Economic and Market Outlook

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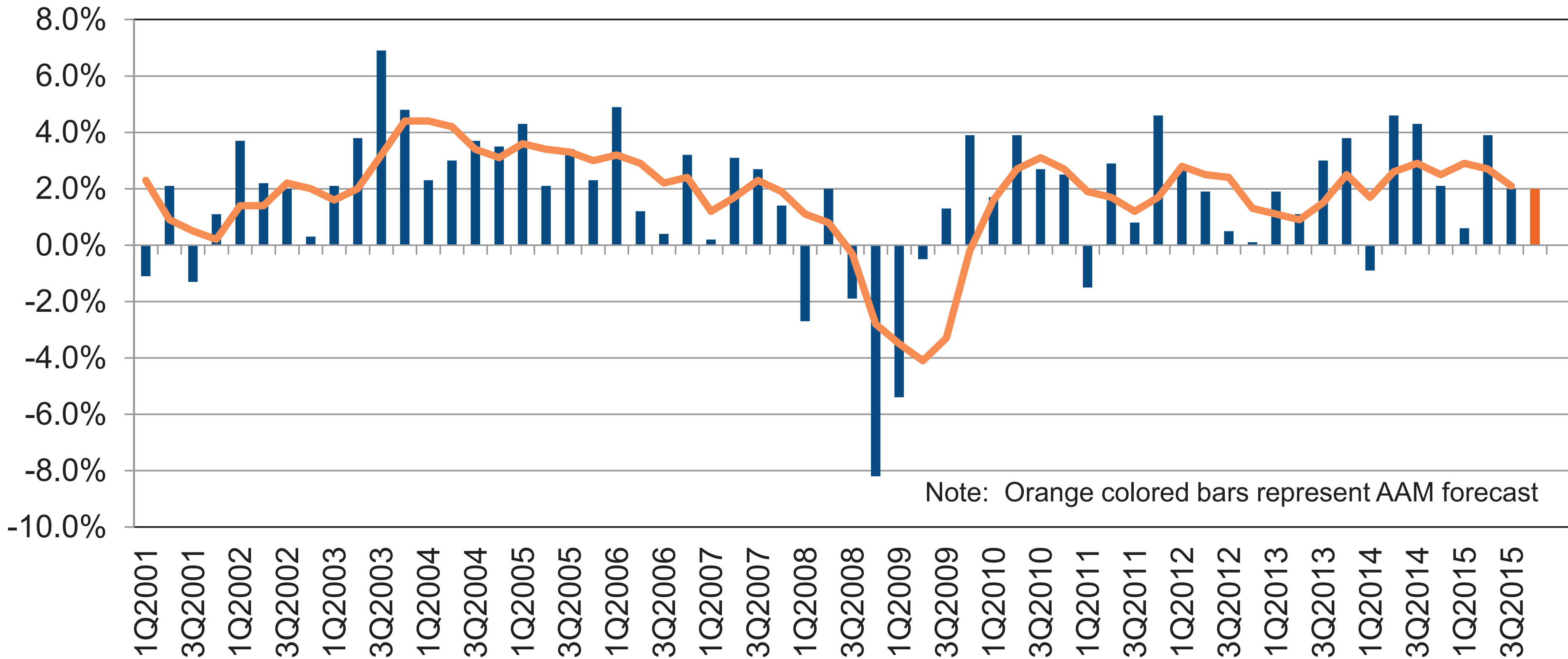
Economic Review

An economist is someone who, when he sees something work in practice, wonders if it can work in theory.

–Ronald Reagan

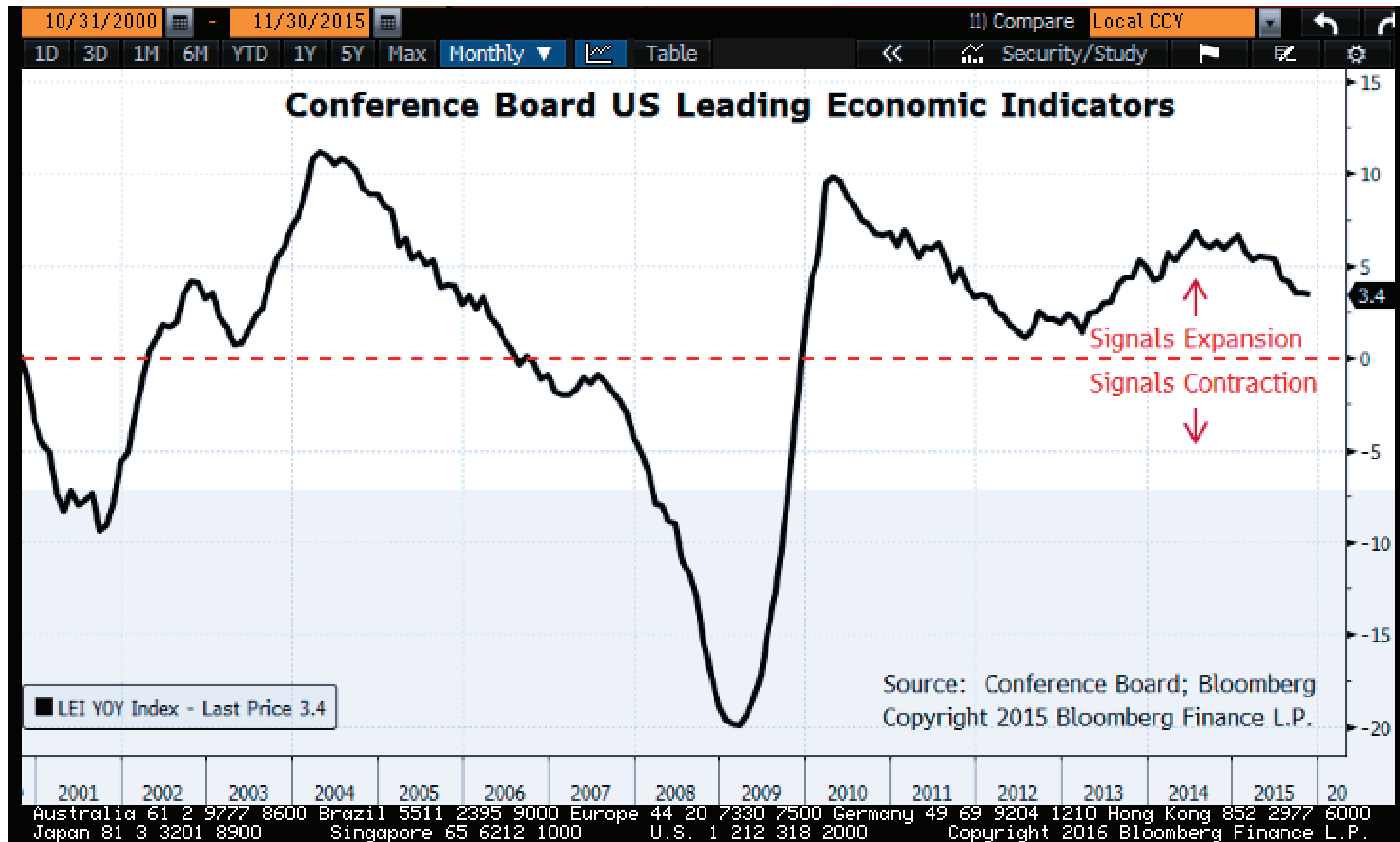
US Economic Growth: Slow but Solid Growth

(Source: Bureau of Economic Analysis, Bloomberg)



- Our Q4 estimate is 2.0% ann. but there are risks to the downside. We anticipate growth for the entire year at 2.40% to 2.45%.
- Our 2016 estimate is for 2.25% to 2.5% US GDP growth.
- The US economy continues to be a two steps forward, one back environment. While developments overseas are concerning, they are not anticipated to derail US growth. Recession risk is low.
- However, there is a high possibility that growth will not accelerate beyond the current 2.0—2.5% trend line in place since 2009.

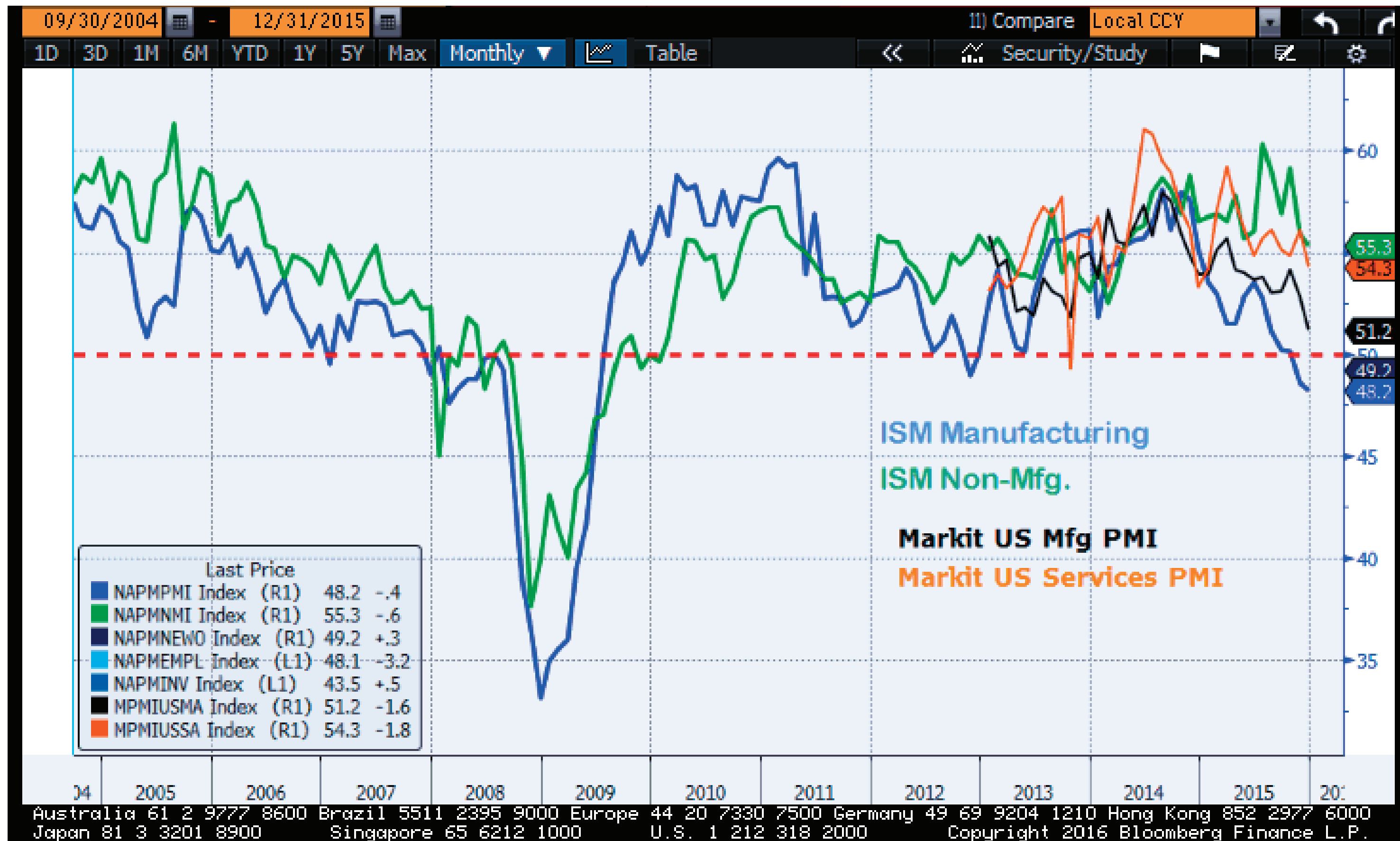
An Index of Leading Economic Indicators Signals Expansion



- The LEI is a ten component composite including new orders, building permits, jobless claims, stock prices, credit conditions, interest rate spreads, consumer expectations, and hours worked.
- While the index can register false signals of contraction/recession, it currently indicates that a recession is unlikely.
- While still historically low, we have raised our probability indicator of US recession from 15-20% to 20-25%.

