Q4 2015 Annual Commentary

"We can't live in a state of perpetual doubt, so we make up the best story possible and we live as if the story were true."

Daniel Kahneman

Escalating geopolitical tensions emanating from the Middle East and North Korea combining with heightened concerns regarding a pronounced downturn in China's economy and the plunge in crude oil prices to fresh 12-year lows have been the New Year's present awaiting investors upon a return to work following the holidays.

The vulnerability of the Middle East was recently highlighted as Saudi Arabia cut off diplomatic relations with Iran on January 2nd. This followed by a day the execution of Nemer al-Nemer—a prominent Shiite cleric put to death in the mass execution of 47 prisoners accused of terroristic actions. A few days later, the world awoke to a proclamation from the North Korean government of a successful test of a hydrogen bomb potentially multiplying their nuclear capabilities.

All of this comes at a time when ISIS has entrenched itself as the most powerful terrorist organization in the world, Europe continues to face economic and political challenges and the geopolitical power of the U.S. continues to decay. It is perhaps an understatement to say that we expect to see a more fragmented and conflicted world in 2016.

The devaluation of the Chinese currency (the yuan is now at a 5-year low versus the dollar) combined with the traditional political interference of the Chinese government in its stock markets (via market circuit breakers) has further unsettled markets and undermined confidence that the Chinese can navigate a soft economic landing.

Meanwhile, global economies ended 2015 on a slower note increasing talk of a possible recession. The stark juxtaposition of darkening global clouds with an improving domestic landscape foreshadow an even more challenging time. We foresee a very low (though modestly rising) probability of a U.S. recession in 2016 with greater risks due to an external shock. We continue to see the U.S. in a slow growth, "muddle-through" economy. Consumer spending (adjusted for inflation) grew at 3.2% over the last year while the contribution from housing to domestic growth continues strong with new home sales and housing starts up 9% and 16% respectively in 2015.Additionally, 2015 represented the highest level of auto sales on record.

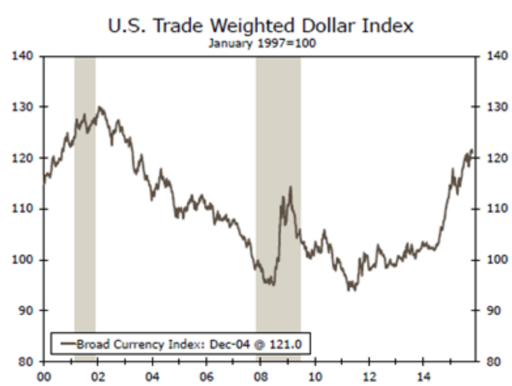
Our long held view that we are in the embryonic stages of a shift from capital to labor remains a theme of ours for 2016 and beyond. We expect wages and real incomes to continue to rise at a greater level than is currently anticipated. A strong dollar and collapsing commodity prices will continue to drag down net exports and manufacturing. However, the winner in this environment should be the U.S. consumer who benefits from lower oil prices and reduced prices of imported goods. The consumer will continue to be a critical component to economic growth and one we anticipate to be in an improving trend.

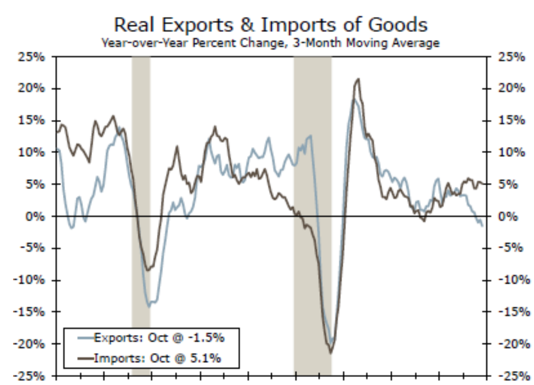
UNITED STATES:

As the Federal Reserve embarks on the long, slow process of rate "normalization", concerns naturally center on the restrictive impact of Fed rate hikes on economic growth. Six years of very growth-friendly monetary policies engendered only an average of 2.2% GDP growth during the economic recovery. Despite one of the weakest (though fourth longest) economic recoveries on record, this tepid growth was still sufficient to close the output gap and move the economy towards full employment. Is the U.S. economy strong enough to continue to grow in the face of the headwind of rising rates?

We note that the economy has already been experiencing a tightening in financial conditions over the past 15 months following the end of quantitative easing in late 2014. In a sense, the economy is already feeling the impact of rate hikes. In particular, the dollar has appreciated sharply since the middle of 2014 (decreasing the competitiveness of global manufacturers in the U.S.), and while some of that increase was a response to weaker foreign growth, much also reflected the inevitability of the need for more normal policy in the US.

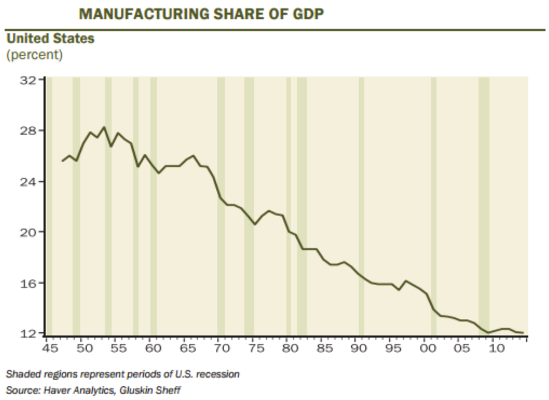
A notable gulf has opened up in the growth rates of real imports and real exports in recent months (bottom right). The contribution of net exports to real GDP growth has shifted since 2013 from a 0.3% support for growth to an average drag of -0.7% over the last five quarters. The most recent data from November actually was additive to 4Q GDP, however, this was due more to a large drop in imports as exports remained weak. For the year through November, imports are off almost -5% but exports have declined further at -7%. With global growth anticipated to remain slow in 2016 and a continued drag from dollar appreciation, we see real net exports exerting a modest drag on overall GDP growth in Q4 2015 and through at least the early part of the new year.

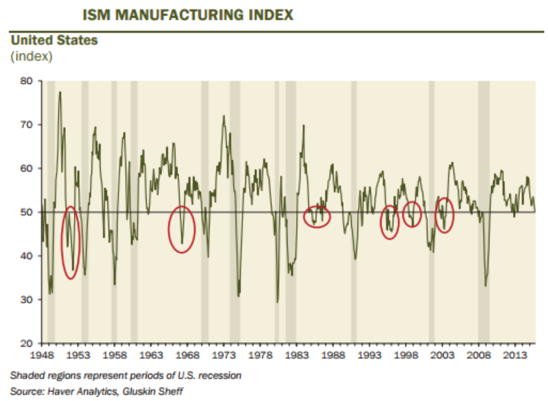




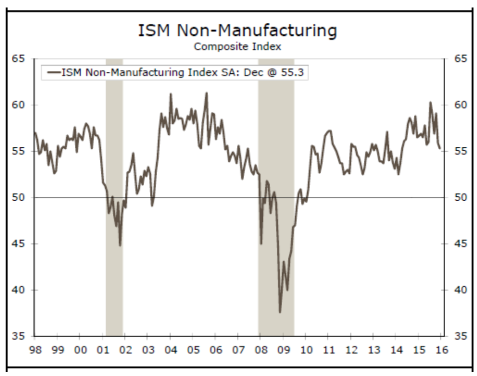
Much has been made of the weakening readings from the Institute of Supply Management (ISM) that depicts a manufacturing sector in recession. The narrative centers on the correlation of this index to domestic recessions. The U.S. manufacturing sector is coming under pressure from weak global markets and a strong U.S. dollar that is up over 20% from levels of 18 months ago. The higher dollar has the effect of weakening the relative competitiveness of exported goods in the face of already weak global demand. However, does this indicate an increased likelihood of recession?

Underscoring the diminished role of manufacturing in our economy is the following statistic. Since 1983, there have been seven distinct periods during which there was a contraction extending six months or longer in the ISM manufacturing index. Only three of these occurred during recessions (circled in red on the chart below right). This contrasts with the prior 35-year period when eight of ten of these periods occurred during recessions. As noted in the chart below on the left, manufacturing as a share of GDP has declined from over 28% at the peak in the 1950s to just 12% today.





