INVESTMENT OUTLOOK

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RATIONALIZING UNCOMFORTABLE CHOICES

- Equities should outperform bonds by 5-7% over the next year as Treasury yields rise toward 2.5% and interest rates are hiked at least twice in 2016. Global equity returns exceeding 5-7% will be more difficult with valuations closer to normal now. Moderate economic growth isn't exciting, but remains sufficient for economies with still resilient profit margins and productivity. Despite June's equity volatility, our global tactical equity models remain constructive for the next year. Transitory effects of plunging oil prices and U.S. dollar appreciation, which gutted energy earnings and inflation is underappreciated, but the impact of these effects is sunsetting now.

- Global bond markets are significantly overvalued with negative real yields, particularly in the U.S. and U.K. where economic growth is better and inflation is increasing. Negative interest rates for German Bunds and Japanese Bonds can't be sustained, well below 2009 lows even as inflation firms. We recommend underweighting bonds, overweighting cash, and minimizing interest rate sensitivity, favoring shortr maturities and floating rate securities.

- Investors need to be vigilant about the impact of rising U.S. rates on global bonds and other rate sensitive investments. Emergency monetary policy is no longer needed, thus we are concerned about the impact of interest rate normalization and eventually winding down central bank holdings. Treasury 10-year bond yields need to rise above 5% to normalize vs. normal inflation, while steady interest rate hikes proceed with every other meeting or 1% per year.

- While some investors suggest low interest rates and flatter yield curves are a sign that economic growth is slowing or slipping into recession, these relationships are misleading. Global imbalances due to central bank interventions persisted over an extended period and must correct. Financial reform of market makers has intensified fixed income illiquidity risk, which is difficult to measure.

- Waiting for valuation corrections is uncomfortable, such as waiting for equities to correct in 1999-2001, but patient investors should be rewarded. We underestimated the effects of foreign demand for Treasuries, expecting yields to rise this year, not fall. Instead, imbalances increased with continued explicit central bank manipulation of market prices, which drove global 10-year yields below 2008 crisis levels. Hedging currency risk is an easier decision as long as European and Japanese central banks continue quantitative easing. Repricing of global bonds presents the greatest danger to the world economy.

- Britain voted to *Leave* the European Union (EU) after over 40 years. It is a remarkable decision worth taking the time to understand why membership in the EU Common Market no longer served their best interests. This decision has little near-term economic impact, but reflects anxiety about underperforming economic potential. Our outlook is distinct from consensus, being more constructive about the U.K.. Potential growth should benefit from improved competitiveness, attracting foreign investment.

- Alternative strategic asset allocation policies have lagged traditional balanced strategies. Historically derived asset class volatility and correlation are evolving and unstable, suggesting risk-focused methodologies can yield inefficient investment policy allocations. If the next crisis is rooted in sovereign debt, aggravated by expanding fiscal deficits adding to debt, plan funding risk is higher than assumed.

- *Rationalizing Uncomfortable Choices* begins with how to minimize unintended risks, anticipate consequences of higher bond yields, while improving estimates of evolving asset class volatility and correlation measures. Relative asset class valuations are critically important to consider. Economic uncertainty has increased, and asset owners are presented with many unfamiliar new products that seem appealing, but with limited real-time experience. Structural relationships can change, but "it's different this time" typically never works out well.

Unforced Errors

The *Search for Greater Authenticity* (Q2/2016) was a summons for beginning a conversation about simplifying portfolio construction to encourage more efficient and effective asset management at lower cost. Too often, we have lost track of the things that matter, fail to check the data, or even experiment a little. Many factors have increased uncertainty, including persistently weak growth, high fiscal deficits, market imbalances, prolonged central bank intervention, headwinds of malformed policy decisions, and geopolitical cross currents. Domestic threat of terrorism has increased with indiscriminant ISIS attacks on our homeland and other western nations. Society seems less sensitized to these atrocities as consumer confidence remains resilient. In *Rationalizing Uncomfortable Choices*, the list of pivotal investment questions is longer than ever, but we should begin with minimizing unforced errors and unintended risks.

Many new strategies have stormed the gates of asset owners since the Financial Crisis, yet their practical benefit has often proven allusive. Strategies promise to minimize risk or improve portfolio diversification seem appealing, but may not be efficient and tend to fall short of objectives. Forecasting expected returns remains challenging, but risk has become unstable and is evolving rapidly at a critical interest rate inflection point. Pension Plans that used to hold 60% equity on average, now hold less than 40%---their long duration and leveraged bond holdings are likely more risky than assumed. Shortfall to still high return expectations of 6.5% or more has consequences. Large endowments continue to increase alternative exposures, now over 57%, seemingly oblivious to illiquidity risk and interest rate sensitivity that may compound distress as yields rise. Private/illiquidity risk premiums seeking to be exploited have declined by at least half due to crowding out (too much money chasing a capacity limited asset class), and thus high management fees have become more difficult to overcome. Skill choosing private fund managers with multi-year lock-ups is more difficult to assess and limits rebalancing. Quantifying interest sensitivity of private holdings marked-to-market even quarterly is also challenging at a critical inflection point.

