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SECOND QUARTER 2016 REPORT
FOR BROKERAGE ACCOUNTS

Stocks closed the quarter with modest gains as the rally that started during the first quarter lost some of its steam. A string of fairly weak economic data, particularly relating to employment, helped keep the investment atmosphere subdued. Much of the discussion during the quarter revolved around the Federal Reserve as it continued to push back the time horizon for its next interest rate hike on the weaker than expected employment data. Oil prices also continued their steady march upwards during the quarter, briefly reaching $60 per barrel. Britain's referendum vote to leave the European Union, also known as "Brexit", caused a spike in volatility towards the end of the quarter with little overall change to stock index returns.

The bigger and longer lasting impact from Brexit was felt in interest rates and bond markets along with the value of the British Pound. In the US, 10-year Treasury bond yields hit a low of 1.39%. This pushed the year-to-date return on 10-year Treasury bonds to 8.0% as market values increased on lower rates. Junk bonds also produced a 9.1% return for the first six months, an opportunity we used to exit remaining holdings in the space. Although US Treasury bonds are approaching historically low yields, they are still quite attractive relative to other government debt. Currently 36% of all sovereign government debt globally is yielding less than zero, or negative rates, as of June 30th. Another 41% of sovereign debt is yielding between 0% and 1%, leaving only 22% yielding over 1% in annual interest. As investors continue to seek income substitutes for bonds, high yielding stocks, such as utilities, telecoms, and consumer staples produced big returns, despite having little growth and steep valuations. The value of the Pound has fallen to its lowest level against the US Dollar in 30 years, and further weakness is expected as the currency tracks the trajectory of the country's economy.

Major Stock & Bond Indexes (Total Return)			*Lipper Mutual Fund Indexes (Total Return)*		
	2Q16	YTD		2Q16	YTD
S&P 500 Index	2.5%	3.8%	Large-Cap Core Funds	2.0%	2.3%
Dow Jones Industrial	2.1%	4.3%	Large-Cap Growth Funds	0.4%	-2.4%
Russell Midcap Index	3.2%	5.5%	Large-Cap Value Funds	2.6%	2.9%
Russell 2000	3.8%	2.2%	Mid-Cap Core Funds	2.1%	3.6%
MSCI EAFE (USD Gross)	-1.2%	-4.0%	Small-Cap Core Funds	2.4%	3.0%
MSCI EM (USD Gross)	0.7%	6.4%	International Large-Cap Core	-0.7%	-2.9%
NAREIT US Real Estate Ind.	7.4%	13.7%	Emerging Markets	2.1%	6.2%
Barclays US Agg. Bond (3-5yr)	1.2%	3.4%	Core Bond	2.3%	5.1%
Bloomberg Commodity	12.8%	13.3%	High Yield	4.2%	6.6%

THE GLOBAL POLITICAL CLIMATE:

Britain surprised the world on June 23rd with its decision to leave the European Union in a referendum vote. Outside of a few days of market turmoil, the impact on the United States is likely to be minimal as exports to the UK account for less than 0.7% of GDP. The greater risk comes from the US exposure to the UK banking system, which in aggregate totals about $919 billion, larger than any other country. Despite the exposure to UK banks, there have been few signs of stress thus far, and regulatory changes enacted since the financial crisis should ease concerns over financial contagion to US banks. The greater damage will occur to the UK economy, which is likely to fall into recession as trade with the EU falls and workers are relocated to other European countries. Over time, the greater risk to Europe and the global economy is the future of the EU and whether other countries see Britain's decision to leave as a way out.

The US version of Brexit will unfold over the next several months as the country selects a new President. As in the UK, much of the Presidential election will be fought over opposing views on immigration and trade. Feelings on immigration are largely emotional, while trade revolves primarily around economic issues. Trade between humans can be traced back to the Stone Age when individuals collaborated to exchange goods or services to benefit each other. Matt Ridley writes in his book *The Rational Optimist: How Prosperity Evolves* that evidence of trade dates back to Australian aborigines when a particular stone axe from a quarry mined and guarded by the Kalkadoon tribe was found throughout the continent. In this case, one tribe found they were the best makers of this axe and traded with other tribes for things including spear barbs. This helped each tribe focus on its strength and use that skill or good to acquire other useful tools it needed to survive and prosper. This trade model developed over thousands of years as farmers, hunters, and ship builders prospered by focusing on their local resources and trading these for other goods, leading to a better and more efficient lifestyle.

In 1817, stockbroker David Ricardo put into words the theory that had been in use for 30,000 years. Ricardo called this "competitive advantage", using the example of England trading cloth for Portuguese wine. In this example, Ricardo explains that to produce cloth, England may require the labor of 100 men for one year, or to make wine would require 120 men for the same time. If Portugal could produce the same amount of wine with only 80 men and the same cloth with 90 men over the same time period, it would be to Portugal's advantage to only make wine and export this to England in exchange for cloth. This allows each country to focus on what it does best, elevating the economies of both nations. Ricardo's law of competitive advantage is still taught in business schools today and is the basis of years of trade policy.