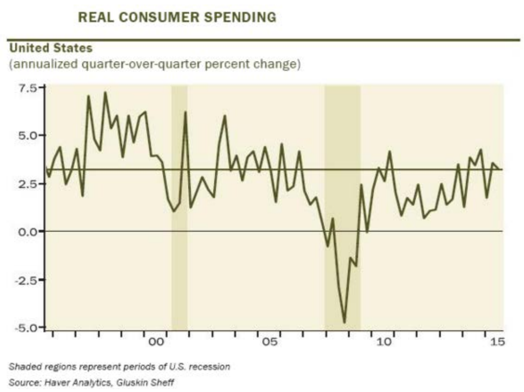
While the recent contraction in the ISM manufacturing index to a level of 48.2 in December (lowest since 6/09) should not be ignored, it is more critical to focus on the non-manufacturing ISM as it represents almost 90% of our service-based economy. The non-manufacturing ISM peaked over 60 in July but has trended lower since with a December reading of 55.3 (chart below). The ISM headline fell from a 3Q average of 58.7 to 56.8 in the 4Q. Still these are solid readings and appear to be more consistent with the overall growth pause in 4Q rather than a prolonged downturn.

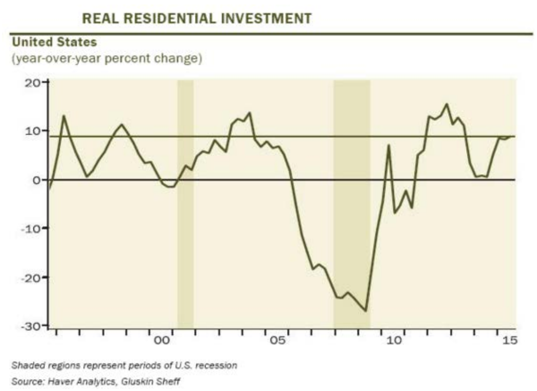


Despite the headwinds from manufacturing, trade and government spending, we entered 2015 with an expectation for the strongest annual growth of the economic recovery (though only 2.5%). We were a little too optimistic. We now see full year 2015 GDP coming in at 2.2%, consistent with the average growth rate of the recovery.

Despite slower than expected growth, the thesis upon which the optimism was predicated remains on trend. It has been our baseline view over the last 7 quarters that tightening labor markets and lower levels of inflation would awaken the long slumbering U.S. consumer and engenders a cyclical upswing in consumer spending. As consumer spending accelerated to an annualized rate of 3.8% in the second half of 2014, we felt strongly that this would continue in 2015 and override the drag from trade and manufacturing. Combining this with stronger housing data in residential construction (to fill low inventory levels and growing demand) would lead to a cycle high in growth.

Consumer spending is poised to close 2015 with a full year increase of 3.2% adjusted for inflation. For the most recently released GDP report on 3Q, consumer spending rose at a 3.0% a/r, the fifth time in the last six quarters it eclipsed the 3% level. These are solid numbers and compare very favorably with the higher growth periods of the last 15 years (chart below left). Additionally, real residential investment (housing) has started to contribute to GDP growth at a faster pace and grew at a 7.3% a/r in the 3Q though down from 9%-10% rate in the first two quarters of 2015. It is now up 9.2% y/y.





For 2016, we see many of these trends continuing with solid wage gains and, perhaps, lower savings rates (which jumped from 4.6% to 5.5% from 4Q 14 to 4Q 15) supporting continued solid spending. Real income growth may slow as the oil plunge data moves out of the base calculations (year-over-year) but nominal wage growth should rise. Though residential construction growth may also slow, it may be from a larger base and should contribute more to overall GDP growth. Historically, residential fixed investment has represented about 5% of GDP though it troughed at 2.4% during the housing downturn in 2010. It now has grown back to 3.7% of GDP and we feel this has more room to run.

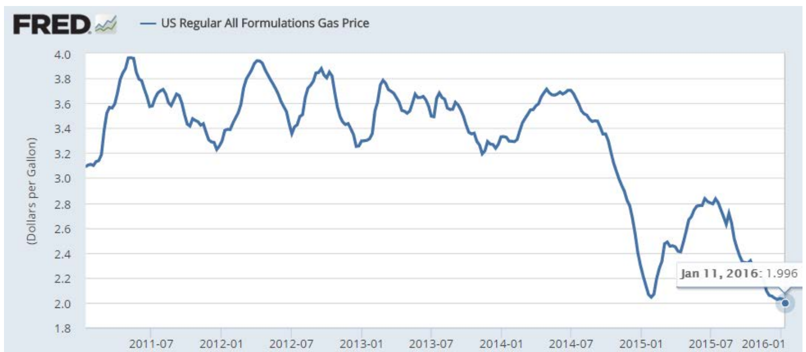
One item working in favor of a potential upside surprise may finally be the weather and seasonal impacts. After two years of a weather-induced, weak first quarter, the impact of El Nino (along with lower home heating bills) will most likely create an upside surprise to growth in the early part of 2016. While the consensus of economists in a recent Wall Street Journal survey forecast a 2.6% growth rate in 2016, we are a little more circumspect. Without stabilization in the rise of the U.S. dollar and fall in the price of crude oil, we are again looking for growth to approximate 2.25% in 2016.

OIL & INFLATION:

The price of oil collapsed from over $115 per barrel in the middle of 2014 to end the year at $57.33. In 2015, crude oil fell an additional 35% ending the year at $37.04. Following an additional 20% decline towards $30 a barrel in early 2016, many Wall Street analysts fear a drop into the $20 area. Wolfe Research suggests such a scenario could lead to bankruptcies and reorganizations for as many as 30% of American oil & gas producers. The oil collapse is unsettling global markets and continuing to have an impact on equity and fixed income holdings related to the resource sectors. Many sovereign wealth funds in oil exporting countries may continue to liquidate financial assets to support government budgets. We do not know at what levels oil prices may settle. In spite of many of the negative consequences, we still view the decline in oil in a more positive light for the overall U.S. economy.

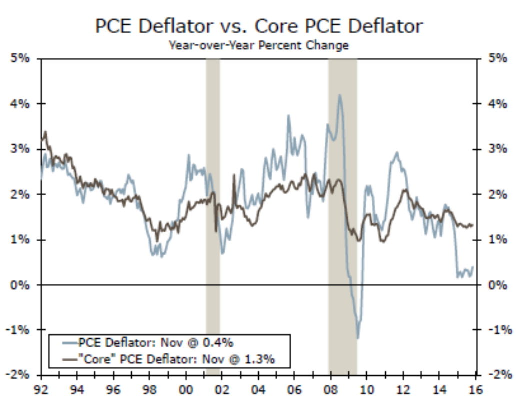
Since the oil price peak, national gas prices (see chart next page) have dropped from $3.70/gl to $1.99/gl. We have viewed this event as a giant transfer of resources from oil producers to consumers. As consumption comprises almost 70% of U.S. GDP, the very things that have hurt manufacturing and oil have been very beneficial to the consumer.

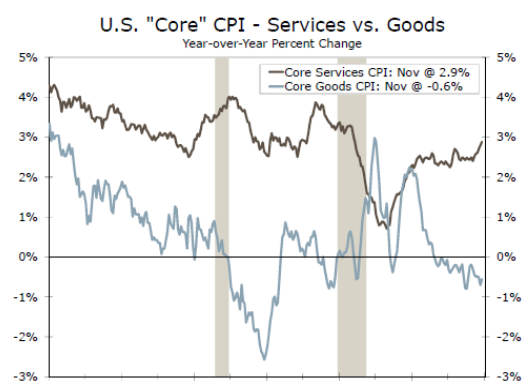
The good news for the consumer is that this modest benefit to growth should continue in 2016. According to the International Energy Agency (IEA), the current excess supply of oil should remain at least through 2016. The IEA now estimates world demand growth to drop from 1.8 million barrels per day in 2015 to 1.2 million in 2016 with excess supply rising 300 million barrels as extra oil from Iran hits the market. We have yet to see what impact the recent severing of diplomatic relations between the Saudis and Iranians may have on this market.



