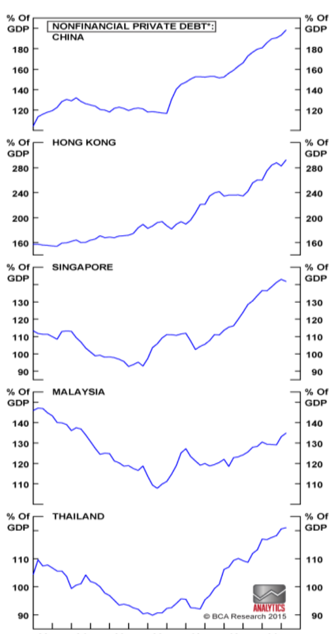
Global Economic Thoughts and Reflections

Global growth should continue to muddle along for the remainder of the year. The United Sates will remain in positive territory as well as Europe, Japan and China. China's slowdown has had an impact both on commodity prices and emerging markets.

The U.S. faces a continued structural demand problem going forward. Aging population, tight lending standards, plus relatively high debt will be a long term headwind. Residential investment stands at 3% versus long term average of 6%. Real consumption growth has been less than 1% over the last 7 years and productivity has slowed to 1.5%. With full employment and cyclical issues coming into play it is hard to get excited in the short run. Economic forecasts continue to be at 2.5% real growth but the Atlanta Fed's forecast is signaling that 3rd Q 2015 may be less than 1%. This year total real growth may be again under 2%. This should not be surprising given the employment situation. Economists continue to rave about the 5.1% unemployment, the number out of the workforce continues to decline. As an example, the percentage employed in the 25-54 age range has dropped from 83% to 77% over the last 15 years with most of this over the last 10.

Europe has a much more promising short term outlook with several years of pent-up demand. An accommodative ECB should keep the region on a general uptrend. Some of the impulses for growth, however, may fade in 2016. Lower oil prices, a weak Euro and thawing credit markets will no longer be a tailwind.

Japan has been in a 20 year plus deflationary cycle and population aging will continue to weigh heavily on the Japanese. The weak Yen and low real rates are pushing up corporate profits as well as lifting exports. Japan's labor force continues to shrink and productivity remains just 36% of the U.S. so challenges still remain.

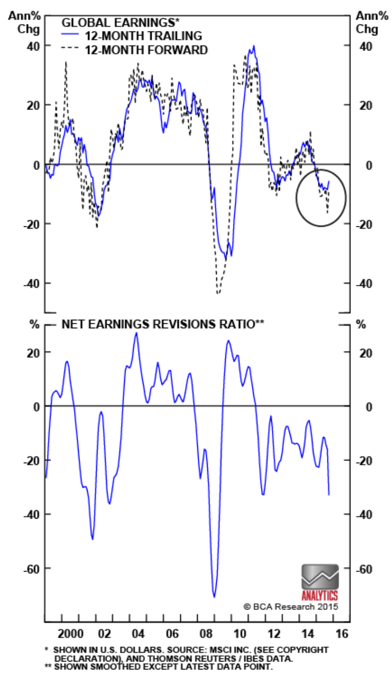


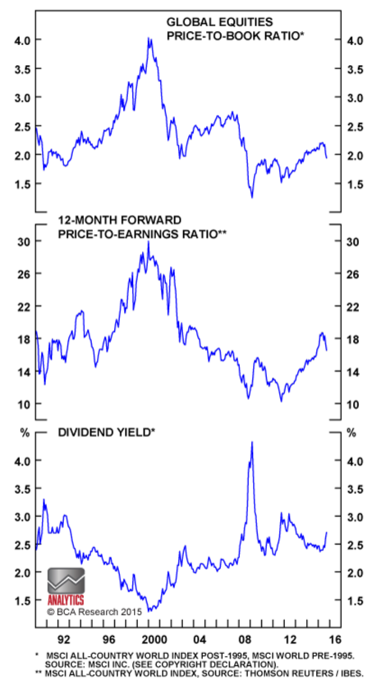
China's slowdown is evident with rail freight year-over-year change at -10%, electricity output growth at zero and loan growth declining by 50% over the last two years. China's day of double digit growth are behind them but expect them continue to be a source of the global savings glut. China's transition from a service oriented economy will put pressure on commodity prices for several years. They will continue to be a deflationary force as well.

Emerging markets are our biggest concern. While asset prices have come down and look reasonable, dollar denominated debt has doubled over the last 6 years to $9.0 trillion. With a strong dollar and slowing commodity prices, this makes them a source of risk. Along with suppressed sovereign rates, an EM bond bubble is being fueled. That being said, forecasting tail events is a loser's game.