Over time free trade has increased global wealth, but distributed it unevenly giving rise to our current political environment. As developed economies increase specializations in technical fields, poorer nations have developed a competitive advantage in lower skilled endeavors such as manufacturing. According to Richard Dobbs, James Manyika, and Jonathan Woetzel, in their book *No Ordinary Disruption*, as recently as 1990 43% of the population in the developing world lived in extreme poverty earning less than $1.25 per day. Only one in five people on the planet earned more than $10 per day, the level of income which households reach the "consuming class" threshold and can afford to buy discretionary items. Over the past 20 years, trade has helped lift 700 million people out of poverty and added 1.2 billion to the consuming class.

In the book _Global Inequality: A New Approach for the Age of Globalization_ economist Branko Milanovic developed a chart that is becoming known as the "Elephant Curve". This essentially shows that free trade has significantly increased the incomes of people in the lower 70th percentile of the global income distribution along with those at the very highest percentile. This means that people living in emerging countries such as China, India, Brazil, Mexico, etc, have seen their incomes and standard of livings increase dramatically as low skill jobs are exported to these countries. Likewise, highly educated people in developed economies have also benefited as these economies have specialized in innovation. The group that has seen virtually no increase in real income over the past 20 years resides in the 75th to 95th percentile, which includes the working class in developed economies such as the US and Britain.

This unequal distribution of income within developed countries has driven much of the current political climate and is likely to remain for some time. As with the British referendum on leaving the European Union and Donald Trump's popularity in the US, there is a trend towards rejecting globalization and free trade in developed nations. In addition to the US presidential election, France and Germany have elections next year. The current nationalistic trend is likely to play a role in other important elections as well, and have lasting implications on the global economy. The current environment has a number of parallels to the post Great Depression political climate of the 1930s when a number of fringe candidates rose to power and countries retreated from the global stage to focus on domestic issues prior to entering into World War II.

Although the income gap in developed nations may be untenable, simply adding tariffs on trade in an effort to bring back manufacturing is unlikely to be successful. Manufacturing has already been returning to the US at a rapid rate, however factories are highly automated and run by trained engineers rather than teams of production line workers. The days of a high school education leading to a middle class profession are not likely to return in the future. In 2015, the median weekly wage of a high school educated worker of $678 was 40% below the wage earned by a worker with a bachelor's degree and 57% below a worker with a post graduate degree. This would lead one to believe that an investment in their further education would be a more effective means of solving the income gap.

OUTLOOK:

The US economy is still growing at a strong enough pace to create jobs and encourage consumer spending. Although there have been some pockets of weakness over the past several months, we do not see anything in the data to indicate a dramatic change in the trajectory of the economy. The current market recovery and economic expansion that started in March 2009 is now 89 months old, the third longest expansion on record. We are certainly in the late stages of recovery, but a recession is still probably at least a year away. Given the slow pace of recovery, it would not be a surprise to see this recovery approach a similar 120-month recovery that stretched from 1991 to 2001.

Corporate earnings have been weak over the past year; however, this looks to be changing as the number of companies warning of weak profits for the current quarter has fallen to its lowest level since 2012. Stock valuations are relatively high on a P/E multiple basis, meaning stocks are less attractive than they were a few years ago. We expect an earnings recovery to help support stock prices through the remainder of the year and barring a geopolitical shock, provide reasonable returns to stocks for the full year.

PORTFOLIO CONSTRUCTION:

Finally, we would like to add a comment on the way we construct portfolios given the current market outlook. We do not believe in timing markets as it has been demonstrated that trying to predict short-term movements in asset prices is random and impossible to consistently do with any degree of accuracy. Even if someone correctly exited stocks the day of the Brexit vote, the chances they returned into the market two days later are remote, and now the market has completely recovered. We do, however, pay attention to valuations and become more cautious on asset classes as they become more expensive. In the case of stocks, valuations are beginning to look rich which means returns over the next few years will likely be lower and volatility higher than what we have been used to. For long-term investors, we continue to buy stocks in our price range as companies and their earnings grow over time, return money to shareholders, and generate consistent appreciation. Most of our US portfolios generate well over a 2% dividend yield, an attractive rate in today's low interest rate environment. This yield helps to provide additional safety through economic downturns.

Given our current outlook, we are also adding alternate sources of returns to portfolios that are not dependent on the direction of the overall stock or bond markets to generate positive returns. Since different asset classes do not all move in the same direction at the same time, they offer additional diversification benefits and reduce the overall volatility of the portfolio. The most common asset class used to diversify stock portfolios are bonds. In times of distress, bonds exhibit a negative correlation and move in the opposite direction to stocks. During periods when stock returns are going down, bond returns are going up, dampening the loss to your portfolio.

In addition to bonds, we also use "Alternative" asset classes during times of increased market volatility. We have been increasing this Alternative allocation as our outlook for stocks is fairly tempered and as more options become available. These Alternative investments include private equity companies that purchase companies not publicly traded, macro strategies that use a top-down approach to invest in a number of asset classes through the use of exchange traded futures, real estate investment trusts and ETFs, infrastructure funds that purchase airports and toll roads, merger arbitrage funds, and several other strategies. Although fairly new to us, many of these strategies have been around for decades and have proven diversification benefits and consistent returns.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We want to meet with you at least once a year to review and update any changes in your goals and objectives. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

Stephen C. Biggs, CFP®, CFA

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