WILMINGTON TRUST

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Capital Perspectives

Investment analysis & insights from Wilmington Trust Investment Advisors

Contents

Editor in chief:
Clayton "Cam" Albright III

ON THE RECORD

The way forward in a post-Brexit world

Tony Roth, Chief Investment Officer

It would be pretty hard to have escaped the headlines of two weeks ago, when the United Kingdom's referendum ended in an historic and greatly unexpected decision to exit ("Brexit") the European Union, or EU. The shock was heard and felt around the world, with uncertainty-fearing markets dropping precipitously. On the day after the vote, the Dow Jones and S&P 500 indexes took roughly 600- and 100-point plunges, respectively. Take a moment to recall the volatility we experienced in early 2016, however, and we're reminded that nothing lasts forever. As I write this month's letter, the tempest-tossed tide of fear has already begun to recede. Let's look at where things stand now in terms of what we expect, what remains to be seen, and what it means for client portfolios.

We expect…

The U.K. to exit the EU, despite a petition to hold another referendum that is being circulated and signed by British and Northern Irelanders who are vehemently protesting the vote's results. That said, while this is our base-case scenario, there are numerous paths that could achieve a "remain" result and together they present a realistic possibility.

No immediate reset of formal trade or other economic relations between the U.K. and the EU. In light of Prime Minister David Cameron's resignation, the clock to actual independence from the EU does not begin to run until a new British government is elected and formally notifies the union of its intention to leave. In our view, this will not take place for at least several months.

For the better part of this summer, we anticipate a great deal of political chaos to continue in the U.K. The expectation of a possible Brexit was having an immediate

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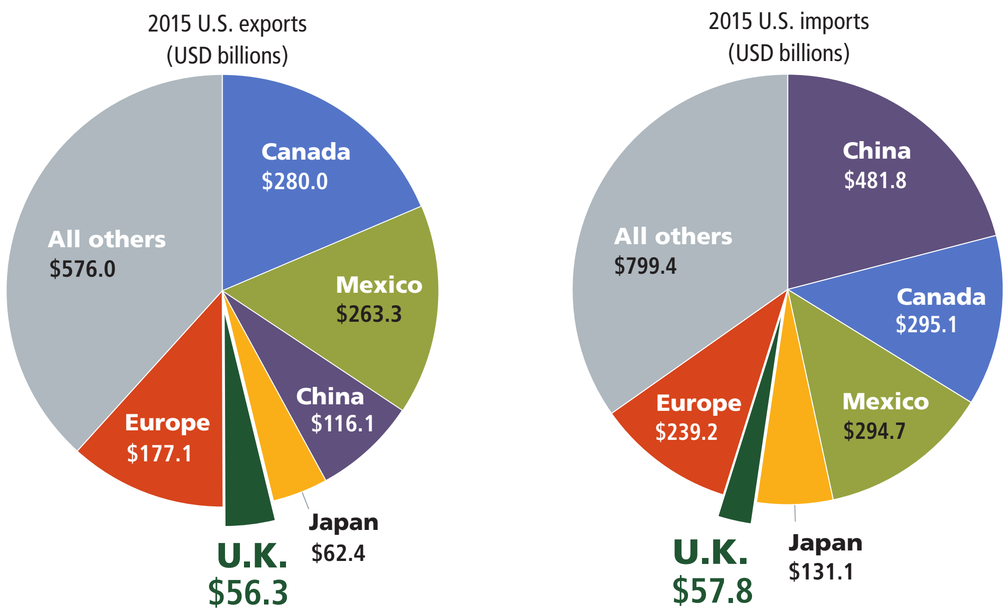
FIGURE I

The U.K. represents only 3% of foreign trade and less than 1% of U.S. GDP



Source: U.S. Census Bureau's Foreign Trade Division

negative impact across a variety of industries within the U.K., most notably financial services companies, but this may now be somewhat offset by the unprecedented decline in the U.K.'s currency, the pound, which should have an immediate, stimulative effect on its economy. Globally, central banks also possess the necessary tools and coordination to ensure adequate liquidity in financial markets.

Contentious and lengthy agreement negotiations. Article 50 of the Lisbon Treaty incepts the two-year period of negotiations for bilateral agreements to replace European Commission directives that control EU dealings. Even before the new government is installed and invokes Article 50, the wrangling will ensue. We expect a certain degree of hostility in the negotiations—it is, after all, a divorce of sorts—particularly on the part of the EU who aims to discourage other members from exiting. We do not, however, expect it to descend to a *War of the Roses* level of punishing malice, if for no other reason than the U.K. economy is currently the EU's second-largest, which should provide the union with significant leverage during the squabbles.

...the internal political trajectories of other EU member-states—particularly Italy, France, Spain, the Netherlands, and Portugal—stand to exercise part of if not the predominant influence over the path of global financial markets.

A radio-silent Federal Reserve. The odds of the Fed raising short-term interest rates before the U.S. presidential election are now slim, due to both the macro uncertainty Brexit has yielded, as well as the direct tightening on the U.S. economy resulting from U.S. dollar strength.

Limited U.S. economic impact. The U.S. economy continues on sound footing and Brexit should not have a material impact on this trajectory over the balance of this year. The U.K. represents just about 3% of foreign trade and less than 1% of U.S. gross domestic product, or GDP (Figure 1). Consequently, any recession that the U.K. might suffer would not in itself have a direct, material domestic impact. Of course, we will not be completely

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Brexit-immune, and expect some increased risk of consumer or business retrenchment on spending, capital expenditures, or hiring in response to ongoing uncertainty and market volatility.

