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QUARTERLY INVESTMENT OUTLOOK
SEPTEMBER 2016

SUMMARY

- Fed policy appears to be shifting toward price level/nominal GDP targeting. A price level targeting policy is geared to raising inflation expectations, thereby creating a backdrop conducive to increase spending. Maintain core TIPS holdings as a hedge.

- Treasury yields are at risk of moving higher. We calculate "fair value" at 2.3%, using the 10-year maturity. An overshoot to 2.5%+ would create a buying opportunity.

- The oil markets have largely rebalanced according to energy analyst Matt Conlan, at BCA Research. We believe there is increasing risk of a spike upwards in 2017.

- Global growth is stagnant, but marginally positive. Policymakers in the U.S./China, which collectively account for roughly 38% of global GDP, are slowly shifting to targeting more stimulus via fiscal thrust.

- The S&P 500 has entered an overshoot phase, which could ultimately reach 2400. Over the intermediate-term the market is overbought and may consolidate/correct its recent gains above 2050.

- We are maintaining our defensive industry core holdings, while selectively adding cyclical exposure. Our foreign holdings in China "H" shares, Japan (currency hedged) and Europe offer better value.

MACRO TRENDS

Over the past four years U.S. nominal GDP growth has decelerated from 4.3% to 2.4%, while the GDP price deflator has declined from 1.9% to 1.1%. Over the same period the two-year note yield has fallen from over 4% to under 1%, as the savings rate doubled. A slowdown in growth and lower rates has changed consumer behavior. In normal times, a decline in interest rates would result in lower savings. With baby boomers retiring en masse, lower interest rates prompted a sharp increase in savings.

In view of the above, policy makers hit the panic button, which in our view only exacerbated the trends to weaken growth. Three injections of QE helped drive equity prices to all time highs, as investors believe QE4 is the new "Greenspan put." Meanwhile, corporate executives have reacted to a weakened economy by substituting $500 billion per year in equity buybacks for corporate investment. This has contributed to both a decline in our capital stock to GDP ratio, while driving productivity to a meager 0.5% annual rate.

Moreover, the inexorable result of these misguided policies have generated a great income divide. Corporate executive salaries/benefits have risen to over 300 times that of average workers. Inflation adjusted wages have stagnated since the Great Financial Crisis. Both Clinton and Trump are trying to win the election by promising a sharp increase in fiscal infrastructure expenditures. While our airports, roads, bridges and tunnels could certainly benefit from modernizing, we question whether the private sector wouldn't be better equipped to get the job done more efficiently. Martin Barnes, a senior Managing Editor of BCA Research, believes there is ample private savings to finance infrastructure bonds. We agree with Larry Kudlow, a current CNBC business commentator, that a significant reduction in corporate taxes to 15% from 35%, financed by a 5% tax on repatriation of corporate savings held abroad, would be good policy. Lowering individual taxes, by implementing a flatter tax, would reduce "inflation creep", present in the current progressive tax system. The supply side combination of lower business and individual taxes would benefit growth. A secondary benefit would be lowering our debt/GDP ratio (corporate, household and government) which stands at 250%. More growth would reduce the burden of normalizing interest rates from the Fed to the natural forces inherent in shifting the investment/savings equilibrium balance higher.

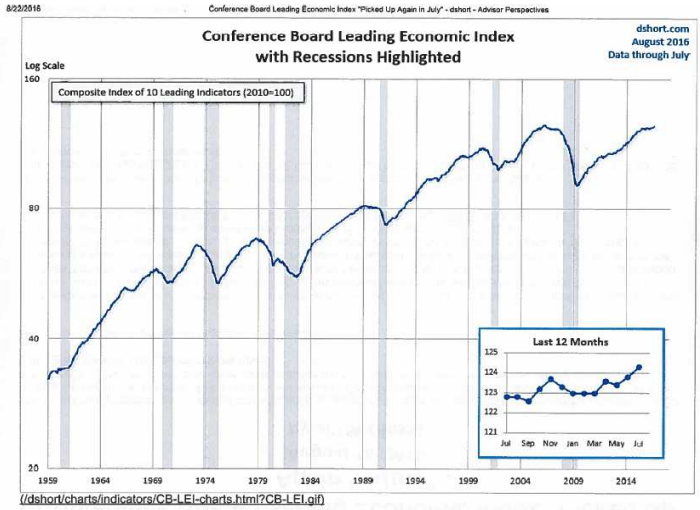
As discussed by Dr. Peter Berezin, Global Strategy Editor at BCA Research, the current populist uprising is likely to differ from previous "soak the rich" movements. Reducing income inequality, modifying agreements to ensure fair trade, protecting main street from costly bank bailouts, and reducing fiscal austerity, could be long-term benefits for economic growth. As Berezin suggests, the implementation of the Dodd-Frank Act insures that banks are more likely to resemble utilities than "casinos" in the future. He cites an IMF paper, which concludes that rising income inequality has reduced the level of real consumption by 3.5% between 1990 and 2013, equal to more than one year of spending. This reduction in aggregate demand also contributed to the decline in interest rates, which effectively served as an offset. The issue of "trade fairness" is also valid when one considers that,

