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QUARTERLY INVESTMENT OUTLOOK
JUNE 2015

SUMMARY

- Dollar strength should fade.
- Fed Bank of Atlanta's GDP tracking model puts 2Q15 growth at 0.8%. Our base case is the U.S. economy will struggle to grow above 2-2.5%.
- We are revising earnings growth for 2015 to flat from +6%. Margins are pressured by lack of pricing power and rising wage costs.
- Treasury yields could drift lower over next several months if oil prices reach a plateau and the FOMC members revise their Fed funds forecast ("dots") lower.
- Given that equity valuations are elevated, our portfolio strategy is defensive. We are seeking alpha in select foreign markets, energy, health care, and financials. Maintain core position in investment grade corporates. Hold gold miners as a hedge against market volatility and a weak dollar.

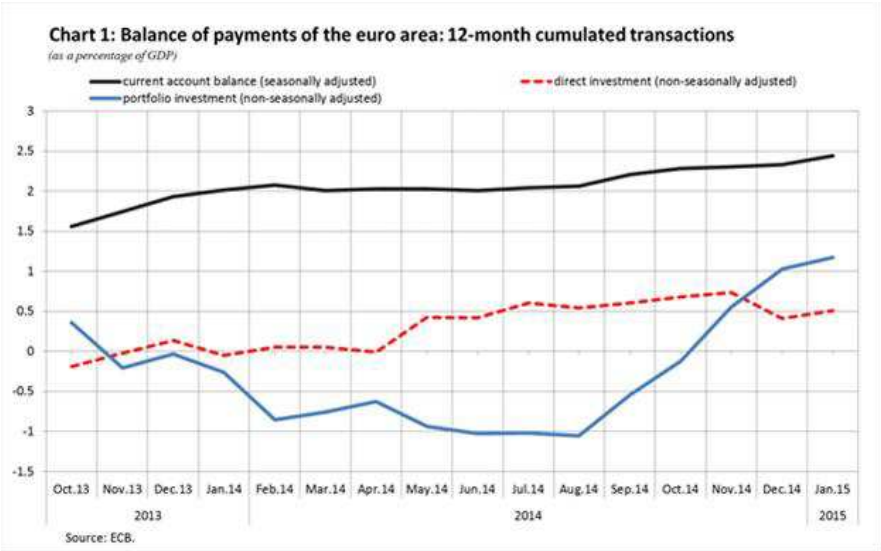
MACRO TRENDS

The Fed seems determined to begin normalizing interest rate policy later this year. This has raised interest rate expectations, placing renewed upward pressure on the dollar, which has lead to a correction in commodities. Is this the beginning of renewed uptrend in the dollar? We reject this notion.

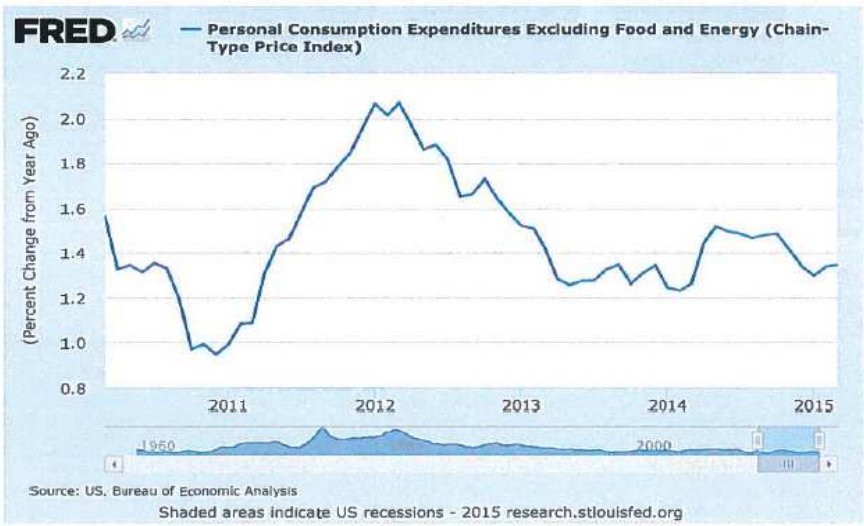
Ultimately, currency trends are a function of real growth, interest rate differentials and balance of payments. U.S. real growth 1Q15 was at -0.7% and The Federal Reserve Bank of Atlanta's tracking model projects 0.8% for 2Q15. According to Eurostat real growth in the Euro Area was at 0.4% in 1Q15, having trended higher for three consecutive quarters. BCA Research is projecting real growth of 1.5% for 2015. Despite improving growth, we believe the ECB will continue its policy of Quantitative Easing. The surprise could be that the Euro area further strengthens, reflecting an increase in credit

availability, a weak Euro, and lower oil prices. The lack of Euro area bond issuance in the summer, coupled with ECB purchases, should place downward pressure on Euro area interest rates.