Persistent U.S. dollar strength. While we do not feel there will be a repeat of the 20%–25% appreciation witnessed over 2014–2015, we believe U.S. dollar (USD) muscle should stay flexed through at least the fourth quarter. This is particularly the case in light of the weakling euro, whose integrity has significantly depleted and may not survive the next five years.

Mixed impact of lower global growth estimates. The U.S. corporate earnings recession is likely in its later innings, though changes to earnings estimates based on Brexit have not yet been generally made to individual stocks. Significant pullbacks in U.S. equities from current levels should therefore present buying opportunities, particularly in light of the depressed rate environment. We believe the U.K. will very likely continue to enjoy access to the EU open market zone with little material differences outside of the financials sector as a result of Brexit.

It remains to be seen…

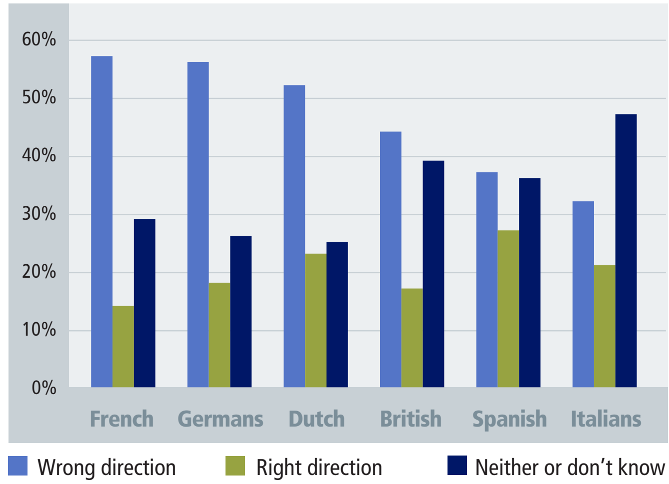
What is next for Europe and the EU. Ultimately, the critical question is whether Brexit represents a single, contained event (of course, with ramifications as discussed), or if it is the precursor to a pattern (much like the Arab Spring in 2010–2011) of exits and other shocks. Will the EU survive sans the U.K., or will it begin to unravel? In recent months, the pound has greatly depreciated against both the euro and the USD. Majorities of French, Germans, and Dutch—in addition to the large numbers of British, Spanish, and Italians—feel the EU is going in the wrong direction (Figure 2).

It also has yet to be determined whether Scotland (and even Northern Ireland) will look to secede from the U.K. and whether London will remain the financial center of Europe, or if that role will shift to Germany, as has been suggested. *Over the next year or so, the internal political trajectories of other EU member-states—particularly Italy, France, Spain, the Netherlands, and Portugal—stand to exercise part of if not the predominant influence over the path of global financial markets.*

FIGURE 2

Europeans say the EU is heading in the wrong direction

Eurobarometer poll, November 2015



Source: Eurobarometer Standard Survey, December 2015

Brexit's impact on emerging markets. Over the short term, this space could suffer from the sustained strength of the USD and the weakening global GDP outlook. For those nations with high current account surpluses, though, a potent greenback may be beneficial. China, for example, seized the Brexit opportunity to allow the renminbi to trade above the critical 6.6 USDCHN level. The Chinese may be using the Brexit turmoil to hasten the devaluation of their currency. Will markets and central banks tolerate continued renminbi depreciation, possibly to the 7.0 level, which we believe would be positive for emerging markets? *(Get greater detail in our In Focus, "Tipping points for emerging markets," on page 10.)*

U.S. political implications. No doubt, Brexit was in large part catalyzed by a wave of anti-immigration sentiment. That leaves us to wonder whether the feeling—which has clearly rippled across the pond and infused Donald Trump's platform—will sustainably buttress the presumptive Republican nominee's candidacy. We believe the perception of a viable Trump outcome will unsettle markets as Labor Day approaches.

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We do not, however, expect it to descend to a *War of the Roses* level of punishing malice, if for no other reason than the U.K. economy is currently the EU's second-largest, which should provide the union with significant leverage during the squabbles.

For more on Brexit, see our June 24 Investment Commentary, *The United Kingdom to depart the European Union,* by Clem Miller, Portfolio Manager of the Wilmington Multi-Manager International Fund.

Our portfolio positioning

We were and remain well positioned, particularly in light of recent events. Our U.S.-centric overweight in equities and general emphasis on quality solutions has stood us in good stead.

Our holdings of European and other developed international equities are a fairly small portion of our portfolio so the market impacts have been minimal. This significant underweight to non-U.S. equities underscores our lack of confidence in European growth and indeed the euro itself.

On the fixed income side, our Investment Committee met last week and decided to reduce the significant overweight to our taxable high-yield position and move closer to our strategic asset allocation. We noted that a high-yield overweight was still reasonable in light of the generous income returns. However, as we approach the later stages of the credit cycle, prudence suggests a risk reduction in our taxable high-yield overweight position. By contrast, for high-net-worth investors using *tax-exempt* high-yield investments, the significant overweight is acceptable, given market structure differences and better credit fundamentals in the tax-exempt vs. taxable high-yield markets. Funds available as a result of the sale were reallocated to our investment-grade fixed income position.

After the financial crisis in 2007–2008, we began to speak in terms of a "new normal." Recent events are just another indication that "normal" is itself in a continuing state of revision. Risk is heightened but so is opportunity, and we shall continue to seek untapped potential value.

This is the world we live in and there is no going back. Only onward and, by remaining ever-vigilant, hopefully upward.

Please note that this is a joint July–August publication, so we will not be publishing a separate issue next month. I wish you a relaxing and enjoyable summer.

