Summary

At its June 28, 2016 meeting, the Asset Allocation Subcommittee of the Capital One Asset Management ("COAM" or "Firm") Investment Policy Committee made no changes to the firm’s tactical stance.

Guidance

While valuations in some riskier asset classes are becoming more attractive, our concerns regarding the prospects for growth globally and for corporate earnings in the U.S. remain intact. As such we maintain a cautious stance, underweight to both equities and commodities and overweight Domestic Investment Grade Fixed Income and Diversified Alternatives.

Discussion

When the Committee met, markets were feeling the aftershocks of the United Kingdom’s historic vote to remove itself from the European Union. The British pound and the Euro had both fallen heavily and stock markets around the world were trading significantly lower than just prior to the vote. U.S. Treasuries, meanwhile, had seen a drop in yield as investors fled to safety. The political situation in the UK and Europe broadly was evolving rapidly with news buffeting markets multiple times per day.

Regular readers of our bulletins may recall that COAM has taken a progressively more conservative stance over the past couple of years and entered the Brexit turmoil underweight stocks and with lower-than-normal exposure to international assets. That position was clearly helpful in the fallout from the Brexit vote. However, the market realignment and lower stock valuations in the few days following the vote, have not resolved the concerns that led us to our cautious stance. If anything, the Brexit vote underscores and exacerbates many of these concerns.

Deflationary pressures remain in place globally. The Brexit vote only makes it more difficult for European leaders to reignite meaningful growth on the continent – add the negotiations for Britain’s treaties with the European Union to the list of distractions (refugee immigration, Ukraine, et multiple cetera) that will demand their attention, while potential trade disruptions and guaranteed uncertainties will make for an even more challenging business climate. At the same time, the British decision raises concerns that other nations may look to stage their own exit. We place the odds of a second nation exiting the EU at under 50%. There are no mechanisms specified for a nation that (unlike the UK) utilizes the Euro as its official currency and we expect electorates to take a wait-and-see approach as the UK attempts to navigate the process. Nonetheless, the possibility is not so remote as to be beneath attention and we will continue to monitor political events across the European Union closely.

More generally, the Brexit vote highlights a growing antipathy to globalization and free-trade, a trend that is gathering prominence domestically in both major parties as we head toward fall elections in the U.S. The potential for unwinding of trade deals adds another headwind to profit growth and thus risk to equity investment both at home and abroad.
On the other hand, following the Brexit vote, the odds of further rate hikes from the Federal Reserve dropped dramatically. As such, domestic fixed income investments have seen a decrease in their overall risk profile as the prospect for higher interest rates that adversely affect the principal value of fixed income securities has diminished. We are not changing our overall stance of having slightly more interest rate exposure than our benchmarks, but will be looking for opportune moments to come back in line with the benchmarks as the marketplace stabilizes.

With any likely Fed hike receding in the future and the U.S. dollar having spiked in the fallout from Brexit, we are less concerned about a strengthening greenback. We may still see further strength in the U.S. currency, but the magnitude of that trend appears to be muted. With this backdrop, two assets that we have avoided for the past several months are becoming more attractive: Emerging Markets Equities and Diversified Commodities. We are not yet moving to re-initiate holdings in those asset classes, but the case for them is building.

Emerging Market Equities have been in a multi-year decline relative to U.S. equities, but that trend appears to be stabilizing and possibly reversing. Earnings-per-share in the stocks has seen a recent uptick and conditions in major emerging countries from China to Brazil to India appear to be stabilizing and, in some cases improving. However, valuations are not yet at extreme lows and with uncertainty still roiling markets we are not yet ready to re-establish our position. We will be watching the space closely, however.

Commodities are also benefitting from a stabilizing picture, particularly in China. Supply and demand dynamics in global crude markets are coming closer to balance. Meanwhile, usage of industrial metals such as copper has picked up as well. However, temporary disruptions in supply account for at least some of the apparent balance in crude and the picture for global demand is still somewhat tenuous especially in light of the Brexit vote. As with Emerging Markets Equities, we will monitor closely to see if an entry point is developing.

On the whole, then, we retain our conservative posture with an awareness of several risks to the global economic climate. However, with market realignments we are beginning to see prices that begin to look attractive and we will look to move judiciously back into such assets if and when conditions merit.