Though inflation readings have remained stubbornly low, we expect that to change soon. Through readings in November, the Personal Consumption Expenditure (PCE) price index (the preferred measure of the Federal Reserve) has now nudged into positive territory at 0.4%y/y with the core reading (excluding food & energy) sitting at 1.3% y/y (see chart below left). For reasons outlined below, we now anticipate the headline and core PCE readings to align just a little below the 2% target of the Federal Reserve in 2016.

Inflation (as with many of economic calculations) is computed year-over-year so is subject to the impact of the base calculation. In the more popular CPI calculation of inflation (see chart below right), we already note that goods inflation is stabilizing but running at a -0.6% y/y decline while service inflation (75% of the composition) is moving to 2.9% y/y. Downward pressures from low oil prices and a strong dollar heavily influence the recent low inflation readings on the goods side of the calculation. Both of these should ease early in the New Year.





Consumer energy costs were down 17% from a year earlier in November. However, almost all the drop occurred before the spring, and the level of prices has not changed much since. Lower gasoline prices will drag inflation lower in December, but unless gasoline keeps sliding at this rate, its effect will fade next year. While the trade-weighted dollar is up 11% from a year ago, its pace of ascent has slowed since

August, when it was up 16%. It does not need to decline but only to stop rising for upward pressure on import prices to resume. As noted below, we also anticipate increases in wage costs (up 2.5%y/y in December) that should further the upward pressure on these inflation readings.

THE FEDERAL RESERVE:

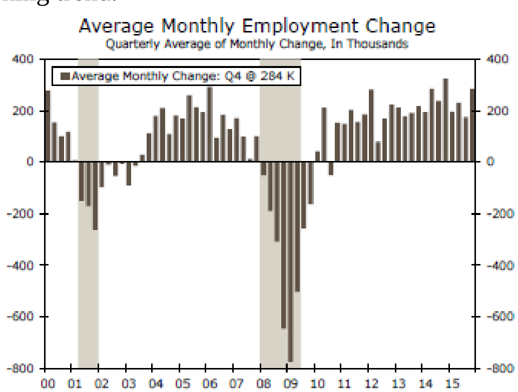
We have postured for much of the last 18 months that the Federal Reserve would not raise interest rates in 2014 or 2015. While this was a clear minority position, we questioned whether the economy was yet self-sustaining. Our view that a rising dollar (potentially exacerbated by interest rate increases) and the end of quantitative easing were also forms of tightening framed our position that the Fed would remain on the sideline as manufacturing moved into recession. We were close on our prediction as the Fed waited until December of 2015 to finally raise rates by a quarter-percentage point and pledged a gradual pace of further increases.

The Fed appears to have responded to continued robust job creation in the United States and other signs that the country's economy is recovering including indications of increasing wage growth. In deciding to raise interest rates, Janet Yellen took the unprecedented step of moving toward the multiyear normalization of its overall policy stance in diametric opposition to other central banks.

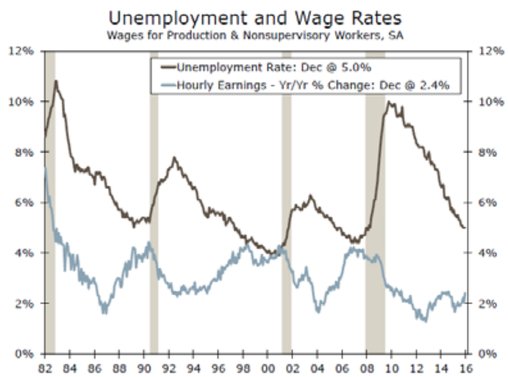
The European Central Bank (ECB) and Bank of Japan (BOJ) face a very different set of economic conditions. Though economic growth is improving in these regions, it remains somewhat sluggish and the risk of deflation is still present. We expect the ECB and BOJ to expand and extend monetary measures. It is logical under this relative scenario to anticipate a further dollar increase and softening of the euro and yen. However, this position may represent the most crowded view in the markets and, therefore, may not materialize. This may especially be true if the PBOC acts to intervene and prevent further weakness in these currencies versus the yuan.

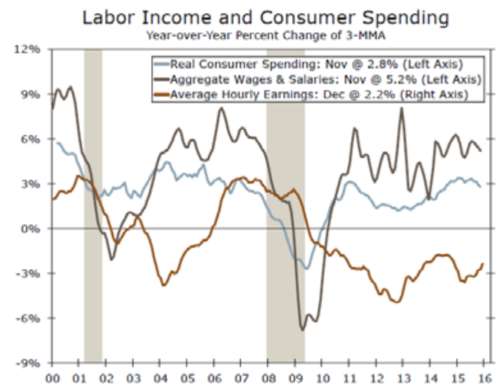
EMPLOYMENT & WAGES:

The final jobs report for the year was in sharp contrast to most economic data that had indicated a slowdown in the final quarter of 2015. For the full year, job creation totaled 2.7MM (an average of 221K per month), the second highest level (behind 2014 total of 3.1MM) in the last 17 years. Indeed, momentum in hiring seemed to build in the final quarter with an average of over 284K jobs added per month and an unemployment rate that fell to 5.0%. As often mentioned in these pages, higher growth of labor hours should correlate with growing GDP. This indicates an actual contraction in productivity occurred during the quarter continuing this weakening trend.



After rising 0.4% in October, average hourly earnings rose another 0.2 percent in November but were disappointingly flat in December. Still, the year-over-year growth in hourly earnings increased to 2.5% (a cycle high) up from the 2.1% average in the first half of the year. Meanwhile, aggregate labor income (which more closely tracks consumer spending as it includes benefits and hours worked) continues to increase at a faster pace. Aggregate wages & salaries increased at a rate of 5.2% over the past year (chart on following page top right).

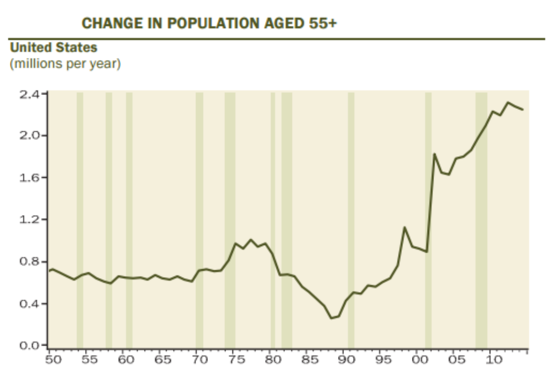


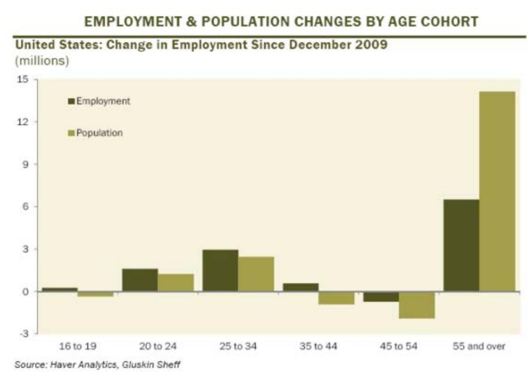


Our view for 2016 is one of continuing job growth as the expansion matures but at a more moderate pace than the past two years. These gains should remain strong enough to further lower the unemployment rate. With a slowly growing labor force, it may only require 100K new jobs per month to maintain or even lower this rate. As job markets tighten, we should see our long awaited reversal of labor over capital as wages continue to ascend. Households and consumer sentiment and spending should solidly benefit from these rising incomes. The strength of the overall job market comes despite employment losses in areas directly or remotely connected with the U.S. dollar and/or commodity prices where areas such as the mining sector have lost over 120K jobs in 2015 alone.

Finally, it is worth readdressing that our aging demography is on full display in the employment and wage data and should not be confused with real improvements in the labor market. There are currently almost 95MM people in our country who are "outside of the labor force". Thus, the labor force participation rate (though rising modestly) is near 35-year lows at 62.6%.