Until September,

Tony

Tony

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Investment positioning

Portfolio targets effective July 1, 2016 for high-net-worth clients with nontraditional assets

	Aggressive			Growth & Income			Conservative		
	Strategic asset allocation (long term)	Tactical asset allocation (short term)	Change this month	Strategic asset allocation (long term)	Tactical asset allocation (short term)	Change this month	Strategic asset allocation (long term)	Tactical asset allocation (short term)	Change this month
Equities									
U.S. Large-Cap Core*	23.0%	32.2%	—	16.3%	22.6%	—	7.6%	10.0%	—
U.S. Large-Cap Sectors*	23.0%	19.8%	—	16.3%	13.6%	—	7.6%	5.9%	—
U.S. Small-Cap	13.8%	9.0%	—	8.2%	5.0%	—	1.5%	1.0%	—
International Developed	19.5%	19.1%	—	12.7%	12.4%	—	5.0%	4.9%	—
International Emerging Markets	9.7%	5.8%	—	3.6%	2.0%	—	1.0%	0.7%	—
Total Equities	**89.0%**	**85.9%**	**0.0%**	**57.0%**	**55.6%**	**0.0%**	**22.7%**	**22.4%**	**0.0%**
Fixed Income									
U.S. Investment Grade–Tax-Exempt	0.0%	0.0%	—	30.0%	25.4%	—	64.3%	53.8%	—
High-Yield– Tax-Exempt	0.0%	0.0%	—	2.0%	5.0%	—	2.0%	4.9%	—
Total Fixed Income	**0.0%**	**0.0%**	**0.0%**	**32.0%**	**30.4%**	**0.0%**	**66.3%**	**58.7%**	**0.0%**
Real Assets	**4.0%**	**7.0%**	**0.0%**	**4.0%**	**7.0%**	**0.0%**	**4.0%**	**7.0%**	**0.0%**
Nontraditional Hedge	**5.0%**	**5.0%**	**0.0%**	**5.0%**	**5.0%**	**0.0%**	**5.0%**	**10.0%**	**0.0%**
Cash & Equivalents	**2.0%**	**2.1%**	**0.0%**	**2.0%**	**2.0%**	**0.0%**	**2.0%**	**1.9%**	**0.0%**
Totals	**100.0%**	**100.0%**	—	**100.0%**	**100.0%**	—	**100.0%**	**100.0%**	—
Forecasted Performance									
Expected Return	**4.2%**	**4.1%**	—	**2.9%**	**2.9%**	—	**1.4%**	**1.7%**	—
Expected Standard Deviation	**16.0%**	**15.2%**	—	**10.6%**	**10.3%**	—	**5.4%**	**5.7%**	—
Strategy Yield	—	**2.2%**	—	—	**2.4%**	—	—	**2.5%**	—

* Large-cap allocations are broken down into the portion designated for use with active or passive managers (U.S. large-cap core) and the portion using our Sector Allocation Strategy (U.S. large-cap core sectors). Tactical positions are shown on page 7 in the graph "Our sector inputs and allocations." Source: Wilmington Trust Investment Advisors, Inc. (WTIA)

Note: Rounding errors may cause the allocation subtotals of some asset classes to differ slightly from the building blocks of their allocations.

Our reference allocations are developed from our long-term economic outlook, reflecting our highlighted themes as well as the insights of our investment and economic professionals, reference allocations serve as a baseline strategic allocation for long-term investors. The expected returns presented constitute the informed judgments and opinions of Wilmington Trust about likely future capital market performance. No assurance can be given as to actual future market results or the results of Wilmington Trust's investment products and strategies. Strategy forecasts are derived from the expected return and volatility assumptions in Wilmington Trust's Capital Markets Forecast 2016–2026, which is available on www.WilmingtonTrust.com or upon request from your Investment Advisor. A summary of the calculations used to develop these numbers can be found in the disclosures section under Forecasted Performance. Return projections are pre-tax and pre-fees. Volatility (standard deviation of return) estimates are based on pre-tax return projections.

There is no assurance that forecast results will be realized or that any investment strategy will be successful.

Please see disclosures for information about our asset allocation strategies, risk assumptions, performance forecasts, fee assumptions, and other important information.

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Major themes

Investment themes	Current positioning	Potential tipping points
Prefer healthcare & technology An aging population, medical science break-throughs, expanding social media applications, various mobile devices, and new innovations could create investment opportunities.	Through our sector approach, our underlying allocations favor both health-care and technology. We continue to monitor electoral developments for any potential positioning shifts.	**SIGNS:** Regulations restricting growth, profitability, or the ability to innovate new products; too-rich valuations.
Inflation picking up but still manageable Year-over-year inflation readings are likely to reach 2% but we believe any major threat should be well contained even after the impacts from lower oil prices are absorbed.	Real assets are positioned to benefit from market opportunities in U.S. TIPS but the limited inflation threats are supported by no allocation to commodities.	**SIGNS:** Tighter labor markets that force wage growth toward 4%; a pickup in global investment that reverses commodity price declines; a dramatic drop in the U.S. dollar.
Income a main component of returns Higher yield levels and overall modest equity and fixed income returns over the next few years should result in dividend and interest income being the main source of returns.	Current exposures include high-yield bonds and REITs which have the potential to provide high income levels. Recent moves have reduced the 2.5x overweight to taxable high yield with proceeds placed in core holdings to keep a focus on income.	**SIGNS:** Dividend growth does not keep pace with GDP growth; dramatic, longer-term collapse in credit conditions.
Emerging markets to reemerge Portfolios should have a meaningful long-term emerging markets (EM) allocation. Short term, commodity exporters will continue to struggle with growth, inflation, and currency depreciation.	We remain underweight EM but are looking for potential entry points based off of triggers that focus on Fed policy and Chinese economic stabilization and growth.	**SIGNS:** Indications that the commodity markets are taking a greater toll making a recovery very difficult; signs that economies are not shifting from old to new.

