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Professional Advice for Serious Investors

ECONOMIC AND MARKET OUTLOOK
2016

Investors in 2015 found all markets to be generally unkind. Despite Central Banks continuance of zero interest rate policies, equity markets did not respond in a very positive manner. Even the U.S., despite steady money flows into the markets, experienced flat returns. Emerging markets were particularly hard hit as commodity prices, particularly oil, crashed. The hunt for safety and return will face mounting obstacles globally. Returns across all asset classes finished largely under 5%. 2016 will be challenging and investors need to make a harsh assessment of asset class exposures.

Table I. Asset Returns in 2015

Equity		Hedge Funds	
S&P 500	1.38%	Barclay HF	0.91%
Russell 1000	0.92%	Barclay Multi-Strat	0.14%
Russell 2000	(4.41%)	Barclay Event Dr.	(2.97%)
MSCI EAFE	(0.81%)	Barclay Glob. Macro	2.09%
MSCI Emerging	(14.93%)	Barclay FOF	(1.84%)
Fixed Income		**Real Assets /S&P Commodities**	
3 mon. T-bills	0.05%	Commodity	(32.86%)
Barclay US Aggregate	0.55%	Crude	(45.34%)
Barclay US Treasury	0.84%	Natural Gas	(39.14%)
Barclay US Gov/Credit	0.15%	Gold	(10.88%)
Citi Mortgage	1.56%	Soybeans	(14.63%)
Barclay Corp HY	(4.47%)	Corn	(19.22%)
Barclay Municipal	3.30%	Wheat	(22.31%)
Barclay 5 Yr. Muni	2.43%	NAREIT	(0.41%)
JPM Emerging Markets	1.82%	NCREIF Farmland	

Source: S&P 500, MSCI, Russell, Barclays, JP Morgan. S&P GSCI, NAREIT & NCREIF

Global Economy

The global operating plan for the past 8 years has been to flood the monetary system with liquidity which inflated stock assets in the hope that "easy money" would result in a growing economy. Even a generous reading of the global economies would grade the result of that activity to be a failure. Now the central banks have no bullets left and the economies are sliding downhill as commodity prices, particularly oil, implode. Many argue that falling oil prices will have a positive impact on consumer spending. Unfortunately, there are many global consequences that will have profound negative economic impacts. As seen in Table II. GDP growth is slowing and unemployment remains persistently high.

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Table II. Global GDP and Unemployment Rates- 2013 Estimates

	GDP%	Unemployment %
Global	2.8	8.0
EuroZone	1.6	12.0
Emerging	3.0	7.2
Asia Pacific (x-Japan)	6.5	7.0
Latin America	2.0	7.4
U.S.	2.2	5.1
U.K.	2.4	5.8
Germany	1.7	6.9
China	6.3	4.1
Russia	-.0.05	5.6
Japan	-1.4	3.5

Source: PCM Partners, LLC

Europe, already hampered by slow economic growth, is now faced with the prospect of being overrun by the wave of refugees from the Middle Easy, primarily Syria. Through the wisdom of the United Nations many of the European countries committed to allowing the mass migration without any real blueprint of how they will be assimilated into the various countries. For example, with an already stressed economy, Prime Minister Merkel has agreed to allow approximately 800,000 refugees into Germany. To compound the problem, there have been an increasing number of sexual assaults on women by these refugees. Similar occurrences have occurred in other countries that have opened up the gates to these refugees. The debate in the U.S. has gotten more intense as well. According to the FBI, there are no reliable methods to vet these new immigrants in any swift and accurate manner. As terror attacks by small groups of radicalized Islamists has increased globally, concern over this open border policy will result in providing an easy pathway for terror to spread worldwide. Republican Presidential candidate Donald Trump has made inflammatory remarks about not allowing Muslim's to immigrate here. This has met with sharp loud responses on both sides of the issues. He has struck a chord with a segment of the voting population who value domestic security as a burning issue.

