MARKET PERSPECTIVE

JANUARY, 2016

> ***"The ebb and flow in industrial activity and corporate earnings must be anticipated. It is not the probability of those future swings which should be the primary concern but rather the probable amplitude of those swings."***
> **Benjamin Graham**

IN VIEW: Federal Reserve Takes Cautious Stance on Monetary Policy

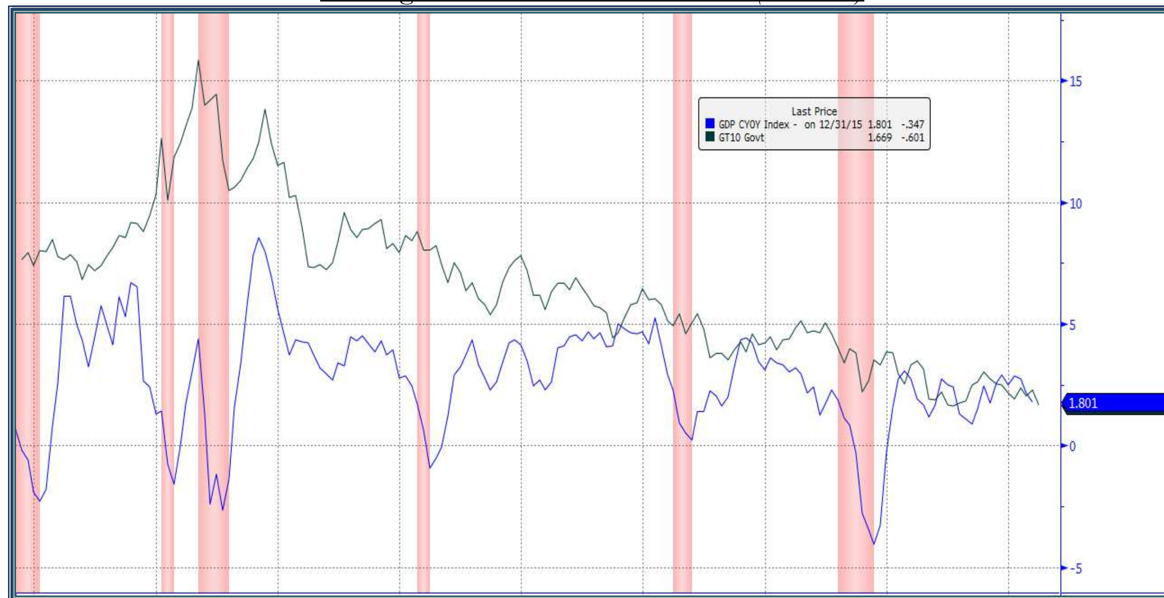
In determining the magnitude of corporate earnings, an assessment of the business cycle is essential. After seven years of aggressive monetary stimulus, with near zero short term interest rates and successive rounds of quantitative easing, the Federal Reserve took a well forecasted small step and notched the Federal Funds rate higher by a quarter of one percent at year end. The new targeted range (0.25% to 0.50%) was raised against a backdrop of an economy growing at 2.0% during the third quarter, based on the revision by the Bureau of Economic Analysis. Federal Chairwoman Janet Yellen confirmed this month that additional increases are likely this year, but dependent on the pace of economic activity and an increase in core inflation to near the Fed's 2% desired pace.

The FOMC's current projection is for four additional increases this year, but that seems aggressive given the fragility of the world economy with limited, if any, growth in Europe and declining growth in China. With deflation a concern in parts of the world, it is questionable whether U.S. inflation will move meaningfully higher given sagging energy prices and limited wage growth. Our working assumption is that U.S. growth will remain positive, but subdued with GDP tracking at a 2.0-2.5% rate. This view is spurred by some strengthening in consumer demand, though negatively impacted to some degree by a sluggish manufacturing sector and curtailed exports due to dollar strength. This suggests an environment where some modest additional pressure is likely to develop on the short end of the yield curve in response to one or two Fed moves. However, it is questionable as to how much impact there will be on longer rates if growth remains modest and inflation subdued.

