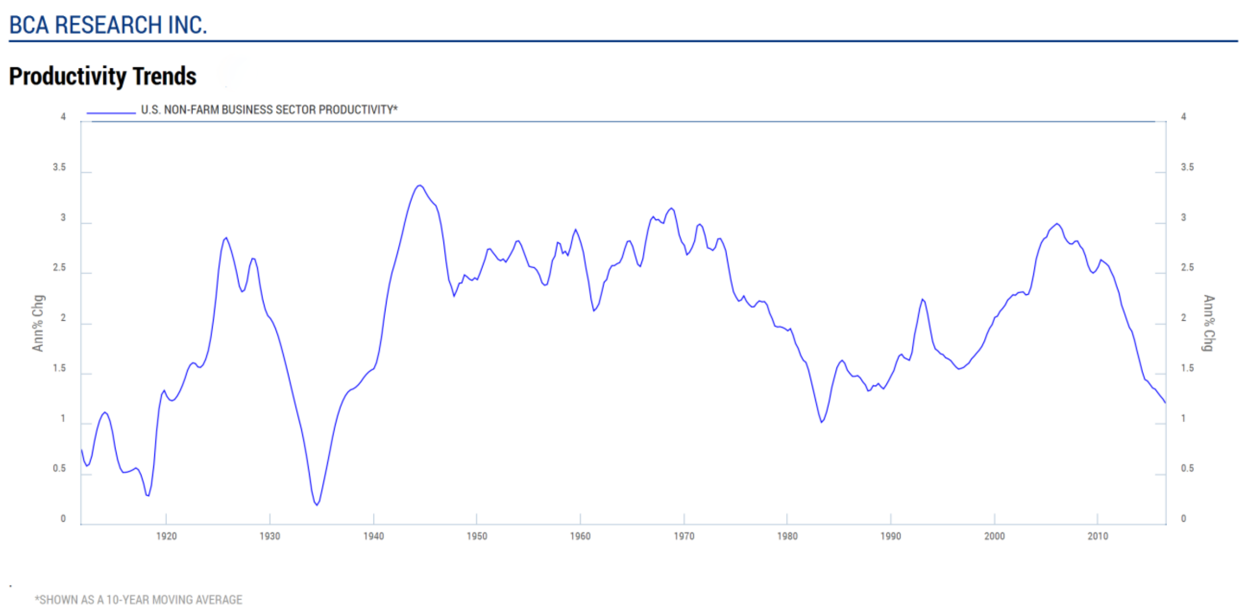
Global Economic Thoughts and Reflections Fourth Quarter 2016

U.S.

The U.S. economy is operating in two separate gears. Domestic consumption continues to grow as well as consumer credit, which is now near previous peaks at approximately 20% of GDP. However, global headwinds continue to restrain manufacturing. U.S. profit margins continue to shrink, and wage pressures continue to build. This could fuel consumption a bit longer, but eventually companies will look to increase productivity—defined as output per hour worked—at the expense of labor.



Profit margins continue to shrink as is evidenced by six quarters of declining S & P 500 earnings. The bottom line? The U.S. is stuck in a low-growth environment.

Inflation

This is a word that has been tossed around by the Fed. For the first time in many years, we see the potential for price increases beyond Fed targets. This would encourage rate hikes. Two areas that need close monitoring are the output gap and wage increases. First, the output gap: The GDP gap, or the output gap, is the difference between actual GDP, or actual output, and potential GDP. If this calculation yields a positive number, it is called an inflationary gap and indicates that the growth of aggregate demand is outpacing the growth of aggregate supply. This condition has not existed for an extended period of time. In 2008, projections were for a substantial gap where supply dramatically outstripped demand. This would lead to deflationary pressures. This has mostly been the case as central banks have stubbornly tried to thwart deflationary forces. While successful to varying degrees, it has been the private sector pulling back investment that has shrunk the supply. The gap now in the U.S. is approaching zero and is greatly reduced in many other developed economies.

