Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

Second Quarter 2016 Investment Review & Outlook

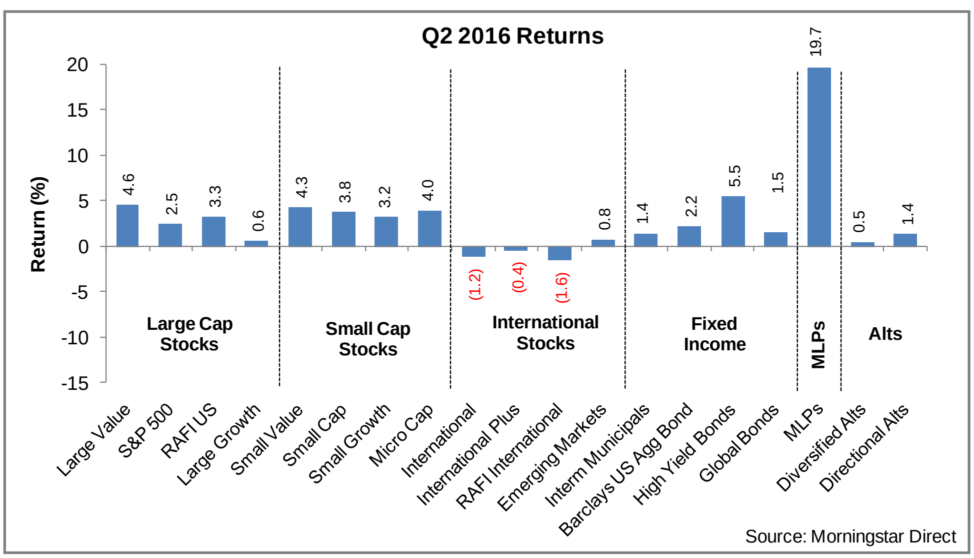
To Our Clients and Friends,

For the first 84 days of the second quarter, global financial markets were relatively well behaved – a respite from the choppy environment that began last May. Stocks traded in a tight band throughout the period, with significantly fewer major moves (four 200+ point days in the Dow) than the first three months of the year (22 such days). Markets were positive in April and May and were on track for the same in June amid this low volatility.

Unfortunately, the schizophrenic equity markets we endured last August and in January reappeared in the final week of the quarter. On June 23rd, citizens of the United Kingdom voted to end its membership in the European Union – an unexpected outcome that triggered sudden losses across a broad range of markets. Most of the quarter's gains were wiped out in a brief two day period as market volatility surged. The final week was marred by six consecutive moves of 200 points or more in the Dow, including a 600 point decline in the first day following the referendum.

We urged calm in an update on Brexit shortly after the event, noting that the process would take years to play out and that the choice had far more political, rather than economic, implications. The reality was that the United Kingdom's distinct currency and central bank limited the complexity of an exit from the European Union. Still, we were surprised that markets shrugged off the historic news so quickly; following an initial two day sell-off, markets quickly reversed and regained much of their pre-Brexit levels by quarter end.

Ultimately, market reaction to Brexit shows up as a blip on what looks like an otherwise benign period (though, to be fair, we may not know the true toll for months or even years). Virtually all asset classes finished the quarter higher, save for European stocks that suffered slight losses. Emerging markets – the supposedly riskiest part of the global markets – also finished with positive returns. That market continues its strong run this year amid stability in the U.S. dollar and commodity prices.