Janet Yellen's prepared testimony, as part of the semiannual Monetary Policy Report (MPR) to the Congress, was absent any direct reference to the health of the U.S. banking system. Investors are concerned with the fact that investment grade banking yields are flirting with the 3% level, and that banking spreads are at their highest levels since September 2012.

EXHIBIT I

Declining Interest Rates vs. U.S. Recessions (red bands)



Source: Bloomberg and Altman Research

As the 5-year note yield broke down from its 2 ½ year trading range of 1.25% to 1.85%, the Fed should be concerned with a flattening of the yield curve, and its impact on net interest margins. This is all going on while loan demand is seeing its best growth since the financial crisis. The recent spike in spreads, falling Treasury yields, and the flatter curve all likely reflect concerns about the health of European banks, Japanese banks, the effects of negative interest rate policies, and the contagion effects on U.S. banks. We believe the Fed should be focusing on shoring up confidence in the U.S. banks and should take precedent over other objectives of monetary policy (i.e., employment and inflation), if financial conditions continue to deteriorate.

Our *Fixed Income Strategy Highlights* commentary in January shows the municipal yield curve rate changes during the year. The recent decline in longer rates since late May, which accelerated in recent weeks, reflects growing uncertainty over the global economy, equity market volatility and to some extent a flight to safe harbor securities in reaction to heightened global terrorism. The sharp decline in the Chinese equity market at the beginning of this month is reflective of global market fragility.

Despite our expectation that longer rates will remain reasonably subdued over the near term, we are maintaining lower than neutral portfolio durations in client accounts. Increased potential volatility associated with low rates argues for a degree of caution.

CLOSE-UP: The Economic Landscape

During the second quarter of 2015, the real GDP had grown at a 3.9% rate. While consumption is still strong, growing at 3.0%, such statistics as industrial production, manufacturing and exports have been slowing largely as a result of lagging growth in the global economy. The weakness in the global economy is best reflected in the collapse of commodity prices that was mainly brought about by the slowing Chinese economy as it attempts to restructure from an investment-led economy to one centered on consumption. Commodity prices peaked in 2008 as producers vastly expanded output to meet Chinese demand; and then, as demand weakened, it caused the current depression in many commodity prices such as oil, tumbling from $140 to $27 per barrel today. Since the majority of global commodities are priced in the U.S. Dollar, declines were aggravated by the rising dollar, a haven for currency stability.

While commodity prices reflect the weakest aspect of the current global economy, there are other sectors, such as consumption, health care, housing and technology which are performing quite well. Over 12 million jobs have been created over the last five years bringing the unemployment rate down to 5.0%. This progress with job creation influenced the Federal Reserve to normalize rates based on the recognition that quantitative easing combined with a zero interest rate policy has had some adverse effects on the economy. The Fed has expressed concern that excessive borrowing could contribute to asset bubbles and lead to the inability of many investors to earn a decent return on their money without taking on excessive risk.

The Federal Reserve has hinted that while there will be further rate hikes in 2016, they will be extremely modest. At present, inflation is quite moderate at 0.7%, as measured by the Consumer Price Index (CPI), for the twelve month period ending in December. The data for the Producer Price Index (PPI) for the same period is one of deflation, namely a fall of -2.7%. The commodity collapse is reflected in this data. While the Federal Reserve has taken the view that inflation is not at its desired level of 2.0%, it is compelled to preemptively raise rates now so as to minimize the disruptive impact of a faster response.

Since employment is a lagging indicator, some leading indicators such as capital investment and durable goods orders have not been particularly strong in recent months. Some investors have taken the view, particularly in light of the commodity collapse, that perhaps the main risk to the economy at present is one of deflation. The central banks with their currently expansive monetary policies, including negative interest rates, have endorsed this position.

We believe that the lessons of the Great Depression have been learned and that the current Federal Reserve will act prudently if further economic weakness occurs, resulting in a reversal of its stance despite the potential risk of damaging its credibility. As discussed in prior commentaries, we believe that we are in a long economic cycle, albeit a weak one with annual growth of 2.0 to 2.5%, as opposed to the more normal business cycle of 5-6 years and 3.0% economic growth.