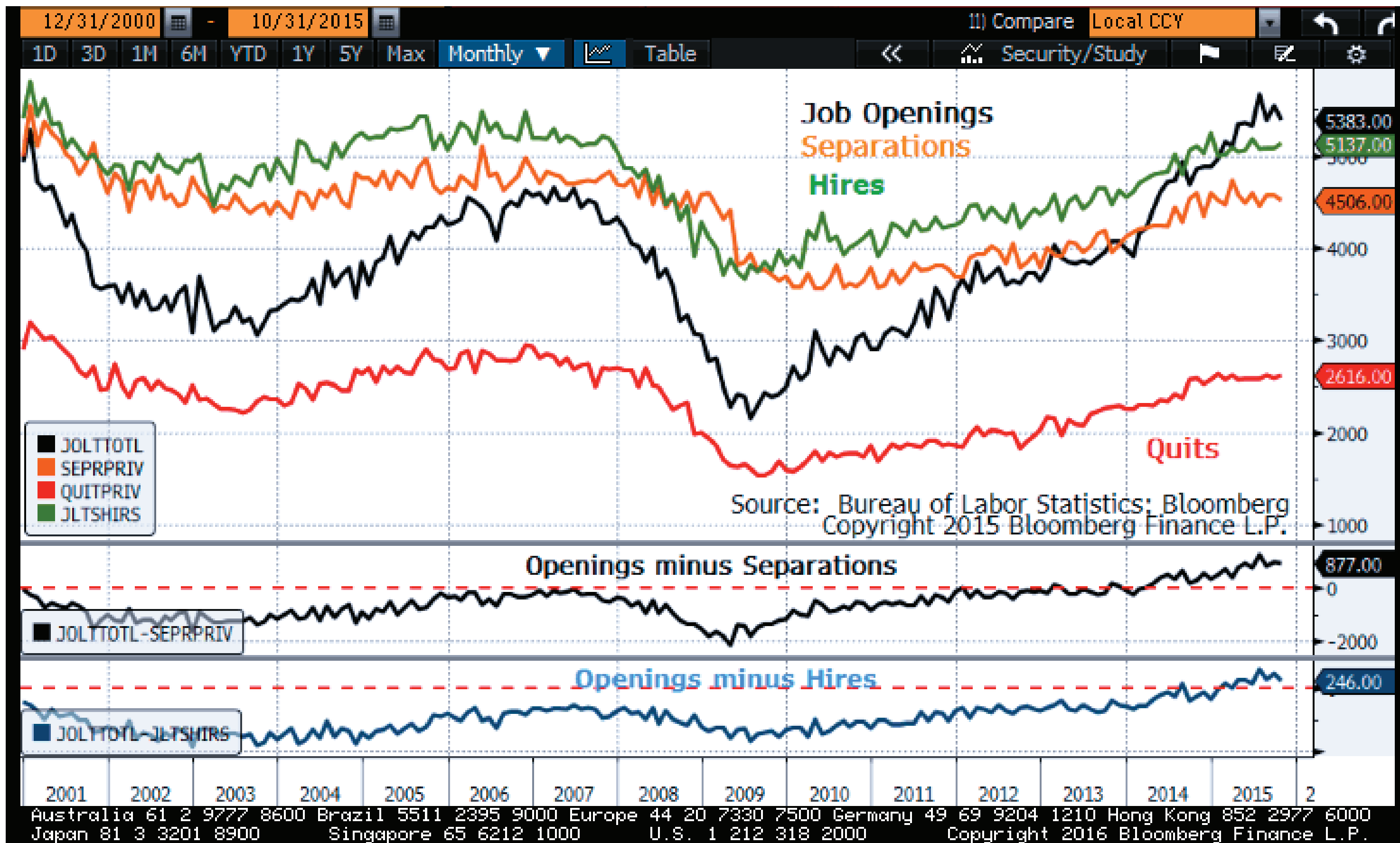
Institute of Supply Management Surveys Diverge

(Source: Institute of Supply Management, Markit, Bloomberg)



- The ISM Surveys tend to lead the direction of the US GDP by 3-6 months. Readings above 50 are considered expansionary; below 50 signal contraction.
- The Service/Non-Manufacturing survey continues to indicate expansion while the Manufacturing survey has moved into contraction territory. Divergences since 2009 later converged and recession was averted. We believe this will be the case in 2016.
- Markit PMI indicators have declined, but signal expansion.

Labor Supply Continues to Tighten; Signals Higher Wages



- ➢ The uptrend and level of Job Openings is indicative of increasing demand for labor and a strengthening labor market environment.
- ➢ The difference of Openings to Hires and Separations indicate increasingly tightening labor supply.
- ➢ Additionally, the uptrend in “Quits” is a positive and correlates with increasing wage levels. (Willingness to quit an existing job, often due to confidence in finding new work, is considered a positive indicator.)

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Labor Market: Continuing Overall Health

(Source: Bureau of Labor Statistics, Bloomberg)

- The Non-Farm Payrolls (NFP) 6 month average for net new jobs stands at 229k, 3 months avg. at 284k. Indicating increased hiring.
- Hiring is broad based through a number of industries (diffusion index).
- Small business hiring plans remain solid (NFIB).
- Part time workers who want to work full time remains stubborn.

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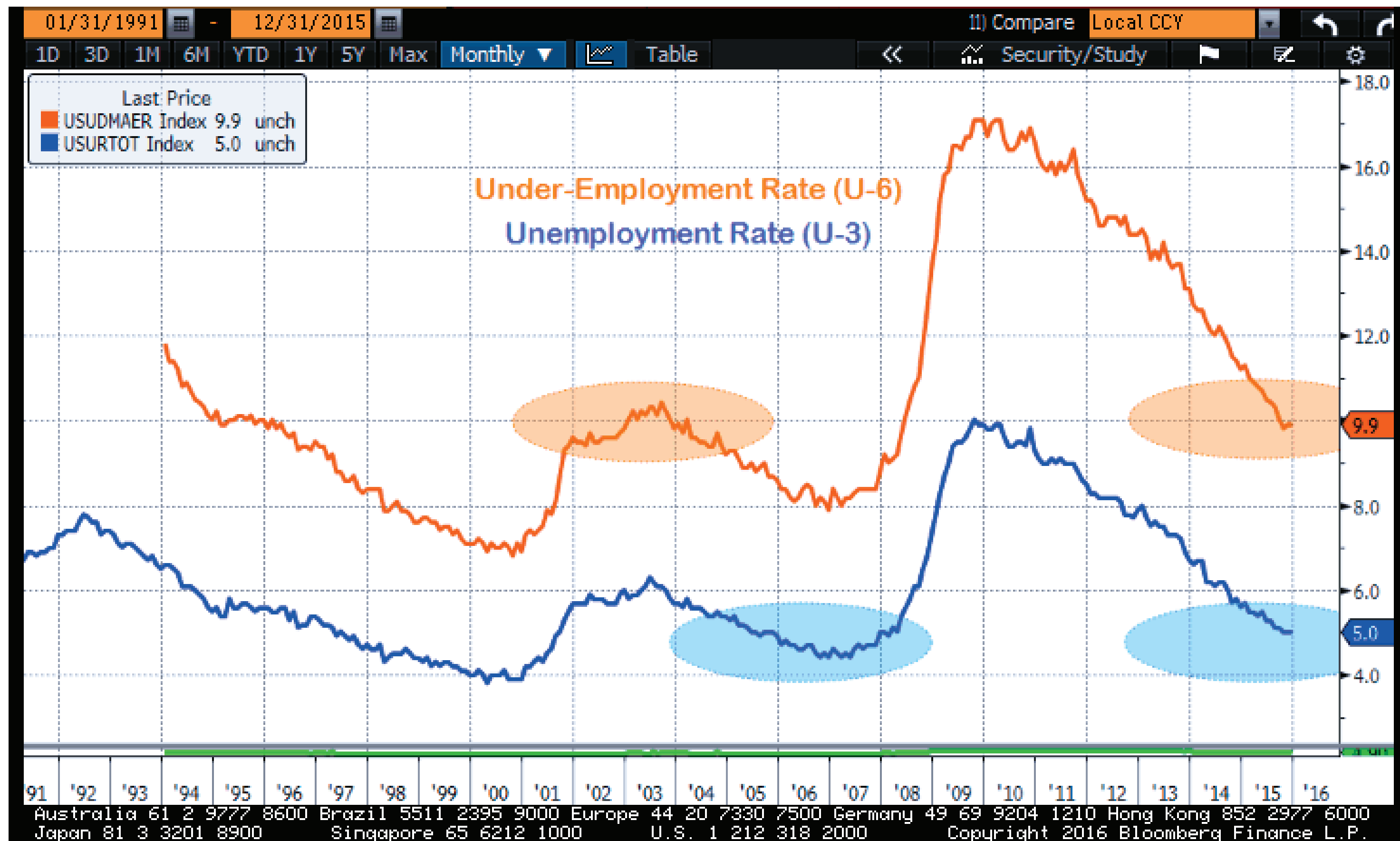
US Unemployment Nearing "Full Employment" Levels

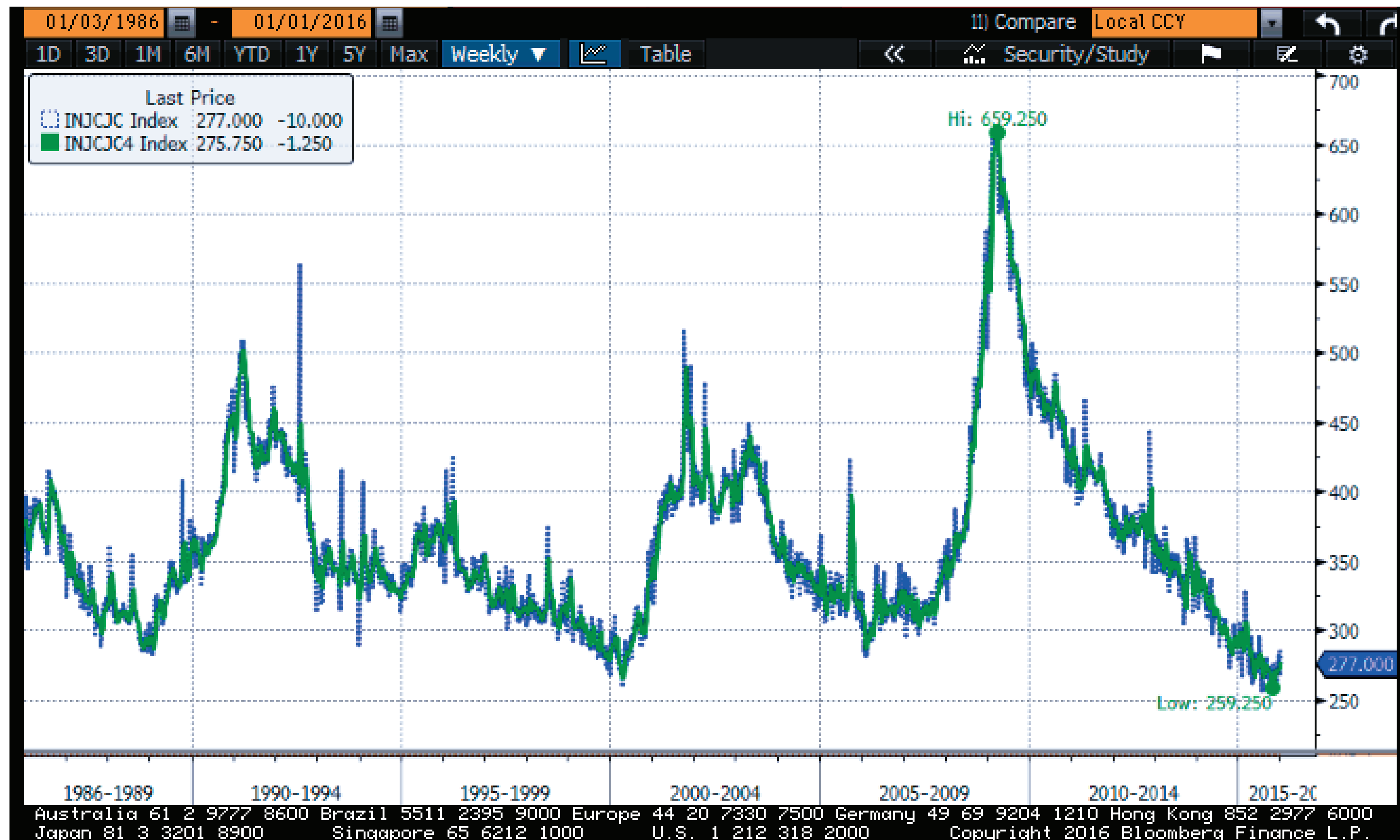
(Source: Bureau of Labor Statistics, Bloomberg)



- ➢ For the US, we continue to see a declining trend in unemployment rates and U-6 (accounts for part-time workers wanting to work full-time and those who want to work but have temporarily stopped seeking a job).
- ➢ We expect these trends to continue. The U-3 measure is at pre-recession levels and near estimates of "full employment." While U-6 remains stubborn, it is improving at a more rapid rate.

