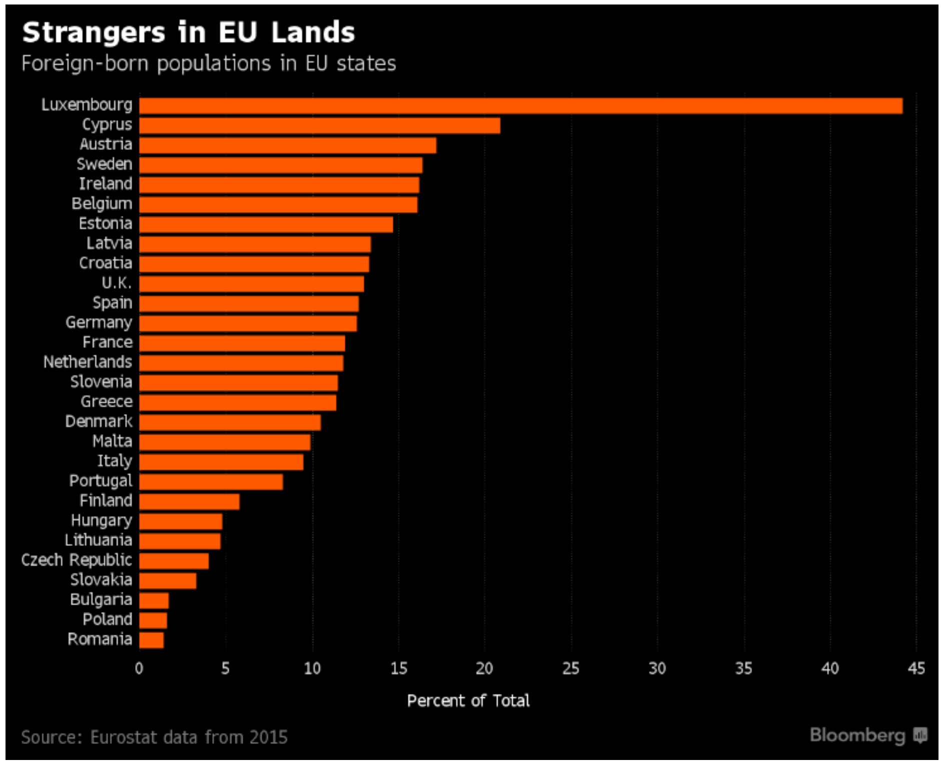
THE MATHER GROUP

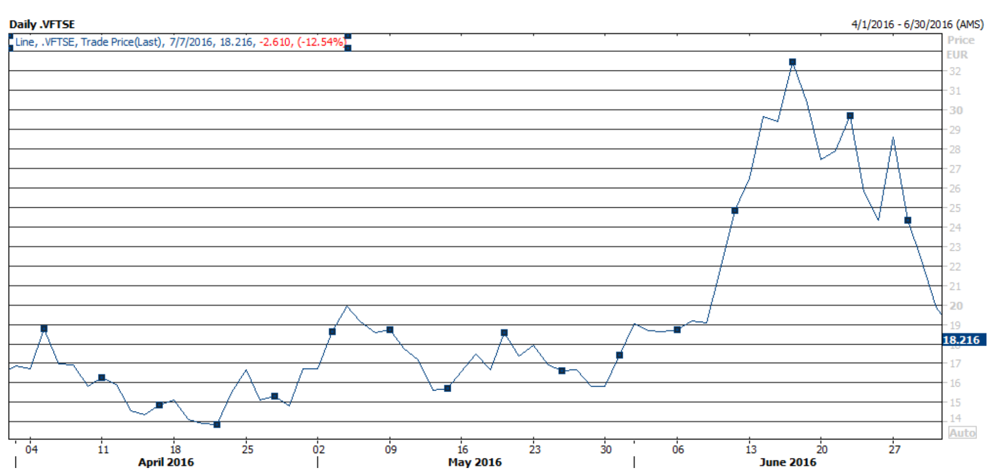
MARKET COMMENTARY
SECOND QUARTER 2016

MARKET SPOTLIGHT: BREXIT



The European Union (EU) is an economic and political partnership involving 28 European countries. It was formed after World War II to foster economic cooperation, with the idea that countries that trade together are less likely to go to war with each other. The policies of the EU aim to ensure the free movement of people, goods, services, and capital within the internal market, and maintain common policies on trade, agriculture, fisheries, and regional development. In its referendum held on June 23, the UK voted to leave the EU by a majority of 51.9% to 48.1%. The impetus behind the referendum was the shortfall of $12.5 billion annually of funds sent and received to the EU. Further, high levels of immigration to the UK from within the EU contributed highly to the overall decision. EU members can travel freely within the union, resulting in a large foreign-born population as shown in the chart above. The idea of maintaining UK sovereignty was particularly relevant to older and less affluent voters.