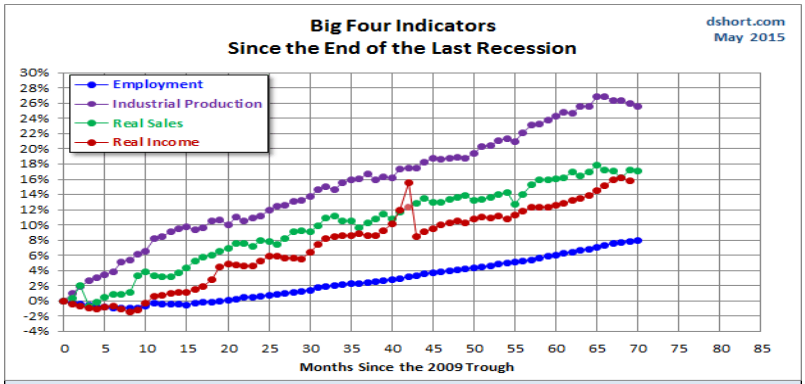
Through 4Q14, the U.S. current account was -521.7 billion dollars or -2.9% of nominal GDP. This contrasts with an estimated current account surplus of 2.5% for the Euro Area. Balance of payments analysis lends support to the euro versus the dollar.



A strong dollar is a drag on U. S. exports while simultaneously pressuring import prices. The net result is deflationary for U.S. economic activity. Net exports subtracted -1.5% from 1Q15 GDP. A recent IMF study concluded that a 10 percent upward move in the dollar is the equivalent of a 1 percent rise in interest rates. The Fed is very much concerned with recent dollar strength. Chairwoman Yellen has repeatedly emphasized price stability as a prerequisite for monetary tightening. The chart below shows the PCE core inflation rate at 1.3% yoy. It is premature to conclude that inflation has bottomed.



With weak growth forecast for intermediate term, we find it odd that the Fed is emphasizing interest rate renormalization, a strategy that has contributed to dollar strength and increasing deflationary pressure. Moreover, the near term economic outlook is for weak growth. The table below is a summary of trends in employment, industrial production, real sales and real income. These four indicators were watched closely by Dr. Geoffrey Moore, a founder of the National Bureau of Economic Research, as key drivers of business cycle trends.

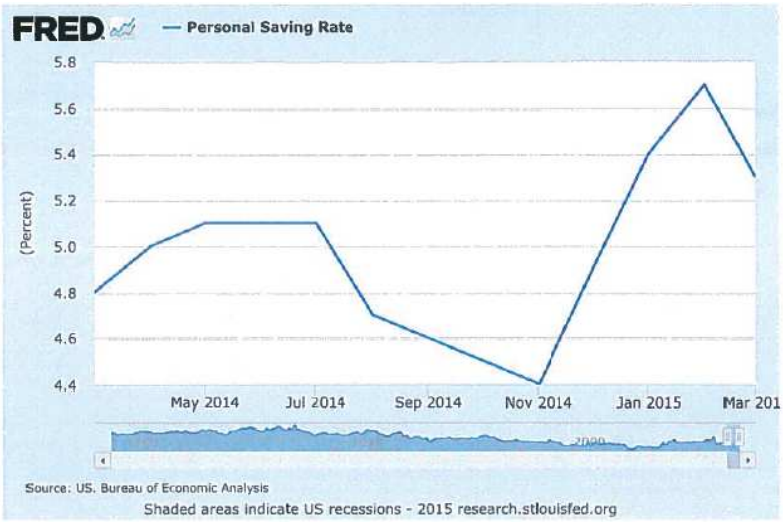


Big Four Indicators Month-over-Month

Indicator	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Employment	0.17%	0.21%	0.18%	0.15%	0.18%	0.16%	0.30%	0.23%	0.14%	0.19%	0.06%	0.16%
Industrial Production	0.48%	0.41%	0.35%	-0.02%	0.70%	-0.04%	1.08%	-0.05%	-0.34%	-0.06%	-0.32%	-0.26%
Real Sales	-0.01%	0.09%	0.08%	0.66%	-0.41%	0.38%	0.80%	-0.54%	-0.09%	-0.75%	0.89%	-0.10%
Real Income	0.00%	0.17%	0.23%	0.40%	0.13%	0.34%	0.64%	0.51%	0.66%	0.23%	-0.27%	

Employment is released the first week of the month, Income the last week, Industrial Production and Sales mid-month.