China is seeing its economy slow from high single digits to mid-single digits over the past few years. While a GDP in China is expected to be at a quarter century low (If one does believe reported data), it is still the envy of the world. The overall slowdown in China has accelerated the decline in oil prices. The economic slowdown has impacted the equity markets in China as well. The government has organized large-scale purchases of stocks by government-linked brokerages and investment funds to prop up the plunging market. China's growing non-performing bank loans are becoming more of an issue as well. In the end China's growth will be strong relative to the global economies however problems are building which will undermine global growth and markets.

Emerging markets are experiencing a sharp decline in growth due in large part to plummeting commodity prices. Debt expansion has risen to uncomfortable levels. Brazil is one economy that will face a difficult year and is heading for a deep recession. Policy makers must deal with Brazil's worst inflation increases in 12 years along with a weak economy. In addition, Brazil faces further credit downgrades and growing corruption scandals.

Russia's economy is contracting as well. This may pose the most dangerous problem to the world. Russian President Vladimir Putin is suffering domestically from a budget that has disintegrated as oil prices fall. He has tried to change the discussion with movement on the Ukraine and more recently, sending armed forces into Syria. Additionally, the ruble continues to fall against the U.S. Dollar. It has been estimated that for Putin to satisfy domestic budget concerns oil needs to be trading above $60/bbl. In recent weeks it has been trading around $30/bbl.

There are two complicating matters with oil. First Iran has received a get out of jail card as the U.S. has lifted sanctions on Iran in return to its promise of not building a nuclear bomb. Iran has announced it plans to add 1 million barrels per day to its production. The lifting of sanctions will also allow Iran to attract foreign investment needed to re-build its energy industry.

Also hiding in the shadows of the oil sell-off is ISIS, the junior varsity of the terror world. They have captured oil capacity in Iran and is selling to anyone at any price for anyone who has cash. The activities of these two regimes are making its neighbor Saudi Arabia very nervous. The Saudis have been trying to buy peace in its kingdom by passing out money to the various groups in the homeland. With Iran and ISIS gaining more power the Saudi's are concerned that the ruling family may be forced out which will add to the growing turmoil in the Middle East. Recently Saudi's executed 47 Shiite prisoners including one leading cleric which brought outcry's from Iran. Now this turmoil has been occurring on several levels for centuries however, the stakes now have global implications economically. The unrest can turn violent at any time hitting an economy that is in no position to take even a slap let alone a punch from one of the groups that has gone rogue.

In Table III.

The forecasts suggest a mild interest rate environment, as central bankers remain reluctant to drastically increase rates. The U.S. Federal Reserve increased the Fed Funds rate in December and further increases were suggested. As the weakening economy unfolds and stock market volatility erupts, Central bankers are unlikely to raise rates. The possibility that they may reverse course and cut rates in another futile attempt to breathe life into the economic carcass.

European Central Bank (ECB) head Mario Draghi has hinted at the ECB's March meeting may call for additional stimulus and lower rates. Similarly, Japan is considering more easing that will add to its debt level that is dangerously high relative to its GDP. Also IMF Managing Director Christine Lagarde is suggesting that monetary easing is needed to prevent a collapse. This has encouraged equity markets and it has done little else.

Table III. 10 Year Interest Rate Estimates -2016

	%
Global	3.0
U.S.	2.7
Euro Zone	1.0
Emerging	4.5
Japan	0.25
UK	1.9

Source: PCM Partners, LLC

U.S. Economy

The U.S. recovery remains limited at best. In fact, there is a body of work that suggests the recovery may be the worst of all time. GDP growth is anemic and is sliding back toward a recession. The administration points to a 5.0% unemployment rate and creating over 4 million jobs. In reality, the unemployment rate is largely a