However, the chart below on the left indicates the change in population turning 55 each year. This is not a new phenomenon as it started in 2000 when the first baby boomers turned 55. The narrative that most job gains are going to the age 55+ cohort is true. However, I maintain this is less due to the need for workers to stay employed longer (though this definitely has some impact) than to the fact that this age cohort is growing dramatically.



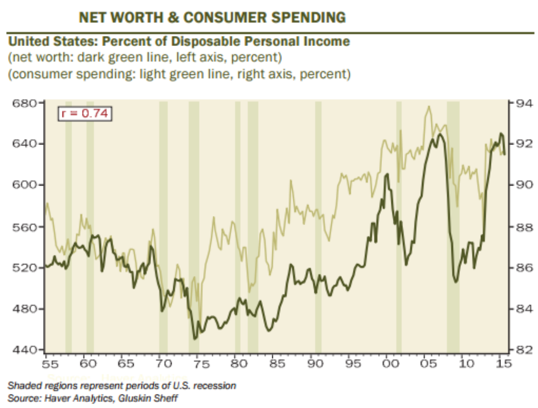


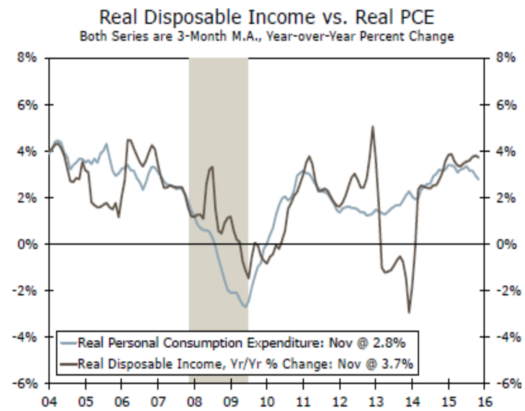
Though anecdotal, it is also probable that the aging of the labor force is impacting wages. Generally speaking, older workers are paid more than younger workers. As the average or median age of the workforce slows (due to retirements in larger numbers), it is logical to assume that wages may follow.

CONSUMER:

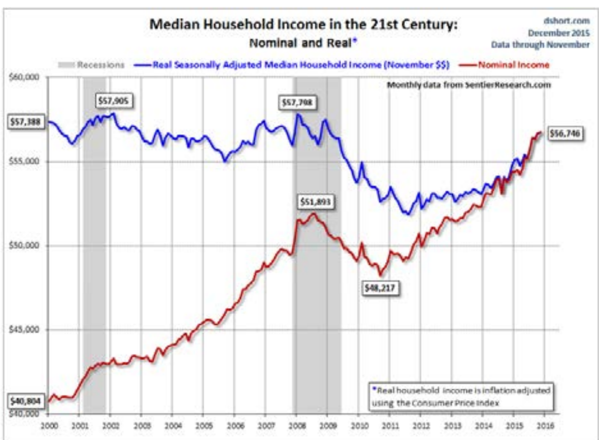
The Federal Reserve release of the U.S. Flow of Funds report for 3Q continued to paint a very strong picture of the consumer in the United States (though declining for the first time in over four years). This data show that aggregate household net worth (total assets minus total liabilities) is now $85.2T, down slightly from the record high posted in 2Q. Though real incomes are rising and the consumer is in improving fiscal shape, we are always alert to consumer confidence and the impact it may have on spending. If household net worth declines, consumers historically increase savings at the expense of spending (chart below left).

During much of 2015, there was a lot of focus on weaker than expected retail sales and the implications that weaker data has for overall consumer spending. However, the retail sales reports do not account for retail services only physical merchandise. It may be surprising to note that spending on clothing and footwear comprises only 3% of total spending. Services comprise 67% of consumer spending and this trend continues on the ascent. Overall, real consumer spending is currently growing at 3.2% y/y pace, comparable to levels prior to the recession. Disposable personal income adjusted for inflation is growing at a faster pace than spending at 3.5% y/y (chart below right). With the savings rate now 5.5% versus 4.6% a year ago, the consumer is in solid shape for continued spending gains.



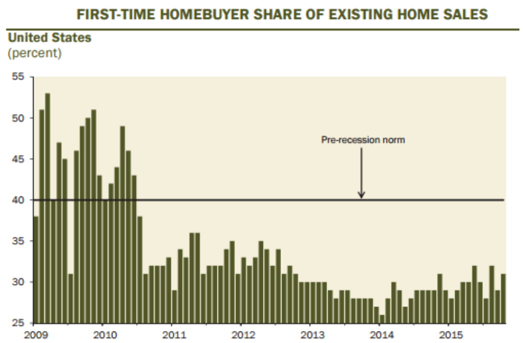


Most of the data we review is aggregate data. The major limitation here is that is may be skewed by large outliers. In the case of the consumer, income inequality clearly has this effect and it is often useful to view the data of the median. On this front there is improving but still sobering news. According to data from Sentier Research, the real median household income (chart on next page) from the most recent data in November is $56,746 continuing an upward trend that has been in place since the lows of November 2011. The good news is this represents an inflation-adjusted increase of 4.8% y/y. The not so good news is this is still lower by -1.8% from the interim high of January 2008. Nonetheless, the outlook for the consumer continues to improve.



HOUSING & AUTOS:

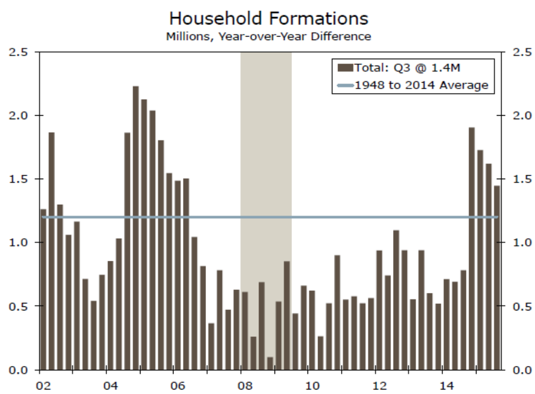
We have long noted that the housing recovery would morph from an investment driven one to a more traditional market based more on improving job and wage growth. As this unfolded over the last year, the primary concern remained the low share of home sales from the first time homebuyer (chart below) and the impact of historically low levels of household formation needed to drive demand. The good news is that we continue to see improvement in those metrics and housing remains on an uptrend that started in mid-2011.

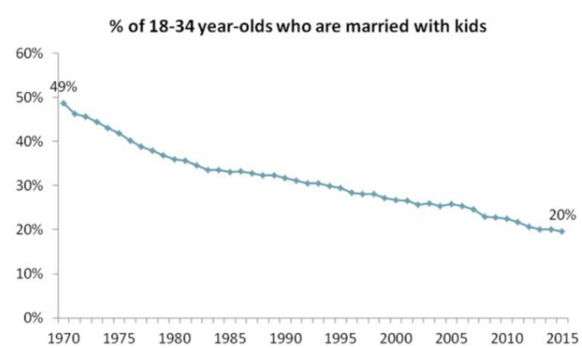


Certain drivers, most often demographics, affect the rate of growth of household formation. In the period following World War II, the onset of the baby boom led to high household growth, averaging more than 2% per year between the mid-1960s and the early 1980s according to data from Core Logic. During this period, baby boomers reached prime household formation ages. Smaller birth cohorts conceived in the 1970s led to household formation rates almost half of the prior levels between 1990 and the mid-2000s.

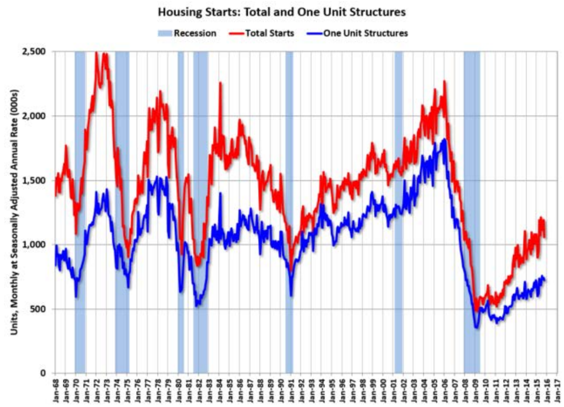
However, the economy may also have an important though more temporary influence on household formation. While an economic expansion would have the likely consequence of creating more, solid-paying employment opportunities that allow young people to strike out on their own, an economic recession might have the opposite impact. This effect was particularly pronounced in the aftermath of the Great Recession, the longest and deepest recession since the 1930s as household formation rates fell to the lowest levels recorded since the end of World War II.