Initial Jobless Claims

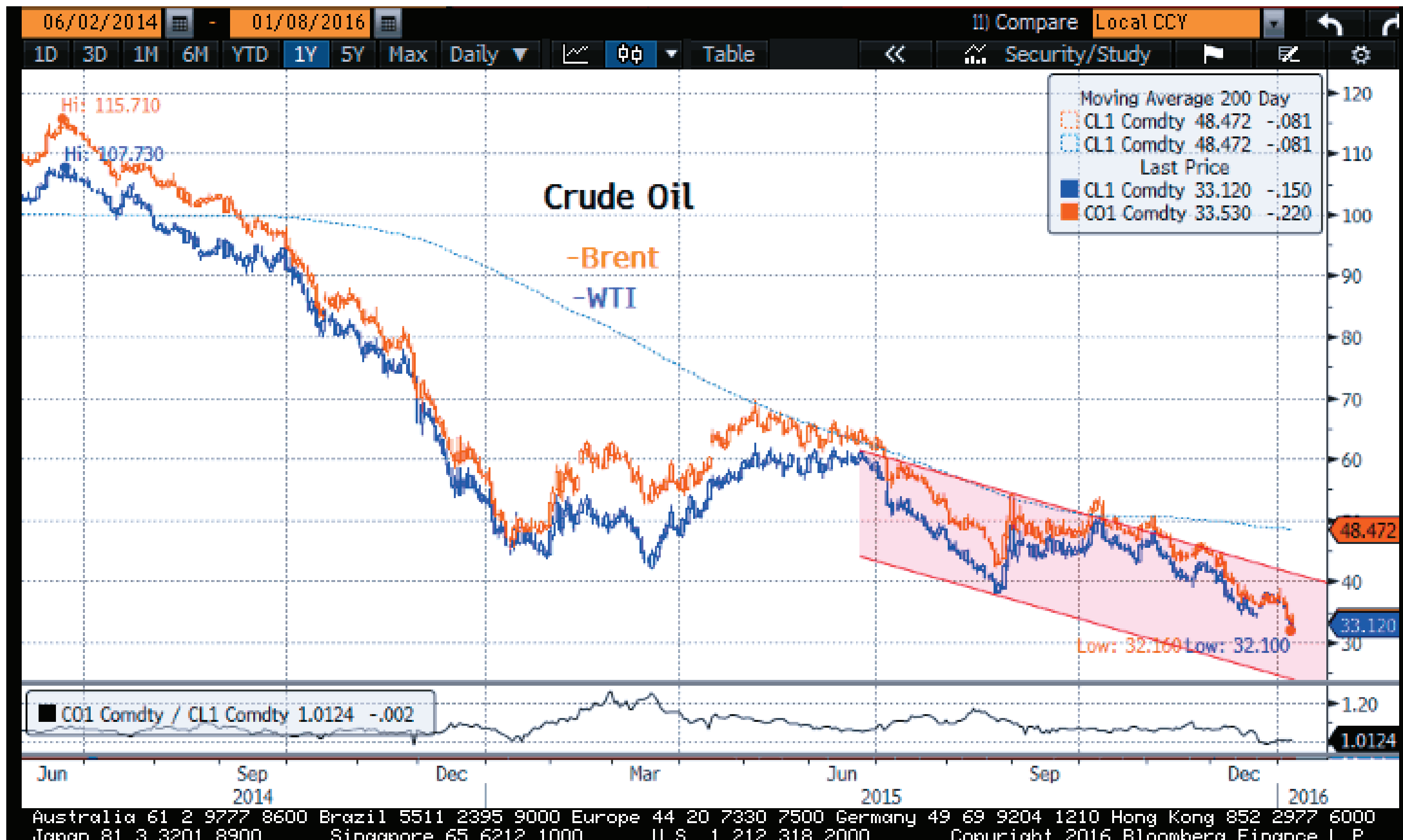
(Source: Bureau of Labor Statistics, Bloomberg)



- The Initial Claims is a leading/coincident indicator, is updated weekly, and is not subject to calculations nor revisions, making it a preferential data set.
- A new US recession is unlikely without a significant increase in weekly claims data.

What's Next for Crude Oil? Lower for Longer

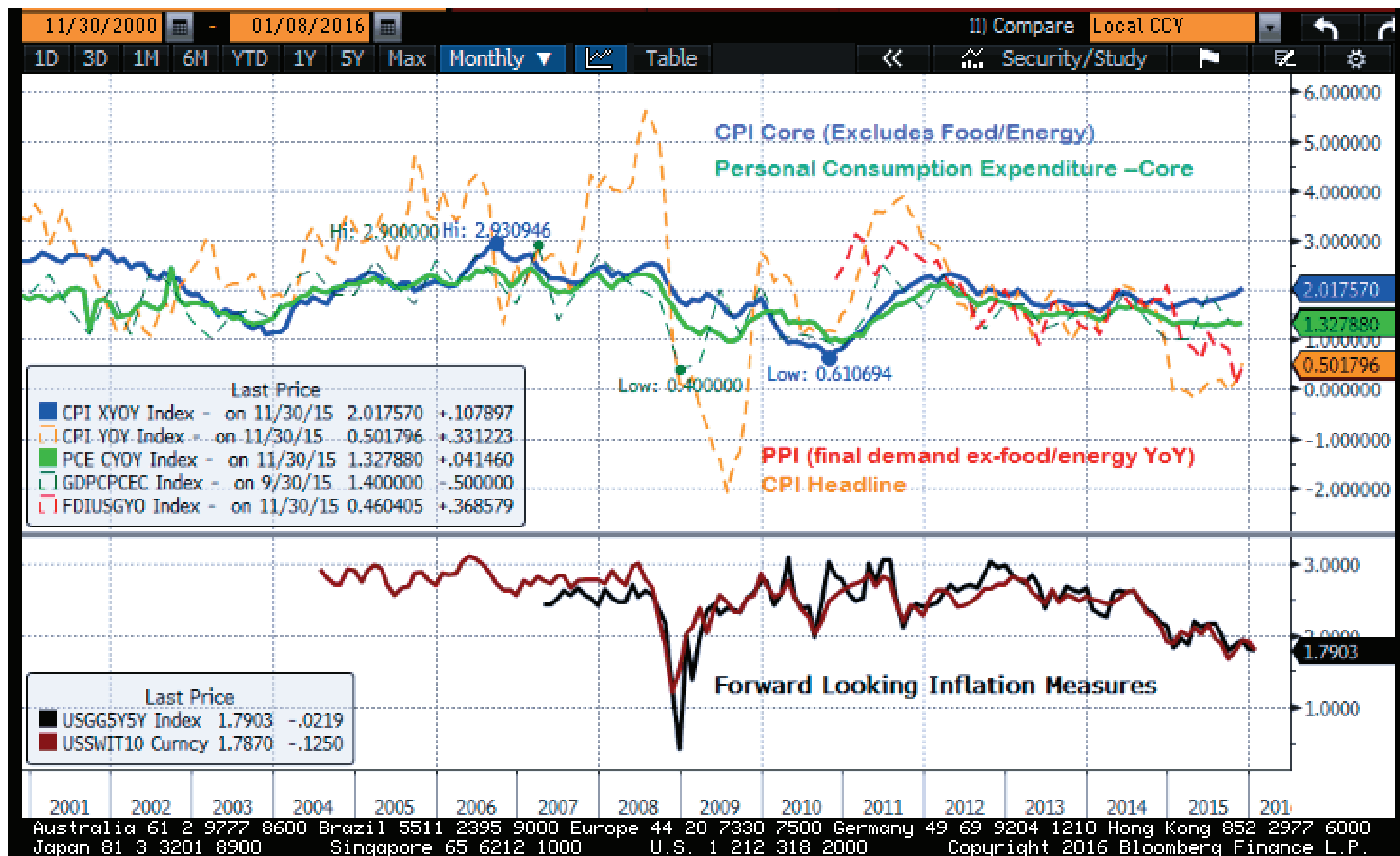
(Source: Bloomberg)



- The price decline in oil may not be resolved until production is reduced, or at least anticipated to decline.
- While this creates difficulty for oil related industries, it is generally good for consumers and economies overall, however, the precipitous declines can lead to financial stresses. Many producers hedge commodity exposure, but these hedges are generally only for 6-18 months. A prolonged decline becomes increasingly problematic for related debt. We anticipate that crude prices will remain low for longer.

Muted Current Inflation and Expected Future Inflation

(Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Bloomberg)



- Inflation has been historically low over the last 5 years as measured by the CPI and PCE. Future expectations continue to trend lower as well.
- By our estimation, inflation may not be an issue for another year or two, however, inflation pressures are building (wage increases

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Interest Rate Environment and Bond Market Outlook

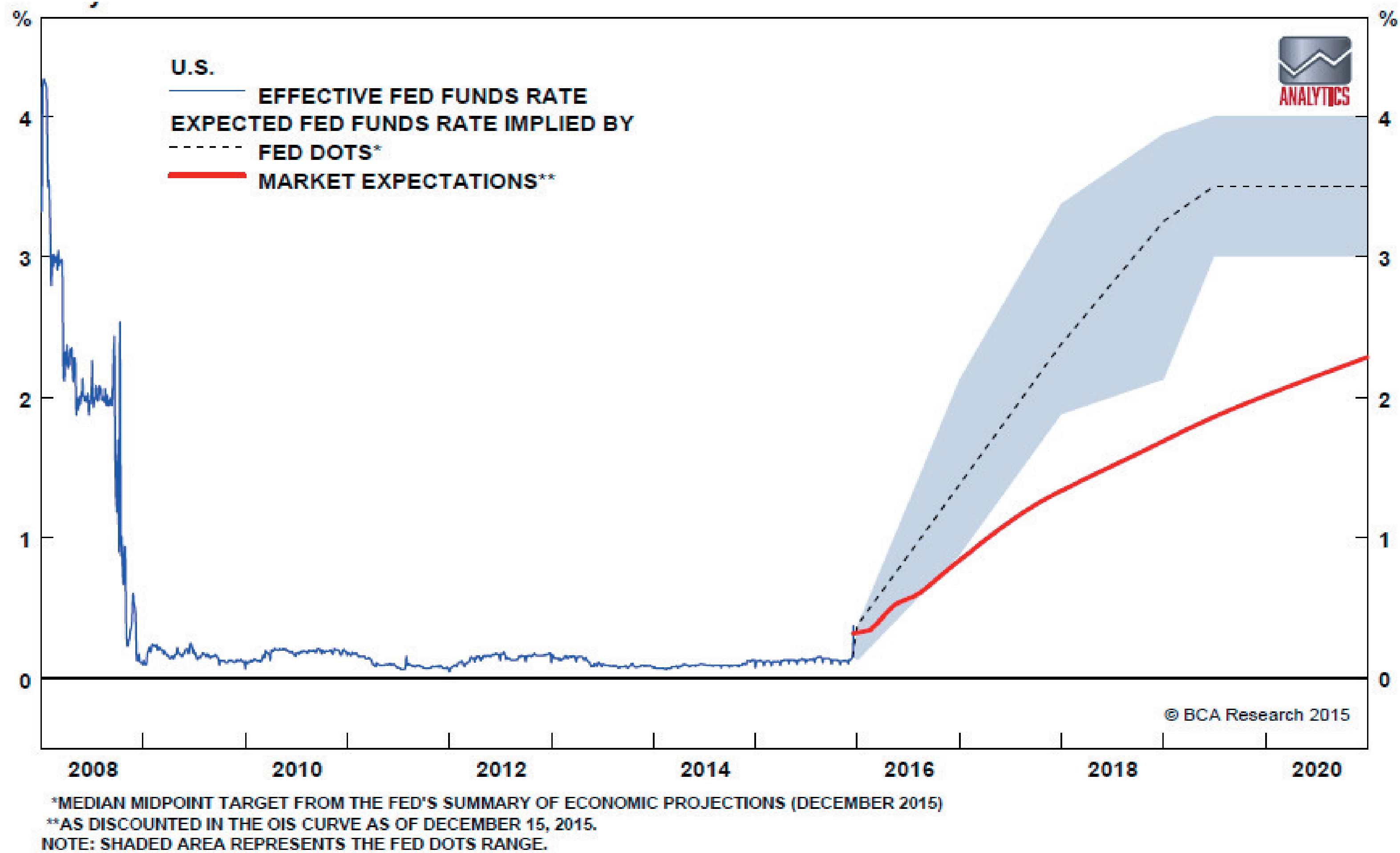
Bonds are like a catcher; you don't have them on the team to steal bases and chase down fly balls, you have them to stop the wild pitches.

–Paul de Moor

VP Capital Markets Strategy, Fidelity Investments

Markets Disagree with Federal Reserve Rate Forecasts

(*Source: BCA Research*)



- Market participants are not taking the FOMC at their word regarding Fed Funds Rate forecasts.
- We are sympathetic, believing the neutral rate is closer to 2.0%--2.5%, not the 3.5—3.75% rate indicated by the FOMC's "dot plot" of projections.