according to the U.S. International Trade Commission, the proposed TPP (Trans Pacific Partnership) Agreement would boost the level of real GDP by only 0.2% after 15 years.

In the end, the outlook for the financial markets will depend on how populist policies are implemented. If they're supply driven, the outcomes could extend the current investment cycle. On the other hand should they evolve into a tax and spend sequence, financed by more money printing, the investment cycle could be shortened. In this scenario the endgame would be more currency devaluation and another financial crisis. Stay tuned!

CURRENT ECONOMIC TRENDS

The latest Conference Board Leading Economic Index increased 0.4% to 124.3 from June and stands 1.8% above year ago levels. In the latest six month period the index grew at a 2.1% annual rate. This suggests that a period of moderate economic growth should be sustained through yearend 2016. A spokesperson for the Board said "there may even be some moderate upside growth potential if recent improvements in manufacturing and construction are sustained."



Doug Short (dshort.com) reports that the National Bureau of Economic Research Business Cycle Dating Committee emphasizes four "big indicators" that the committee weighs heavily in their cycle identification process. The latest trends in the big four are shown below:

Months Since the 2009 Trough

Big Four Indicators Month-over-Month

Indicator	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Aug
Employment	0.11%	0.10%	0.21%	0.20%	0.19%	0.12%	0.16%	0.13%	0.10%	0.02%	0.20%	0.18%
Industrial Production	0.10%	-0.26%	-0.14%	-0.64%	-0.42%	0.48%	-0.13%	-0.97%	0.46%	-0.16%	0.42%	0.74%
Real Sales	-0.13%	0.14%	-0.22%	0.16%	0.55%	-0.56%	0.45%	-0.40%	0.81%	-0.05%	0.61%	0.33%
Real Income	0.33%	0.20%	0.36%	0.14%	0.37%	-0.17%	-0.18%	0.19%	0.07%	-0.01%	0.12%	

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

While industrial production (coincident indicator) picked up strongly during August, both incomes and spending (adjusted for inflation) were weak. Measured on a yoy rate of change basis, both income and spending are expanding at 1.6% and 1.4% respectively. Both have slowed sharply over the past six months and should be monitored closely.

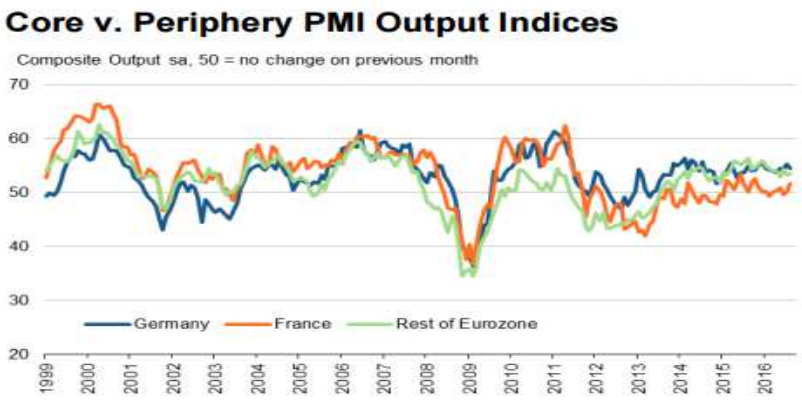
Our analysis above indicates that the business recovery remains intact but is proceeding at a tepid rate. With inflation running at 1.7% yoy rate, as measured by the personal consumption expenditure price index, we don't see any pressing need for the Fed to raise rates. While the expansion remains subpar when compared with those pre-GFC, it may last longer than generally expected.

EURZONE UPDATE

We remain bullish on select European equities. Their markets trade at a significant discount to ours on both a price-to-book and Shiller P/E basis.