Over the past year, the creation of new households has accelerated, as has our optimism for continued increased contributions from housing towards economic growth. Through the first nine months of 2015, compared to the same period a year earlier, the number of new households has grown by 1.4 million. This is the largest annual growth in a decade (chart below left) and a level we have now exceeded for each of the last four quarters. As the job market has improved for the 25-34 year cohort, many now have the financial wherewithal to form their own household. Still there are certain sociological trends that may retard progress on this front. An especially important one is that people are waiting longer today than in the past to marry and start a family. Since 1970, the share of the 18-34 year old cohort that is married with children has dropped from almost 50% to the current level of 20% (chart below right).



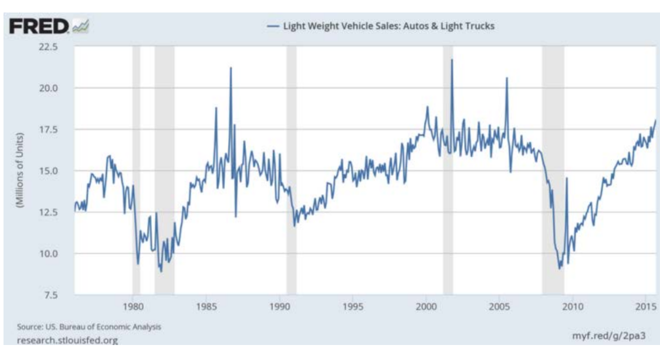


Though increases in housing starts have averaged over 17% in the last four years, they remain substantially below the levels of the prior 30 years despite population growth. Housing starts have averaged 1.08MM in 2015, up 8% over 2014. However, this compares with an average of 1.38MM for the 30-year period prior to the Great Recession. Reflecting the move towards multi-family (apartments), single-family starts are averaging 706K on an annualized rate an increase of 9% from levels of 2014. Single family starts for the 30-year period prior to the Great Recession averaged over 1.08MM.



With supply extremely low in the lower end market and demand continuing to improve, we foresee housing starts continuing their momentum into 2016. Real residential investment is up 9.2% y/y and has historically represented over 5% of gross domestic product. In 2010, during the depths of the housing crisis, this contribution dwindled to 2.4% but has since rebounded to 3.7%. At these levels, we anticipate a more meaningful contribution to overall growth even with a modest slowing in housing activity.

Auto sales for November came in just south of 18.2MM annualized units, exceeding 18MM for the third consecutive month, an unprecedented event. Though sales slowed in December to an annualized total of 17.3M vehicles, the 2015 total of 17.47M set an all-time record according to Autodata. Indeed, auto sales have doubled since 2009 (see chart on following page) in the strongest advance in almost 40 years or since the Oldsmobile Cutlass Supreme was the best-selling car in America. However, the slowdown in December (though only one data point) does give us pause as this is often a critical and strong month. While still solid, we are increasingly of the view that auto sales may have peaked and the incremental benefit of low gas prices may fade.



According to Experian, leases accounted for about 27% of new purchases in the third quarter while financing of new vehicles reached 86.6% both record levels. The easing of lending terms has been a key factor in the meteoric rise of car sales. Almost one third of new vehicle financing is for terms extending six to seven years. The average FICO score for consumer loans on these cars is 710, the lowest since the Great Recession. With the average loan now almost $29,000, the average monthly payment is nearing $500.

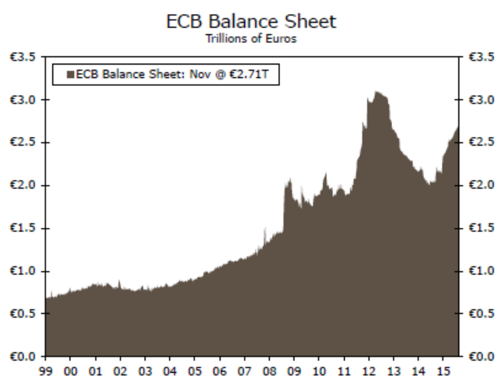
Though we have little concern for any credit crisis emanating from auto loans, we do feel strongly that this will both cannibalize future sales (with longer terms and negative equity for longer) and potentially crowd out other spending.

INTERNATIONAL:

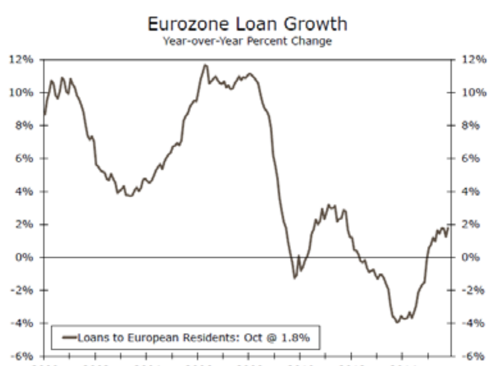
EUROZONE:

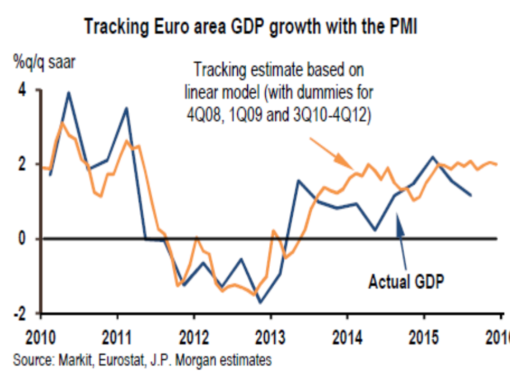
Ever since European Central Bank (ECB) President Mario Draghi hinted at the last policy meeting on October 22 that more accommodative policy measures would be discussed at the December 3 meeting, market participants had been anticipating that the Governing Council would take some dramatic steps. Although the ECB did announce some policy changes, those changes generally fell short of market expectations.

The ECB, under its version of quantitative easing (QE) is currently purchasing €60 billion worth of bonds per month and announced an extension of this program for another six months until March of 2017. These bond purchases have boosted the size of the ECB's balance sheet (chart below). However, this level is still well short of its 2012 peak prior to failed efforts at austerity. We feel this allows additional ammunition for further stimulus.

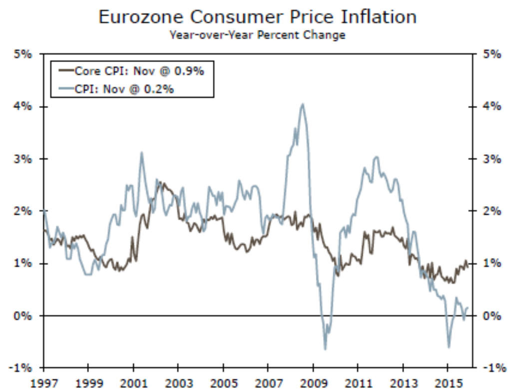


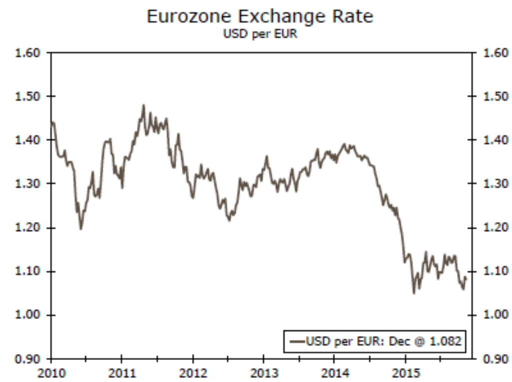
Real GDP in the Eurozone was up 1.6 percent on a year-over-year basis in Q3 2015 and we look for modest increases in coming quarters. Some of the ECB's past policy actions to increase bank lending (which supplies 75% of corporate funding) are starting to work (chart below left). The Purchasing Manager indices (PMI) that we follow for both the manufacturing and service sectors in the region are still rising and consistent with GDP growth of 1.5% to 2% (see chart below right).