Interest Rate Expectations: Slightly Higher, but "Flatter"

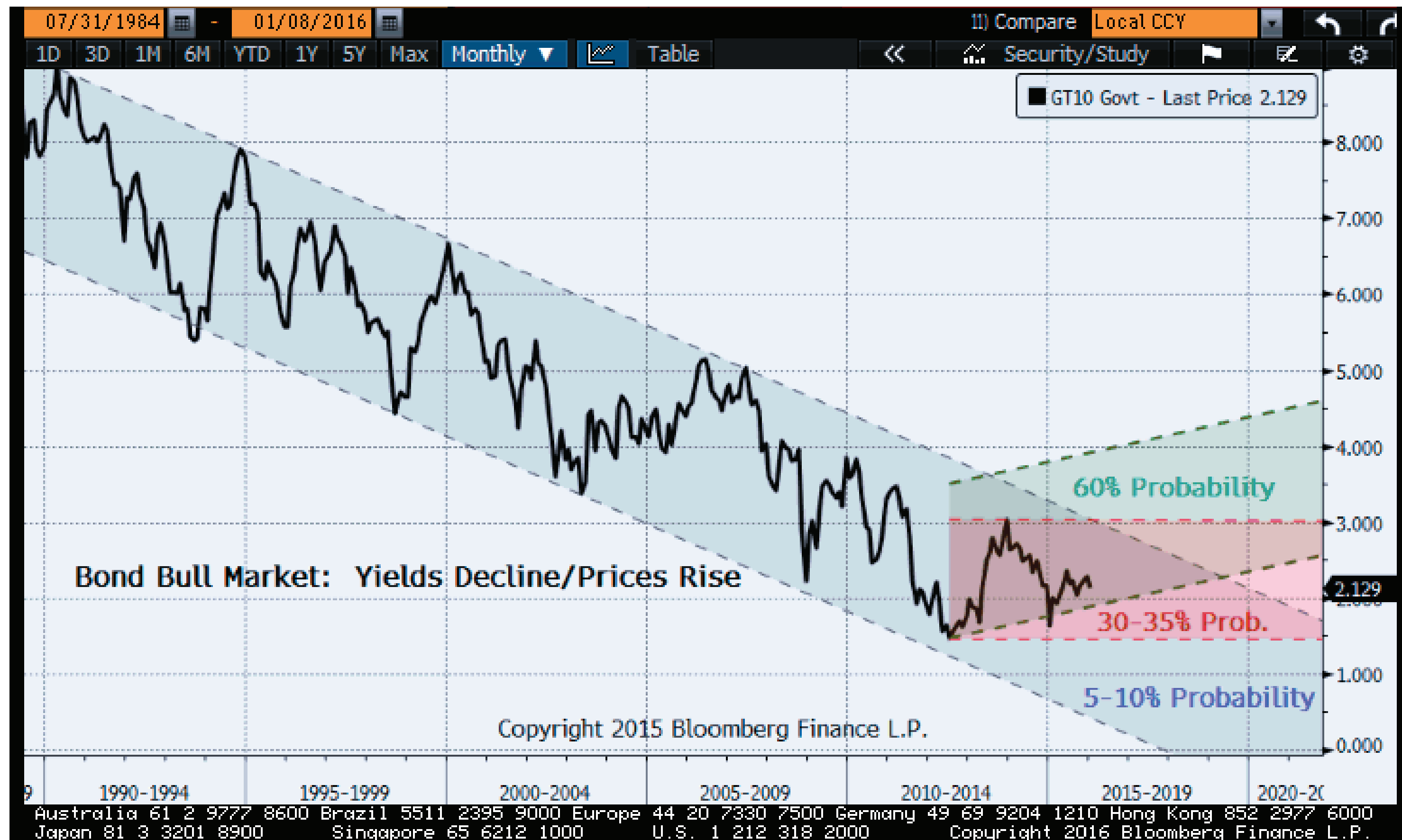
(Yield Curves: current—solid, 12/31/2013—dotted, 2/1/08—dashed *Source: Bloomberg*)

➢ Our bias is that rates will move higher, but the rate of change and the impact on different maturities is likely to be asymmetrical. We anticipate a "bear-flattener" in the intermediate term—short term yields increase more than intermediate and long term yields.

➢ As a result, we are beginning to move from a bulleted, "roll" oriented strategy to a modified barbell. This is a relatively "defensive" position that historically has mitigated portfolio price declines while still enhancing yield over a laddered or bullet strategy.

The Three Decade "Bond Bull" Has Likely Ended

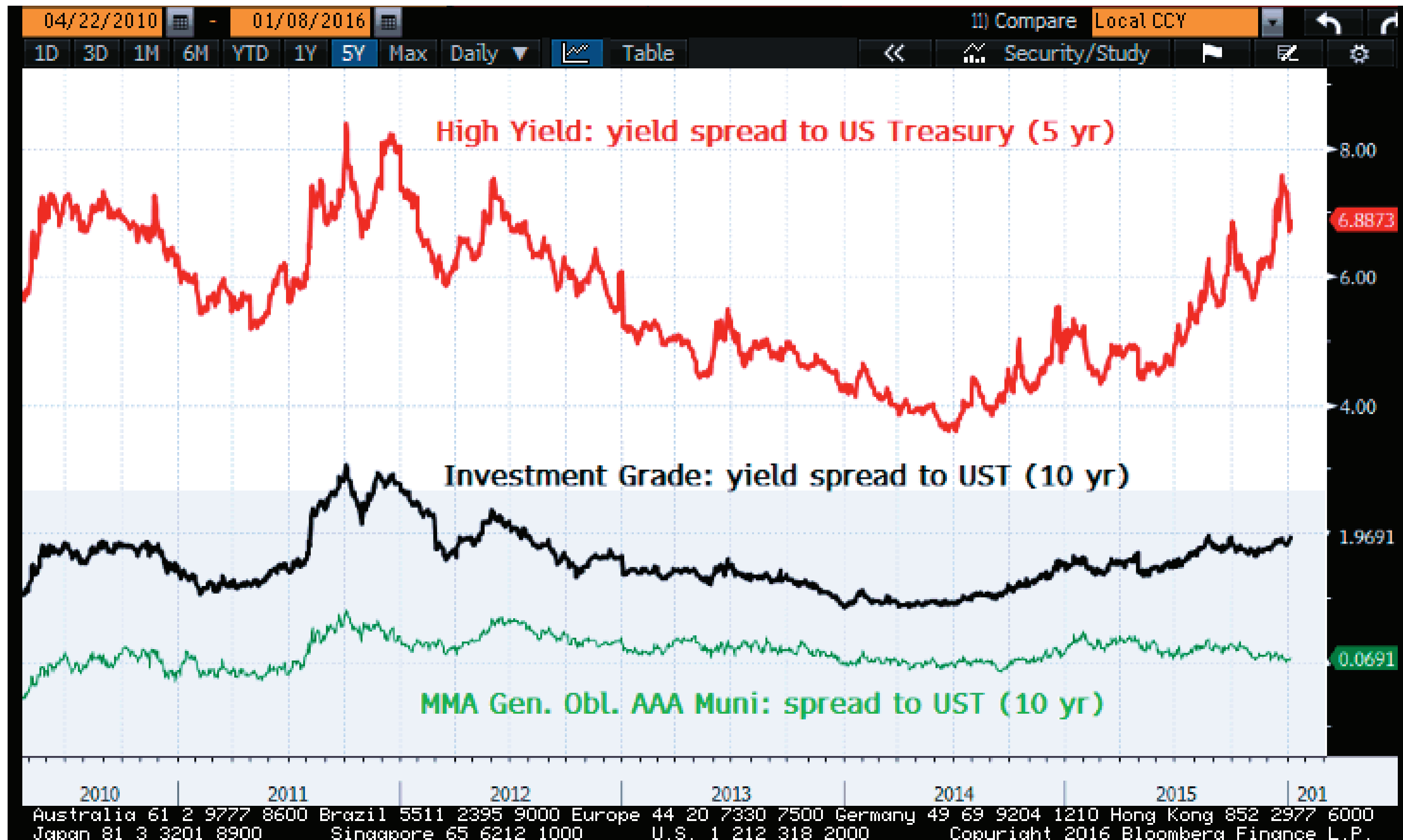
(Yield on 10 yr. US Treasury Note; Source: Bloomberg)



- The long lived bond bull market has most likely drawn to a close.
- The general bias of interest rates should be higher over the next few years. A "bond bear" has implications for fixed income investors, but is not as dire as it sounds.
- Still, there is a heightened probability that rates may not increase materially for a number of years.

Where is the Opportunity and Risk in the Bond Market?

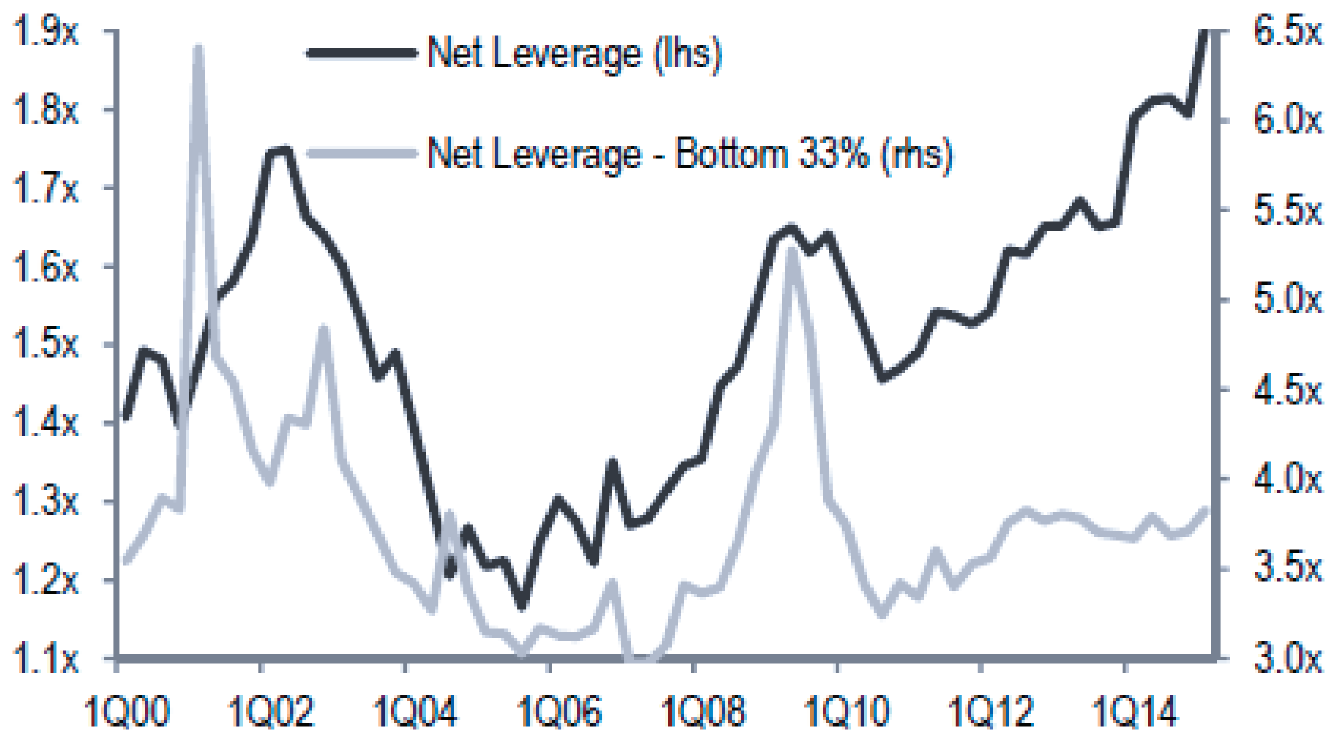
(*Source: Bloomberg*)



- We continue to see some value in municipal bonds, but our opinion has soured on investment grade and high yield (junk) corporate bonds. ***Diligent credit analysis is a MUST in this environment***.
- We are unwinding an overweight to IG corporates and have eliminated our allocation to HY, ***it is late in the credit cycle***: corporate balance sheet health is eroding and companies continue to engage in share holder friendly actions at the expense of bond holders.

Credit Cycle

(Source: JP Morgan)



- We are becoming increasingly concerned about the level of leverage for investment grade credit (AAA-BBB rated corporate bonds) along with continued activity, such as debt issuance for share buybacks and dividends, which favors equity investors over debt investors.
- There is a significant chance that the credit cycle will be elongated compared to previous cycles, however, caution is becoming the better part of valor for credit investors.

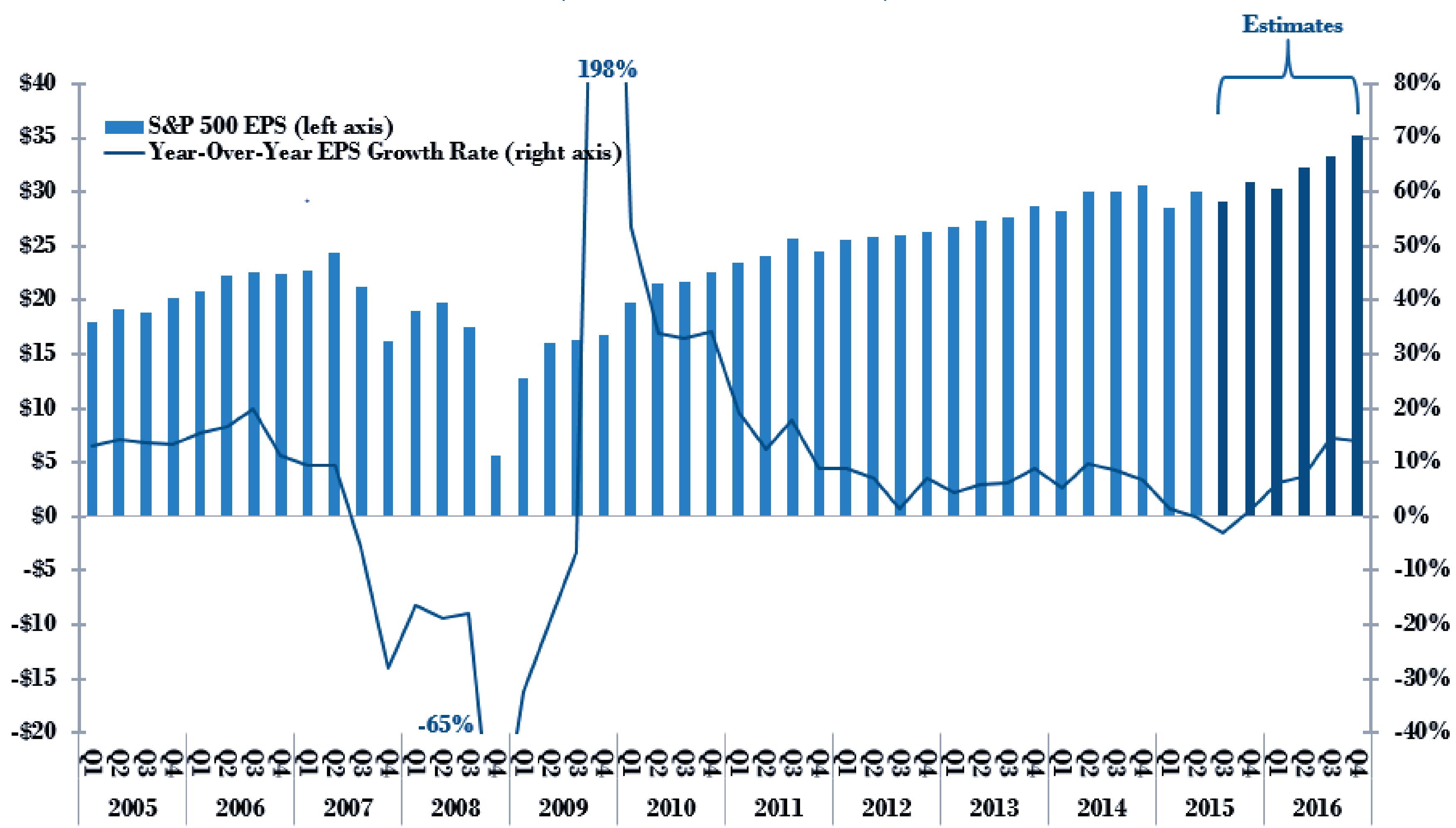
Equity Markets Review

The stock market is a mixture of fear, hope, and greed, loosely tied to the business cycle.