We expect real GDP to grow at 2.5% for 2016, with weakness in the first half followed by strengthening in the second half. The same pattern should prevail for corporate profits, for an overall gain of 5.0% with the CPI advancing by 1.7%. To grow faster, the U.S. economy needs regulatory relief and tax reform, as well as a lower U.S. dollar. We do not expect this to materialize under the current Administration and much will depend on the 2016 elections. One should add however, that the recently passed $300 billion highway bill and the $1.1 trillion omnibus spending bill, both bipartisan efforts, and signed by the President, will exert fiscal stimulus in 2017 - albeit at the expense of budgetary discipline.

Discussions of a U.S. recession typically intensify around increased financial market volatility, as we have been experiencing since the start of 2016. Despite notable risks to the economic outlook, however, we do not think the data supports a recession. Real GDP grew in the fourth quarter at a tepid annual rate, as net exports and inventory investment subtracted a combined 0.92 percentage points from growth. But real final sales to domestic purchasers, which exclude net trade and inventories, rose at a 1.6% annual rate and was up 2.5% y/y, showing the economy has more resilience than the headline GDP number indicates. Moreover, even though goods output fell at a 1.5% annual rate in Q4, services output expanded at a 1.8% annual rate, and has averaged 2.0% over the past two years, the most since early 2008. This shows the robust growth in services is more than offsetting the decline in the goods sector, keeping the current expansion in tact.

Therefore we conclude that a decline in stock prices is not sufficient alone in resulting in a contractionary phase for the U.S. economy. Additionally, our analysis indicates that the housing wealth effect is larger than the stock market wealth effect, suggesting that rising home values are offsetting, or greatly reducing, the negative impact on consumer spending from the decline in stock prices.

However, we also recognize that a slowdown in certain sectors has increased the risks to the overall economy. We monitor those risks closely. Reports such as factory activity slowing has been dragged down by the strong U.S. dollar and weaker demand from abroad; energy output, which accounts for nearly 30% of industrial production, fell 8.9% in 2015, due to the precipitous decline in oil prices; inventories are high relative to sales; and corporate credit spreads, particularly high yield, have widened in recent months, a sign of growing nervousness and uncertainty in the business sector. Despite the aforementioned risks, the aggregated indicators that we deem relevant as lead indicators still suggest that the U.S. economy is not in recession territory and thereby support our current view that there remains a low risk of imminent contraction.

The indicators that we monitor have a relatively good track record for identifying recessions. The key levels are based on historical performance and our qualitative assessment. We would like to see the majority of our indicators turn before we conclude that a recession is imminent. To date, the weakness evidenced at the state level remains concentrated in states that are dependent on energy production. The percentage of states expected to expand over the next six months was by far above the 50% level that would suggest a contraction or recessionary phase in the general economy is premature. Similarly, the breadth of the y/y changes also shows growth is expected to accelerate in nearly 1/3 of the states, and is also above the key recession level of 8%. Although the U.S. State Leading Index, based on the same methodology as the individual state leading indexes, suggests somewhat slower growth over the next six months, it does not confirm a U.S. recession at this juncture.

Financial conditions remain relatively loose, despite the recent widening in corporate credit spreads, particularly high yield. The Chicago Fed's National Financial Conditions Index - which is based on developments in money markets, debt and equity markets, and the traditional and "shadow" banking systems - rose to its highest level since September 2012. Nevertheless, it continues to indicate accommodative credit conditions.

The Labor Market Overview :

Nonfarm payrolls rose an average of 221,000 per month in 2015, and job growth accelerated in Q4 to an average of 284,000, the highest level in nearly a year. Additionally, labor demand remains strong, with the job openings rate near its highest level since 2001. A recent release by the Conference Board shows Employment Trends ticked up 0.2% in January and indicates a positive trend of 1.9% over the past year. There are signs of growing labor shortages that the Fed chairwoman Yellen referenced in her recent Congressional testimony. Nearly half of the small businesses in the NFIB (National Federation of Independent Business) Survey, the biggest share since data started in 2008, report few or no qualified applicants for their job openings. Amid tightening labor market conditions, the recent pickup in initial claims for unemployment insurance is not particularly worrisome. The four week average of claims rose to 285,250 last month, up from a cycle low of 259,250 in October 2015. Keep in mind that this is far below the key recession level of 500,000 claims.