The fundamental support remains pent-up domestic demand, which has lagged behind that in Japan and the US by 6% and 12% respectively since 2010. Any negative impacts on tourism and consumer and business confidence emanating from the terrorist attacks in Paris in November should be temporary. With the additional benefits of falling oil prices and a lower euro (down almost 11% on a trade-weighted basis in the last year and 20% over two years) to support export competitiveness, we feel the Eurozone may surprise to the upside in 2016 and we look for growth approaching 2%.



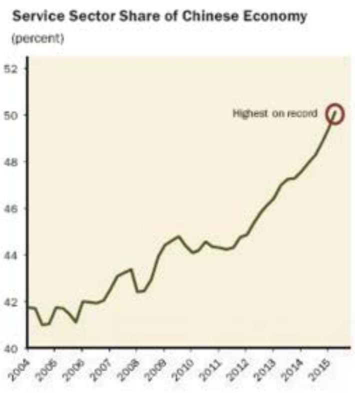


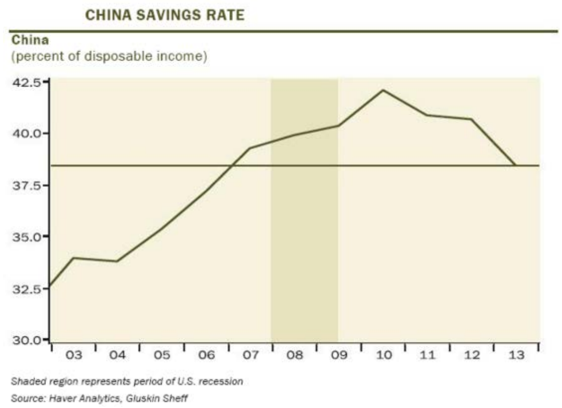
CHINA:

The slowdown in the China economy continues to be one of the major headwinds for global growth. As China has contributed about 40% to the growth of global GDP during the recovery (see chart below), recent data is concerning. Boosting government spending may be a Keynesian prescription for many countries to lift their economic performance. China, however, is looking to move away from its reliance on the government as a driver of growth and towards an economy driven by private consumption and investment. This is a challenging transition and much of global economic performance is tethered to whether they can successfully engineer such a soft landing. So far, the results are mixed.

The growth in the service sector (primarily wholesale and retail trade along with finance and real estate) in China has actually been very impressive in recent years growing from 44% of GDP in 2010 to 51.6% at the end of 3Q 2015 (chart below left). While the transition to a more consumption-based economy continues to hurt manufacturing and industrial profits, the service sector has been in expansion mode for almost 3½ years.

However, the Chinese economy has a long way to go before its domestic consumer will be a significant driver of economic growth on par with major developed countries. China's consumer represents just 38% of GDP (2014), compared to an average 60% for the G-7 and 70% in the U.S. The Chinese save almost 40% of their disposable income (chart below right), so the potential demand is there with just a small retrenchment in the savings rate. It is understandable for a society undergoing such a dramatic social and economic change to express a preference for savings over discretionary consumption underscored by the lack of a viable social safety net. While we remain optimistic on this transition longer term, the short term remains uncertain.





Until recently, Beijing has kept the yuan tied to a very strong dollar resulting in many other countries' exports gaining an edge over China. Since 2011, the yuan has risen over 30% versus the euro (China's largest trading partner) and 40% versus the yen. This further crimps exports and the most recent data in October exhibited a year-over-year decline of -3.7%. This pushed the People's Bank of China (PBOC) to cut benchmark interest rates six times in 2015 to the lowest rate ever and even allowing the yuan to decline.

However, the larger perspective is that the recent weakening of the yuan is a small reversal of a major long-term trend. Since 2005, the broad trade-weighted index for the Chinese currency has strengthened 50%. Following the first devaluation of about 2% in August of 2015, the yuan is now about 5% down from recent levels. China may be using the yuan to regain export growth and preserve foreign exchange reserves. However, the devaluation may shock European and U.S. markets towards extreme risk aversion and, thus, be counterproductive.

Analysts estimate that the PBOC has $3.33T in foreign currency reserves. This represents the largest stockpile in the world and, seemingly, an insurance policy against a depreciating currency and the capital outflows that may go along with that decline. However, the burn rate of that stockpile is increasing. According to data from Bloomberg, foreign reserves in China plunged by $513B or 13.4% in 2015. This was the first drop since 1992 and bears continued scrutiny.

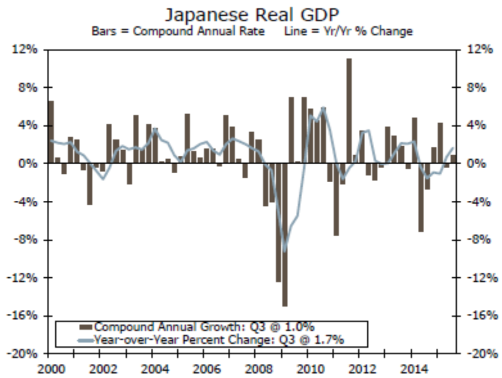
We have noted in the past that much of the growth in China since the Great Recession has been debt-fueled. The country's debt-to-GDP ratio has nearly tripled since 2000 from 121% to 282%. Private debt in China is now 6X larger than in 2007. The recent slowdown in growth in China is acting as a headwind to the government's objective of paying off much of this debt. Growth rates of GDP for China by official government statistics have dropped from 10% in 2010 to below 7% in 2015. Consensus is for a further decline in 2016 to about 6.5%. Though optimistic of the success of the long-term transition, we would look for rates of growth far lower than consensus.

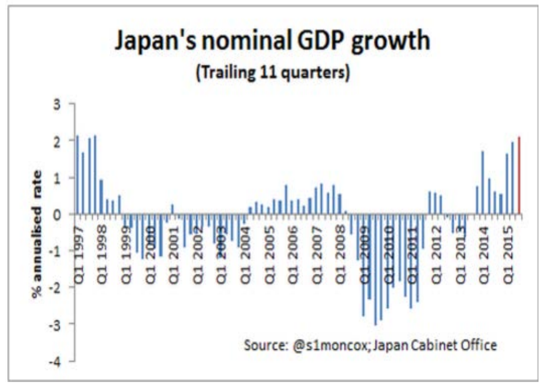
JAPAN:

Prime Minister Shinzo Abe was elected in 2012 with a specific mandate and platform. His goals were to provide monetary stimulus to arrest the lost decades of deflation along with short-term fiscal stimulus and long-term debt reduction. Additionally, Abe was looking towards structural reform to lift Japan's long-term growth rate. The Bank of Japan's (BOJ) version of QE commenced in 2013 with massive purchases of government bonds aimed at boosting inflation to 2% over a two year period from deflationary levels.

So how is that going? Perhaps a little better than the most recent reading for November of 0.3% y/y might indicate as falling oil prices dominate that headline figure. When one excludes food & energy, the "core" rate of inflation is now near 1%, the highest since 2008.

Japan's aging demography has created a shrinking labor force and, along with low productivity growth, analysts estimate long-term "potential" growth for the economy to be only 0.5%. This means that they will be more prone to swings in and out of technical recessions. Indeed, even modest shocks such as last year's tax increase (a horrific policy move) and a slump in exports to China can easily push growth into negative territory, without initiating a genuine cyclical downturn. This is precisely what occurred over the prior two quarters when a small contraction in 2nd quarter growth preceded a solid 1% q/q reading in 3q. This growth increased the year-over-year rate to 1.7%, the highest since 2013 (chart below left). Additionally, nominal GDP growth was revised up to a 3.5% a/r, the highest in five years. As the chart below right shows, nominal GDP growth in Japan over the last 11 quarters is the fastest in almost 20 years.