Moreover, global macro factors make this a timely investment. For instance, the Citigroup US Economic Surprise index has hooked downwards towards the zero bound, while the Citigroup Economic Surprise Index for the G10 remains in positive territory. This is indicative of relative outperformance from past economic readings emanating from Europe relative to the United States.

The Brexit vote appears to have had little impact on European business activity. Augusts' Flash Eurozone PMI Composite Output Index nudged up to 53.3, a seven month high. The survey data are consistent with the region's GDP growing at an annualized rate of 1.6% for the second quarter, which is greater than the 1.1.% growth logged by the United States. Germany remains the European growth engine, but future growth will be more broad-based as France's PMI Output has recently hooked up, while the rest of Europe continues its modest expansion (below). Stronger European growth relative to the US is dollar-bearish in the near term.

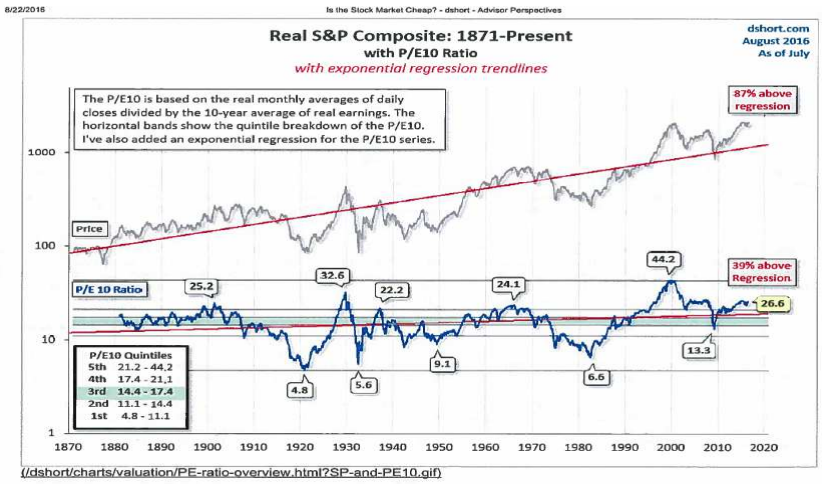


Source: IHS Market

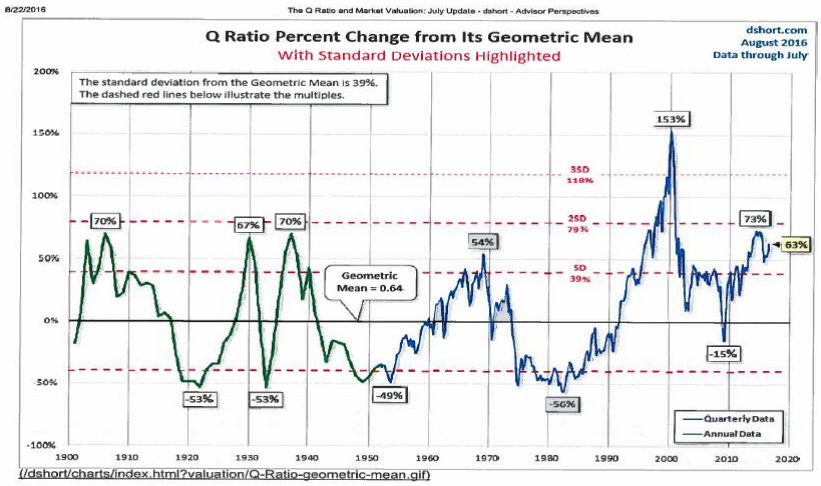
STOCK MARKET

The equity market has entered an overshoot phase, as measured by both the Cyclically Adjusted Price Earnings Ratio and the Tobin Q Ratio. Both, taken together, are consistent with forward total returns of 4.5% over the next twelve years according to BCA Research.

The chart below, courtesy of Doug Short, shows the CAPE-10 Ratio plotted back to 1870. Only twice in the previous 146 years has this measure of equity value been higher, i.e. 1929 and 2000. At its current level of 26.6x the ratio is in the 5th percentile of observations and 39% above its historical regression line.



Another useful measure of equity valuations is the Q Ratio, developed by Nobel Laureate James Tobin. It measures the total market value of equities divided by the replacement cost of all its companies. Warren Buffet has developed a simpler version, which compares the market value of the Wilshire 5000 equity index to GDP. Both measures show similar results.



The Q Ratio is shown above since 1900. The present value of the Q Ratio is 1.04, as of July 2016. This places the ratio 65% above its geometric mean, which is greater than 1.5 standard deviations.