The outcome of the referendum took most market participants by surprise. As shown the chart below, the volatility of the FTSE (Financial Times Stock Exchange Index) spiked immediately after the referendum, but has since abated. The British pound fell to a three-decade low. The FTSE 250 Index of UK stocks hit a two-year low. Rating agency Standard & Poor's has already downgraded the UK's credit rating to AA from AAA. The S&P 500 had its largest two-day drop since last August.



A week after the UK referendum decided on an EU exit, initial sharp market falls have been followed by a period of relative calm. However, we think that further market falls cannot be ruled out. UK politics is likely to remain unsettled for some time and the Brexit decision has also revealed underlying concerns about the EU itself. Uncertainty about the overall situation is likely to persist.

With that in mind, The Mather Group is limiting its exposure to the Vanguard FTSE Europe ETF, which has a near 4% dividend yield while eliminating HEDJ which has a 2% dividend. The governing Conservative party is due to conclude its leadership with elections on September 9. During this period, UK politics are likely to remain uncertain. It is becoming clearer that it will be enacted, and we will monitor as the situation develops. Given the political uncertainty, we think that further periods of volatility will remain. One immediate impact is that a Fed rate hike this summer now looks very unlikely. Further, the Bank of England has already stated that it may loosen policy. These accommodative policies should help markets find a firmer footing.

DOMESTIC EQUITY PERSPECTIVE

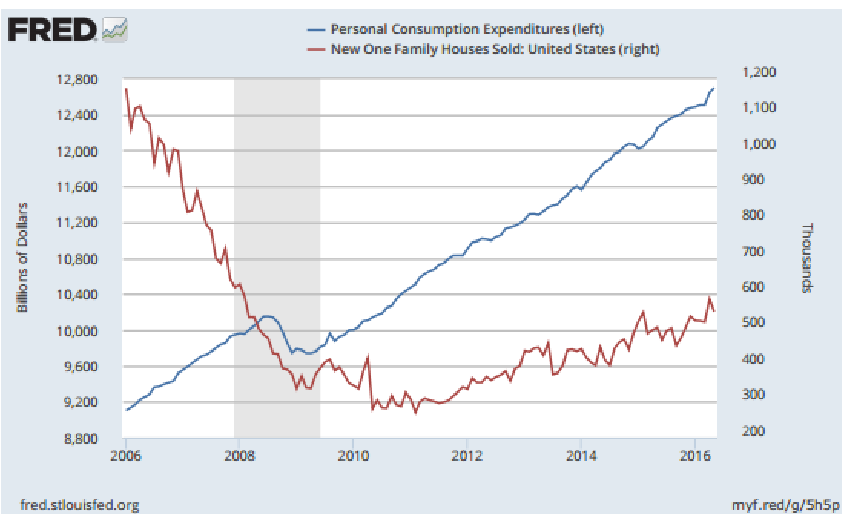
Domestic Market Returns

Equity Index	Q2 Total Return %	12-Month Total Return %
S&P 500	2.46%	3.99%
Dow Jones Industrial	2.07%	4.50%
NASDAQ	-0.56%	-2.89%
Russell 2000	3.79%	-6.73%