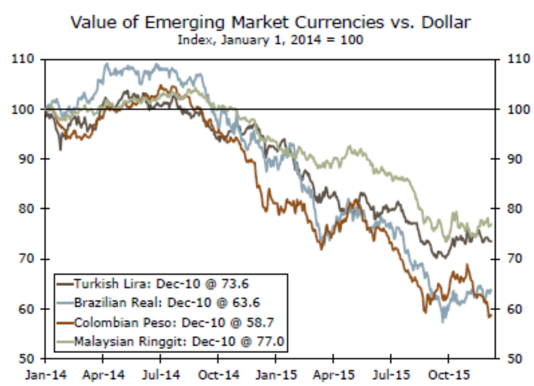




The unemployment rate, which adjusts for a shrinking labor force may be a better indicator of the improvement in the underlying economy. It has edged down from 4.1%, when QE began, to 3.3% for the most recent November reading and was as low as 3.1% in October. This is just off the lowest reading since 1995. As importantly, the participation rate in Japan has been on an increase since 2012 reflecting the structural reform attempts at increasing employment for women and the elderly. We look for these improvements to reflect modest GDP gains of a little over 1% for the full year.

EMERGING MARKETS:

The Federal Reserve's first rate increase in almost a decade is stirring fears of another wave of turmoil in emerging markets that have already been hit by collapsing commodity prices, rising debt levels and slowing demand. Plummeting currencies (see chart below) are creating problems for many central banks especially for commodity exporters and those who have borrowed heavily in U.S. dollars.

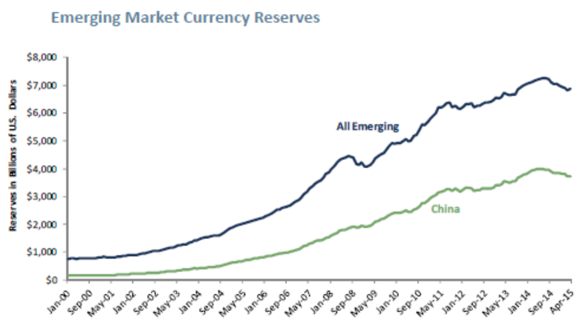


Emerging market GDP growth has slowed from 7.4% in 2010 to an estimate approaching 4% for 2015. Though these rates of economic growth would be the envy of the developed world, emerging economies conclude 2015 with the fifth consecutive year of decelerating growth.

Emerging economies in aggregate now account for about 40% of total global output (not marginal growth).This potential impact is why the International Monetary Fund (IMF) was pleading with the Federal

Reserve to hold off on any rate increases until at least 2016. The IMF estimates GDP growth to rebound to 4.6% in 2016 but some bottoming in commodity prices and currencies may be needed for that to materialize. If the U.S dollar continues to rise and commodity prices test new lows the situation for the commodity exporters will worsen. Therefore, we continue to be concerned about most Latin American economies and favor the emerging economies of the Asia region where aggregate growth should approach 6%.

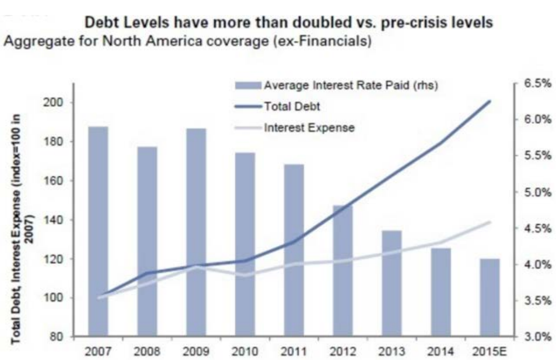
Flexible exchange rates and large foreign reserves can cushion the impact of capital outflows and emerging markets, though weakening, are in much better shape than during the Asian and Latin America crises of the late 90s. Data compiled by Reuters show that central bank reserves in 15 of the largest emerging economies are down over $600 billion from the end of last year, including $500 billion from China. However, the IMF still estimates total reserves to approach $7T versus only $659B in 1999 (see chart below). This should allow emerging markets to avoid the full-blown crises of 1998.

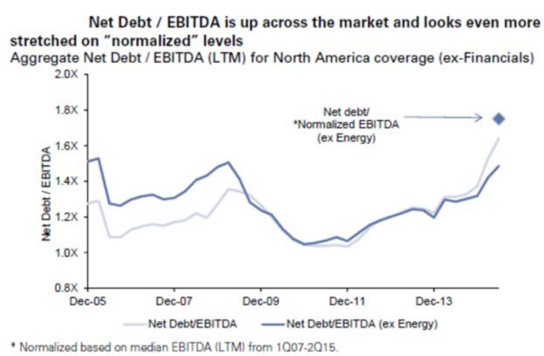


MARKETS:

We have heard from more than one client over the last few quarters a common bullish refrain on the strength of corporate balance sheets in the United States. This popular narrative may owe its genesis to the fact that much of corporate debt has been "termed out" to longer maturities with lower interest rates reducing the interest expense on income statements.

While this may be true, corporate leverage is now at the highest level in a decade as companies not only refinanced existing debt to more favorable terms but also issued record levels of debt often to fund buybacks and mergers. Total debt on corporate balance sheets may now be more than twice as large as pre-crisis levels as the charts below from Deutsche Bank show. Refinancing risk is low and so long as interest rates remain range-bound, as we expect, this is not an imminent concern. However, we would expect corporations to slow the pace of buybacks, dividend increases, M&A and debt issuance. Without expanded top line growth, this may hamper earnings gains.



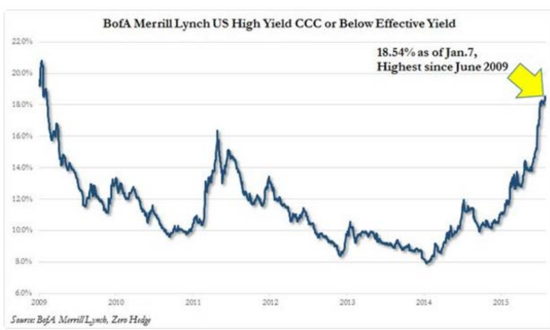


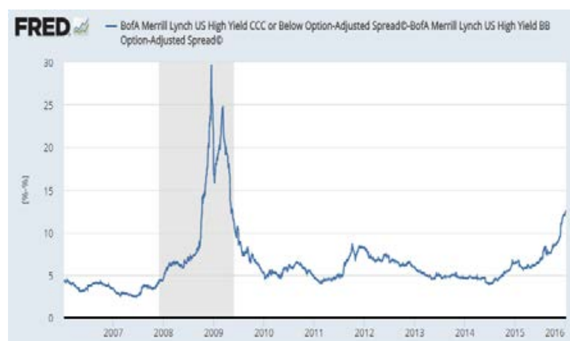
Deteriorating conditions in the lower-rated (high yield) corporate bond market have heightened market concerns. On this front, we are a little more optimistic. The high yield bond market endured the first annual loss since the credit crisis, reflecting concerns among investors that a six-year U.S. economic expansion is on borrowed time. This decline has elevated fears of another credit event and ignited increased worry in the equity markets, as these declines historically presage economic downturns.

U.S. corporate high-yield bonds are down over -5% this year, including interest payments. Junk bonds have posted only four annual losses on a total-return basis since 1995 and 2015 represents the first year of declines for this asset class outside of a recession. While most of the decline centers in the commodity areas, there are worries that the selling has spread towards other lower-rated debt making it more difficult for all companies to borrow new funds.

The junk-bond default rate forecasts are for a rise to over 3% in 2016 from 2.1% this year, though still below the 30-year average of 3.8%. If oil were to continue a downturn and remain in the $30 level for the year, these default rates would breach that level. As noted in the chart below on the right, CCC-rated bonds in this space have experienced price declines and yields rising from 10% to over 18% during 2015. However, refinancing risk is currently low as the most distressed bonds (CCC and lower) have less than 15% of total outstanding debt set to mature in the next two years. It is 2018 when much of the outstanding debt will mature.

