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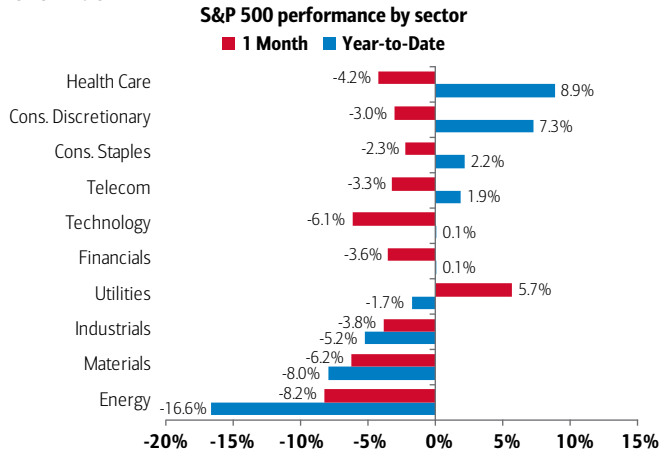
Dog Days of Summer

Markets are experiencing another bout of volatility, as the S&P 500 experienced its biggest one-day selloff since February 2014 yesterday. With this decline, the market has fallen roughly 4% since its May high, erasing its gains for 2015. While the market has historically performed poorly in late summer, we would advise investors to remain patient, stick with high-quality equities, and use the current volatility as an opportunity to rebalance their portfolios in line with their goals.

Volatility has picked up as investors face a number of growing uncertainties — whether the downturn in commodity prices and weak economic activity in China are indicating a global growth slump, as well as when the Federal Reserve (Fed) will raise rates. While these uncertainties will likely keep volatility elevated, we don't see this as a reason to panic and abandon equities.

Exhibit 1: Commodity-related sectors have weighed on the index



Source: Bloomberg, MLWM Investment Management & Guidance.
Data as of August 20, 2015. **Past performance is no guarantee of future results.**

Energy selloff a near-term headwind, but a long-term boost to growth

The Energy and Materials sectors have followed the steep decline in commodity prices this year, dragging down the overall market with them (see Exhibit 1). However, cheaper energy is ultimately a positive for the economies of oil-importing countries such as the U.S., Europe, China and Japan.

Furthermore, U.S. growth is improving thanks to the consumer, which comprises roughly 70% of the economy. Consumer confidence has been steadily boosted by improving labor markets, rising home prices, stronger household balance sheets and cheaper energy prices, which are putting money back in consumers' pockets. Combined, this should translate into a pickup in consumer spending and overall U.S. growth.

Additionally, the recent Chinese yuan devaluation, along with the collapse in Emerging Market currencies in general over the past few months, has spooked investors concerned with a growth slowdown. However, our view is that China's currency move was designed to support growth by boosting export competitiveness for domestic producers and increase exchange rate flexibility in the long run.

Volatility and uncertainty can give way to opportunities

While the current stock market pullback has left market watchers unsettled, pullbacks of 5% or more happen on average three times a year, according to the BofA Merrill Lynch Global Research U.S. Equity Strategy Team. There has yet to be one this year, and given the breakdown in that the S&P 500 fell below a key technical level, we would not be surprised to see the market remain pressured in the near term.

Nevertheless, we would advise investors to remain patient and use the current volatility as an opportunity to rebalance their portfolios in line with their goals. Our preferred regions are the U.S., Japan, and Europe. We favor high-quality large cap companies with stable

earnings and cash flows, as they are likely to better weather the volatility. We have a negative view on Emerging Market equities, as a slowdown in Chinese economic activity, falling commodity prices, a stronger U.S. dollar and a rising rate environment should continue to weigh on the asset class.

Bonds can help diversify a portfolio and offset equity market volatility and remain a critical component of a diversified portfolio. We reiterate that Treasuries and high-quality municipals should be the core of a fixed income portfolio, in our view. We expect high yield bonds to remain under pressure from the high concentration of energy companies and an expected pickup in defaults.

Risks to our view

We reiterate our positive view on the global economy, and a preference for equities over bonds. However, we recognize several risks to our outlook. Policy uncertainty may escalate into September when the Fed next meets, the congressional budget expires (leading to concerns of a government shutdown) and the Iran nuclear agreement will be presented to Congress. Additionally, continued negative economic data abroad could reinforce fears of a global growth slowdown, which could cause further declines in equities. Although this is not our base case, these developments bear watching.

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