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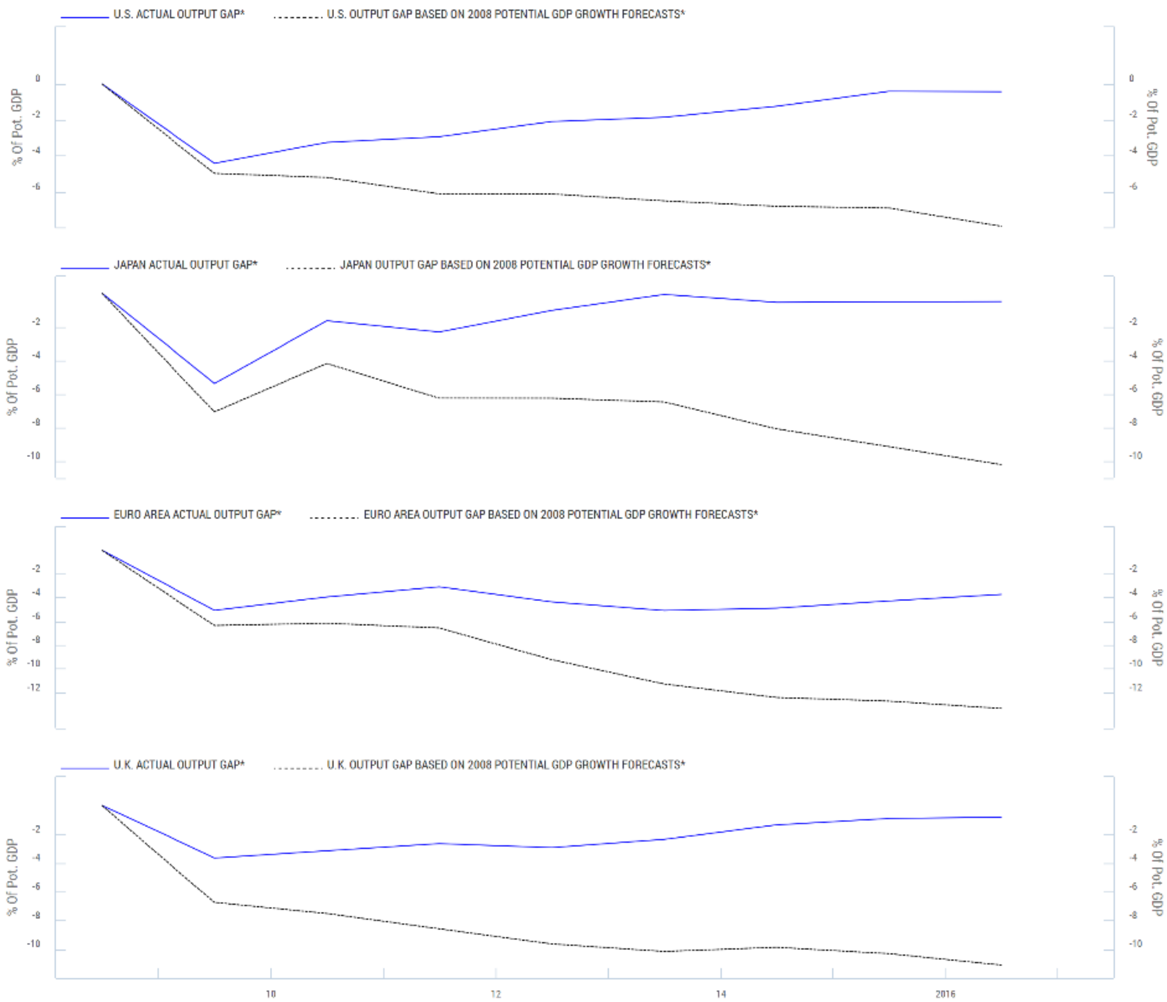
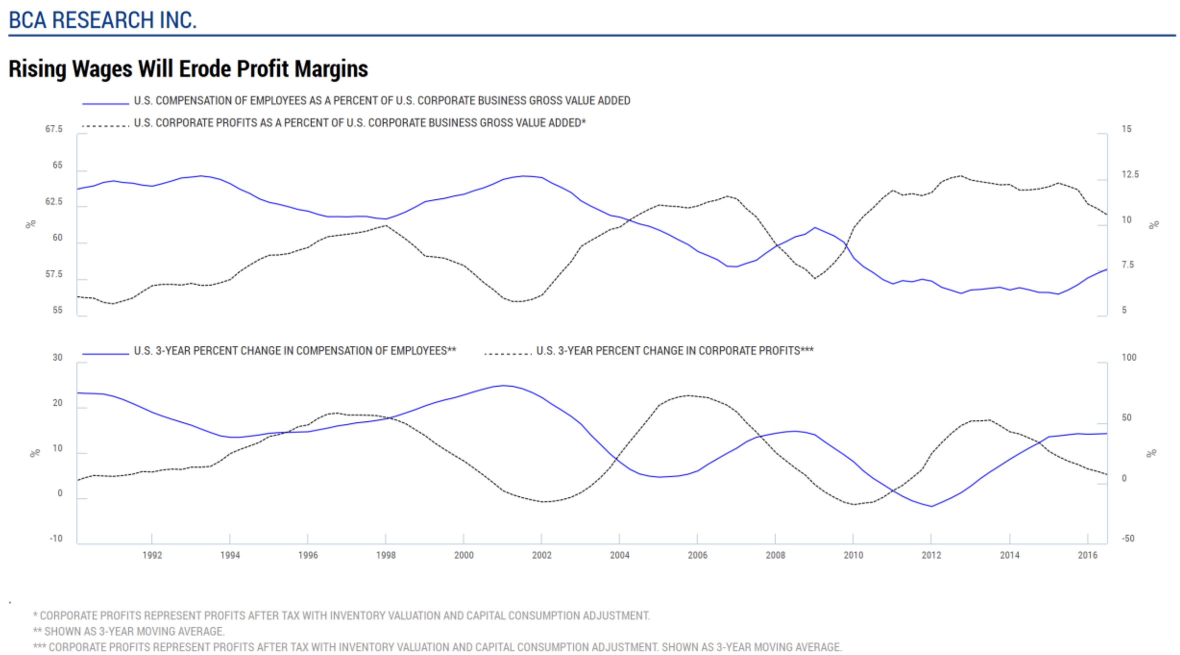
Output Gaps Have Narrowed...