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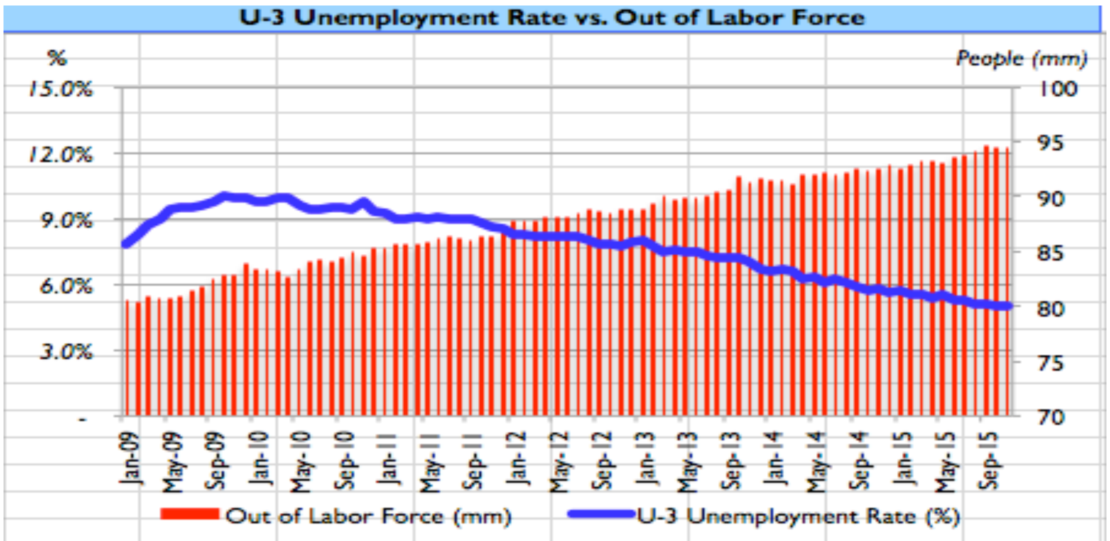
mathematical fiction and the jobs created have not made any significant impact on wages, which is needed for true growth.

Chart I. Unemployment and Labor Force



As seen in Chart I. the unemployment rate is down to 5%, which has historically signified full employment. What have increased to record levels are folks out of the labor force. Several have argued that the increase is the result of Baby Boomers retiring. Unfortunately, that is not supported by reality. The number of 55+ in the work force has increased not decreased. Additionally, the labor participation rate has fallen to 62.8%, lowest in decades.

A strong unemployment number is not reflected in the GDP output. Since the recession ended GDP growth has averaged 2.2% (through the end of 2014) roughly half of the recovery of other recessions.

Table IV. Economic Recoveries – 5 Years out of Decline

Period		Avg GDP Growth
1934-1938		6.70%
1983-1987		4.60%
1976-1980		3.70%
2010-2014		2.20%

Now as the weakness continues we are seeing news signs of an economy on life support. New layoffs are being announced. Wal-Mart had announced it will close 269 stores, 154 in the U.S affecting about 10,000 employees. Johnson and Johnson have announced a workforce reduction of 3,000. DuPont has also indicated it will reduce staff by 1,700 people. Concurrently, President Obama has announced that no new leases will be signed with coal companies in his attempt to shut down the entire industry. It will add to growing list of those unemployed. Calls will resume for a higher mandated minimum wage as the presidential election heats-up.

The auto industry has set a record in 2015 with 13.83 million cars sold, on the backs of low interest rates. Unfortunately, 51 million cars were recalled for various issues. In addition, a new trend may lower car sales. The advent of Zipcar or car sharing can save stretched middle class family's budget around 5% by sharing rather than owning. A trend that needs to be followed as it will also impact interest income on auto loans for financial institutions. Many other capital sparing developments are in progress that will have the effect of lowering economic output and employment.

Housing which was the engine for economic growth in the 2000s (as well as its demise) is still struggling despite a zero interest rate policy and easing of lending standards. Housing starts and building permits weakened at the end of 2015. Now as we head into 2016 the possibility of higher rates and stagnant income looks to keep the housing market flat.

Other weakness in the industrial and manufacturing sector are being revealed as well. The ISM manufacturing index reported a level of 48.2 in December, the lowest since the recession. Railroad cargo has dropped 5.1%, the most in 6 years. Industrial Production in December fell for the third straight month as did Capacity Utilization.

