Global Economic Thoughts and Reflections

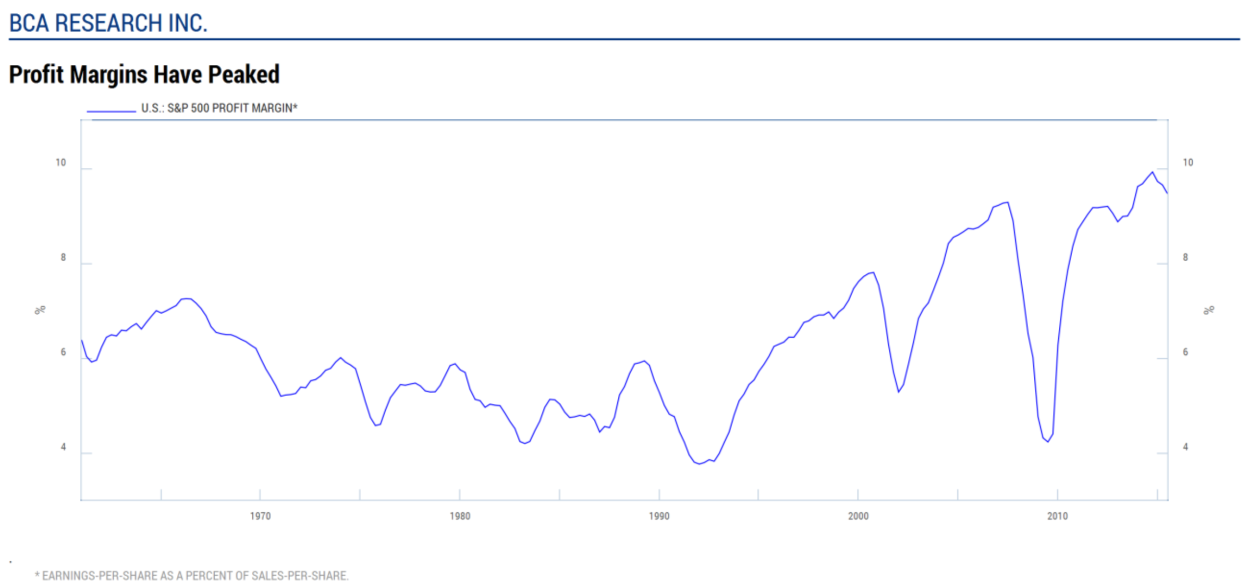
At the beginning of each year, everyone has an opinion of what the markets are going to do. The conversation always talks about the uncertainty investors' face in terms of both the economic climate and asset returns. I have to be candid and say when have returns ever been certain? The global economy and related markets are complex thus predictions and outlooks are largely difficult. This is evidenced by economists' inability to predict recessions and pundits to predict stock markets. Not a great track record. Never the less, it is important to review what's going on in the world and markets to gain some perspective on portfolio allocations.

As a constant reminder, we are valuation based and deal in probabilistic versus deterministic ideas. What is the chance I'll make 8% rather than if I make 8%. The economy is a distraction from that analysis. It is not to say the economic climate isn't important, but it is not intuitive translating market returns to the economy. Nor has this ever been a linear relationship.

Not much has changed our opinion from our October view point. For those that missed it, here are some salient points:

1. Global growth will be modest. (This is always a safe place to be but not very bold)
2. U.S. faces some thematic headwinds as well as some short term difficulties. Transportation and freight indexes are declining and ISM Purchasing Managers Index has declined six straight months.
3. Europe has some pent up demand and is in better shape for short term growth but still challenged with high unemployment.
4. China's growth will be around 6%. They may also be a source of global financial disruption in 2016. Their numbers appear to be suspect in many cases.
5. Emerging market debt struggles will continue because of dollar denominated debt and commodity prices. This is starting to be an issue. Brazil may have its deepest recession in the last 100 years as deficits continue to widen.
6. Oil looks to go below $30 and commodity based currencies are continuing to struggle. We discussed the possibility of the Canadian dollar going below 70 last year at this time as well as the oil bear market continuing. Any price strength will be swiftly met by U.S. and Canadian oil production. A tough road ahead. The trade-weighted CDN has been declining for 3 years. This could be getting long in the tooth. Saudi Arabia's deficit just hit $100 billion. That is a lot for a small country. Look for them to continue pumping oil plus they are motivated to keep Iranian oil off the market. Markets can overshoot fair value by a significant magnitude for an extended period of time. Both on the upside and downside!