Differentiating genuine innovation from re-labelled old strategies with a subtle twist and maybe less capable or even higher fees is a challenge. Here is a list of some popular trending strategies and their forerunners: multi-asset solutions (global balanced), dynamic allocation (global tactical asset allocation), Robo-advisor (Internet retirement advice), smart beta (quantitative management), risk factor investing (completion fund, style rotation), high conviction (concentrated, 130/30), and risk parity (equal weighting). Investors may stand on the shoulders of giants to exploit a greater number of opportunities with more products, powerful analytical tools, and greater access to data. Unfortunately, the number of choices, required sophistication, and macroeconomic uncertainty has at least paralyzed investor decision making, and likely driven excessive risk aversion.

Multi-factor portfolio risk management provided the basic building blocks for quantitative equity and completion fund management for at least two decades. Risk factors are now available individually as investable ETF products or may be combined in so-called smart beta solutions. Risk factor investing has extended equity style and size factors to include quality, volatility, leverage, dividend yield, carry and other factors. This will be an interesting innovation to watch over the next several years.

Dismantling internal capabilities and resources of asset owners has undermined direct investing capabilities. Indirect benefits and self-reliance require sophisticated investment staff, from making strategic decisions to grappling with market uncertainty. Cost savings of leaner staffing has too often translated into reduced performance and unintended consequences. Consider the 20-year success of the Canadian Model, which exploited direct investing capabilities at lower total cost leveraging peer collaboration, independent boards, and competitive compensation plans for retaining talented staff. Canada's public pension plans outperformed those who are a manager-of-managers (inc., pensions, endowments, foundations) on average. Like-minded sovereign wealth funds enjoyed similar success. Rapidly expanding Outsourced CIO providers should help enable their clients, not just replace their investment capabilities. Asset owners might look North to Canada for a smarter approach to investing.

A simpler strategic policy allocation can enhance liquidity and transparency, which can be managed at lower cost. Active management may be more easily integrated across a larger share of assets. Observe that a simple 60/40 global balanced portfolio matches the performance of the NACUBO Endowment Study return, but with 1% less risk since the study's inception (2002-2015). Over the last decade, this balanced portfolio realized 70 bps higher returns with 1.4% less risk. Similar risk-adjusted underperformance for the Milliman Corporate 100 Pension Funding Study is observed for 2000-2015. These observations challenge the status quo of institutional asset management. Investors should recognize many provocative new strategies often ring hollow, disappointing adopters.

Presumed wisdom driving complexity and alternative exposures should be reconsidered, as the demise of the 60/40 balanced portfolio *has been greatly exaggerated*. We believe global multi-asset portfolios and can be greatly simplified, yet result in more robust objective-driven management. Asset allocation remains the most critical investment decision and it deserves greater attention. More typical asynchronous economic conditions have driven down correlations and increase international country diversification. Strategic Frontier seeks to be a trusted independent advisor to help manage these decisions, while avoiding unintended risks and *unforced errors*.

Many investment trends and regimes have been observed in managing institutional, high net worth, and mutual fund assets over more than two decades. The pendulum swings both ways in various dimensions, but is often disruptive at the most critical time. A rotation between strategy specialization and global balanced management has been gathering momentum with increasing commitments to multi-asset strategies and global allocation funds. The beginning of other favorable global balanced regimes began in 1994 and 2003, also coinciding with interest rate inflection points and increasing dispersion of economic conditions.

I worked alongside many that have since retired, but graciously provided perspective on their decades of experience. Being a fundamental quantitative investor, I have relived the good, bad, and ugly of the post-war era in millions of backtests. The breadth and length of datasets has increased in 25 years since beginning development of our global tactical allocation models for equities, bonds, and currencies spanning 15 countries. We've learned that experience and good intuition matter—experience helps to avoid prior mistakes, but good intuition keeps clients out of trouble in the future.