Don’t miss our invitation-only *Capital Perspectives* conference call on July 21 at 1:00 PM ET

Please join our Chief Investment Officer Tony Roth and Chief Economist Luke Tilley on a conference call, where they will offer market and economic insights and explore what they could mean for portfolios.

Joining them on the call will be special guest Rick Rieder, Chief Investment Officer of Global Fixed Income at BlackRock. The speakers will take questions from listeners after their discussion.

Callers in the U.S. and Canada: 800.616.7436

International participants: +1 303.223.4396

Call reservation number: 21813768

Note: Please dial in 10 minutes early so you’ll have time to register before the call begins.

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ASSET CLASS OVERVIEW

Equities

	AS OF JUNE 30, 2016		
	Month to date	Year to date	Trailing 12-month return
S&P 500	0.3%	3.8%	4.0%
Russell 2000	–0.1%	2.2%	–6.7%
MSCI EAFE	–3.4%	–4.4%	–10.2%
MSCI Emerging Markets	4.0%	6.4%	–12.1%

Sources: FactSet, Bloomberg. Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

U.S. equities

U.S. equities' decline is difficult to assess and time but the immediate effects were felt most acutely in the financials sector which declined 8% versus 5.3% for the S&P 500 index in the two-day period after the vote. An S&P trading range of 1830–2130 is still in place and 2Q earnings are likely to print a decline of roughly 4% on a year-over-year basis. Brexit's impact on internationally sourced revenues is likely to be a source of conversation on earnings conference calls. Despite Brexit fallout, a return to positive year-over-year earnings growth is expected by 4Q as the energy drag abates.

We expect modestly positive equity returns and economic strength, which provide relatively good returns in a low-yield, low-growth environment. Our year-ahead target for the S&P 500 is 2093 ($135 times 15.5x forward P/E). This would produce a 6.9% total return from the current level of 1998. The final outcome is a portfolio with a balanced view.

Our preferred sectors from the model are technology, telecom, and financials, where we see reasonable valuations relative to the broader market. Macro's more balanced view favors technology, healthcare, and financials. The quant model favors telecom, utilities, and technology. The fundamental view is more positive on healthcare, industrials, and technology, which have reasonable valuations given their long-term growth potential.

International

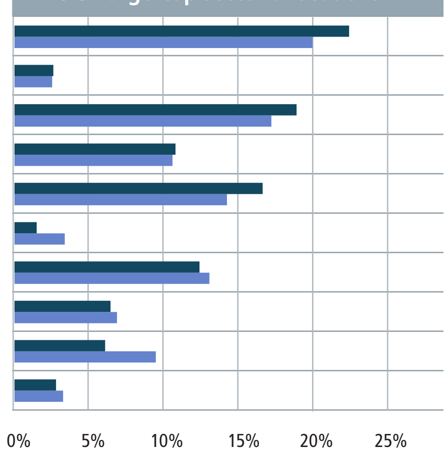
Equity markets recognized that Brexit will likely have its greatest negative impact on the capacity of London to provide financial services to the eurozone. As such, shares of U.K. and eurozone commercial banks, some of which were already struggling due to firm-specific problems, plunged in the vote's aftermath. The Italian and Spanish equity markets were particularly impacted. As with the Greek situation, Brexit raises the potential threat of eurozone or EU financial disintegration, which falls more heavily on European peripheral markets like Italy and Spain.

Atop all this, the pound's large devaluation and euro's depreciation have translated to still-greater negative returns in USD. So far, emerging market (EM) equities have been far less impacted by Brexit and EM banks are less integrated with European financial services. Also, technology is a big component of EM equities, which helps to insulate EM markets from global financial instability. However, there are expectations that Brexit could lead to a global economic growth slowdown, which of course would negatively affect EM equities.

Our sector inputs and allocations, as of June 30, 2016

		OUR ASSESSMENT		
GICS sector	Sector rank	Macroeconomic	Quantitative	Fundamental
Technology	**1**	1	3	2
Telecom	**2**	6	1	6
Financials	**3**	3	6	4
Industrials	**4**	8	4	3
Healthcare	**5**	2	9	1
Utilities	**6**	4	2	9
Discretionary	**7**	9	8	7
Energy	**8**	7	10	5
Staples	**9**	5	5	10
Materials	**10**	10	7	8

U.S. large-cap sector allocations



Sources: Bloomberg, WTIA

Benchmark: Russell 1000   Current allocation

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ASSET CLASS OVERVIEW

Fixed Income

	AS OF JUNE 30, 2016		
	Month to date	Year to date	Trailing 12-month return
Barclays U.S. Aggregate Bond Index	1.8%	5.3%	6.0%
S&P Municipal Bond Index	1.6%	4.3%	7.8%
Barclays Ba High Yield Index	0.7%	7.6%	4.1%

Sources: FactSet, Bloomberg.

Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

U.S. Treasuries

The U.S. Treasury market—especially longer-duration bonds—was the major beneficiary of the geopolitical uncertainty in June. The 30-year Treasury has a rate of return of over 17% year-to-date. Globally, over $10.5 trillion in bonds offers negative yields to maturities, making Treasuries more appealing to investors overall. As expected, the yield curve continued to flatten over the month. The yield difference between the 2- and 10-year notes compressed by 12 basis points, or bps, (0.12%) to roughly 84bps as the probability of Fed rate hikes plummeted amid Brexit and disappointing employment growth.