It should be noted that both the CAPE-10 and Q Ratio compare equity valuations in the context of long-term time horizons and are not useful for short-term investment forecasts. In this regard, BCA Research has used both ratios as well as six others to calculate expected market real returns for 23 countries over the next 10 years. The U.S. ranks 16th with an expected real return of 4%.

ENERGY

- The oil market should rebalance in the second half of 2016, driving prices towards $55 per barrel by yearend.
- Oil will trade in a range of $55-65 per barrel in 2017 as shale oil production stabilizes and OPEC is unable to increase output. Prices will be constrained from moving higher as global stockpiles are drawn down.
- A supply shortage could emerge in 2018 as insufficient investment limits production growth, while inventory reduction intensifies. This may open the door to a price overshoot.

BCA Research believes that the oil market will rebalance by 4Q16. The rebalancing will be led by falling production in shale plays, lower output from select OPEC countries (Nigeria due to infrastructure attacks and Venezuela due the collapse of the socialist state), and global oil demand growth of 1.45 million barrels per day (MBPD) for 2016. Shale oil's capital constraints have prevented many firms from investing in new drilling, which has resulted in the rig count decreasing from 853 a year ago to 404 on May 20, 2016. This problem is compounded by the fact that oil output from shale wells declines by an estimated 40% per year. We expect that this will cause shale output to decrease by 1 MBPD by the end of 2016 to roughly 4 MBPD. This decrease has been partially offset by a ramp-up in Iranian production, a one-off event. This is evidenced by a recent plateauing in their production at a rate of 3.85 MBPD, which is below their pre-sanction rate of 4.0 MBPD.

Shale production should begin to stabilize in 2017, but the process will take longer than many expect. Matt Conlan, the Energy Sector Strategist at BCA Research, highlighted that it will take new wells between 4 and 6 months to start producing after their spud date. This is two months longer than the market anticipates as exploration and production (E&P) firms have refined their drilling process. It will

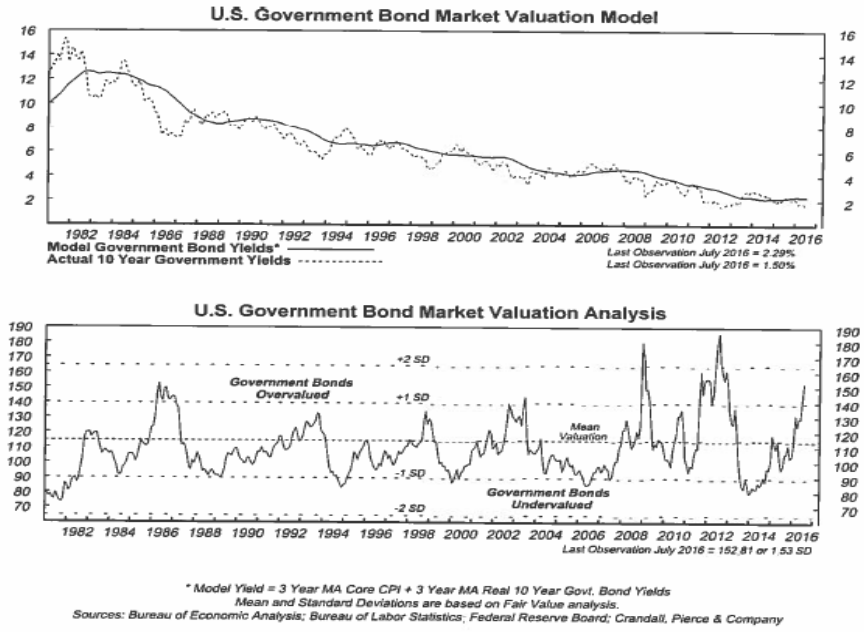
take an additional six months after the rig count begins to increase to curtail production declines from older, less efficient wells. Thus, shale oil production shouldn't even stabilize for another 6 to 9 months. Conlan estimates that it will take another 12-18 months to increase production by 1 million barrels per day. Meanwhile, global demand is likely to grind higher at a rate between 1.5 and 2%.