The Presidential election is heating up. The Republican field is finally narrowing and the Democratic nomination now appears to be a race and not a mere coronation. The prospect of FBI recommending charges against Hillary Clinton for the server shenanigans is gaining traction. Many strategists post a chart of stock market returns based on presidential year and party. This year we may see those charts tossed aside. Voters have choices unlike any other time in history. For Republicans, the front-runner seems to be Donald Trump (Accepting polls at face value), a businessman who has never held political office. On the Democratic side Bernie Sanders, a socialist is gaining traction. Things won't be settled until the summer but it should provide plenty of entertainment. While amusing at one level either candidate will face a variety of hurdles and growing unrest, domestically and globally.

Spending will be a big topic regardless of who wins. The U.S. is currently nearing $19 trillion in debt. The CBO in recent weeks has revised the fiscal outlook for the U.S. and rising budget deficits and growing debt seem to be the order of the day. Next add the burgeoning student loan problem on top of the public pension deficits along with the Medicare and Social Security issues and the economy and tax system will be overwhelmed. Bankruptcies may likely be an everyday occurrence for student loans and municipalities paying enormous benefits. The make the "wealthy pay their fair share" will add to the unrest that is already enveloping the U.S. due to policies that pits one group against another.

Outlook

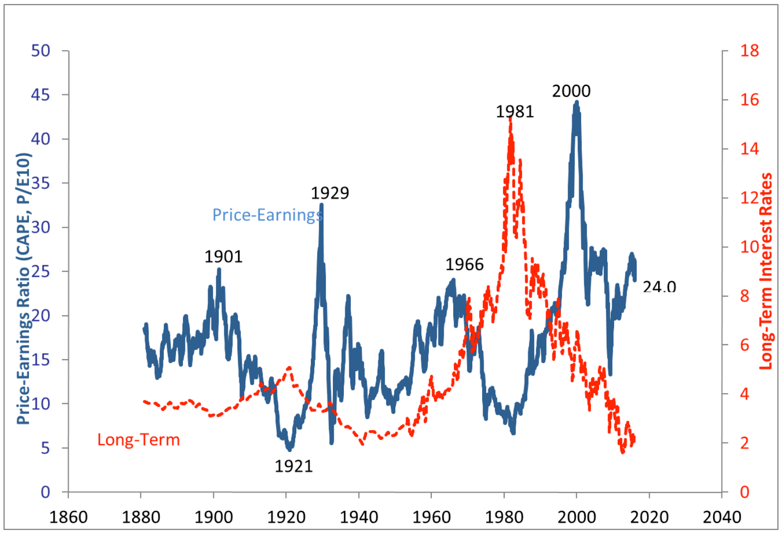
Since 2012 we have been warning about the possibility of the global economies slipping into another recession and the accompanying decline in the equity markets as the central bank policies for the past 8 years have essentially failed to spur growth. Regulations and easy money have made limited growth while fueling another asset bubble. Governments still believe they can fine tune the economy and not have any negative consequences. Additionally, political unrest is growing and in some instances being imported into various countries. The unrest will grow as the food and water crisis remain unsettled.

The decline in oil prices will add to the tensions. It will also increase the radicalization of terrorists as the oil money, which flowed generously at $100/bbl, is leaving many young jobless and poor at $30/bbl. This tension will increase as oil may dip to $15-20/bbl for a short period of time.

The spending spree in the U.S. is unsustainable and there is an increased risk that the economy will slide into a recession in 2016. The promises of free things will fade and those who felt entitled will become agitated and we may see an increase in them acting out their rage. None of which will help grow the economy nor increase investment markets.