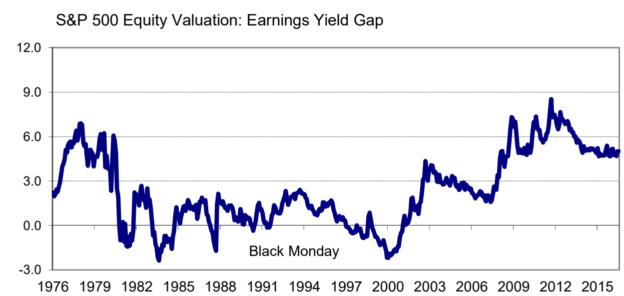
Capital Markets

June was extremely volatile due to an unexpected vote for Britain to leave the European Union. While initial investor reaction was not surprising, we have seen stability restored more quickly than even we expected. Teresa May has become Britain's new prime minister, replacing David Cameron in relatively short order, and promise to move quickly to execute the will of the people expressed in this referendum. For those with discipline and conviction in a distinct view, the fat pitch of uncertainty was an unusual tactical opportunity.

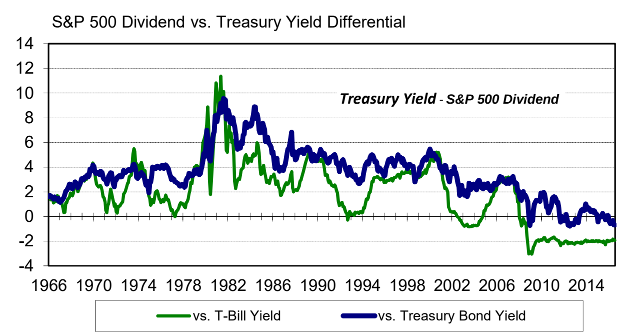
For Q2, performance measures were constructive and belie June's intermonth volatility. The S&P 500 returned 2.5% and small-cap equities (Russell 2000: +3.8%) outperformed. European equity indices recovered most of their losses, although the British pound (-8.2% in June) did not recover. The FTSE-100 Index returned 6.5% and U.K. 10-year Gilts returned 5.5% during the quarter.

Global equity markets were led by the U.S, Canada (3.4%), and Latin America (5.3%). Bonds also performed well (Barclays Aggregate: 2.2%), but lagged equities. Long maturities extended their gains with strong foreign flows favoring U.S. dollar denominated debt. The Yen strengthened more 9.6%, mostly in June, which was said to reflect a flight to safety, although Japan has the second lowest credit rating among G-7 countries (only Italy is lower).

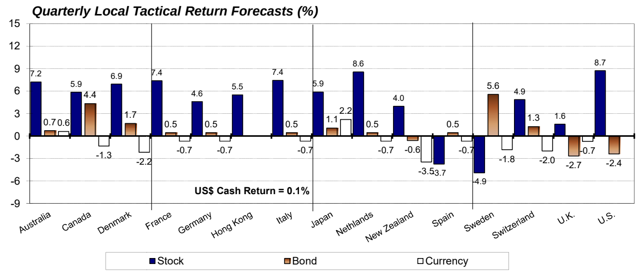
Global equities are still reasonably priced, but bonds are overvalued, based on our respective valuation factors. Europe is cheap, but growing more slowly than the U.S. and risks being a value trap. Inflexible labor and rising regulatory costs needing reform has adversely impacted both European and Japanese profit margins. While relative differences are interesting, our proprietary valuation measures suggest most equity markets are undervalued, including the U.S. S&P 500.



Low volatility and high dividend yield equities are expensive and should underperform as interest rates rise. An important reason dividend factor tilts are still in favor is clear in the chart below.



Expected returns from our Global TAA models are summarized below. Global equity return forecasts increased since our last update, and the U.S. is again the most attractive equity market, followed by the Netherlands, Italy, France, and Australia. The important driver of global equity forecasts has been our earnings yield valuation. For decades it has continued to work well, not only in the U.S., but also across the largest 15 countries in our global multi-factor models. Those focused on Shiller's CAPE ratio, suggesting U.S. equities are overvalued, are being misled. The issue we are most concerned about is economic growth, needed to bolster earnings growth and benefit from still high profit margins. Global breadth of compelling equity forecasts below is noteworthy.



Our U.S. dollar forecast supports further strength, while U.S. and U.K. bond forecasts declined, and are now quite negative. Treasuries may remain a preferred safe-haven for foreign investors, but U.S., U.K., and Japanese bond valuations are daunting. The only reason Japanese and European bond forecasts are positive is that economic growth is poor and inflation risk is benign---for now. Investors seeking to buy European equities should consider hedging.

Market volatility has increased with potential growth uncertainty, BREXIT, monetary policy changes, and divergent economic conditions. Emerging Market profit margins have collapsed since 2012 due to rising labor costs, which undermined productivity and potential growth. Automation, adaptive robotics, and machine learning are eroding the competitive advantage of labor intensive production. Extended supply chain costs (i.e., shipping, quality control, energy costs, supporting infrastructure, etc.) and protecting exposed intellectual property rights are deciding factors, reversing offshoring trends that exploited lower labor costs. Their historic advantage is now their Achilles' heel.