Investment-grade corporates

Fallout from Brexit included the decline in Treasury yields in June. Risk premiums for investment-grade corporate debt have moved wider to compensate for lower risk-free yields and the increase in Brexit-related volatility. The current option-adjusted spread of the Barclay's U.S. Credit Index was 150bps, modestly wider than the 141bps on May 31. During June, large U.S. banks underperformed due to their exposure to European banks and persistently low global interest rates. Market volatility has slowed the new issue market throughout last month. According to Bloomberg, June volume of just $62.3 billion (through June 28) falls far short of the expected $100 billion supply. We expect any market stability to be met with increased supply as the pipeline of issuers remains robust.

High-yield corporates

At risk, high-yield (HY) bonds posted positive returns in June while leveraged loans were slightly ahead. Notably, the month's institutional loan volume was the heaviest in 12 months ($67.7 billion) due to a big increase in repricing and refinancing activity (65% of month-to-date activity).

Our HY enthusiasm is curbed in the context of a 15% rally since mid-February in light of Brexit, the length of the current credit cycle, and an anemic growth and earnings profile. Even so, valuations (ex-commodities) are attractive in the context of default risk, global central bank easing, and faded fears of a hard landing in China. These positive macro developments which reopened capital markets, in our opinion, appear baked into HY bond and loan valuations making them attractive.

Municipals

Spurred on by the risk-off trade after Brexit, municipals continue to show strength in 2016. Yields have fallen from 20bps in the 2-year to a full 73bps in the 30-year. The benchmark 10-year yield now stands at 1.37%, down 57bps year to date. Total returns are equally impressive. Strong fund flows have continued unabated to the tune of over $32 billion year to date industrywide. Sizable coupon and principal redemptions in July and August support continued positive demand trends.

International

An immediate result of Brexit was the precipitous drop on yields of developed-country sovereign bonds, perceived as safe havens. In particular, Japanese, German, and Swiss bond yields slid further into negative territory. Spanish and Italian government bond yields plunged, as investors reallocated to them out of equities. The large drop in U.S. Treasury yields gave a boost to USD-denominated EM bonds, which generally have long durations.

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ASSET CLASS OVERVIEW

Real Assets and Nontraditional

	AS OF JUNE 30, 2016		
	Month to date	Year to date	Trailing 12-month return
S&P Developed Property Index	3.6%	9.5%	12.3%
Barclays Inflation-Linked Bond Index	4.1%	8.4%	7.4%
UBS Bloomberg CMCI (commodity) Index	4.1%	13.3%	–13.3%

	AS OF MAY 31, 2016		
Hedge Fund Research Institute Indexes	Month to date	Year to date	Trailing 12-month return
Fund Weighted	0.4%	0.8%	–4.0%
Equity Hedge	0.8%	0.2%	–5.3%
Event Driven	1.2%	2.3%	–4.9%
Macro	–0.9%	0.5%	–2.7%
Relative Value	0.9%	2.1%	–1.5%

Sources: FactSet, Bloomberg.
Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

REAL ASSETS

Listed real estate

Global developed listed real estate has seen steady gains for the year, but Brexit led to drastically different outcomes that varied by geography. On the trading day immediately following the vote to exit the EU, the Dow Jones U.S. Real Estate index dropped –0.54% while the NAREIT United Kingdom index fell –19% in USD terms.

Inflation-linked bonds

Inflation-linked bonds continue to be a top-performing asset class, though the decline in nominal yields due to a flight to quality has been the primary driver rather than increased inflation expectations.

Commodities

Through the middle of the year, the commodity complex is showing widespread profits. Oil and gas are up dramatically year to date and even more so from February's lows. Precious metals has also seen huge gains brought on in large part by market volatility. Agricultural commodities have been mixed.

NONTRADITIONAL HEDGE

Equity hedge funds

May marked the third consecutive positive month for these managers, with technology and energy specialists leading the way. Equity funds managed to get back to positive territory for the year, though many large, established funds are still in the hole from a difficult January–February.

Event-driven hedge funds

Event driven was the top-performing strategy in May. The distressed/restructuring and special situations sub-strategies both gained roughly 2%, and merger arbitrage also had a strong month. Activist managers saw slight losses.

Macro hedge funds

Macro saw losses across most sub-strategies with systematic, trend-following strategies seeing the poorest results. Despite declining for three months in a row, macro was the best performer during the volatile January–February time period and remains positive for the year.

Relative-value hedge funds

Relative value strategies had a strong May with all sub-strategies showing solid gains. Relative value has been the top strategy for one, three, and five years.

NONTRADITIONAL PRIVATE MARKETS

Middle market private equity multiples declined sharply in the first quarter, from 8.6x enterprise value over earnings before interest, taxes depreciation, and amortization in 4Q 2015 to 6.5X in 1Q 2016 in U.S. deals between $25 and $250 million. This decline appears related to the quality of companies being sold rather than a widespread fall in values, as many of the best targets were snatched up in the latter half of 2015 and multiples are close to where they were in 1Q and 2Q of 2015.

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IN FOCUS

Tipping points for emerging markets

As we discussed in our 2016 *Capital Markets Forecast* commentary, "Wheat from the Chaff: Obstacles and opportunities," we believe emerging markets (EM) offers attractive returns in the long term and can be very beneficial to portfolios, hence its inclusion in our long-term strategic asset allocation (SAA). In our tactical asset allocation (TAA)—where we aim to capitalize on short-term market opportunities—we have maintained an EM underweight since September 2013, due to the commodities slump and other challenges faced by those economies.

As with other asset classes, we are always considering what would prompt us to shift a TAA allocation. For EM, we believe the macroeconomic situation has already improved. But EM equity market performance is not just determined by the local economic performance; in fact, far from it. Given the improvement in economic performance, before increasing our EM allocation, at the macro level we would need to see either an improvement in the outlook for China or confidence that our Federal Reserve will be more measured in its rate hikes than it's communicated. Additionally, we are monitoring internal dynamics of EM equity composition for signals of a good time to change our allocation.