The Conference Board's Consumer Confidence Index has been range-bound since Q4 2014, and has averaged 97.5 over the past 12 months, close to its highest level since early 2008. Despite increased financial market volatility at the start of 2016, consumer attitudes remain positive, boosted by solid jobs growth, cheaper gasoline, and rising home values. The current level of confidence is consistent with trend economic expansion. Historically, a level below 63.2 has indicated a recession.

Business Confidence and the Manufacturing Sector :

Business confidence, however, deteriorated notably in the second half of 2015, moving closer to pre-recessionary levels. This negative trend is coincident with the CEO Confidence Index which dropped in the fourth quarter to the low levels of the third quarter of 2012. As expected, the outlook for the first half of 2016 has also deteriorated. This level of business pessimism has historically been associated with falling corporate profits and weaker capex growth.

One of the major themes in our 2016 economic outlook was whether the slowdown in factory activity would remain contained in that sector, or whether it would spill over to services, in which case the risk of recession would rise significantly. The ISM Manufacturing Index recent decline since the summer of 2014 confirms this hypothesis. It ticked up slightly to 48.2 in January, but was below the break-even level of 50 for the past several months. Factory activity has suffered from the strong U.S. dollar, weak global demand, and the shrinking of the shale industry, due to the fast and steep decline in oil prices.

However, services continue to grow at a robust pace, offsetting the decline in factory activity for now. The ISM Non-Manufacturing Index has declined only modestly over the past four months to 55.8 in December, and has averaged 57.3 since August 2014, when the manufacturing index peaked. The key recession level is 51.4.

The Outlook for the Financial Markets

As 2016 unfolds, the long-cycle hypothesis that the U.S. economy can maintain slow but steady growth of approximately 2.0% and extend for another two or three years, as compared to the traditional five to six year typical cycle, will be challenged. Many economic forecasters are now worried that the U.S. economy is about to enter a synchronized global recession, particularly aggravated by the emerging markets, who have suffered by the slowdown in China which just reported growth of 6.9% for the calendar year. The U.S. just reported fourth quarter GDP at +.7%. Prior to this release, consensus expectation by economists had already been lowered from the 2.0% forecast in the third quarter.

While Chinese statistics are generally viewed as unreliable, it is clearly evident that decades of booming growth has made the Chinese economy the second largest economy in the world next to the U.S. As the Chinese economy transitions from an investment-led one to one focused on consumption and services, the question of mercantilism arises. The Chinese economy, similar to Germany, focuses on exports while restricting imports resulting in large foreign reserves. This policy has the effect of restricting the growth of other countries dependent on Chinese demand. In contrast, the U.S. is carrying a large trade deficit, close to $531 billion through the fourth quarter, which does support economic growth in other countries. At present, global trade is declining while many countries are depreciating their currencies to spur economic growth through exports.

Generally, depreciating currency is a form of protectionism that dampens global trade. Economists prefer international cooperation to increase economic growth, rather than solely rely on continued Central Bank monetary expansion. The Trans-Pacific Partnership that was recently signed after years of negotiations in February has yet to be passed by Congress.

The big question on the minds of equity investors is how far will the recent decline in stocks go? On January 20th, the S&P 500 fell to 1814 intraday or below the closing price 1867 registered on August 25 in 2015. Given the historic high valuation of equities in 2000 trading at 150% of GDP (a ratio that Warren Buffet has cited as a useful tool), the current more modest valuation ratio of our markets (102% of GDP) validates a range-bound market, assuming no recession. One must be mindful, however, that the market on a strictly forecasted earnings basis may be slightly overvalued if the aggregate expected earnings potential in 2016 comes under greater pressure. Although we are not technicians and cannot predict the future, a good case can be made that stocks in the context of historically low interest rates could continue to fluctuate in the recently established wide-price band between 1820 and 2050.