.Economic Observations

The global economy expanded 3.1% in 2015 and can accelerate in 2016 on the heels of stronger global growth. Declining global trade seems to have troughed, but waning fiscal austerity helps too. U.S. growth can re-accelerate with fading transitory headwinds. Global growth languished during the first quarter, increasing just 1% A.R. in the U.S. The second quarter should rebound, as has been observed in recent years. Real growth in China and India has slowed, as rising wages with high labor intensity undermined profit margins, thus earnings. Global economic differences will increase as monetary and fiscal policy diverges. And investors need the independent and trusted advice to identify key issues, but also recommend what to do.

Economic Forecasts	**2012**	**2013**	**2014**	**2015**	**2016e**	**2017e**
U.S. GDP (Y/Y Real)	2.3	2.2	2.5	2.0	**2.1**	**2.4**
S&P500 Earnings	6.0	5.7	8.1	-0.9	**2.0**	**8.0**
U.S. CPI Inflation (Y/Y)	1.8	1.8	0.7	0.7	**1.5**	**2.5**
U.S. Unemployment	7.8	6.7	5.6	5.0	**4.9**	**5.0**
Fed Funds Target	0.25	0.25	0.25	0.25	**0.75**	**1.75**
10y Treasury Notes	1.85	3.00	2.17	2.27	**2.50**	**3.50**
S&P 500 Target	1426	1848.	2059.	2044.	**2150.**	**2300.**

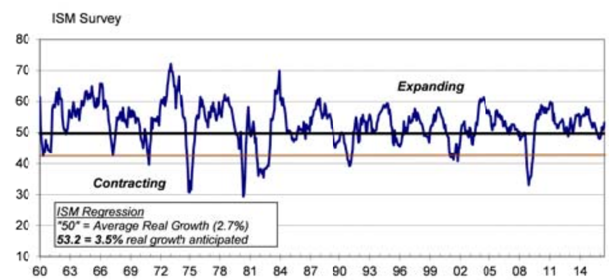
Source: Strategic Frontier Management

Our 2150 S&P 500 target implies a total return of 7.4% with a 2.2% dividend yield in 2016. S&P 500 earnings declined in 2015 entirely due to the decline in energy sector earnings, which extended into 2016. Earnings for all other sectors combined grew in excess of 4%. As oil prices stabilize closer to our equilibrium of $50-60, energy sector earnings should rebound as well. Two meaningful equity corrections already this year provided unusual tactical opportunities buying into dips. Consensus S&P 500 Operating Earnings expectations are summarized below---note 2017's earnings growth reflects a modest rebound in energy earnings.

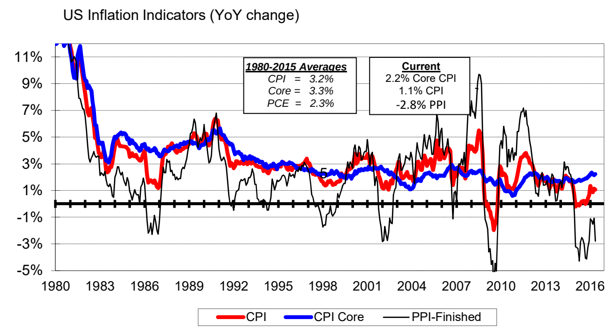
Consensus	2018e	2017e	2016e	2015	2014	2013	2012
Growth	10.1%	14.3%	0.9%	-0.9%	8.1%	5.7%	6.1%
Earnings	$ 149.16	$ 135.42	$ 118.52	$ 117.46	$ 118.52	$ 109.68	$ 103.80

Source: Strategic Frontier Management & Thomson Reuters I/B/E/S

The ISM Purchasing Managers Survey is one of the most timely and best predictors of the business cycle. Although often misinterpreted, "50" equates to potential growth of 2.7% over the next year, so a recent reading of 53.2% suggests about 3.2% real growth over the next 12 months based on the historical relationship—U.S. growth is still muddling along, albeit better than most other developed economies, particularly Japan and Europe. Observing less than 2.7% potential growth has been a function of various policy headwinds, not a new regime of secular stagnation.



While growth has been relatively stable, changes in inflation are more interesting. Inflation has been limited by a strong U.S. dollar, weak trade, lower import prices and declining energy prices. Lower commodity prices can be a precursor to recession, but energy conservation, substitution, and innovation combined with new domestic supply enabled by technology drove oil prices over $100 to well below $35. These transitory effects depressed inflation and energy sector earnings, but freed up disposable income. CPI inflation plunged as low as 0.1% in 2015, but rose to 0.9% by year end as deflationary forces began to sunset. Inflation risks are increasing with rising cost of housing, regulation, wages, and benefits toward 2% core inflation (x-food, energy), even if commodities level out. Central banks might be surprised how fast inflation rises.