In the U.S., profit margins appear to have peaked and top line sales are struggling. There is some pressure on wages at 5% unemployment. Even though actual unemployment may a be a bit higher, it still is a factor for profits. How do companies maintian profits in this environment? They layoff people. Small business employment gains have been declining since 2014. Health insurance costs have risen as much as 60% for small business. The pent up demand from the 2009 recession and high unemployment is no longer a source of growth. The strong dollar could shave off as much as 1.5% of GDP gains. We are not as optimistic about the U.S. ecnomy as the Federal Reserve.



What about the Fed's monetary policy? Many agree that the move was about "saving face". Apparently, this is now a monetary policy directive. We're not saying they shouldn't have, it just appears to us that if earnings are declining and inflation is well below your targets with full employment you might favor waiting a bit. Here is something to consider. Repurchase agreements (repos) and reverse repos are instruments to add and subtract liquidity respectively from the banking system. What does a quarter point rise in fed funds mean? It means $105 billion drained from the banking system almost immediately and may approach $600 to $800 billion over the short run. We took notice! That is a tightening of policy that reduces liquidity and is rarely good for risk assets in the medium term. It can take time to have an impact but with valuations high we'd err on the side of caution.

Our biggest concern is the deleveraging process has just begun in emerging markets with slowing growth and a strong dollar which makes the debt repayment difficult. We additionally are looking at the rise in high yield rates and this is often a sign of declining corporate health. Spread widening is potentially a precursor to spilling over in to other risk assets.

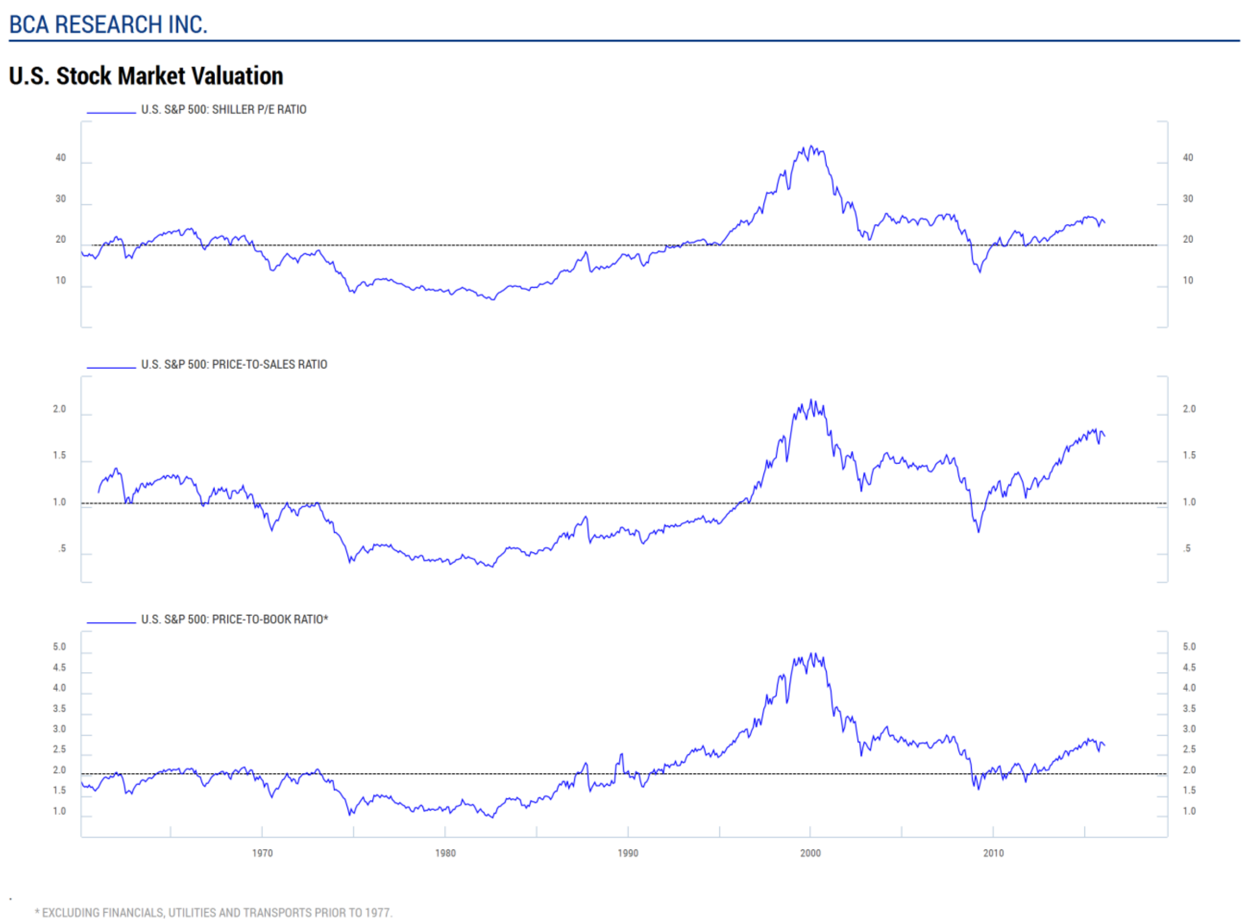
We haven't painted a very rosy picture but all is not doom and gloom. Modest growth and accommodative monetary policy globally gives us cause to think that modest growth is most likely. It is often the change in the rate of growth that influences returns. Slowing growth may be met with lower returns. The U.S. and emerging markets for much different reasons appear to be most at risk of underperforming. I wouldn't be shocked if the U.S. went into recession this year. I'd be in the minority on this position. It pays to be positive over the long run. Running doom and gloom based scenarios can cost you a lot of money. Equites rise 85% of the time on a year-over-year basis. I have not provided much empirical evidence but would welcome your call to discuss and provide accordingly.