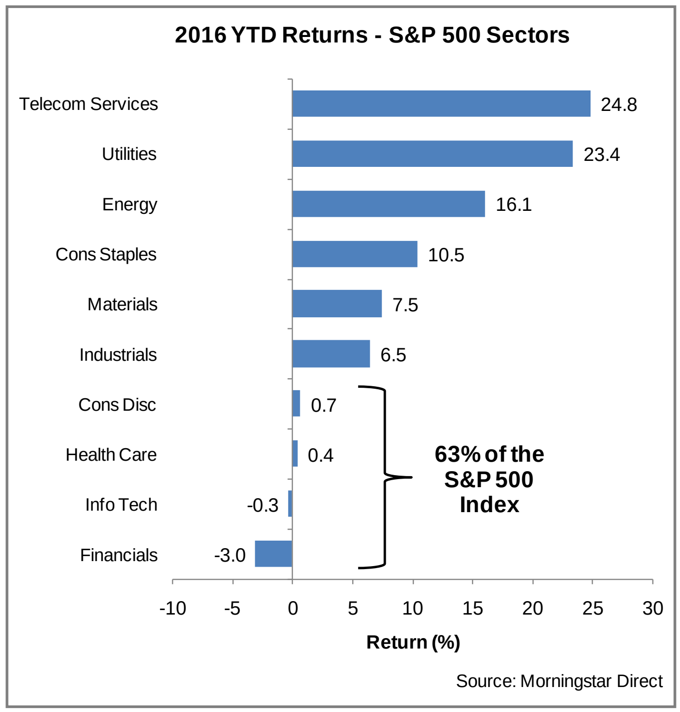


Fixed income markets also advanced in the quarter. Global interest rates fell to all-time lows following the United Kingdom's vote, generating capital gains for longer duration bonds. Unlike the equity markets, however, we have not seen interest rates bounce back to their pre-Brexit levels.

This may reflect expectations of further stimulus from global central banks or simply a more pessimistic view of a post-Brexit world. Credit sectors such as high yield and bank loans performed well through the period as their yield spreads over U.S. Treasuries narrowed.

As we evaluate market performance, we continue to see a "narrow market" dynamic. By that, we mean a handful of sectors or areas of the market are very clearly driving market performance in a thematic rally, while others languish behind. This suggests to us the continuation of macro-based investing rather than a regard for individual company fundamentals. That has posed a persistent challenge for individual investors who focus on bottom up stock selection.

You may recall market performance last year was driven by a handful of individual stocks – the "FANGs" (Facebook, Amazon, Netflix, Google) as they are labeled in the media. This year, performance has been led by "bond proxies" – a term used to describe low volatility stocks with bond-like characteristics. That includes utility, telecom, and select consumer staples companies. Effectively, these stocks offer little in the way of growth or even good value; instead, they offer stable cash flows and consistent dividend yields. Stocks in other critical sectors, meanwhile, such as technology, health care, and financials, have produced little or no return.



We understand the appeal of bond proxies in a low yield environment, but we must also acknowledge the elevated valuations of those securities. At what point do investors wake up and realize that 22x earnings for utility stocks (43% above their 20-year average) just doesn't make sense? Over the longer term, valuations play an important role in investment performance and we must be wary of chasing expensively-priced assets. For those truly seeking current income, better yields can be had in the credit markets with less volatility and more appealing valuations.

In recent days, the S&P 500 and Dow have defied conventional wisdom and breached all-time highs. Amid structural change in Europe, political uncertainty in the U.S., and tepid global growth, it is easy to be skeptical about risk assets. We must acknowledge, however, that there is never an "all clear" signal for investors to invest in equity markets. Throughout history, markets can and have climbed higher in the face of significant adversity.

Is this time different? Perhaps. But the market's behavior surrounding Brexit is a perfect example of why trying to time equity markets is extremely difficult. Even with perfect foresight of the United Kingdom's vote, very few would have correctly predicted where stock markets are trading today. Against that unpredictability, we believe sticking with a long-term asset allocation plan is more appropriate than ever. Avoiding getting whipsawed by market timing is critical to growing long-term wealth, and today's environment leaves investors particularly vulnerable to this risk.

The second half of the year does present some potential pitfalls for the market, most notably a presidential election and uncertainty around the Federal Reserve's interest rate policy. Yet, with the aforementioned factors in mind, we do not believe significant changes in investment strategy are warranted at this time. We would also note that there are indications that fundamentals in the U.S. are improving. Economic data – ranging from employment to housing to manufacturing – has picked up from a soft start this year. Early earnings results from Q2 have also been better than expected, particularly from cyclical companies that stand as bellwethers for the health of the U.S. economy. In a world of pessimism, these are a few green shoots that could provide upside surprise in the months and quarters ahead.

As always, please reach out to us should you have any questions or concerns.

Kindest regards,
Your Investment Team
7/21/2016