Emerging market economic performance

After two years of weakness, economic growth in EM appears to be reaching a turning point. We have combined recent growth data as well as the Bloomberg consensus forecasts in the top eight EM equity markets using weights from the Morgan Stanley Capital International (MSCI) index (Figure 1). After a challenging time during 2014–2015, especially for commodity exporters, EM growth has probably bottomed and is expected to be accelerating in the near term, although the pace of the recovery is gradual and the level of growth remains far below the average of the past decade.

A key component of the recovery is global growth which will help EM exports, where we have seen recent improvement. At the individual country level, the data are encouraging, especially in Asia. China's exports were still negative in year-over-year (y/y) terms in May, down 1.8%, but that is a significant improvement from being down more than 10% back in February. South Korea's exports improved from down slightly more than –15% y/y to –8.4% y/y during the same period. Taiwan's exports witnessed a pattern similar to that of South Korea, although by less magnitude, while India saw its exports growth rebound from –20% y/y in late 2015 to a –4.3% y/y in May. Brazil's export growth has been improving since early 2015, and stood at 8.9% y/y in May, while in South Africa, Mexico, and Russia, export growth has been largely flat during recent months. Although many countries are still in negative territory, the improvement is important because we must be looking for turning points.

FIGURE 1

Emerging markets economic growth

(% change year over year)

Source: Bloomberg

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On June 14, the Institute of International Finance published its EM Growth Tracker, which called all the rallies mentioned earlier "a large upswing" between April and May. It also noted that gross domestic product (GDP) growth across EM rose 0.9% to a 4.3% annual rate. This was the biggest advance in a single month in the past four years. We expect this trend of recovering EM export growth to continue, as global demand is expected to recover gradually.

The Federal Reserve

While it may look positive from an economic growth perspective, before upgrading our current underweight position on EM, we would like to be more confident that the Fed will continue to capitulate to market expectations and end up on a lower interest rate path than it has communicated. Markets are currently pricing in a very slow normalization in U.S. monetary policy, which is supportive of EM growth, but there is a risk of sentiment swinging back to a more hawkish track, especially if the U.S. employment data improve.

A tightening of U.S. monetary policy puts pressure on EM currencies, which is negative for the EM asset class. If the Fed hikes interest rates more rapidly than the market expects, the U.S. dollar would likely strengthen against EM currencies, which would add to EM inflationary pressure through imports. To counter that, EM central banks are historically compelled to raise domestic interest rates to tame the inflationary pressure as well as provide support to their currencies. However, even if EM central banks move in lockstep with the Fed, EM currencies are still likely to weaken to some degree against the U.S. dollar.

Chinese growth

An additional factor as we consider our EM allocation is the risk of a sharper-than-expected slowdown in Chinese growth, which would likely weaken global demand and commodity prices, negatively impacting EM growth prospects. China is in a decelerating phase as it transitions from an investment-driven to a consumption-driven economy, and the market already reflects the anticipation of a gradually decelerating growth trajectory over the next several years. However, we are wary of an event's possible "tail risk" that could cause Chinese growth to slow down more sharply. Given China's important role in international trade and commodity price markets, such a scenario would bring significant pressure on the EM growth outlook and financial stability. In terms of the latest developments in U.K., the concern is that Brexit will undermine global economic growth and spill over into the U.K.'s trading partners, particularly emerging Europe.

Emerging markets equity composition

Within the ups and downs of the EM economies, there is an important structural change going on that was also pointed out in our capital markets forecast. The economies are transitioning from industrial- and commodity-based economies to ones with more domestic spending by increased wealth on the part of the local population. There is a shift to production of high-technology products and mobile services for the population, as well as other consumer and discretionary products. These categories comprise 48% of EM equity markets, up significantly from just a few years ago. As they become an ever-larger share of EM equity, the markets become more attractive.

Consistent with our long-term capital markets forecast, we believe EM offers a long-term investment opportunity and that, while our current underweight is appropriate, we are continuously evaluating the merits of an adjustment to our allocation.

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Glossary

Barclays Ba U.S. High Yield Index
Measures the performance of a subset of Barclays U.S. Corporate High Yield Index with issues rated Ba, the highest speculative-grade quality rating.

Barclays Inflation-Linked Bond Index
Measures the performance of publicly issued U.S. Treasury inflation-protected securities (where par value is adjusted semi-annually based on measures of broad inflation) that have at least one year to maturity on index rebalancing date.

Barclays U.S. Aggregate Bond Index
Measures the performance of the U.S. market of taxable, fixed-rate, investment-grade bonds with at least one year to maturity.

Barclays U.S. Corporate High Yield Index
Measures the performance of taxable, fixed-rate bonds issued by U.S. companies rated below investment-grade quality rating (i.e., speculative grade or high yield) with at least one year to maturity.

Barclays U.S. Credit Index
Measures the performance of U.S. investment-grade corporate and government agency bonds with at least one year to maturity.

Cambridge Associates U.S. Private Equity Index
Measures the performance of a broad range of private equity funds (e.g., buyout, growth equity, sector focus, and mezzanine funds) based on end-to-end calculation of data compiled from over 1,100 U.S. private equity funds formed since 1986, including fully liquidated funds.

Collateralized loan obligation (CLO)
A security backed by a pool of debt; often low-rated corporate loans.

Commercial mortgage-backed securities (CMBS)
A type of fixed income security, typically in the form of a bond, that uses commercial real estate loans as collateral.