Stocks

We discussed six months ago that low volatility and high valuations made stocks vulnerable to bad news. The beginning of the New Year has again demonstrated this. 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 third 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. The risk metrics look more appealing for FX stocks than U.S. equities. Global stocks are not as expensive as in the 90's 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
- Shiller PE at 26
- Dividend yield at 2.0%.

Diverging indexes also look troubling. Transportation and broader indexes, like the NYSE Composite and Russell 2000, have been much weaker than the S & P 500.



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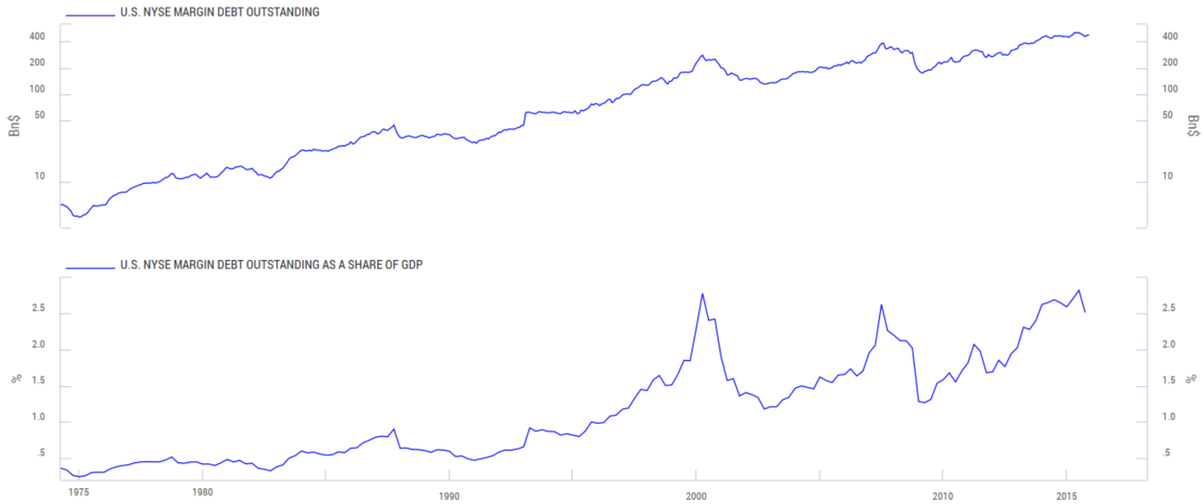
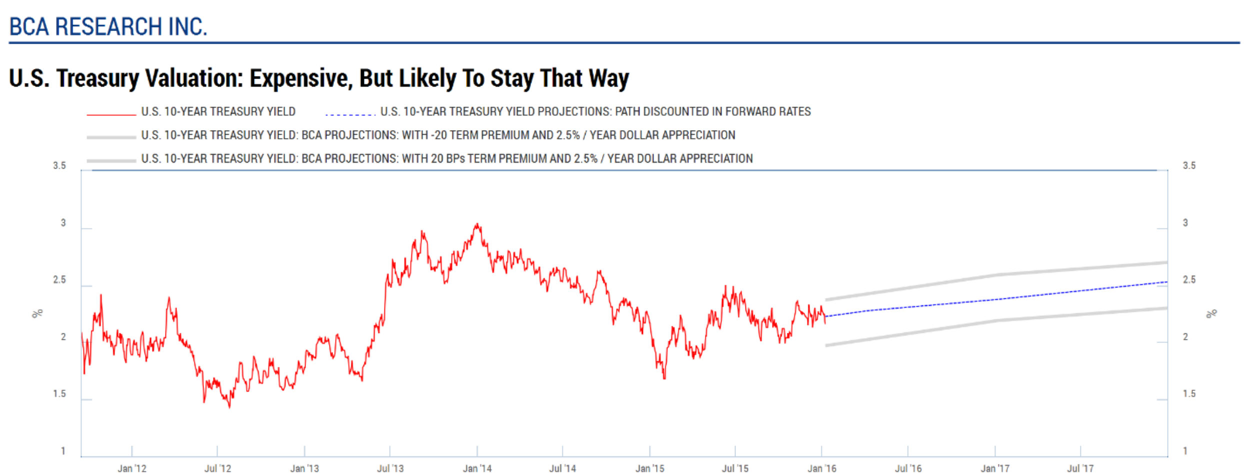
Margin Debt Adds To Vulnerability



Bonds

High yield and investment grade corporate debt continued their slide in the fourth quarter, but it is too early to go bargain hunting. We are not particularly concerned about sovereign bond rates rising too much as the economy continues to move along at a snail's pace and inflation stays very tame. In fact, we added to treasuries in some instances at the end of the year. In last quarter's update, we showed corporate health declining and so we prefer to own less corporate debt. The municipal bond market was a strong performer on a relative basis last year. Municipals appear much more fairly priced as treasuries' yields have risen. We choose owning treasuries as an alternative to new purchases but will hold our existing positions in municipal bonds. Bonds, in general, are difficult to hold on a nominal basis. Yields of 2% are not compelling. Never chase yields when nominal rates are low. Higher yields means higher risk. You may not see the risk but it is there. High yield rates have risen from about 4.25% to about 6.25% in the last 18 months. The average is about 7.5% with a wide range in between. At somewhere around 9%, we'd show interest.



Conclusions and Portfolio Concepts

Because we are long term investors, quarter-to-quarter changes in our view might not be significant. The only change to our thinking is we are getting more conservative. This comes at the risk of being wrong on the upside but we never violate our investment policy statement. We are at our maximum underweight collectively on stocks and overweight our maximum on fixed income. We have taken some positions in short duration treasuries as of 12.31.2015.

- Maximum underweight to 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.
- Neutral on real estate.

It is important to keep in mind that being a long term investor is not buy and hold. It is making a series of planned strategic short term decisions to be successful. It is not short term trading but continuously reviewing and rebalancing your portfolio. We are always concerned about our value-at-risk and become more sensitive to this issue when valuations are high

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. Please feel free to contact me at my email below and I will get back to you.

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