The markets are now at the stage where the Fed's action is nearly irrelevant. Valuations remain historically high and "buying the dips" has become quite risky. Valuations over the past years have amounted to nothing more than the popularity of a company being chased by a crowd of investors. Investors now no longer sneer at valuations. In our November Monthly Comments (Deer Season) we warned of a possible decline of 50% in stocks. Stocks have since sold off 10% from its peak. Approximately 72% of stocks in the S&P 500 returned flat to negative returns in 2015. That warning remains in effect. S&P 500 earnings will report a decline in earnings of approximately 4.7%. The decline led by an estimated decline of 66% in energy sector and a decline of 25% in the material sector. Current estimates for 2016 are for earnings to grow about 8%. Coincidently 8% is the long-term growth average for earnings and is likely to be subject to downward revisions thought the year.

Chart II. Historical P/E and Interest Rate Levels



Source: http://www.econ.yale.edu/~shiller/data.htm

In the above chart we see that the Shiller P/E ratio is still trading above its long-term average of 16.5. One might observe that under low interest rates the market will trade at higher valuations. The last time interest rates were at current levels the S&P 500 was still trading on a P/E basis 30-40% below current levels. In past cycles, rates have not been artificially held low creating little economic growth but an asset bubble.

Asset Allocations

Our outlook for 2016 remains guarded and preservation of capital remains our primary concern. The trifecta of a presidential election unlike any before, growing terror and domestic unrest and the reversing of years of poor monetary policy will put extreme pressure on the economy and the investment markets.

Equities		18%	Alternatives	32%
U.S.		8%	Hedge Fund	12%
Developed Global		8%	Private Equity	20%
Emerging Markets		2%		
			Real Assets	22%
Fixed Income		18%	Real Estate	12%
Municipals		12%	Farmland	5%
Global Bonds		3%	Commodities	5%
High Yield		3%		
			Cash	10%

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Investments

Equity investments are likely to continue to experience high volatility. Unless there are some extreme positions changes globally to reverse course from the weak economic environment, we expect equities to be weak and may trade down another 25-35%. From a strategic view an investor should wade in slowly into the equity markets and wait for capitulation before holding full weights, especially in Emerging Markets.

In the fixed income asset class, interest rate policies remain unclear. Muni bond buyers should not chase yield by extending out on the yield curve. Muni underwritings may need to reflect higher coupon rates as state and local governments may need to shore up their budgets. Spreads in high yield have increased 100 basis points from the summer lows to over 500 basis points (around 400 ex-utility and energy). Although a distance from the 800 bps spread in 2011, there are attractive areas for those seeking a higher level of income. Keeping the high yield bonds to a very short duration will keep volatility to a minimum.

Although we have listed hedge funds under alternatives asset class, in the current market, they may be more useful to protect capital and reduce risk. The key will be find managers that can make money in up and down markets and are not merely leveraged long only funds. Private equity, although a long-tailed asset may provide better valuations and equity exposure which will be less subject to market gyrations. Private equity investors may also be a source for higher interest rates for those who might want a level of income in addition to their equity exposure.

Real assets typically do well under rising inflation. It is very unlikely that on a global basis we will see roaring inflation. Despite that expectation real estate and some commodities will offer diversification and returns that are uncorrelated to the public markets. Although we do not expect single homes demand to grow, apartments and commercial spaces are seeing increasing demand and growth. Additionally, in a more specific real estate type asset, farmland remains an attractive place to invest. Farmland has had positive annual returns for the past 24 years with an average annual return of 12.2%. Statistically one should expect a retracement of those gains however the ongoing food crisis continues to support that growth.

In the commodity sector we would expect the agricultural sector to recover as the food and water issues are having a global impact. Industrial metals and soft goods may underperform. Precious metals, primarily gold and silver are showing surprising strength. China despite its economic issues has imported 862 tonnes of gold in 2015, an increase from 813 tonnes in 2014. As global unrest increases it is quite likely investors will add to their holdings of gold and silver.

We also think it may be prudent to hold some level of cash in a portfolio until there is more clarity in the investing markets. A cash holding while earning essentially zero will hedge the portfolio and offer dry powder when the economic and market smoke clears. Remember from a capital preservation position, if your portfolio declines 50% (easier math) you will need to subsequently return 100% to get back to par. Maintaining the portfolio value in the long is helped immensely by protecting against large downside losses.

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