–Jeff Saut
Chief Investment Strategist,
Raymond James Financial

Earnings Expected to Improve After Setback

(Source: Thomson Reuters)



- S&P 500 earnings in 2015 are expected to decline by 4%-5% year-over-year this reporting period.
- Looking into 2016, we anticipate further earnings growth, although the growth rates are expected to be in the mid-single digits, not the double digit growth rates experienced for much of the post 2009 recovery.

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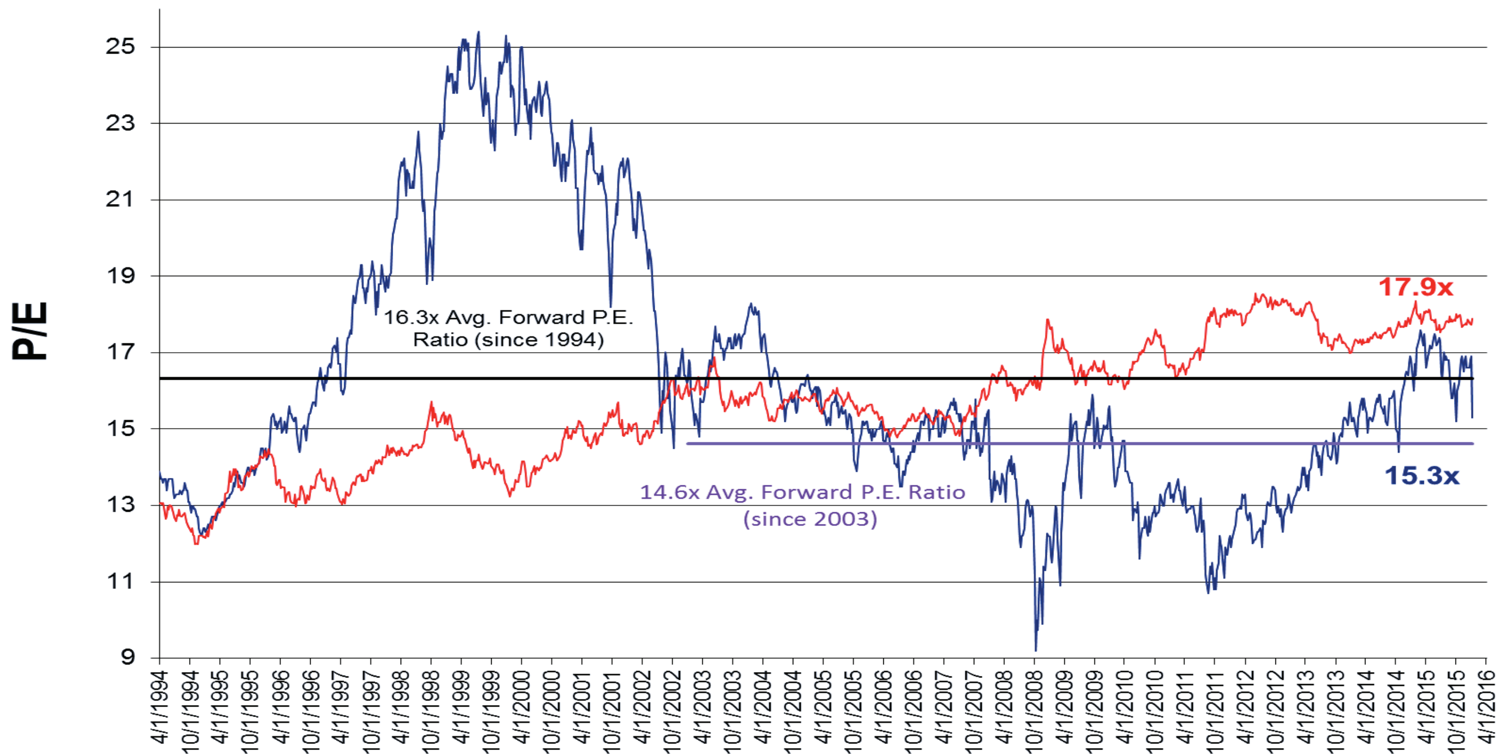
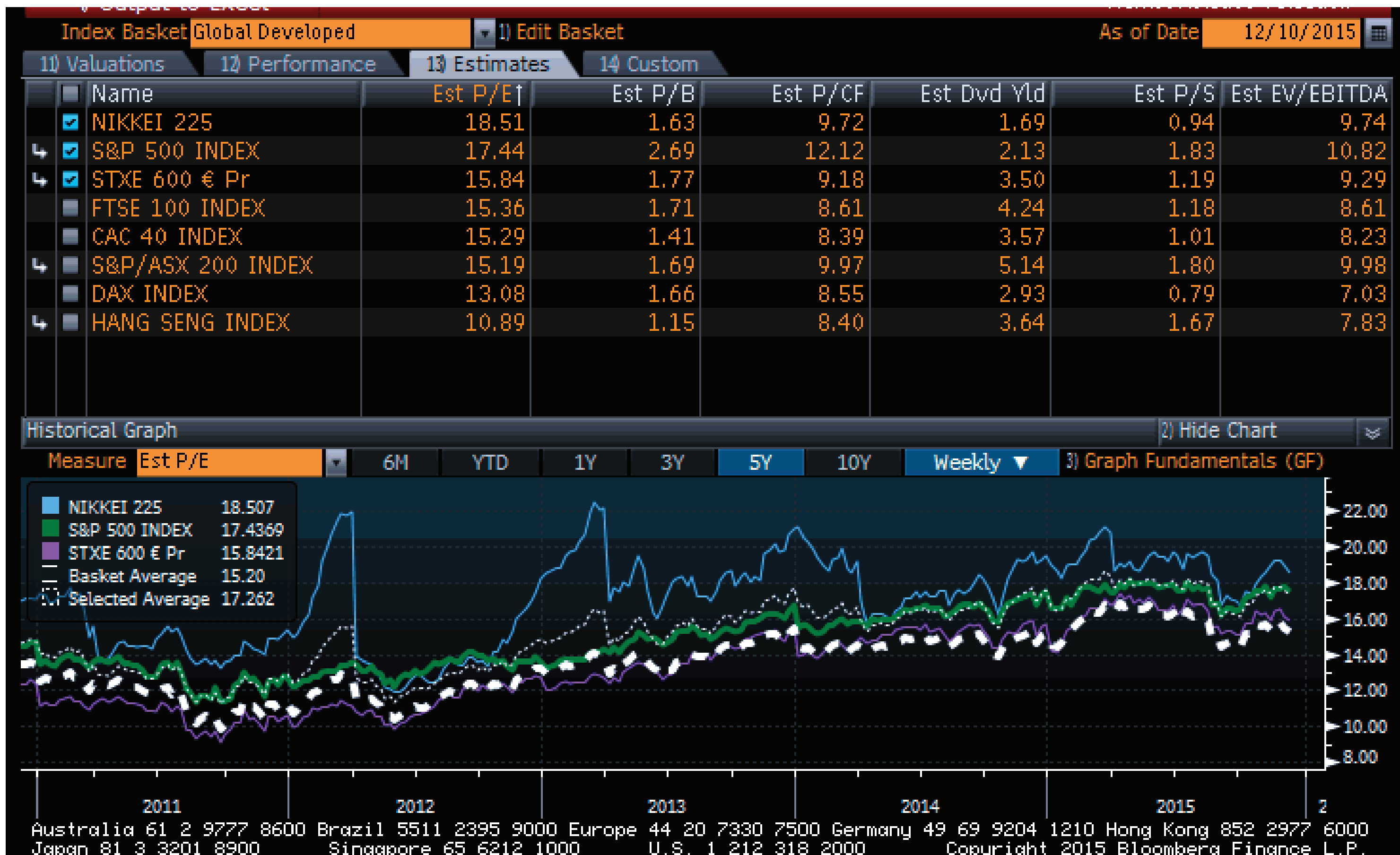
US Equity Valuation is Fully/Fairly Valued



- The S&P 500 Forward Price / Earnings multiple stands at 15.3x –dropping below the post "Tech-Bubble" average of 14.6x, and the average of the past 20 years (16.3x), and below the model's "fair value" of 17.9x.
- Our model shows stocks to be 14.4% undervalued (based on a factor of the interest rate environment).

Global Equity Valuations Favor International over U.S.

(Source: Bloomberg)



Name	Est P/E	Est P/B	Est P/CF	Est Dvd Yld	Est P/S	Est EV/EBITDA
NIKKEI 225	18.51	1.63	9.72	1.69	0.94	9.74
S&P 500 INDEX	17.44	2.69	12.12	2.13	1.83	10.82
STXE 600 € Pr	15.84	1.77	9.18	3.50	1.19	9.29
FTSE 100 INDEX	15.36	1.71	8.61	4.24	1.18	8.61
CAC 40 INDEX	15.29	1.41	8.39	3.57	1.01	8.23
S&P/ASX 200 INDEX	15.19	1.69	9.97	5.14	1.80	9.98
DAX INDEX	13.08	1.66	8.55	2.93	0.79	7.03
HANG SENG INDEX	10.89	1.15	8.40	3.64	1.67	7.83

- Headwinds in the US include lack of pricing power, increasing labor costs, dollar strength and the reversal of monetary policy.
- Europe, while far from perfect has prospects to improve, as does Japan. Both are in a monetary policy position similar to where the US was 2-3 years ago, and economic and market reforms, while slow to come, are generally favorable.

Emerging Market Equity: The Temptation of a Falling Knife

(*Source: Bloomberg*)

- As an asset class, EM is cheap on an absolute, historical, and relative basis. However, they are likely to get cheaper still. Market reforms are needed, and slowing Chinese growth is a headwind.
- Still, keeping an eye towards the asset class, and select countries vs. a broad basket, should eventually present an attractive, longer term opportunity.

US Large Cap Equity: A Test of August 2015 Lows?

(*Source: Bloomberg*)

- We were skeptical of the low/rally/retest sequence in August/September 2015. It appears that another test of the 2015 low, and possibly the October 2014 low, is underway.
- As long as fundamentals (earnings outlook, economic growth) do not change, we would view the price decline as a buying/rebalancing opportunity.

Additional Observations and Considerations

You can observe a lot just by watching.