Commodities
A basic, physical good used in commerce—such as corn, gold, beef, oil, and natural gas—that is interchangeable with similar types of goods. Investment exposure in commodities may be obtained directly, through futures or other derivatives, or by investment in companies with business exposure to one or more commodities.

(CBOE) Volatility Index® (VIX®)
A key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility. Several investors expressed interest in trading instruments related to the market's expectation of future volatility, and so VIX futures were introduced in 2004, and VIX options were introduced in 2006.

Dow Jones U.S. Real Estate index
Tracks the performance of the stock of U.S. real estate companies and real estate investment trusts, or REITs.

DXY Index
Measures the value of the U.S. dollar relative to the currencies of several significant trading partners.

EPRA/NAREIT U.K. Index
A subset of the FTSE EPRA/NAREIT (Financial Times Stock Exchange European Public Real Estate Association/National Association of Real Estate Investment Trusts) Developed Index, which incorporates UK-listed real estate investment trusts (REITs), and real estate holding and development companies.

Exchange-Traded Fund (ETF)
A security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

Euro Stoxx 50 Index
Europe's leading Blue-chip index for the Eurozone, provides a Blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

Global Industry Classification Standard (GICS)
Developed in 1999 by Standard & Poor's and MSCI Barra in response to the global financial community's need for a complete, consistent set of global sector and industry definitions.

Gross domestic product (GDP)
Often cited as an indication of the economy's overall health, GDP measures the value of all finished goods and services produced over a certain period, expressed on an annualized basis.

Hedge funds
A nontraditional investment, these funds afford their managers more latitude to pursue their insights than traditional, long-only investing. Hedge fund strategies include trading across financial markets, employing leverage and taking concentrated or short positions. Some common examples of types of hedge fund strategies include:

> **Event-driven**
> Strategies that seek to take advantage of pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition, or spinoff.
>
> **Macro**
> Strategies that seek to take advantage of movements in broad economic variables and the impact these can have on capital flow across equity, bond, currency, and commodity markets.
>
> **Relative-value arbitrage**
> Describes a basket of strategies using an array of related securities; purchasing the side that is expected to appreciate while shorting the related security that is expected to depreciate, e.g., stocks of the acquiring versus the acquired companies in an acquisition, convertible bonds versus stocks of the same issuer, etc.

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Glossary continued

High-yield (speculative-grade) credit
Bonds of issuers deemed to be at risk of (or in) default on interest and/or principal payments, as reflected in their quality ratings. Such issuers typically offer higher yields to compensate investors for higher credit risk.

Hedge Fund Research Institute (HFRI) Fund of Funds Composite
Benchmark designed to reflect the results of over 800 domestic and offshore fund of funds using a broad range of hedge strategies. The index is equal-weighted among reporting funds, which must have at least $50 million in assets or have been active for 12 months. Funds report returns net of fees. The broad index is used to illustrate the results of hedge funds of funds generally, with sub-indexes focusing on specific strategies.

HFRI Fund Weighted Composite Index
Encompasses over 2000 funds, to the increasingly specific-level of the sub-strategy classifications. The funds are weighted based on the asset size of the underlying indices.

HFRI Equity Hedge Index
Index of hedge funds that mainly manage their portfolios through both long and short positions in equity securities and derivatives.

Investment-grade credit
Bonds of issuers deemed to have at least adequate protection of their capacity to meet financial commitments, as reflected in their quality ratings. Such issuers tend to offer lower interest rates than more speculative issuers as a result of the higher credit quality implied by such ratings.

iShares Currency Hedged MSCI Eurozone ETF (HEZU)
An exchange-traded fund provides broad exposure to exporters and local Europe-focused companies, while hedging exposure to fluctuations between the euro and the U.S. dollar.

ISM Non-manufacturing Index
An index that tracks economic data, it is based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management.

J.P. Morgan Global High Yield Index
Consists of fixed income securities of domestic and foreign issuers with a maximum credit rating of BB+ or Ba1. This index seeks a high level of current income by investing primarily in a diversified portfolio of debt securities that are unrated or rated below investment grade. Capital appreciation is a secondary objective.

J.P. Morgan Leveraged Loan Index
Designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers.

J.P. Morgan U.S. Liquid Index
Market-weighted index that measures the performance of the most liquid issues in the investment-grade, U.S. dollar-denominated corporate bond market.

MSCI ACWI ex USA Investable Market Index
Captures large-, mid-, and small-cap representation across 22 developed market countries outside the U.S. and 23 emerging markets countries. With over 6,000 constituents, the index covers approximately 99% of the equity opportunity set outside the U.S.

MSCI EAFE Index
Measures the performance of global developed equity markets in Europe, Australasia, and the Far East, excluding U.S. and Canada.

MSCI Emerging Markets Index
Measures stock market performance in the global emerging markets, covering over 800 securities across 23 markets and representing roughly 13% of world market capitalization.

Nontraditional assets
(also referred to as alternative investments)
Seek risk exposures and return drivers that are different from traditional, long-only financial market investments. Exposure may be sought by targeting particular assets, such as real estate or commodities, or through strategies with more latitude to pursue manager insights, such as trading across financial markets and/or taking short positions (i.e., hedge strategies).

Private equity
Nontraditional asset that pursues investment in equity or debt securities of operating companies, typically with the intent to exert control over the management of company and often targeting a particular industry, financial condition, and/or stage of development.

Quality ratings
Used to evaluate the likelihood of default by a bond issuer. Independent rating agencies analyze the financial strength of each rated issuer. Moody's ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa and better are considered "investment grade." Bonds rated Ba and below are "speculative grade" or "high yield." Similarly, Standard & Poor's ratings range from AAA to D. Bonds rated BBB– and better are considered "investment grade" and bonds rated BB+ and below are "speculative grade."