Strong evidence suggests that innovation, including application of technology, have boosted profit margins, and thus earnings growth, despite moderate economic growth and low measured productivity. Demographics, evolving skill requirements, and process efficiency gains have limited job growth, but labor markets will adapt---it just takes time. Labor productivity became less cyclical as labor intensity declined. Low wage countries that benefited from globalization have stalled with increasing automation, robotics utilization, and machine learning. Country divergences will depend on relative sector composition, interest rate sensitivity, competitiveness, fiscal policies, and regulation.

Income has become a popular political focus in this election year, yet there are various misconceptions about the data. For example, wage growth has always been correlated with inflation, so 4.0% wage growth has tracked CPI inflation of 4.2% over the last 50 years. Indeed, wages increased 2.3% over the last five years, actually exceeding CPI inflation of 1.8%. Thus, slowing wage growth is simply a function of moderating inflation. How can this be so contrary to the notion that household incomes declined? Household incomes include effects of higher taxes, evolving demographics (retiring Boomers), changing benefits (health care costs rising), and number of wage earners. Real wage growth hovers near 0%, because it is historically governed by cost of living increases. Over a lifetime, wage growth of an individual exceeds inflation with experience, promotion, job hopping, and compounding. If wages are rising 2%, why do we focus so much on the dumpster fire of household income?

A minimum wage is a starting wage, not the wage one earns over a lifetime. In a perfect world, there is no need for defining a minimum wage, but otherwise it is logical to index it to inflation, as long as you don't start off too high. Looking back at the history of seven minimum wage increases since 1956, we estimate that if Congress had indexed cost of living increases, a similar minimum wage could have ranged from $7.03 (vs. 1990) to $9.89 (vs. 1974). Wide geographic cost of living differences suggest that too high a federal minimum wage could put any state at a competitive disadvantage. Rising unemployment in Puerto Rico is in part a consequence of uncompetitive labor costs. Indexing 2009's minimum wage increase would boost the current $7.25 to $8.03. As a matter of policy, it would seem appropriate to boost the minimum wage to about $8.00 or 10% increase, then index it to inflation.

Household net worth is published quarterly by the Federal Reserve, and has been useful to monitor the progress in household deleveraging and financial health since the Financial Crisis. The recovery in home prices, increased home equity (net of debt), and grater retirement savings are also evident. Financial assets of $71 Trillion comprise 69% of total assets. Of that, $11 trillion sits idle in bank deposits and cash equivalents earning nearly nothing, but remain a store of value that could be invested with greater economic confidence.

Household Balance Sheet ($Bs)	*2012*	*2013*	*2014*	*2015*	*2016-Q1*	Annualized vs. 2007	*1-Year*
Total Assets	83,234	93,168	98,368	101,770	102,625	2.9%	2.4%
Tangible Assets	25,151	27,719	29,215	30,991	31,547	1.4%	6.3%
Households: Real Estate	19,885	22,351	23,732	25,291	25,789	1.1%	6.8%
Financial Assets (inc. retirement)	**58,083**	**65,449**	**69,153**	**70,779**	**71,078**	3.6%	0.8%
Deposits (Bank Acct + Money Fund)	9,227	9,602	10,211	10,753	10,854	4.6%	4.9%
Change in Assets%	7.9%	11.9%	9.4%	8.1%	7.1%		
Liabilities	**13,636**	**13,785**	**14,168**	**14,520**	**14,538**	0.2%	2.7%
Home Mortgages	9,491	9,404	9,404	9,494	9,511	-1.3%	1.5%
Consumer Credit	2,920	3,096	3,318	3,535	3,542	4.3%	6.6%
Household Net Worth	**69,598**	**79,384**	**84,201**	**87,250**	**88,087**	3.4%	2.4%
Growth Rate (y/y)	9.5%	14.1%	10.5%	8.6%	7.6%		

Source: Federal Reserve, Flowof Funds (Table B.101)

While household and business balance sheets improved, including a $39 trillion increase in household net worth since the end of Q1/2009, the U.S. government is still running a 4.5% fiscal deficit with over $19.2 trillion in debt. Globally governments have not deleveraged, increasing their liabilities, both in terms of total debt and higher fiscal deficits. U.S. Government debt has increased $8.57 trillion or 80% since January 2009, including $831 billion in fiscal stimulus that could have been better spent on long-term infrastructure projects, as intended, rather than inefficient handouts and "clunker" programs.