Most of the weakness, over the past several months, was concentrated in industrial production and real retail sales. The weakness in production was impacted by the rising dollar as export orders weakened. Electricity output is declining, contributing to the weakness in production. The softness in real spending may be related to the rise in the personal savings rate, shown below. Since November, 2014 the savings rate has increased from 4.4% to 5.3%.



Given lower oil prices, expectations were that consumers would increase their spending, but it appears as if most of the windfall from lower energy prices may have been saved.

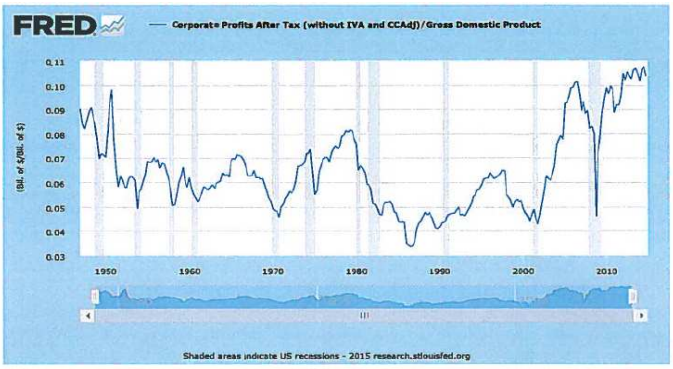
Bottom Line: The Fed will lower its interest rate expectations implicit in the dots curve, thereby further delaying, perhaps into 2016, an increase in Fed funds. This action should allow bond yields to drift lower, and the dollar to weaken.

OIL PRICE - Update

Latest Energy Information Agency forecast calls for an oil production decline (June/May) of 86,000 bbl/day for the seven major shale producing basins in the U.S. This follows a 60% decline in North American oil rigs from a peak of over 1600 last October. With WTI prices holding close to $60/bbl., we expect continuing production declines over the next several months. Analysts have focused on the large backlog of uncompleted wells "fracklog" as a reason to expect rising production, but we're unconvinced. **First**, 60% of well costs are related to completion. This is significant with well costs averaging $6 million. Shale oil breakeven are $75/bbl. for the Eagle Ford and $85/bbl. for the Bakken and Permian Basins. These are the three most prolific basins. **Secondly**, companies are encumbered by high debt and are generating negative free cash flows at current prices. Hedging helps, but we believe profits will go to debt reduction. **Third**, much of the recent price correction is related to renewed dollar strength, which we believe should gradually fade.

THE STOCK MARKET - Fundamental Trends

Our fundamental analysis of earnings, a key driver in valuation models, is that profit margins (see chart below) are peaking. Top line growth mirrors that of nominal GDP at 3.6%. Wage costs are rising at a 3% annual rate, while pricing power is expanding at 1 percent. With the unemployment rate trending towards 5%, wage costs should continue moving higher. As such, profit margins should decline from peak levels of 10.5%. We are revising our earnings expectations downward from +6% to flat for 2015. Moreover, visibility into 2016 is clouded with the Fed set to raise interest rates. Consensus estimates of $133 for 2016 seems too high. Our starting estimate for 2016 is $125, which computes to an estimated P/E ratio of 17x. While above the historical mean of 14.5x, the estimated P/E ratio doesn't appear excessive when viewed in the context of a 2% 10-year treasury yield.



Reflecting the weak profit outlook and full valuation level for the S&P 500, we are maintaining a defensive investment strategy. Recent additions to our defensive holdings include pharma, soft drinks, food producers, and regional banks. However, due to attractive valuations, we are maintaining exposure to energy, gold and copper miners. These deep cyclicals tend to track trends in the dollar. As such, any weakness in the dollar should have a favorable impact on these positions.