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<tr>
<th>Asset Class</th>
<th>Q1 2016 Tactical Position</th>
<th>Q2 2016 Tactical Position</th>
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<tbody>
<tr>
<td>Stocks</td>
<td>Under Weight</td>
<td>Under Weight</td>
<td>Continuation of slow global growth:</td>
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<td>Extraordinary liquidity provision from the Fed is over (quantitative easing).</td>
<td>-2</td>
<td>Negative Outlook: The imbalance between elevated security valuations and contracting corporate earnings is likely to be corrected in the near-term. Poor technical momentum, weak market breadth, elevated valuations and contracting profit margins in a challenging environment lead us to a more defensive posture on Equities overall in the near-term.</td>
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| Bonds       | Equal Weight              | Over Weight               | Central credit markets themes - deflation concerns and default risks abroad:  
  • The Fed has backed away from aggressive normalization due to weak global growth.  
  • The collapse of oil prices has depressed inflationary expectations globally.  
  • Default risks are elevated in energy, materials and global trade sectors driving flight to quality.  
  • Pervasive negative interest rates in Europe and Japan are driving capital to the US.  
  • Re-leveraging corporate balance sheets for unproductive purposes is late cycle behavior. | Neutral Outlook: Slow global growth, modest US growth and the likelihood that US inflation trends remain tame in 2016 drive our sanguine assessment of interest rate trends. Acknowledging global deflationary risks, we continue to maintain modestly long durations relative to benchmarks and a tilt to quality issuers with strong balance sheets. | 0 |
| Cash        | Equal Weight              | Equal Weight             | Outlook for Cash returns is improving modestly as the Fed moves toward normalization:  
  • The trajectory for rising short-term interest rates is diminished due to slow global growth.  
  • The Fed’s modest goal is to raise the Fed Funds rate to 1.5-2.0% over next 2-3 years. | Neutral Outlook: Aggressive Fed projections on expected short-term interest rates last December have been cut back this year due to slowing global growth and continuing sluggish economic conditions in the US. | 0 |
| Diversified Commodities | Under Weight | Under Weight | COAM exited the Commodity asset class in Fall 2014 due to increased volatility and slowing global growth:  
  • The Dollar’s recent decline due to fading expectations for Fed tightening not likely to continue.  
  • Upside volatility has emerged in Commodity prices in recent months, but is unlikely to be sustained as the oil price bounce appears to be technical and unrelated to stronger global demand.  
  • Chinese stimulus not likely to spur significant reacceleration in global growth. | Negative Outlook: Slow global growth, weak oil prices, dollar strength and uncertainty about the Chinese economic outlook are not supportive of commodity prices, an environment likely to continue this year. | -1 |
| Diversified Alternatives | Over Weight | Over Weight | COAM established exposures to Multi-Strategy hedge funds and analogous mutual funds in Summer 2015 to provide diversification with low correlation to traditional assets:  
  • Remain attractive options in challenging financial markets, such as the current environment.  
  • The objective is to provide attractive risk-adjusted returns with lower volatility. | Neutral Outlook: The modest addition to this asset class is in conjunction with steps to underweight equity exposures. Given the expectation for increased near-term volatility of risk-assets, an allocation to multi-strategy hedge funds is expected to help protect investor capital and contribute positive return. | 0 |
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| U. S. Equity      | Over Weight               | Over Weight               | Relative Merits of US Equities:  
|                   |                           |                           | - US is much further along toward monetary normalization (albeit still a long road), offering investors a more resilient economy.  
|                   |                           |                           | - US is relatively insulated from global trade deflationary forces.  
|                   |                           |                           | - US energy independence has created oil price volatility, but also a more competitive manufacturing base.  
|                   |                           |                           | - Favorable outlook for the US Dollar.  | 0             | Neutral Outlook: US equities are expected to continue to outperform Non US markets in 2016, however valuations and earnings growth uncertainty warrant caution in the near term as markets continue to adjust to sluggish global growth, weak capital spending and a strong Dollar. We have adopted neutral positioning in mid-cap and small-cap equities, de-risking allocation composition in anticipation of a correction in the imbalance between elevated valuations and weak earnings growth. |
| Non-U.S. Developed Market Equities | Neutral Weight | Under Weight | Headwinds persist for Europe, Japan and commodity exporters:  
|                   |                           |                           | - Europe and Japan continue to struggle with stagnant economies and slow global growth.  
|                   |                           |                           | - European and Japanese quantitative easing thus far has been largely unproductive.  