Speculative grade (also "high yield")
Bonds of issuers deemed to be at risk of or in default of interest and/or principal payments, as reflected in their quality ratings. Such issuers tend to offer higher interest rates than investment-grade bond issuers as a result of the lower credit quality implied by such ratings.

Russell 1000 Index
Measures the performance of the 1,000 largest companies in the Russell 3000 Index, representing approximately 90% of U.S. equity market cap.

Russell 2000 Index
Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 8% of U.S. equity market cap.

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Glossary continued

Russell 3000 Index
Measures the performance of the 3,000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market.

Russell Midcap Index
Measures the performance of the 800 smallest companies in the Russell 1000 Index, representing approximately 25% of U.S. equity market cap.

S&P 500 index
Measures the performance of approximately 500 widely held, typically large-cap, common stocks listed on U.S. exchanges, as selected by S&P.

S&P Developed Property Index
Measures an investable universe of publicly traded companies in developed markets that are engaged in real estate-related activities such as property rental, development, or management.

S&P Municipal Bond Index
Measures the performance of U.S., fixed-rate bonds exempt from federal income tax, though they may be subject to the alternative minimum tax, with par outstanding of at least $2 million. The index includes bonds of all quality ratings, including non-rated and defaulted bonds, and from all sectors of the municipal bond market.

Treasury inflation-protected securities (TIPS)
A security issued by the U.S. Treasury that has both a fixed interest rate component and a par value that rises with inflation, as measured by the Consumer Price Index. Interest on TIPS is paid semiannually.

UBS Bloomberg CMCI (Constant Maturity Commodity Index)
Diversifies across both a broad range of commodities (27 futures contracts across a number of sectors, such as precious metals, agricultural and livestock) and investment maturities for each individual commodity. It is the first commodity index to include a time dimension.

WisdomTree Japan Hedged Equity ETF (DXJ)
An exchange-traded fund that aims to provide exposure to the Japanese stock market, while hedging exposure to fluctuations between the yen and the U.S. dollar.

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Any positioning information provided does not include all positions that were taken in client accounts and may not be representative of current positioning. It should not be assumed that the positions described are or will be profitable or that positions taken in the future will be profitable or will equal the performance of those described.

Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that would reduce returns.

An overview of our asset allocation strategies:
Wilmington Trust offers five model asset allocation strategies each for taxable and tax-exempt investors with particular sets of risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. Each strategy can be implemented with or without allocations to hedge funds. Strategic asset allocations (SAA) are maintained for each strategy and, on a quarterly basis, we publish the results of all of these strategy models versus benchmarks representing static investments without tactical tilts.

Model strategies may include exposure to the following asset classes: U.S. large-capitalization equities, U.S. small-cap equities, international developed large-cap, international developed small-cap and emerging market stocks, real assets (including international inflation-linked bonds and commodity-related and international real estate-related securities), investment-grade bonds (corporate or municipal), high-yield corporate bonds and floating-rate notes, and cash equivalents. Directional and absolute return hedge funds are distinct to the strategies with hedge funds. Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.

Forecasted performance:
Expected results are hypothetical and do not represent the performance of client accounts or actual investment products. "Expected returns" for each strategy are derived from our forecast returns for the underlying assets as described in the Capital Markets Forecast 2016–2026 and weighted based on their current allocation percentage. Forecasts are subject to a number of assumptions regarding future returns, volatility, and the interrelationship (correlation) of asset classes. Actual events may differ from underlying assumptions, which are subject to various uncertainties. No assurance can be given as to actual future market results. Expected returns for the individual asset classes are based on factors including, for equity-based securities, dividend growth rates and dividend yield changes. For fixed income securities, expected returns are calculated based on principal impacts from changes in the underlying U.S. Treasury curve, yield spread changes vs. the U.S. Treasury curve, and the interest income that could be earned. Estimates of default rates are also taken into consideration. "Expected standard deviations" are forecast from the trailing 10-year rolling standard deviation of the asset class and "Expected yield" is based on the current expected dividend or interest income and is expressed as a percentage of the underlying principal value.

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Disclosures continued

Fee assumptions:
No adjustments are made for advisory fees, transaction costs, or any other expenses. In the course of implementing a given asset allocation, clients could select among a number of investment vehicles or strategies, each of which will have such fees and expenses. These expenses have the effect of reducing returns at a compound rate over time, and would reduce the results shown. In cases where Wilmington Trust, or an affiliate, provides advisory, brokerage, or other services to such an investment vehicle, Wilmington Trust may benefit directly or indirectly from those advisory, brokerage, or other fees. **Investors should develop a thorough understanding of the fees, expenses, and other costs of any investment prior to committing funds.**

Impact of fees:
The following is a hypothetical example of the impact over time of fees charged to a client's account. It is not meant to suggest actual fees, which may vary, and does not reflect actual returns. Assuming an initial investment of $1,000,000 account value and an average annual return of 10%, an annual fee of 100 basis points (i.e., 1.00%) would result in account level fees of $10,641 the first year, $35,351 over three years, and $65,458 over five years. A schedule of Wilmington Trust's fees is available upon request.

Actual results will vary from forecast results:
In the course of implementing a given asset allocation, clients could select among a number of investment vehicles or strategies, each of which would contribute differently to overall results. The returns for individual clients will vary depending upon the performance of each actual investment vehicle or activity, any restrictions, inception date, timing of rebalancing, actual expenses and fees, and other factors.

Risk assumptions:
All investments carry some degree of risk. This publication uses the return volatility, as measured by standard deviation, of asset classes as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. **Investors should develop a thorough understanding of the risks of any investment prior to committing funds.**

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