Source: Morningstar

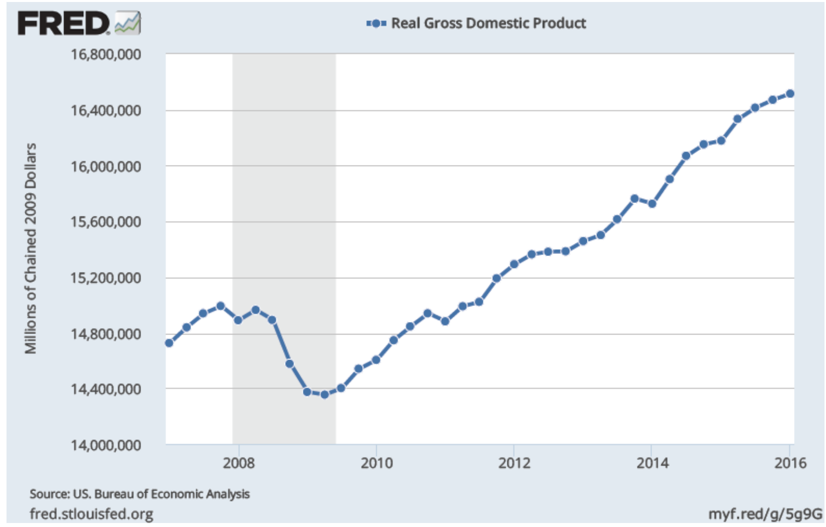
Domestic markets have rebounded after experiencing extreme volatility in the first quarter of 2016, with the S&P finishing +2.46%. While there has been uncertainty over the past 12 months, The Mather Group maintains a positive long-term investment horizon. There have been 81 rolling 10-year periods since 1926. During these periods, the S&P 500 produced gains in 77 of them and losses in 4 – which indicates that the market has increased in 97% of such 10 year periods. Research has indicated that patience and not trying to time the market provides long-term rewards to the investor. The Mather Group will continue to focus on domestic markets.

The United States housing market has been strong thus far in 2016. As shown in the chart to the left, new one-family houses were sold in April at a rate of 619,000 per year. This is the highest level since 2008. With much stricter lending requirements when compared to the pre-housing crisis, a strong housing market is a positive sign to the economy. Home prices are within 10% of the 2006 peak.



Concurrent to the housing market, there has been a substantial restoration of households' ability to spend. During uncertain times, consumer consumption is an important gauge to the health of the domestic economy. Consumer spending accounts for 70% of expenditures-based GDP. Considering that consumer spending carries a disproportionate weight, household spending needs to be strong to maintain GDP growth. Drilling down to this point, one must consider the relationship between household buying power and a household's ratio of household liquid assets to liabilities. When we combine the change in household cash flow and the gains in consumer credit and homeowners' equity, we find that household buying power advanced $1.96 trillion in the four quarters ending Q1 2016. Furthermore, there has been continual yearly Real GDP Growth since the financial crisis as shown in the chart on the next page below.

INTERNATIONAL EQUITY PERSPECTIVE



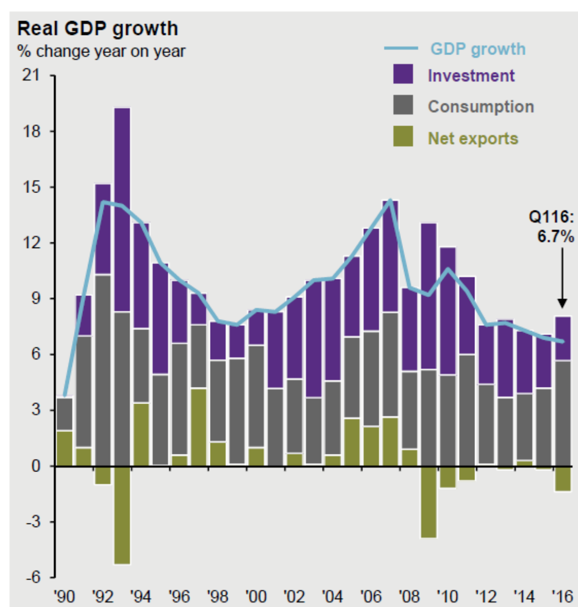
In the wake of the Brexit decision as discussed in the Market Spotlight, a number of factors are worth keeping an eye on in mainland Europe. Uncertainty around growth, inflation, policymaking, and geopolitical developments will keep European markets on edge. Issues within the Spanish and Italian banking sectors along with European banks in general, will continue to be monitored. In the first quarter of 2016, Eurozone GDP growth came in at a strong 0.6% quarter over quarter. This is 1.7% year-over-year through the end of the first quarter. Further credit widening would impact overall financial conditions for the Eurozone and appears to be key for the European Central Bank (ECB). The Mather Group maintains that a European position is essential to a diversified portfolio and expects that Eurozone growth can be positioned well in the second half of the year, potentially providing a strong dividend yield.