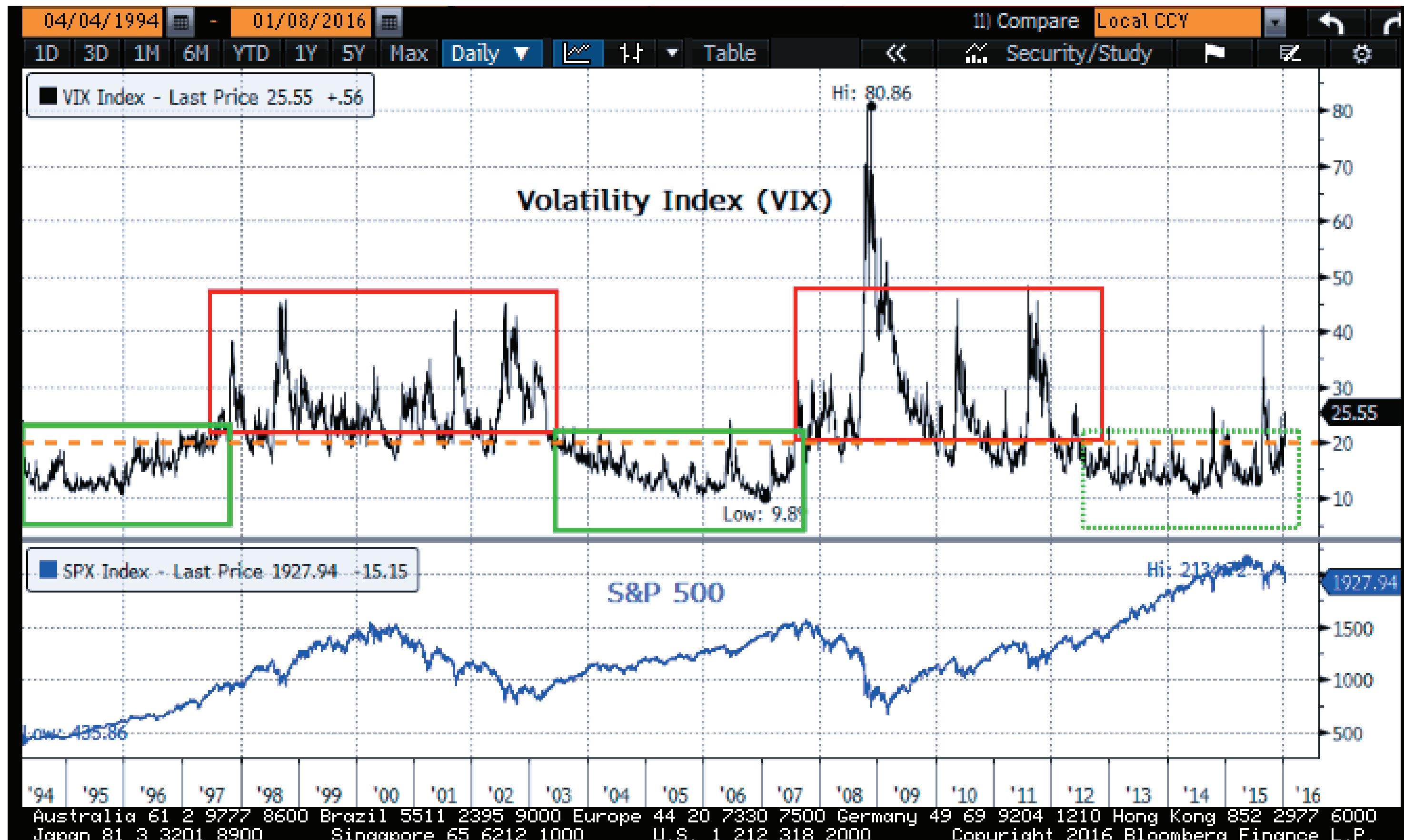
–Yogi Bera

2016 Investment Themes:

Volatility and Lower Returns

Volatility to Increase: A Regime Change

(Source: Bloomberg)



- The Volatility Index (VIX) has been well below it's longer term average of approximately 20 for most of the last 3 years, with only temporary spikes above 20.
- The VIX tends to have 3-5 year trends of above average and then below average readings.
- It's important to note that volatility rising above long term average does not necessarily mean we are moving into a new bear market. (see the late '90s)

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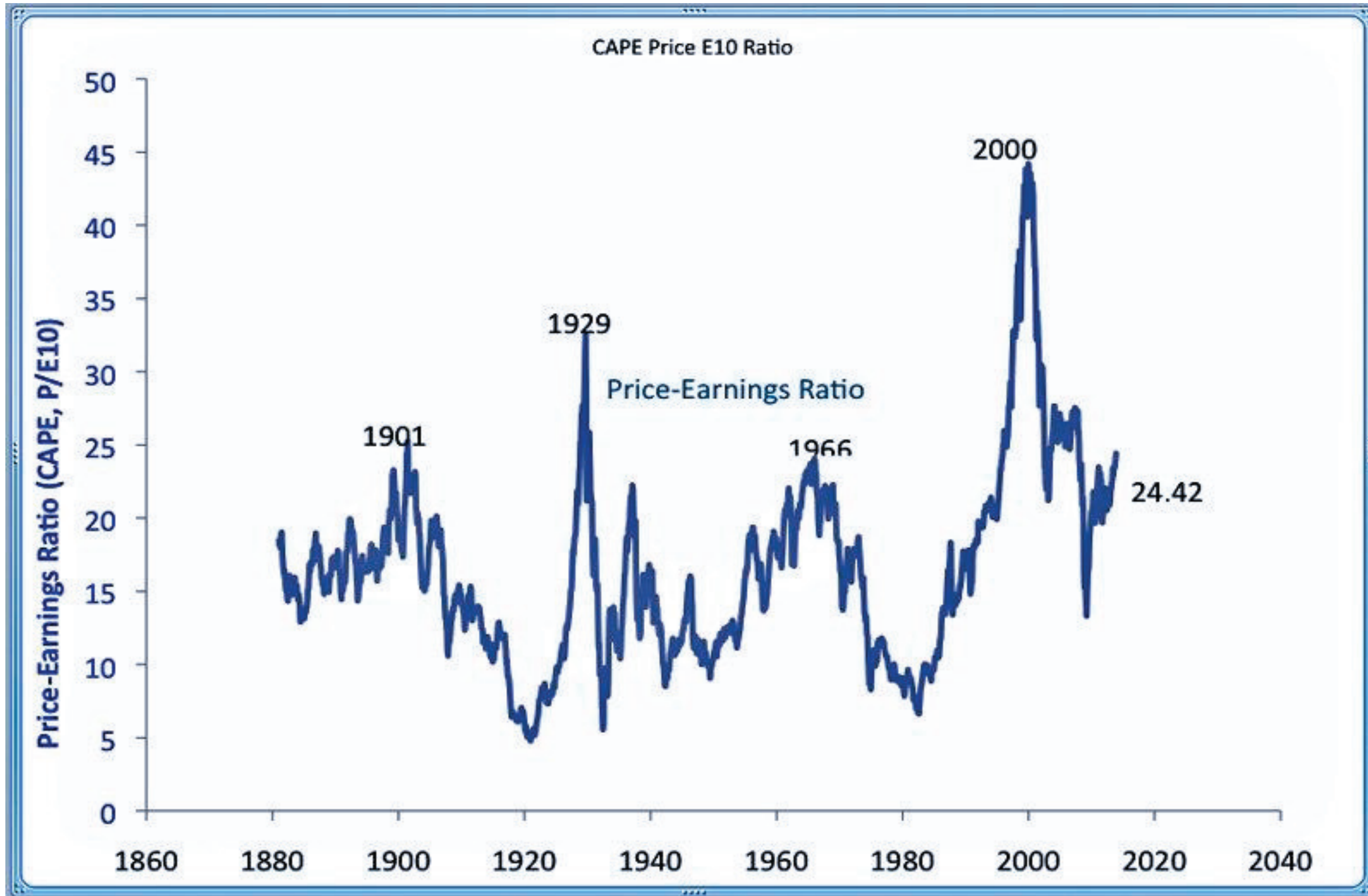
Cyclically Adjusted Price/Earnings: Extreme

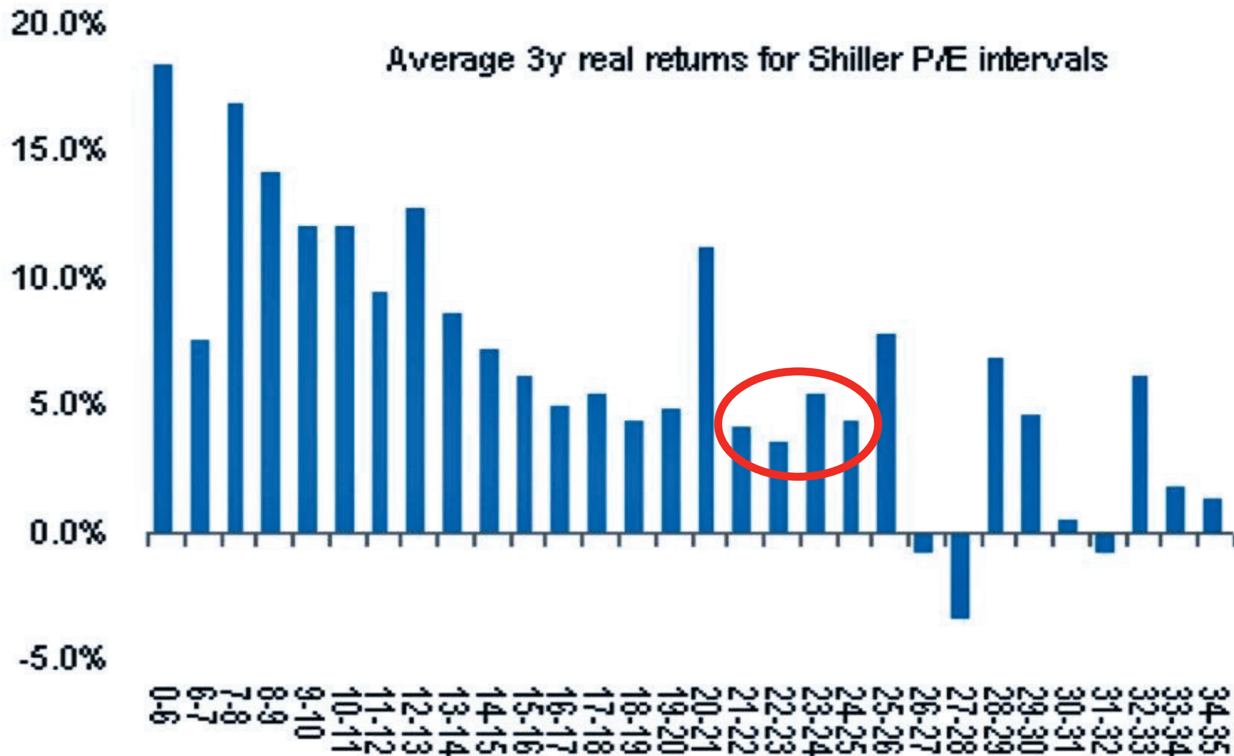
(Source: Yale, Robert Shiller, Business Insider)



- The Shiller Cyclically Adjusted P/E ratio (CAPE) is registering in the 9th decile of data (since 1953).
- CAPE last reached these levels in the mid-1990s, when Fed Chair, Alan Greenspan described markets as “irrationally exuberant” and before rocketing to 48x during the tech bubble.

Cyclically Adjusted Price/Earnings: Indicate Lower Returns

(Source: Thomson Reuters, Credit Suise, Business Insider)



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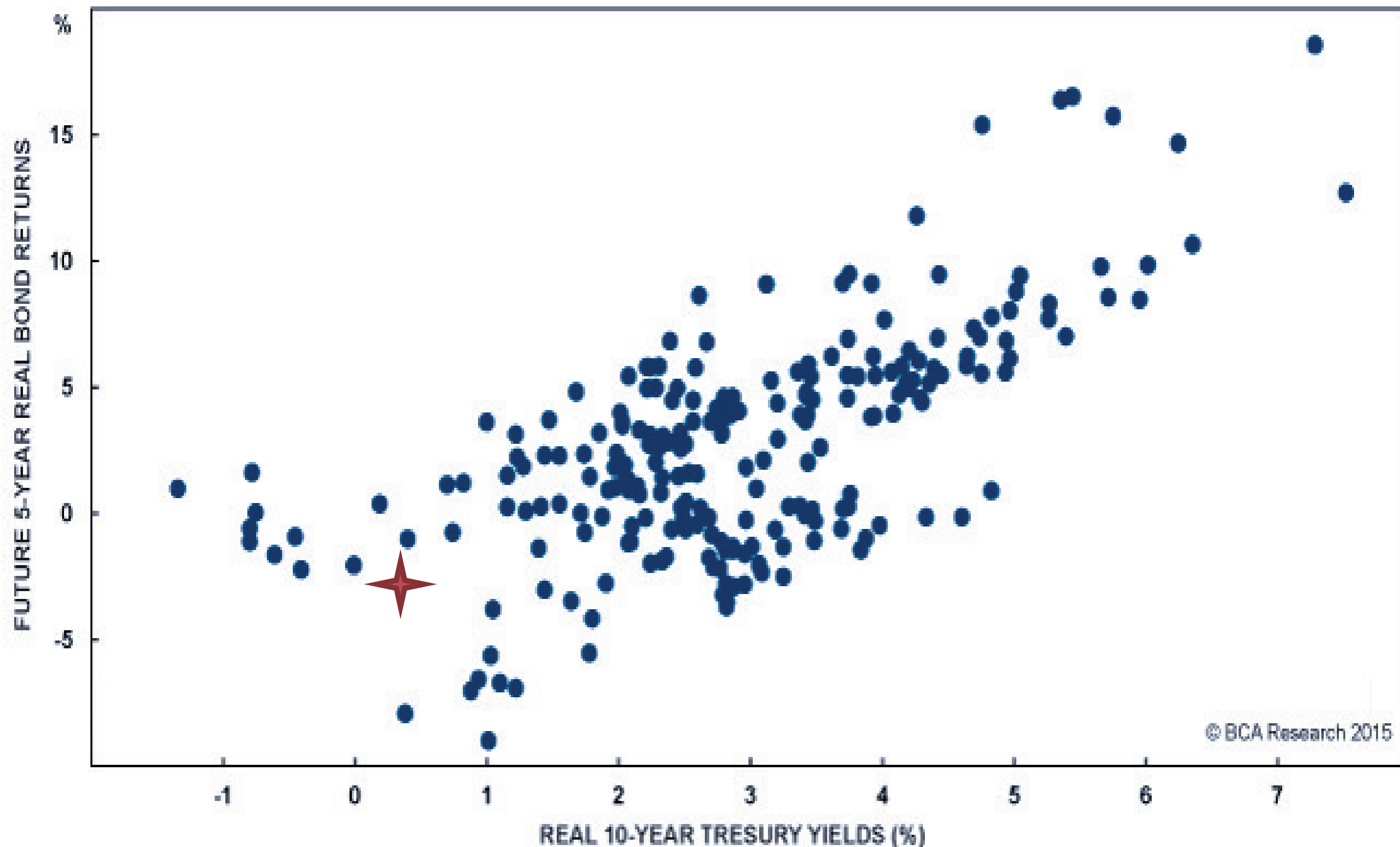
Bond Returns 5 yrs Forward Given Current Real Yield

(Source: BCA Research)



- Based on analysis of historical data by BCA Research, today's yields on the 10 year US treasury implies a total real return of -0.9% and 0.9% five and ten years from now, respectively.
- AAM/IMG believes in the context of unprecedented central bank policy and additional global macro economic factors (aging demographics, savings glut, etc.) may influence total return slightly higher than the BCA estimate, but still well below historical total return for bonds. Investors should expect total returns over the next 3-5 years between zero and the stated yield to worst.