|                   |                           |                           | - Developed market governments are heavily indebted with little fiscal flexibility.  
|                   |                           |                           | - Commodity exporters including Canada and Australia remain hostage to slow growth in China.  
|                   |                           |                           | - Retrenchment in Emerging Markets continues to subject export focused economies to deflation risks.  
|                   |                           |                           | - Russian military aggression in Eastern Europe = elevated geopolitical risks in Europe.  | 0             | Neutral Outlook: Quantitative easing in Europe and Japan have supported financial asset prices however the desired acceleration in economic growth and inflation thus far remains elusive. A sense of diminishing marginal returns has attached to the ECB and BOJ monetary stimulus programs. The upcoming BREXIT vote in the UK on June 23 is a potential source of near-term instability in European markets, with current polling indicating modestly favorable odds of a REMAIN outcome narrowing toward a toss-up as the vote nears. |
| Emerging Market Equities | Under Weight | Under Weight | Slow growth in China and Saudi oil policies combine to hobble growth in Emerging Market Economies:  
|                   |                           |                           | - China continues to struggle with its adjustment to slower global trade.  
|                   |                           |                           | - Saudi oil policy geared towards achieving greater market share induced recession in Russia, worsened conditions in an already struggling Brazil and is contributing to instability across EM.  
|                   |                           |                           | - Chinese fiscal stimulus has temporarily driven commodity price volatility higher.  
|                   |                           |                           | - Chinese support for the Renminbi is unsustainable and further devaluation remains a possibility.  
|                   |                           |                           | - Chinese suppliers in EM continue to bear the brunt of the Chinese slowdown.  
<p>|                   |                           |                           | - Chinese military aggression in South China Sea = elevated geopolitical risks in East Asia.  | -1            | Negative Outlook: COAM exited the class in Summer 2015 as Emerging Markets continue to be burdened with slowing growth in China, depressed commodity prices, currency devaluation pressures and elevated default risks. Our assessment continues to be to avoid Emerging Market equities until the outlook for sustainable growth improves, making for a more favorable re-entry point. |</p>
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| REITs                       | Underweight                | Underweight                | **COAM exited the class in the Fall of 2014 due to our assessment of excessive valuations:**  
  • Elevated valuations and low cap rates continue to dominate sector dynamics.  
  • Late cycle behaviors becoming more prevalent: increased supply, rent weakness, marginal M&A.  
  • Our observation is more REITs are transitioning to disposition mode. | -1           | **Negative Outlook:** Sluggish US economic growth and weak capital spending, combined with long durations, full valuations and cyclically low interest rates tilt the risk/reward assessment away from REITs. |
| Master Limited Partnerships | Neutral                    | Neutral                    | **Price volatility in the crude oil market has created a relatively attractive valuation picture for MLPs:**  
  • Through-put models were designed to insulate against commodity price volatility, however, elevated default risk in E&P drove risk premiums up for capital market dependent MLPs.  
  • Recent signs of stabilization in crude oil prices have guided MLP risk premiums lower. | 0            | **Neutral Outlook:** Valuations are attractive in the class however near-term concerns related to pressures on cash flow, dividend stability, access to capital markets and the outlook for commodity prices warrant a neutral position until the outlook improves. |
| Investment Grade Bonds      | Overweight                 | Overweight                 | **Tailwinds for Investment Grade Taxable Bonds:**  
  • Slowing global growth, low inflation in the US and Europe, deflationary risks in Japan and EM.  
  • Pervasive negative interest rates in Developed economies cap US Treasury yields.  
  • Fed transition to normalization of monetary policy reduces US inflation risk and supports the Dollar.  
  • Deflationary shock to the US energy sector continues to drive cautious behavior across the economy. | 0            | **Neutral Outlook:** Longer-term Treasury yields have grinded lower over the last year and have established new lower trading ranges that were previously interpreted as signs of extreme stress in global markets. Diminished inflation expectations and pervasive negative interest rates abroad have lowered the ceiling on US interest rate risk. Acknowledging lingering deflation risks in the global economy, we continue to position portfolio durations modestly long to benchmarks and express a quality bias for strong balance sheets in security selection. |
| US High Yield Bonds         | Equal Weight               | Underweight                | **COAM continues to capitalize on opportunities to reduce exposure to High Yield as credit risk spread compression permits:**  