Q2 International Market Returns

Index	US Dollar Return %	Local Currency Return %	Difference %
World, except USA	-2.18	-1.49	-0.69
Europe, Australasia and Far East (EAFE)	-2.64	-1.92	-0.72
Europe	-4.22	-0.36	-3.86
Japan	0.88	-7.92	8.80
Pacific	0.38	-4.76	5.14
Emerging Markets	-0.32	-0.29	-0.03
China	-2.69	-1.42	-1.27

Source: MSCI

In comparison to the headlines in Europe, Asia-Pacific economies have been relatively calm in the second quarter of 2016. The latest Chinese GDP number, at 6.7%, reflects the slowest growth rate since the financial crisis. This is shown in the chart to the right. While slow in relative terms, the overall GDP growth in China is still strong. The regions continual growth has beat recent expectations. Risks related to housing, debt, and economic imbalances are rising. It is becoming evident that the Chinese economy is increasing its reliance on policy support. Public sector investment, for example, has spiked sharply upwards this year even while the private sector has dropped dramatically. Regional issues are putting pressures on the labor market. Manufacturing vs. Service industries are separated geographically rather than interspersed, creating boom and bust cycles regionally. Geo-political issues in the South China Sea will continue to stress relations with the West along with other Asian-Pacific countries. Further, the increasing value of the Japanese Yen was challenging for DXJ, our hedged Japanese position. This is



Source: FactSet, National Bureau of Statistics of China, J.P. Morgan Asset Management.

particularly true post-Brexit because a strong currency hurts exports, which is bad for Japanese companies and the economy overall. As a hedged position, it favors a strong US Dollar making the issue two-fold. With those challenges in mind, The Mather Group pivoted early in the second quarter to a domestic, large-cap position.

FIXED-INCOME PERSPECTIVE

After the Brexit vote, interest rates have continued to plunge lower. While central bank policies of low interest rates have saved the financial system from collapse in the past, continued low interest rates have hurt investors searching for steady income. In the infographic below, the asset classes investors have flocked to in search of yield have proven to be extremely risky. These asset classes, such as MLPs, have produced strong gains when rates have drifted lower and oil prices remain high.

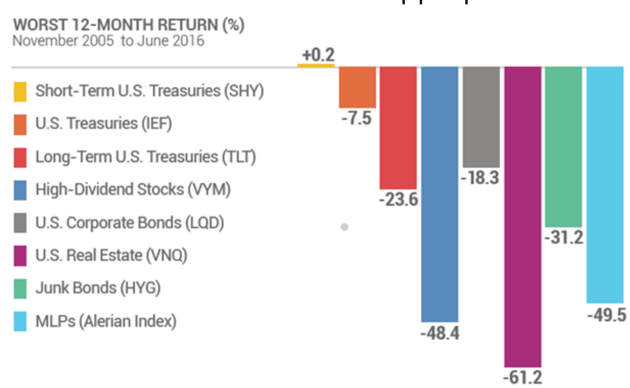
YTD Fixed-Income Performance

Bond Index Title	Return in US Dollars %	Duration in Years
US Aggregate Index	6.05	5.5
US Treasury Index	6.31	6.52
US Credit Index	8.71	7.43
US Corporate High-Yield	9.68	4.2
Global Aggregate Index	6.95	9.66
Global Treasury Index	12.41	8.25
Global Aggregate Corporate (issued in $USD)	7.18	8.46
Global Corporate High-Yield	4.33	9.28
Emerging Market Aggregate	5.92	10.29

Source: Barclays as of 7/5/16

Unfortunately, those strong gains did not last, as the drop in oil caused huge losses in MLPs. With this risk in mind, The Mather Group maintains focus on fixed income categories that have a long standing quality and return.

While Brexit has muted discussions of future rate hikes, a tightening labor market could place upward pressure on inflation. This leaves open the possibility of a rate hike this year. At the least, the vote has certainly decreased the urgency to increase rates. It is likely the Fed will wait for more evidence that employment growth and the overall economy is strong before announcing an increase. The low interest rate environment continues to create challenges for bond investors. Expectations for bonds should be muted and a portfolio mix of bonds with an appropriate duration will provide portfolio stability. Given the current environment, The Mather Group will continue to maintain a fixed-income allocation that takes into account the low interest rate challenges and risks going forward. To implement this strategy, The Mather Group will focus on high-quality investments that have a shorter duration and higher credit quality while maintaining a modest position in higher yielding, lower credit-quality holdings.



Source: Personal Capital

As always, please feel free to contact The Mather Group with any questions about our second-quarter commentary.

Stewart Mather, CFP®, CIMA®