Summary Observations and Investment Strategy

- Investors should begin to prepare emotionally for higher levels/normal levels of volatility compared to the below average volatility present since 2012. Goals based asset allocation and rebalancing will be key.

- Return expectations for equity and fixed income should take into account cyclically adjusted valuations in US equity and global bond markets. Adjusting capital market return assumptions within longer term financial planning is warranted. We recommend a second, or auxiliary, financial planning scenario incorporating 5% total returns for equity and 0% to 2% total returns for diversified fixed income in order to assess probability of success in achieving financial goals.

- Additionally, alternatives to traditional asset classes may need to be explored.

- Note: the call for muted returns is **not a call for a return to a secular bear market** in equity. We anticipate that the secular bull market, while longer in the tooth, is still in tact.

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Questions and Comments

Thank You!

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Bonus Slides

I not only use all the brains that I have, but all that I can borrow.

–Woodrow Wilson

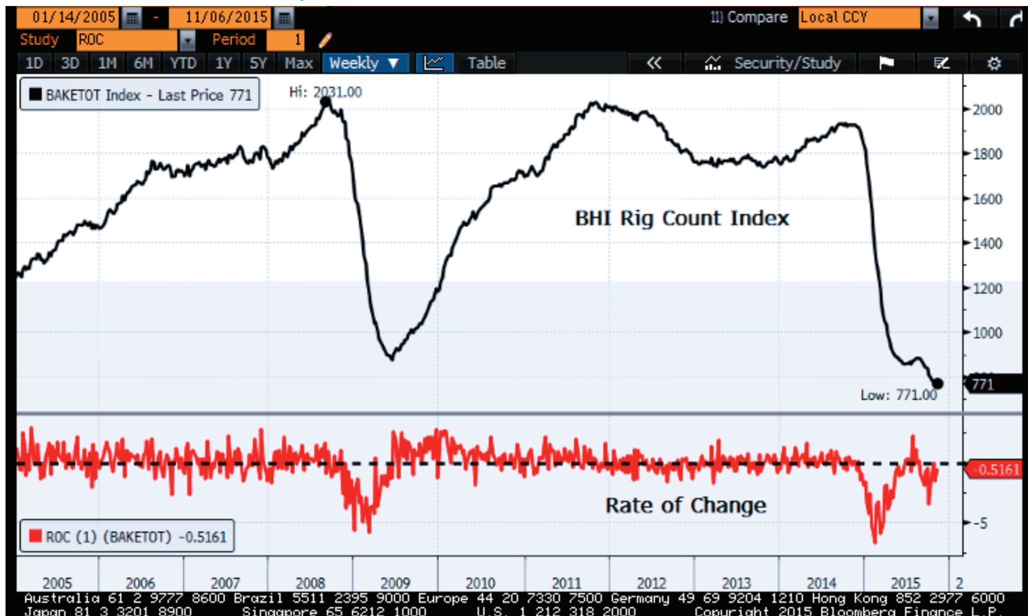
Gold: Maybe a Trade, but not an Investment

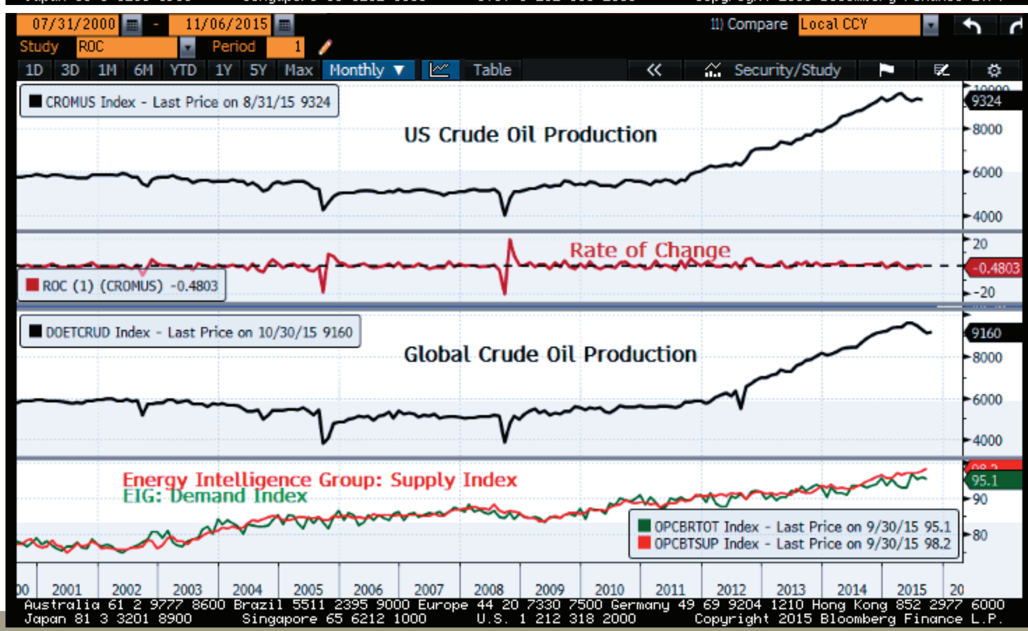
(Source: Bloomberg)

- Gold is a difficult investment to value due to a lack of cash flows. A number of analysts we respect continue to assign a fundamental valuation on gold at $700-900/oz. over the next 1-2 years. Higher interest rates and a stronger dollar will likely put additional pressure on the price of gold.
- However, short term price fluctuation could be volatile.
- It's important to understand the nature of gold as an investment class: a precious metal commodity, that trades like a currency—it's value is tied to exchange for fiat money.

Crude Oil Implications: Supply

(Source: Bloomberg, Baker Hughes, Dept. of Energy, Energy Intelligence Group)



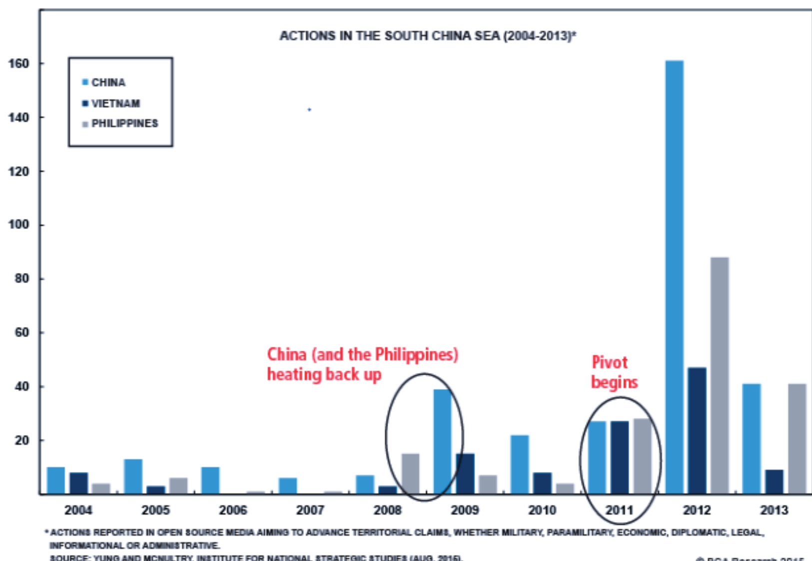


- Rig counts (drilling) dropped precipitously. However, extraction technology continues to make existing wells more productive. Additionally, the cost of new exploration has been dropping to $45-$55/bbl.

- Oil output from US wells remains near record highs, but has experienced a slight drop. With elevated storage and improving technology, we anticipate the oil glut will remain from some time.

The Game of Risk: China Tensions, EU Dysfunction, Putin

(Chart Source: BCA)



- Military conflict in the East China Sea (with Japan) and/or the South China Sea (with Taiwan, Vietnam, or the Philippines) is to be considered a low probability, but high impact event. It does not appear to be garnering the requisite risk premium, i.e. it's not "priced in" to markets.
- Nationalist rhetoric has subsided as of 1H 2015 between China and Japan, however, new "freedom of navigation" exercises by the U.S. Navy and trade partnerships that exclude China but include her neighbors (TPP) are a new dynamic that China views as a provocation.
- China's economic strength is funding an increasingly far reaching, advanced military.

- Although many reforms have been adopted and the economy is strengthening from an extremely weak state, Europe is not out of the woods.
- Political will may still wane, revolting from further austerity via local elections and referendums that may set back enacted and burgeoning reform. Recent soft target terror attacks have bolstered nationalistic parties that also have a strong anti-EU flavor.
- Still, never underestimate the will of politicians and bureaucrats to retain consolidated power. While the EU may fray at the edges is unlikely to unravel.
- Short term market riots are not out of the question, however, Europe, like Churchill's America, will do the right thing after exhausting all other options.

- Russia is a wild card. While conquest beyond Ukraine appears unlikely, proxy wars and chafing from current sanctions may entice Russia to use gas/oil as a "weapon" in Europe.

What are the drivers of a bear market in stocks?

1. **Market valuations are stretched, or "over-valued"**
   Stocks are expensive based on the earnings per share and sentiment is overly optimistic.

2. **Economic recession**
   The economy is headed into recession or currently in recession.

3. **Tight Money/Credit Contraction**
   Federal Reserve policy becomes restrictive: Fed Funds rates are high relative to inflation, lending is restricted and bond issues are shunned, and/or money supply is declining.

Currently…

1. Market valuations, while "full," are not stretched on a historical or relative basis.

2. The US economy is strengthening and far from recession.

3. The Fed is adhering to an easy money policy with a bias to remain dovish, even with the expiration of quantitative easing and rate increases. Bond issues are readily bought and bankers desire to lend.

Three Components of the Fed Rate Hike Cycle

1. **The "Lift-Off" Date**

   The actual start date of a Fed Funds Rate increase is the **least important** of the three components. We had expect the first rate hike to occur in September of 2015. Currently, it appears that the first increase will occur in early 2016. The federal funds futures market indicates less than a 2 in 3 chance of a December, 2015 lift off, and a better than 85% chance in March, 2016 with a greater than 90% probability of a hike by June '16.

2. **The Pace of Rate Moves**

   We expect the Fed to hike rates at a moderate pace of about 3-4 rate hikes per year (the FOMC meets 8 times per year). The futures market indicates roughly 3 rate hikes in the first twelve months of the rate-hike cycle (including the first hike).