  • Reduced long high yield positions in late 2014 as spreads compressed to cyclical lows.  
  • Reduced intermediate high yield positions in early 2016 as spread volatility offered a good tactical opportunity.  
  • Remaining high yield position is very short with low interest rate risk. | 0            | **Neutral Outlook:** The Equity market rally since mid-February has been a catalyst for a narrowing of High Yield risk premiums, presenting a good opportunity to further exit the space, which remains subject to deteriorating credit conditions on a cyclical basis. We continue to maintain a small position in short duration and highest quality instruments within the High Yield space. |
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| International Bonds | Under Weight              | Under Weight              | COAM exited the International government bond asset class in Summer 2015:  
  • Quantitative easing in Europe and Japan drove yields on government bonds to historic lows.  
  • We assess the sector as unattractive on a yield basis and subject to downside currency risk.                                                                                                                                                                                                                                                                                                                                                                           | -1           | Negative Outlook: Government bond yields in Europe and Japan remain at historic lows, mostly negative, offering little benefit from a risk/return perspective, conditions likely to persist for the remainder of this year.                                                                                           |
| Emerging Market Bonds | Under Weight              | Under Weight              | COAM exited EM bonds Summer 2015, continuing headwinds for EM debt:  
  • Slowing global growth, weak commodity prices and a strong Dollar.  
  • Continuing devaluation risk in China exposes deflationary pressures to the sector.  
  • The strong Dollar elevates default risk in heavily indebted counties with Dollar-denominated debt.                                                                                                                                                                                                                                                                                                                                                       | -1           | Negative Outlook: The prospect that China’s economy will continue to decelerate in the near-term and the probability that the monetary policy response will include devaluation warrant a reduction in EM risk exposure.                                                                                                                                |
| Municipal Bonds     | Neutral                    | Neutral                   | Unfunded municipal pension liability is the dominant risk factor in the Muni market:  
  • COAM structures portfolios to insulate against pension risk.  
  • Detroit, Puerto Rico and Chicago are flashpoints that illuminate poor governance.  
  • Judicial remedies frequently establish poor precedents from a G.O. perspective.  
  • Complacency and willful ignorance are pervasive at the local municipality level.  
  • COAM focuses on essential service revs without pension liability and high quality State GO issuers.                                                                                                                                                                                                                                                                                   | 0            | Neutral Outlook: Muni yields are generally rich to Treasuries, leading us to a neutral approach to the sector, as opposed to our long duration tilt for investment grade taxable bonds. Given the relatively rich municipal market, we employ modest positions in short high-grade corporate bonds and US Treasury backed pre-refunded bonds where they can add after-tax value.                           |
Terminology:
Overweight – Meaningfully above the long-term strategic target for the asset class
Underweight – Meaningfully below the long-term strategic target for the asset class
Equal Weight – In-line with the long-term strategic target for the asset class

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<tr>
<td>-2</td>
<td>Very Negative: Extremely unattractive performance outlook in the near-to-intermediate term</td>
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<tr>
<td>-1</td>
<td>Negative: Unattractive performance outlook in the near-to-intermediate term</td>
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<tr>
<td>0</td>
<td>Neutral: Balanced performance outlook in the near-to-intermediate term</td>
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<tr>
<td>1</td>
<td>Positive: Attractive performance outlook in the near-to-intermediate term</td>
</tr>
<tr>
<td>2</td>
<td>Very Positive: Extremely attractive performance outlook in the near-to-intermediate term</td>
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This is only an opinion and not a prediction or promise of events to come.

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<th>Not FDIC Insured</th>
<th>Not Bank Guaranteed</th>
<th>May Lose Value</th>
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<tbody>
<tr>
<td>Not a Deposit</td>
<td>Not Insured by any Federal Government Agency</td>
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