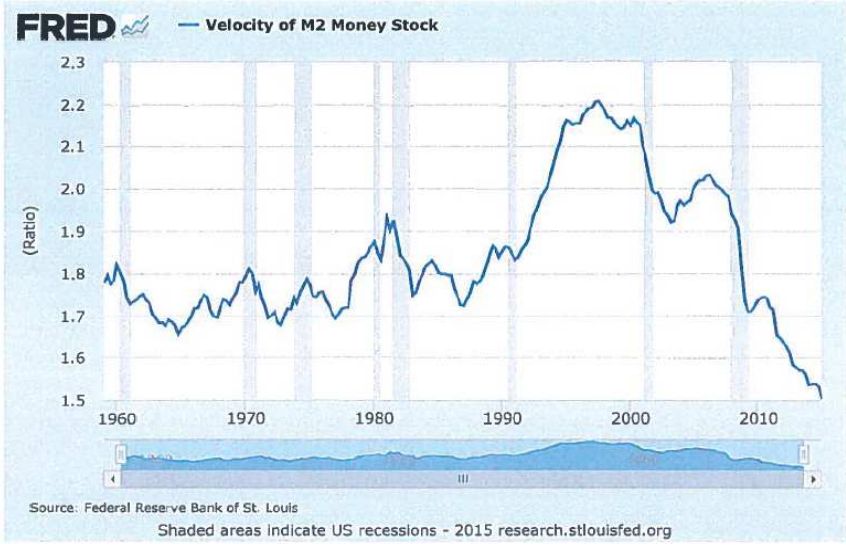
BOND MARKET

The 10-year U.S. treasury bond yield traded down to 1.65% in late January and touched a recent high of 2.35% in May, before declining to its current level of 2.16%. The yield curve has steepened since late January. The 5-30 year spread rose from 107 basis points to 143, while the 2-10 year spread rose from 119 basis to 159 basis. A steepening in the yield curve is usually associated with stronger economic activity, which we would expect to be evident by the second half of 2015.

Since late January, 10-year bund yields rose from 27 basis points to 61 basis points. One reason cited for the sharp rise, much of it taking place in May, was that the trade had become crowded. Another factor was the net issuance of eurozone government debt turned positive in May. Both Citigroup and Deutsche Bank forecast positive issuance for May and June, before turning negative in July. We believe supply conditions will be favorable for eurozone bonds over the summer, which could lead to lower bond yields. The ECB is well aware of this supply constraint and has already begun by front loading its purchases in May/June at $60 billion euro. Greek turbulence has also contributed to the recent volatility in eurozone bond yields. This may be the major contributing factor to the selloff in global bonds.

Dr. Lacy Hunt, of Hoisington Management, argues that zero interest rates are a reflection of a broken monetary policy (see chart on page 6). Private plus public debt have reached a level relative to GDP (close to 300 percent) where economic growth is constrained. This occurs because of the compounding effect interest has on the ability to issue new debt and the organic growth of debt from fiscal deficit financing. Should interest rates rise, this combination could prove lethal. In effect, as Martin Barnes of BCA Research argues, the debt super-cycle has reached a point where monetary policy is geared to interest rate repression.

The policy of interest rate repression doesn't necessarily mean growth is doomed forever, or that we will ultimately be forced to deal with debt liquidation. It does suggest that until debt/GDP levels are lowered, growth will be subnormal. Much progress has already been made in debt reduction by both household and corporate sectors. The public sector debt overhang is the main challenge going forward.



China - Update

In the past we have highlighted the benefits that financial reforms will have on the Chinese economy. For example, a recent decree will allow municipalities to guarantee their debt through the central government. This will result in less onerous funding costs as they raise capital through legitimate channels as opposed to the current method of shadow financing. This should allow the municipalities to more easily fund necessary infrastructure projects. Although we have spent a great deal of time analyzing how these structural changes will allow for more sustainable Chinese growth, we have yet to delve into how this sustainable growth will lead towards China's integration in the global economy. Therefore, it is important that we highlight two recent developments that we expect will continue to buoy Chinese assets.

On the back of the outperformance of the Chinese markets, FTSE Russell has announced that they will include Chinese A-shares in two new emerging market indices. According to the Josh Noble of the Financial Times, this will result in, "A shares [having a] 5 per cent weighting up from nothing currently. That would give domestic Chinese shares a larger weighting than Russia and a similar weighting to Mexico in the FTSE emerging market index". MSCI, which is the most renowned international benchmark, will decide on A-share inclusion on June 9th. As more benchmarks include Chinese equities, passive managers will be forced to buy an appropriate amount of Chinese equities just to match their benchmark allocation. As China continues to grow so will its weighting in the indices. This should increase demand for Chinese equities regardless of their valuations.

Secondly, a goal of the current government is to have the renminbi included in the IMF's basket of reserve assets, which is known as the special drawing rights. As a result they have undertaken reforms that have allowed for increasing convertibility of the currency. Recently they allowed, "individual Chinese and businesses to directly purchase stocks, bonds, and real estate in foreign markets," (WSJ 5/29/2015). As the renminbi becomes more freely convertible, we would expect Chinese stocks to more easily pay dividends to international shareholders. This will also begin to be discounted in the prices of Chinese equities.

We remain overweight Chinese equities and favor the H-shares over the A-shares due to the approximate 30% valuation discount.

RISK FACTORS

- Fed commits a policy error by raising rates prematurely
- A Greek technical default leads to global equity correction
- A renewed decline in commodities
- China's growth rebound stalls

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