EXHIBIT II

Market Capitalization as a Percentage of GDP

Source: Bloomberg and Altman Research

Commodities have been in a major bear market for the last few years and are probably close to their lows, again on the assumption of no recession. The CRB Index (385) of commodities is down 8% from year ago levels, with oil ($27 per barrel) down substantially from last year's level. Gold has gone counter to this trend, since the commodity is typically used by investors as a safe haven during periods of market turmoil. The metal has risen 14% to $1,254 per ounce (as compared to $1,096 a year ago).

The best measure of the severity of the global trade decline and the collapse in commodities is the Baltic Dry Index (290) down 58% over the past year. This is a measure of the cost of carrying commodities by ship, and it has been depressed for much of the economic recovery since 2009. This collapse in demand was the result of slowing Chinese imports at a time when excess capacity (ships) was built during the 2007 boom. As a result, many maritime bankruptcies have occurred in recent years, while over 50 energy-related bankruptcies have also occurred.

Over the past month, interest rates have generally declined, with the exception of corporate bonds that had a modest increase and high yield bonds that had a significant increase because of rising defaults. At present, 10-year Treasury bonds yield 1.70% versus 2.30% a month ago. The low yield of 1.53% was reached on July, 2012 with the recent high of close to 3.0% reached on the end of 2013. Assuming no recession, yields should trade within the 2.0-2.5% range for the balance of the year. In the end of January, the 10-year mortgage bonds yield 3.7% compared to 3.8% a month ago. The big question for the Federal Reserve is whether or not, in view of the recent market turmoil and the slowdown in China, they will continue to raise interest rates three or four times by 25 basis points for the balance of 2016. They have maintained such a stance since the 25 basis point increase in December. If no increase in inflation occurs, they most likely will reverse themselves and allow the U.S. dollar to fall somewhat to improve the export outlook.

The current P/E ratio of the S&P on $119 per share earnings for 2016 is 15.2x. This represents a reasonable valuation from a historical perspective. However, the average hides enormous differences among various sectors of the market. For example, many commodity companies have no earnings because of their product price collapse and a few growth stocks still sell at substantial P/E ratio premiums.

Given the present slow economic growth and the current geopolitical tensions, we believe that it is prudent to approach both established and new investment portfolios with caution despite the recent fall in equity prices. We remain vigilant on owning companies with strong balance sheets that have survived recessions only to emerge as stronger businesses after the cyclical downtrend.

IN SUMMARY:

In the year ahead, we are expecting global growth to improve modestly in 2016, as compared to 2015. Nonetheless, growth should remain below the longer term averages as both the developed markets and emerging markets weigh in on the outlook. We maintain that the U.S. will still lead economic growth in 2016 and we don't expect a hard landing in the Chinese economy. We do, however, anticipate global growth to be impaired by the negative impact of the knock-on effects from the emerging world.

Given these headwinds, we would not expect the Federal Reserve to go counter to the Central Banks' policy of accommodation by continuing to place pressure on U.S. rates based on a "normalization policy" as previously stated. We do expect deflationary pressures will dampen investment spending in the first half of the year and effectively slow the recovery growth path. Geopolitical risk can also exacerbate market volatility. As we've seen, the rising tension in the Middle East can create an environment of uncertainty as well, and could compress market valuations despite improving corporate profitability. However, global liquidity remains supportive with the Central Banks' position. Interest rates are at historic lows, with the average dividend rate on common stocks exceeding the 10 year Treasury yield, and creating a positive backdrop to accumulate stocks.

We are operating under the assumption that the likelihood of a U.S. recession is low, resulting in a market price-to-earnings ratio that is not excessive against the current inflation rate. Unemployment is improving and consumer balance sheets are healthy. Sentiment indicators are still positive with retail sales improving. All these characteristics suggest that U.S. stock participation is still warranted despite the evident headwinds.

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