* BASED ON IMF WORLD ECONOMIC OUTLOOK DATA (OCTOBER 2016).

Wages for the first time in many years appear to be rising, mainly due to improved labor conditions. This will take some time to filter through to actual inflation, but it is worth keeping our eye on as inflation has many implications for financial assets.



Conclusion

The U.S. economy's slow growth trend will continue amid increased wage pressures and struggling productivity. It appears that inflation will gain some steam over the coming year, but this cannot be assured as corporate earnings struggle. Companies will look to layoffs should top line growth not regain some positive momentum. Additionally, corporate balance sheets are retreating further, putting pressure on companies.

We spent significant time last quarter discussing other regions and will provide a more thorough look at the rest of the world in our year-end piece.

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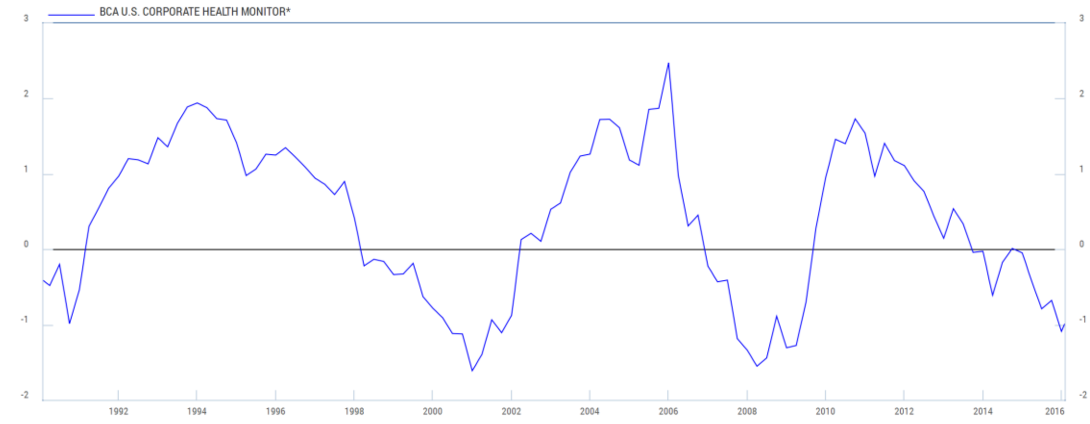
Balance Sheets Deteriorating



*NOTE: SHADING DENOTES PERIODS WHEN CORPORATE HEALTH IS IMPROVING.

Stocks

So how much longer can bonds and gorging liquidity support equity prices? It hasn't been fundamentals because earnings have declined almost 20% in the last 18 months. While they may stabilize here, forward earnings estimates are too optimistic currently.