Stocks

We discussed in last quarter's review that low volatility and high valuations made stocks vulnerable to bad news. China's slowdown, geopolitical issues abroad, an uncertain Fed and declining earnings aided the slide in global stock markets. Stocks were off anywhere between 7% and 17% for the quarter with EM equities providing the most pain. We went underweight stocks in the 2nd quarter not because of anticipating the slide but because valuations and prices were high. This is still the case in the U.S. but less so overseas. The risk metrics look more appealing for FX stocks than U.S. equities. For all that has taken place over the last three months, total return for U.S. and foreign developed markets is about flat as of this writing.



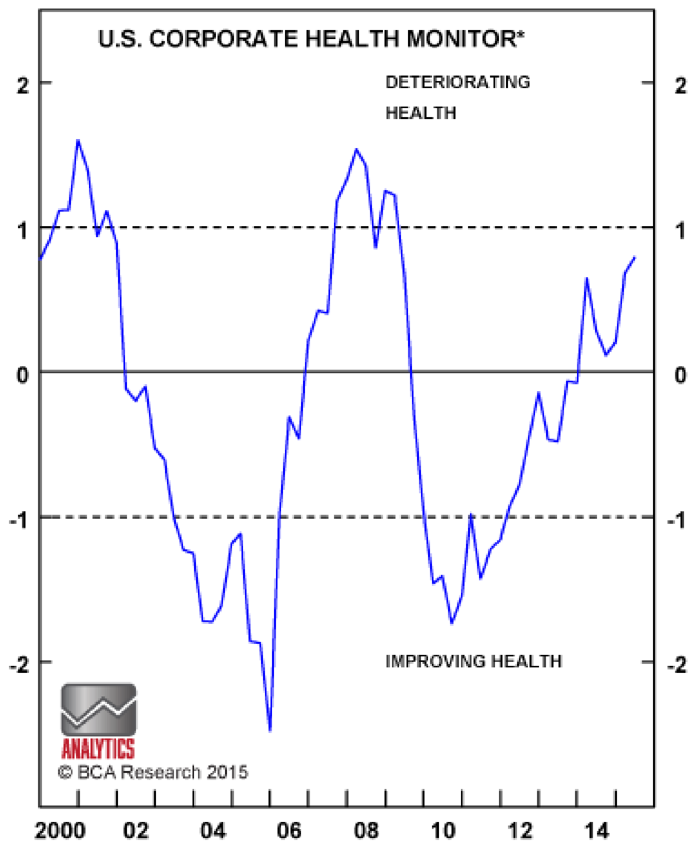


Global stocks are not as expensive as in the 90's and on an earnings yield basis may be more attractive but still they are not cheap either. However, any way you slice it U.S. stocks look much different with:

Price to Book closer to 3; Forward earnings at 18 and dividend yield at 2.0%.

Bonds

Corporate balance sheets continue to erode and profits are now in a full-blown recession given high leverage and weak global growth. This is counter to what you read but it remains a fact that profits are continuing to suffer. This should lead to softer employment and slower capital spending. High yield and investment grade corpoarte debt had a tough quarter but it is too early to go bottom fishing. High yield option-adjusted spreads are above their long term average but they could move higher and we early in the profit downturn cycle (except energy). We are actually getting more conservative by shortening up our duration and improving credit quality while adding more treasuries to the portfolio. We actually think we could extend duration/maturity in the treasury area and make some profits over the coming six months but this is counter to our longer strategic view.



* COMPOSITE OF 6 KEY FINANCIAL RATIOS FOR THE NON-FINANCIAL CORPORATE SECTOR.

Conclusions and Portfolio Concepts

It is late in the economic cycle as auto sales approach 17 million units, unemployment at 5% and productivity growth continues to slide along with corporate profits. We may be a bit early but stock valuations are high here in the U.S., neutral in FX developed markets and slightly cheap in the EM space. Bond yields are low in the quality space but are beginning to look more attractive in the high yield arena. We will be patient and look for selected opportunities as prices become more interesting. We are well aware that we stand in the minority but remember we take a 1 to 3 year horizon in our portfolios. Pent-up demand is gone along with punishing entitlement spending and regulation, bloated federal budget and an increase in corporate leverage. China continues to slow. Europe and Japan are still struggling though look a bit more promising than the U.S. in the short run. Two factors in our quantitative model are signaling lower expected returns over the next couple of years. When asset premiums erode, we turn our attention to risk. We are patient capital.

- Continue to underweight equities with a focus on looking for an opportunity to raise our FX exposure. Our preferred asset class is FX developed markets.
- Underweight high yield and corporate spread product.
- Overweight fixed income while increasing exposure to short term treasuries.
- Underweight commodities though they are deeply oversold and might see a cyclical rally.
- Neutral on real estate.

Just as aside, it pays to be bullish. Markets have gone up 85% of the time on an annual basis. Our tactical shift is based on the fact that the other 15% is down. There is a much higher probability of this when valuations are above average and it is late in the economic cycle.

We would welcome any input as to what you'd like to see or if you have some particular subject you'd like us to explore or write about. Please feel free to contact me at my email below and I will get back to you.

harold@chasefield.co October 8, 2015