A study by Wood Mackenzie highlighted that investment in the development of oil and gas resources from 2015 to 2020 will be slashed by $740 billion and that exploration spending will be cut by an additional $300 billion. We anticipate production growth ex-shale to remain underwhelming due to the trillion dollar curtailment in investment. In fact, oil prices persistently in the $55-65 range will favor shale producers at the expense of OPEC producers. Although OPEC producers may be able to extract oil for as little as $10 per barrel due to their prolific basins, it is impossible to disaggregate many of these nationalized firms' (i.e. Saudi Aramco) costs from the fiscal burden imposed on them by their governments. In order to maintain social order, OPEC government proceeds from oil production and refining will necessitate higher global prices. Case in point is Venezuela, which is responsible for 2 MBPD in output despite its precarious economic position. Any further deterioration in its economic situation could result in a 2 MBPD supply deficit in the oil markets. This is a comparable figure to the 2 MBPD surplus that sent oil from $115 per barrel to $26 per barrel. **For this reason we feel that price risk remains firmly to the upside.**

We anticipate that further productivity gains will continue to decrease domestic E&P breakeven rates and that many of these firms will become cash flow positive at $50.00 per barrel. However, the sector will remain starved of capital as many smaller firms are overleveraged and debt maturities loom large. We believe it prudent to overweight E&P firms that are able to maintain or increase production, that own the lowest cost basins (Permian, Midland, Eagleford), that are at the forefront of technological advancements, and that maintain sufficient liquidity. Underweight oil refiners that will suffer from thinner crack spreads and higher global refinery capacity. Similarly, underweight oil service companies until rig deployment accelerates, and when it does, favor shale rig operators with the strongest technology.

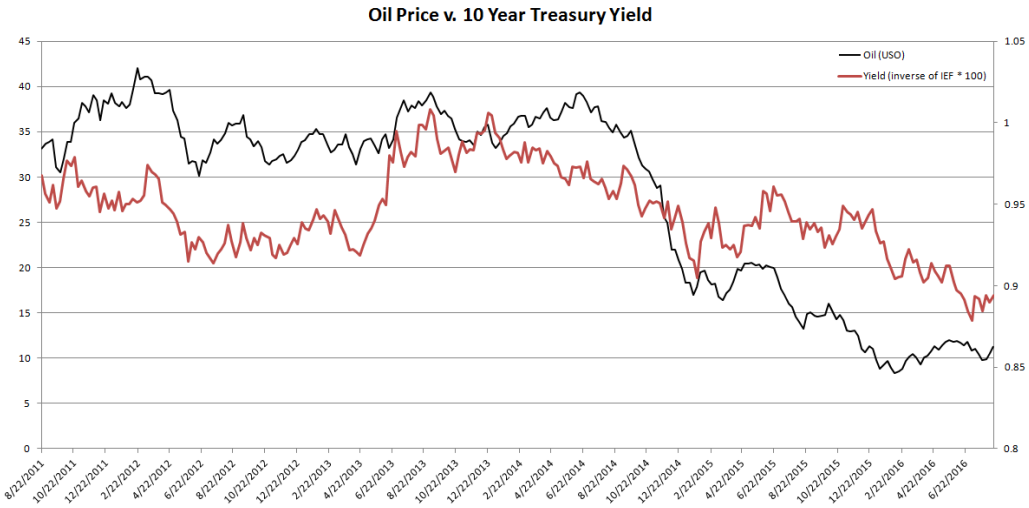
THE BOND MARKET

The U.S. bond market is fully valued. Our Bond Market Valuation Model has an excellent record of tracking the 10-year U.S. Government yield. The Model showed a "fair value" 10-year yield of 2.29% a/o 07/31/16. With the actual yield at 1.50%, it was trading at 1.5 standard deviations below fair value, signaling a significant degree of overvaluation.



As noted above, we expect a continuing recovery into 2017. U.S. leading economic indicators are trending higher with both manufacturing and service oriented purchasing manager indices expanding above 50. Moreover, the new orders/inventory indicators from both series are expanding. In addition, core derived inflation, measured by both the consumer price index and the personal consumption expenditure price are rising at 2.2% and 1.7% respectively.

Our target level for the 10-year treasury yield is 2.5%. Should the yield rise to this level, we would view this as a potential buying opportunity. We believe the potential GDP growth rate is 2%. Yields above 2.5% would be restrictive, resulting in a significant tightening of financial conditions. The study below highlights the strong correlation between energy prices and treasury yields. In fact, an R^2 of 0.42 indicates that 42% of the move in yields is dependent on the move in oil prices. The expectation of higher oil prices lends support to our thesis of an increase in yields.



RISK FACTORS

- A premature tightening of monetary policy
- A spike in oil prices above $80/bbl.
- The S&P 500 reaches an extreme valuation of 20x p/e.

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September 2016