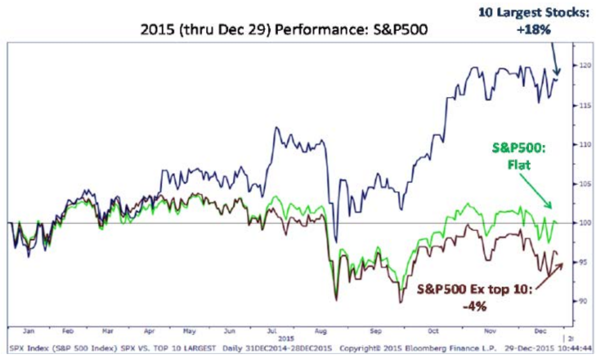
More importantly, over 80% of the leveraged credit space is outside the Energy and Metals/Mining sectors. JP Morgan forecasts only 1.5% default rates outside the commodity space for the next two years far below the 3.5% long term averages. Since 1996, the average yield in the High Yield category has been 9.5% with an average spread to 5-year Treasuries of 577 basis points. With current yields ending 2015 at 9.1% (the highest in four years) and spreads now over 750 basis points, we feel the risk outside of the commodity space to be more than reasonably valued. The chart below right shows the expanding yield spread between the CCC-rated issues and the BB-rated bonds.





Our concerns in the fixed income markets are focused less on rising interest rates or even deteriorating credit quality, though they do exist. The greatest risk may be one of liquidity. One of the consequences of the financial crisis and subsequent Dodd-Frank legislation has been the implementation of the "Volcker Rule" which prohibits banks from conducting certain investment activities with their own accounts. One of those key activities was acting as a market maker in fixed income and providing additional liquidity to the bond market. If there were to be an "event" in the credit markets, volatility will ensue.

For 2015, the Standard & Poor's 500 index finished the year with a total return of +1.4% with the Dow Jones Industrial Average losing -2.2%. The tech-heavy Nasdaq Composite index managed a +5.7% return. These moribund returns, nonetheless, obscure an even more challenging year for equity returns as the S&P is a market-capitalization index which was fueled by a handful of stocks. According to Colonial Consulting, the largest 10 positions gained approximately +18% (chart on top of next page). The equally weighted S&P 500 index actually experienced a drop of -4%. Indeed, 37% of companies in the S&P Mid Cap index are down over 20% from their highs as are over 46% of those in the S&P 600 Smallcap index.

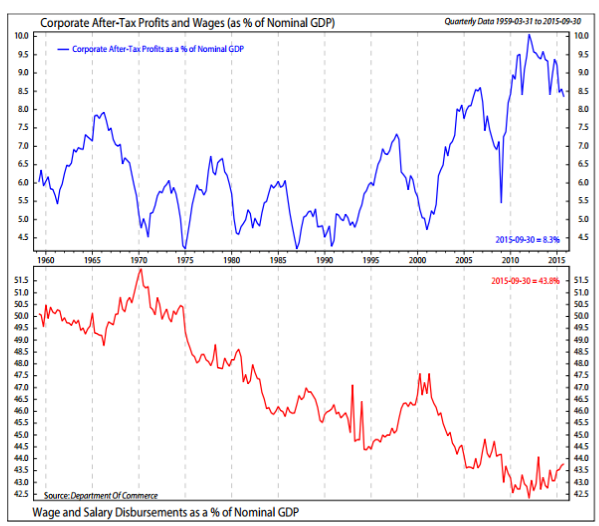


Other equity market indices also fared poorly in 2015. The Russell 2000 SmallCap index experienced a full year drop of -4.4%. The MSCI EAFE index of markets of international developed economies declined -0.81% while the MSCI Emerging Market index was off -14.92%. The most encompassing index of all may be the MSCI All Country World Index (MSCI ACWI). The MSCI ACWI covers about 85% of the global equity markets and declined -2.36% in 2015 (ex-U.S. it was down -5.7%).

According to data from Factset, 2015 S&P 500 earnings estimates forecast a decline of -1% to $117 with profits for the 4th quarter dropping over 5%. This is in line with our below consensus call following 2014. This would mark the first time the S&P has seen three consecutive quarters of EPS declines since Q1 2009 through Q3 2009. Earnings for 2016 are anticipated to grow +7% to $125. We are once again more sanguine, expecting anywhere from a slight decline in earnings in 2016 to an increase of 3% (a range of $114-$120) with profit margins being a key lever.

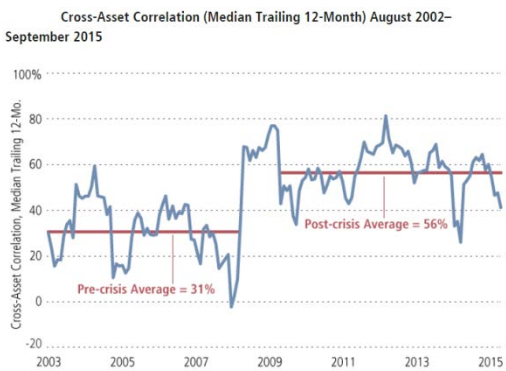
For much of the last two years, we have pointed to historically high profit margins as being unsustainable in the long term and inflating earnings from historic trend growth. The impact of margins on understanding valuation can be dramatic and is best exhibited in the alchemy that has allowed a 1.5% revenue growth rate in the S&P 500 since January 2011 to generate 4.4% in earnings per share growth over the same time period according to data supplied by Thomson Reuters.

We believe our long held view that we are in the early stages of favoring labor over capital will have major economic and market implications. A stronger job picture finally accompanied by solid wage growth should continue to benefit Main Street and sow the seeds for future economic growth. As this transition unfolds, the benefits to Wall Street may not be readily apparent. The chart below from Ned Davis Research shows in two panes the negative correlation between wages as a per cent of GDP (on the bottom pane and rising) juxtaposed to corporate after-tax profits (a proxy for profit margins) on the top pane which appears to have already peaked and started to roll over. This may continue to pressure profits.



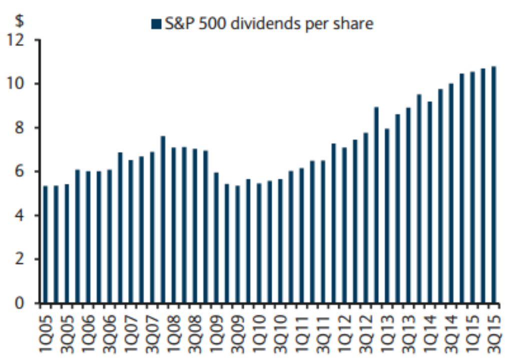
Wikipedia defines diversification as the process of allocating capital to reduce the exposure to any one asset class or risk. However, the key to effective diversification is to populate a portfolio with asset classes with a low correlation to each other.

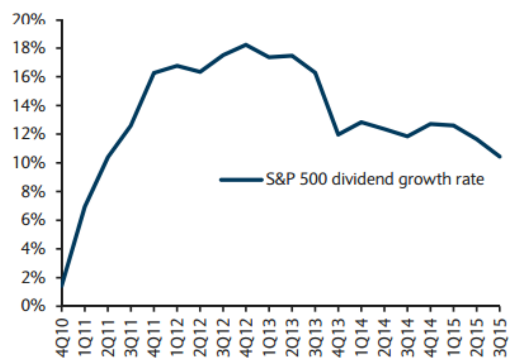
In recent years, diversification outside of domestic equity markets has provided little benefit. As seen in the left hand chart below from Research Affiliates, in the period preceding the financial crisis correlations among major asset classes averaged only 31%. In the eight year, post-crisis period, the correlation of these asset classes has almost doubled and portfolios with allocations outside of U.S. equities have suffered. The dramatic underperformance of non-U.S. equities has created the largest valuation discrepancy (chart below right) since 2000, a period that preceded a long run of superior international returns.



Source: Robert J. Shiller, Credit Suisse research

In a continuing low interest rate environment, secure and rising dividends are critical to growing and preserving income streams. Dividends for 2015 are at new record levels despite declining earnings. On a per share basis, Factset estimates that dividends for the S&P 500 increased 10.9% in the 3Q from the year earlier period. The left hand chart below from Barclays depicts how dividends have doubled from trough levels of 2009. As payout ratios rise (they have increased from a cycle low of 27% in 2011 to 37% in the 3Q) and profit margins moderate, we can expect the growth rate of dividends in 2016 to continue to slow but provide an even more meaningful portion of total return.





Sincerely,

Rick S. Wayne, CFA