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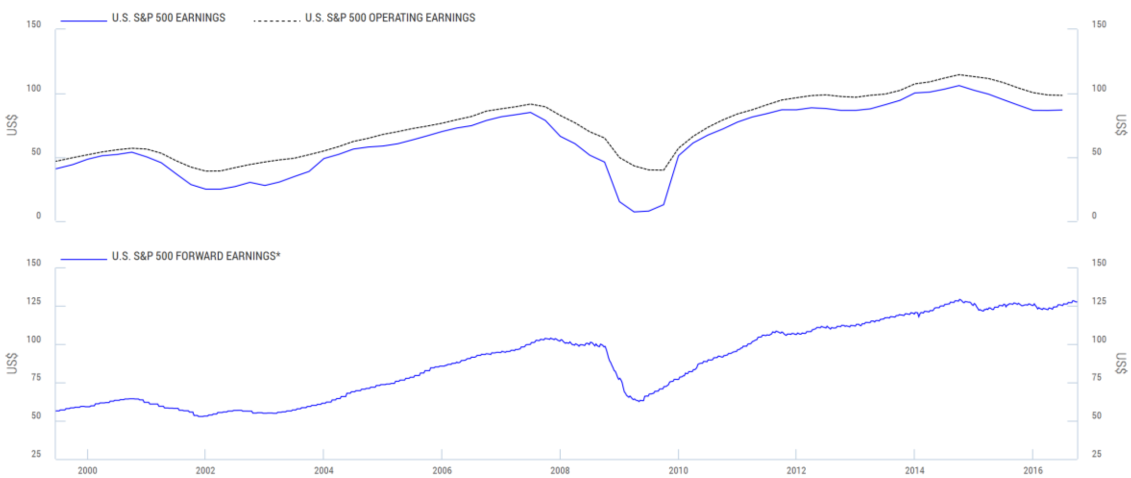
U.S. Earnings



* IBES DATA.

It is no secret that for some time now we have been underweight equities. Most have this in the U.S. where the overvaluation exists. The median PE ratio is now approaching 22, a level not seen in well over 50 years. Regarding financial assets, the ratio of stocks to bonds is currently 2.5 times, the fourth highest since 1950. Clearly, low rates have encouraged risk-taking.

Outside the U.S., stocks have not fared well over the last 15 months. We have seen a significant rebound in emerging market stocks since the February lows. Unfortunately, this has been multiple expansion and not driven by fundamentals, which makes the current rally in emerging markets suspect. We are underweight here as well relative to our strategic allocation for investors.

Bonds

The biggest change in our thinking is really in the bond space. Here we believe the bull market in bonds is over with after 34 years. This creates the biggest challenges for investors. Investors have enjoyed respectable to great returns with modest risk characteristics because of declining yields. Allocations with 40% bonds have fared generally well with modest risk. No longer will investors be able to do this. Investment-grade bonds are yielding around 3.33%, and the 10-year treasury is around 1.7%. With a 40% allocation, this puts your return at roughly 2% for 40% of your portfolio. Even if stocks perform historically at around 9.5%, this makes portfolio returns close to 6.5% before costs and taxes!

This causes investors to reach for returns in other asset classes with higher historical returns, hoping to achieve higher portfolio returns. Hope is not a strategy!

In the high yield and corporate bond space, values have eroded as investors rush to yield.

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U.S. High Yield Isn't Cheap

* OPTION-ADJUSTED SPREAD LESS PROJECTED DEFAULT LOSSES. DASHED HORIZONTAL LINES DENOTE HISTORICAL MEAN +/- ONE STANDARD DEVIATION. SOURCE: BARCLAYS.

Conclusions and Portfolio Concepts

Here are our key concepts going into the end of the year:

Portfolio returns look challenging as stocks appear fully to overvalued and bonds have turned the corner on 34 years of declining rates. We are not calling for rates to rise dramatically as global growth and earnings struggle, but even a gradual rise over the next five years coupled with small gains inflation puts bond returns at zero or negative at longer durations. Emerging market advances since February have been impressive, but fundamentals have warranted such a rise due to debt and a challenging earnings environment. Our call on EAFE-related markets has not been as productive as we'd like. We will stay with this, but we are examining the tactical call carefully.

Commodities are in a secular bear market caused by a supply glut and exacerbated by a market-share war. However, the long run outlook for oil has improved as capex spending has declined in response to lower prices; most of the excess supply should be absorbed by the end of 2017. U.S. and Canadian oil will make a comeback as prices firm up. OPEC will not be able to come to any real output agreement, keeping prices in the $50 to $60 range for an extended period. The risk is still on the downside in the short run.

Here is our stance:

- Continue to underweight stocks collectively by about 20% of your equity allocation. .
- We are overweight bonds but have shortened our duration and will look for opportunities to reduce overall exposure over the coming year. We will wait for opportunities to tactically shift when valuations on risky assets improve. This overweight position has more to do with risk management than trying to improve returns.
- Commodities we will look to move to neutral but are still underweight.
- Underweight high yield as liquidity has lowered option-adjusted spreads.