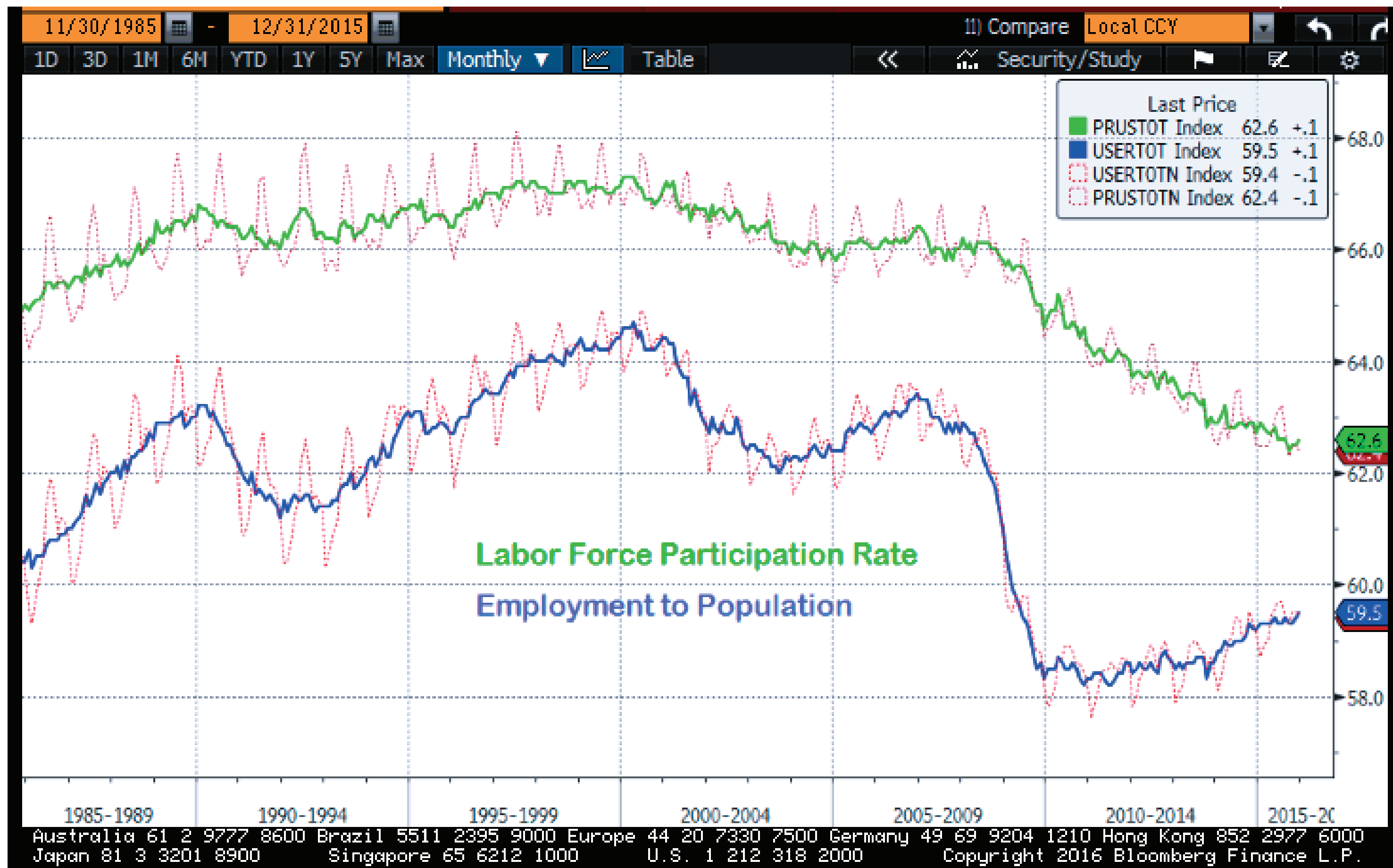
3. **The Terminal Rate**

   We expect the Fed to stop hiking rates when the Federal Funds rate reaches about 2.0% - 2.5%. The longest fed funds futures contract (September, 2018) stands at 1.42% and the 5 yr / 5 yr forward OIS rate stands at 2.4%.

The Federal Reserve elected to pass on raising interest rates at its September FOMC meeting, citing that "global economic and financial developments may restrain economic activity somewhat". We tend to think that the global turmoil will still be a factor at the time of the December meeting. At this juncture, we tend to believe that *if* we are wrong regarding the forecast above, it is more likely that the Fed waits longer or moves slower, rather than the opposite.

Employment Participation Rate

(Source: Bureau of Labor Statistics, Bloomberg)



➢ There has been a lot of talk about the declining participation rate and it's contribution to the drop in the unemployment rate. It's important to note that a fair amount of the participation decline is due to demographics.

➢ It is estimated about 60% of the drop in participation is due to retirement of baby boomers with adequate financial resources.

Slower Growth in China and Effects on Global Economy

(Chinese PMI; *Source: China Federation of Logistics/Purchasing, Markit, Bloomberg*)

➢ While China will likely not experience an economic contraction, growth slower than the 7% target could be problematic, as could the recent currency "re-set" of the yuan.

➢ The greatest impact will be felt by China's trade partners, particularly commodity based economies, and China's competitors, most of which are in SE Asia.

➢ The impact on the US will be limited. (The US is a fairly "closed" or self-sustaining economy.)

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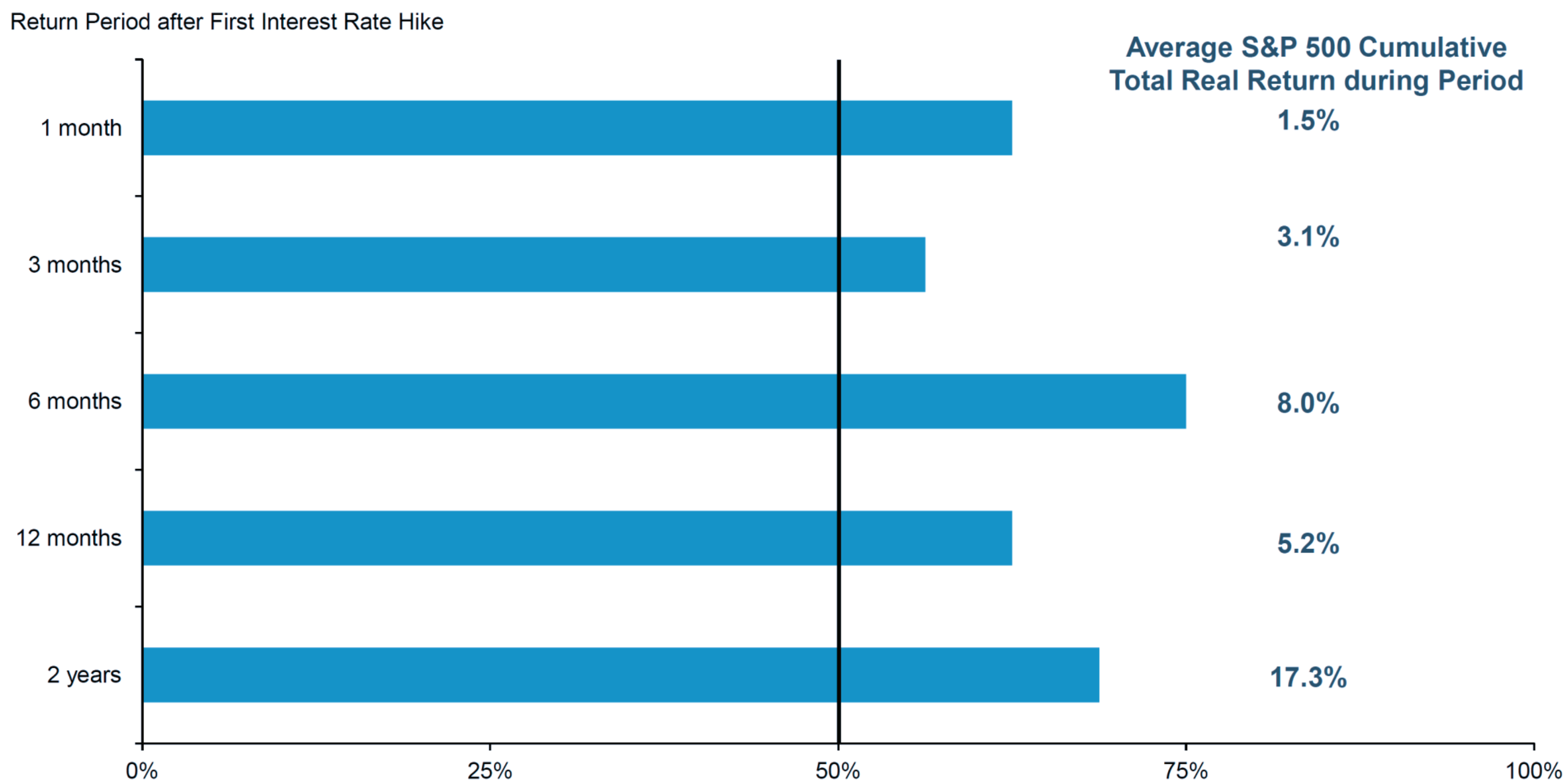
China's Systemic Challenges Remain but Reserves are Large

(*Source: Bloomberg*)

- ➢ China's challenges have been well chronicled: banking/financial system excesses, shadow banking, real estate bubble, etc.
- ➢ However, it is also important to note that the sizable reserves can go along way towards "fixing" or bailing out a number of these issues.
- ➢ So, although China may experience a number of shocks, a total collapse is unlikely.

Fed Tightening Not Necessarily Doom for Stocks



The Federal Reserve's switch to a 'tightening' policy has long worried investors, leading to fears that economic growth will begin to slow and stock prices will suffer. History shows us that, more often than not, this theory has been off-base.

Source: Fidelity Investments, as of September 30th

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S&P 500 Q4 2015 Earning Growth From Year Ago

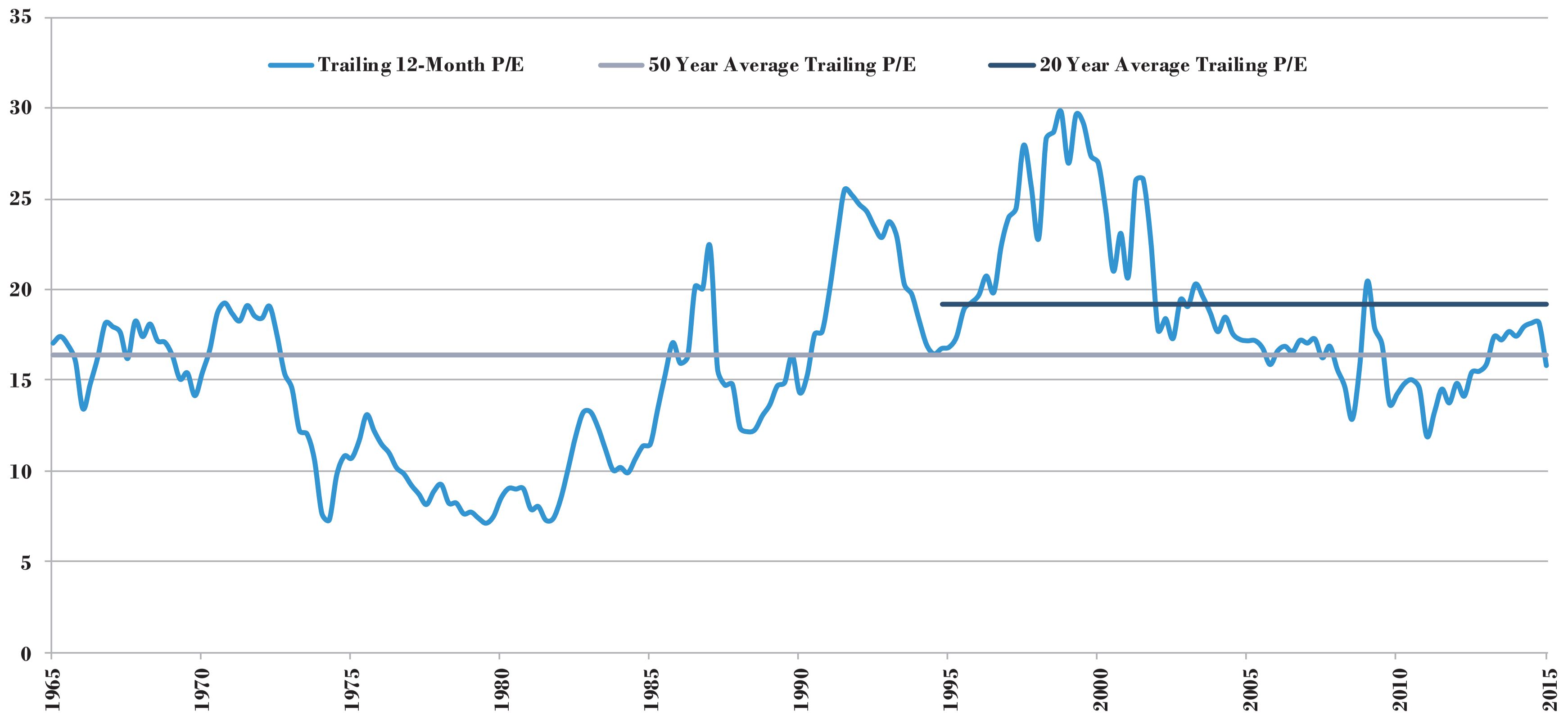
(Source: Thomson Reuters I/B/E/S, January 8, 2016 "This Week In Earnings")

Sector	Earnings $B Q415	Earnings $B Q414	Growth $B Q415	Growth % Q415
Consumer Discretionary	31.2	28.8	2.4	8.4%
Consumer Staples	24.2	24.7	-0.5	-1.8%
Energy	7.0	22.3	-15.3	-68.6%
Financials	53.4	49.1	4.2	8.6%
Health Care	37.8	36.2	1.6	4.3%
Industrials	29.2	29.8	-0.6	-2.0%
Materials	5.6	7.4	-1.7	-23.5%
Technology	62.1	64.7	-2.6	-4.0%
Telecom Services	8.0	6.7	1.2	18.4%
Utilities	6.4	6.8	-0.5	-6.7%
S&P 500	**264.9**	**276.6**	**-11.7**	**-4.2%**

Source: Thomson Reuters I/B/E/S

- Much of the earnings slow down is attributable to the energy sector and the drop in oil prices.
- Additionally, many multinational companies continue to experience pressure from a stronger dollar, making their products or services less competitive globally.
- Eventually, the negative shocks of drastically lower oil and a stronger dollar will mitigate and quarter over quarter and year over year comparisons should turn positive once again.

US Equity Valuation Fairly Valued: Trailing Earnings



➢ The S&P 500 Index is currently trading at a multiple of 15.8-times trailing 12-month EPS. The S&P 500 Index is now trading below the 50-year historical average trailing p/e and below the 20-year historical average.

Source: Bloomberg, as of September 30, 2015

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