Free trade bolsters innovation and competition leading to better products and services, enhanced productivity, as well as economic development, new markets, and expanding prosperity. The ubiquitous principal of comparative advantage provides that goods and services must be produced in the most productive way. Seeking advantage by currency devaluation is foolish, inflationary, and temporary—lesson learned hopefully during the 1997 Asian Tiger Crisis. The ECB and BoJ have been more explicit and egregious exchange rate manipulators than others observing trade weighted exchange rates. Free trade is economically desirable, but sloppy multi-lateral trade agreements can be replaced by simpler bilateral agreements.

Adoption of more bond-intensive pension allocations increased debt holdings with little concern for interest rate sensitivity of leveraged and long duration exposure. We observed such effect on Orange County during 1994 as interest rates rose. Reversing years of asset purchases will crowd out ever growing need for corporate, asset-backed, bank loan, private debt, and mortgage bond issuance. Governments are still spending well beyond their means, and show little desire to reverse spending programs that support their re-election at taxpayer expense. Quantitative easing indirectly reduced interest expense, but eventually this debt must be reissued at higher rates. Credit rating agencies will likely be late again in recognizing the systemic risk of high debt and unsustainable deficits.

Great Inflection Point of Normalization

There is nothing of greater investment significance than the needed inflection point in global interest rates. After seven years holding down interest rates, yield curve normalization should result in negative real bond returns until 10-year Treasury yields exceed at least 4.0%. We underestimated the knock-on effects of lower government bond yields elsewhere, resulting in strong demand for Treasuries, irrespective of valuation. The markets' tendency to overreact to changes in monetary policy increases the cost of policy mistakes.

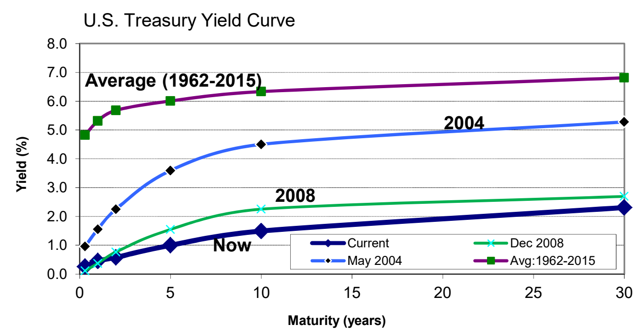
The Federal Reserve was expected to raise interest rates by 1% this year, hiking every other meeting. However, the FOMC voted to pause in March and held its ground again in June, instead of maintaining a steady path of normalization. Give or take a ¼% at such low rates was of little consequence. The committee made a mistake in overreacting to market volatility, weaker exports, and shaky capital investment. Citing lower inflation expectations and "global economic and financial developments of recent months" confused investors. A central bank should focus on domestic factors that are consistent with managing its dual objective of maximizing employment and price stability. Emergency stimulus is no longer needed given 5% unemployment and sustainable 2% real growth. The issue is no longer "when", but how fast interest rates should normalize.

Interest Rates	2015	2016	2017	2018	Longer Run
Average	0.25%	0.83%	1.63%	2.46%	3.14%

Source: FOMC Projections as of June 2016

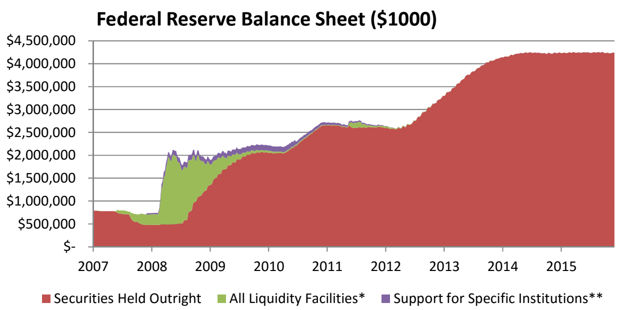
"Stable Prices" might suggest no inflation is desirable, but slightly positive inflation is desirable given deflation often coincides with recession. We have enjoyed low consumer inflation, particularly for imported goods and services bought with a strengthening U.S. dollar. However, central bank preoccupation with *symmetric* inflation targeting is misguided—it is a fool's errand. Between 0-2% inflation is a benefit for consumers, particularly if wages are rising faster. The FOMC should recognize monetary policy is not conducive for economic fine tuning. While the Fed doesn't target inflation as other central banks, the FOMC highlighted low inflation to justify its pause in hiking rates—this rationale is flawed and undermined its credibility.

The extended period of explicitly manipulating interest rates has induced moral hazard for investors, businesses, and households, which predicated decisions on low interest rate expectations for an extended period. Interest rates need to normalize, particularly given unconventional excessive central bank holdings globally. Current bond holdings of $1.36 trillion will mature within the next five years, although bond buying continues to replace refunded issues. Treasury bond yields need to rise 3% just to get back to when the Federal Reserve last started to hike rates in 2004. It is incredible to compare the current yield curve to 2004 and during the Financial Crisis (December 2008), or even the average yields by maturity over the last 53 years!

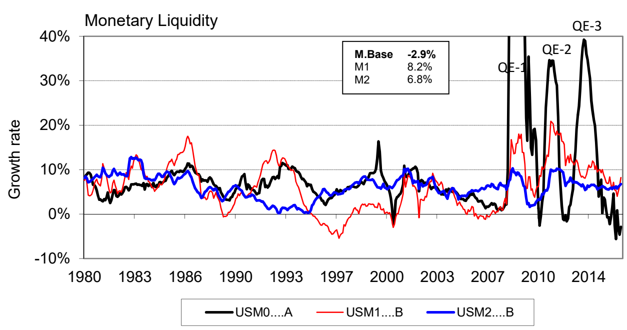


With the November election, restarting rate hikes again is politically difficult, but must be done. Although some believe the economy is too fragile and inflation too low to raise interest rates, persistent monetary stimulus hasn't helped jump-start growth. Raising interest rates to 2% should still be stimulative and consistent with the prudent Taylor Rule. The longer central banks take to normalize, the more likely a bond market correction resembles 1994, instead of 2004. Waiting for the bond market correction preceding the first hike in 1994 was uncomfortable, but the inflection point was dramatic, lasting the rest of the year. Even more troubling may be the unnoticed shift in the FOMC's long-run equilibrium interest rate, reduced from a 4.0% average over 50 years to just 3.14%. Such a shift implies an equivalent decline in 3% long-term inflation expectations, which seems unrealistic.

By the end of 2017, the Federal Reserve could begin winding down its $4.5 trillion balance sheet. Refunding maturing bonds will reduce holdings, but every change in monetary policy seems to cause equity volatility. If the Fed's balance sheet had simply grown an average of 6% since 2007, it would be just $1.56 trillion. Reducing the balance sheet by $3 trillion will be difficult for fixed income markets to absorb, particularly given a current 4-5% fiscal deficit. Consider that 3/8ths of the increased U.S. debt subsidizing expanded programs and stimulus financed at no cost with QE, but like homeowners in 2008, the teaser rate will expire and the bill will come due. As central bank balance sheets normalize, bond investors must to step into the void and taxpayers will pick up the tab. Thus, term risk premiums are likely to increase significantly, which we expect to exceed 0.5% added to cost of capital.



Persistent excess money growth will have lingering economic consequences over the next decade. The monetary base historically expanded 6%, equivalent to 3% real growth + 3% inflation, to provide sufficient credit for a growing economy. Growth in the monetary base is now negative, but observe its' volatility during periods of Quantitative Easing. We should expect it will be difficult to maintain even half of the normal rate of money growth as excess holdings unwind. This could limit economic growth for years, while being an even more consequential for the Eurozone and Japan.



British Independence Day

British citizens voted 52-48 in a referendum to *Leave* the European Union (EU) after over 40 years. We published our view on BREXIT just following the final tally. It is a remarkable decision worth taking the time to understand. Membership in the EU Common Market no longer served their best interests. It will take several years to implement, thus has little near-term economic impact. Our outlook is contrary to the apocalyptic economic predictions of those that prefer to maintain the EU's status quo.

Our outlook is distinct from consensus—we are more constructive on British and global economic growth than most. Falling equity prices, lower bond yields, stronger yen, and higher gold should reverse upon reflection. Rising nationalism reasserted sovereignty and individual rights, which had intensified with malfunctioning agencies, deficient trade agreements, unobstructed immigration, and deteriorating security. Loss of confidence and trust in political leadership reflects decline in economic potential and productivity.

Discarding a 40-year old multilateral treaty will have consequences, but the U.K. has a unique opportunity to declare independence from an unaccountable regime that increasingly failed its constituents. Shifting geoeconomic forces will require investors to reset economic assumptions. It may take a few quarters to ensure economic stability, but this volatility will soon pass and forward looking investors will see the wisdom of this decision. In this case, boring is good, but sometimes change is better! See *British Independence Day.* www.StrategicCAPM.com/#!commentary/ch6q

Concluding Thoughts

Fears of slowing global economic growth remain high, but the U.S. economy has remained relatively immune to various challenges and policy headwinds. Business owners have adapted well for seven years, but new business formations have plunged by nearly a third and efficiency gains needed to maintain productivity seem to be running out. Small business is America's growth engine, but business closures cannot exceed company start-ups, as observed today. An effective way to reduce bank concentration is to increase competition, but financial reform has increased costs that drive smaller banks to be acquired and are too high a hurdle for starting up innovative new competitors.

Housing, investment, and trade will need to boost economic growth over the next two years. Low interest rates reduced the cost of capital needed to spur investment, but excess money growth and increased costs of doing business with less competition will drive higher inflation, followed by higher interest rates. A headwind for banks required to improve their capital ratios and divest certain businesses, as required by financial reform, is moderating. Innovation, technology, and outsourcing has broken the linkage between employment and economic growth, limiting inflation.

Global divergence in fiscal, monetary, interest rate and regulatory policy has increased economic differences, and thus are a precursor to greater capital market dispersion. Countries still matter at a time of greater economic dispersion, which is increasing international diversification. While most strategists expect higher equity volatility, increased volatility should be limited to fixed income and currency markets. Equity risk has behaved differently lately, characterized instead by increased variance-of-volatility. We believe dynamic hedging, including increased utilization of stop-loss orders instead of options, much like portfolio insurance, may be a cause for this unusual behavior in equity volatility. Use of listed options is actually underutilized, not only for hedging, but can be structured in a variety of creative ways for dynamic rebalancing to tactical asset allocation. Differences in asset class, country, sector, and risk factor returns offer greater potential value added opportunity from tactical asset allocation.

We recommend investors reduce fixed income duration (shorter maturities) and favor floating rate and credit exposures—we expect U.K. sovereign debt rating downgrade will prove misguided. The next increase in interest rates likely has been delayed to October, but we expect two ¼% hikes in 2016. Few expect the Bank of England to follow suit, but as stability returns, economic conditions should warrant normalization. Canada may also hike earlier than expected. Normalization of monetary policy is needed, including raising the level of short-term interest rates, while reducing bond holdings to normal levels. We expect interest rates will rise to 1.75% by the end of 2017, which should drive 10yr Treasury yields to 3.5%.

The widening valuation gap between stocks and bonds with record government debt and extended bond allocations could accelerate a rotation from bonds and income alternatives to equities. Avoid safe havens, low volatility, high dividend yield, global bonds, Japanese yen, and particularly gold. Greater currency volatility is expected, in contrast to low volatility observed in recent years. The British pound was unattractive before the BREXIT referendum. Our view hasn't changed, but U.K. Gilts are unattractive. Currency exposure should be partially hedged, particularly Euro and Yen.

It is not surprising imbalances develop when fueled by extraordinarily low interest rates. Investor preferences such as their preference for dividend yield or low risk can push intrinsic valuations to extreme levels. Economic divergence and inflection points in monetary policy are a precursor to increasing bond volatility and return dispersion. Safe haven darlings may become toxic with rising interest rates, including low volatility, high dividend yield, long bonds, gold, risk parity, and many alternative investments. Investor preferences seeking income and low volatility that worked well for the last few years may disappoint with rising rates.

Although intuition suggests market volatility should increase, average equity volatility has declined, but with more frequent spikes. This volatility-of-volatility is consistent with policy uncertainty and an inflection point in interest rates. However, we do expect higher bond market and currency volatility, exacerbated by reduced liquidity and increasing restraints on market makers. Investors need to extend their time horizon and simplify their strategic asset allocation policy.

A concern is how to restore 5-7% earnings growth and boost productivity as labor, tax, and regulatory costs are cutting into margins. Revenue growth stagnates with just 2% real economic growth. Secular consequences of poor policy decisions have taken a toll on economic growth potential, as well as business confidence and earnings. This is true from the U.S. to other developed and emerging countries. Fundamentals matter, but timing is usually more uncertain than direction---particularly those that tend to behave in a contrarian manner, bucking consensus and market trends before inflection points.

In an increasingly uncertain world, asset owners and investment managers are *Rationalizing Uncomfortable Choices.* Adding value was never easy, but managing other people's money requires consistent discipline and transparency. Costs must be managed prudently, effectively, and efficiently, but it seems trade-offs may not always reveal the full costs of strategic decisions. Outsourcing has provided significant sophisticated capabilities smaller asset owners need, but it has also caused many to dismantle core capabilities and resources with many indirect benefits, particularly for strategic decision making and during periods of market uncertainty. Investors are struggling with the breadth of new investment products and strategies---some of these will be innovative, but others are simply re-branded strategies with different cost structure. Trusted independent advisors are needed to minimize unforced errors and identify unintended risks. Only then can investors turn their attention to adding value in seeking to maximize risk-adjusted net return.