INVESTMENT OUTLOOK

David Goerz
Strategic Frontier Management
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SEARCH FOR GREATER AUTHENTICITY

- Equity returns have been spectacular for seven “fat” years, returning 173% for the S&P 500 through Q1/2016 as earnings rebounded to new highs. Global equity valuations are still reasonable with remarkably low interest rates, strong profit margins, and a reasonable S&P 500 17X multiple of forward earnings. Index dividend yield exceeds 10Y Treasuries with a lower tax rate than interest income. Changes in earnings growth and profit margins are critical to forward earnings valuations. Global equities still offer the best potential long-term real return of any asset class, but global earnings growth has fallen 7% through Q1.

- Central bank policies have manipulated interest rates for an extended period, which inflated economic imbalance. Japan’s fiscal deterioration is of particular concern, and could trigger a new sovereign debt crisis. While some European countries progressed on fiscal reform (austerity), the ECB’s easy monetary policy relieved political urgency to execute needed fiscal and labor reforms. Negative government bond yields have increased Treasury demand and strengthened the U.S. dollar, but this should be transitory and increases future potential volatility.

- Global differences in fiscal, monetary, and regulatory policy have bolstered economic divergence, and thus are a precursor to greater capital market dispersion. Most strategists expect higher equity volatility, but we expect increased volatility should be limited to fixed income and currency markets. Equity risk has behaved differently, characterized instead by increased variance-of-volatility. Dynamic hedging such as using stop-loss orders instead of options, much like portfolio insurance, may be the cause for this unusual behavior in equity volatility.

- Greater asset class, country, sector, and risk factor return dispersion offer greater potential opportunity to add value through tactical asset allocation. Neutral global equity exposure seems prudent for now after a brief tactical overweight after February’s correction.

- U.S. dollar strength reflected greater confidence in growth and higher future interest rates attracting capital flows, but remains a headwind to export growth. Gold has plunged 40% from 2011 highs, exposing the flaw that gold is neither “low risk”, nor a prudent “store of value” under current conditions.

- Upside for equities beyond our year-end S&P 500 Index target of 2150 is limited, but another correction could be a buying opportunity, depending on how economic conditions unfold. Uncertainty about rate normalization, global growth, and geopolitical uncertainty, including the U.S. election, moderate by October. Industrial production and business sales have slumped, but retail sales and construction (housing) are still expanding. Disappointing business performance raises concern whether aggressive regulatory and financial reforms are finally having an adverse impact on potential growth in America. Profit margins have been remarkable, but has business exhausted its ability to offset policy headwinds?

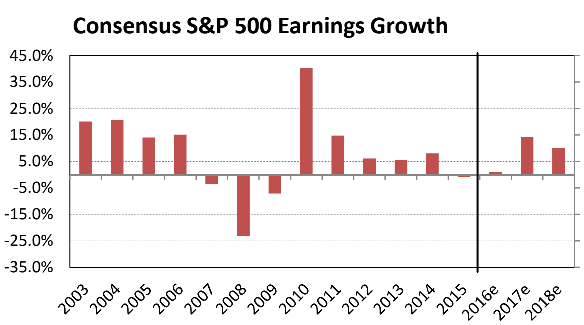
- Global bonds remain overvalued---particularly in the U.S. and U.K. where economic growth is better and inflation is increasing. Negative interest rates for 5Yr. German Bunds and 10Yr. Japanese Bonds can’t be maintained. Concern is warranted about portfolio interest rate sensitivity and susceptibility to illiquidity risk of bonds. Increased regulation on fixed income market makers has intensified illiquidity risk, which is difficult to measure and challenging to hedge. We recommend continuing to underweight bonds and overweight cash, keeping shorter average maturity.

- Scarcity of *Authenticity* is evident in perceived economic myths and populist investing theories. Long-proven fundamental truths are routinely dismissed as old-fashioned, yet provocative and unproven new nonsense is more readily embraced. The need for education and trusted advice in this regard has never been greater as we seek to reveal wealth-compromising perceptions and ill-conceived beliefs with data, intuition, and a longer time horizon.

Economic Conditions

During the first quarter, investors were surprised by a correction in equities through mid-February, although Q1 finished with a gain of 1.4%. China, oil prices, global growth, and interest rate uncertainty continue to plague investor confidence. First quarter growth in U.S. GDP slowed to a 0.5% annualized rate. Slower growth was a disappointing start to 2016. Lower commodity prices and a stronger U.S. dollar undermined earnings growth, albeit narrowly focused in the Energy and Basic Material sectors. As these headwinds moderate, growth in consumption and housing can bolster a rebound. Importantly, we still don't see a recession in the foreseeable future.

Companies drove up profit margins (S&P 500: 10%) faster than their cost of doing business over the last decade, but re-engineering has limits. U.S. profit margins of 10% compare favorably to 7% for non-U.S. public companies. Global equity performance fundamentally depends on earnings yield and growth in earnings, which are a function of economic conditions. In the same way, bond yields must provide a sufficient return relative to inflation expectations.



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 and Datastream

Capital investment leveraged technology and business process re-engineering to improve efficiency and lower cost (less inflation), but since the Financial Crisis government policy decisions compounded hurdles to economic growth and productivity, approaching those impeding European and Japanese growth. Lower potential growth can be reversed, but requires smarter reform of labor, spending, taxes, and regulation. Consequences of changes in policy take years to become visible. Just as tax reform in the mid-1980s benefited remarkable economic growth in the 1990s, lagged impact of health care and financial reform are likely finally taking an economic toll.

The global economy expanded 3.1% in 2015 and can accelerate somewhat in 2016 on the heels of stronger growth in North America, Australia, India, China, and South Korea. Real growth in China and India has slowed, as rising wages with high labor intensity undermined profit margins, thus earnings. Declining global trade seems to have troughed, but waning fiscal austerity helps too. U.S. growth can re-accelerate with fading transitory headwinds in 2016. CPI inflation plunged as low as 0.1%, but rose to 0.9% by year end as deflationary energy costs and stronger U.S. dollar began to sunset. Core inflation (ex-food, energy) has hovered around 2%. Global economic differences should increase as monetary and fiscal policy diverges.

Inflation has been impacted by swings in commodity prices, particularly energy prices. Lagged transitory effects depressing inflation and energy sector earnings should reverse in 2016. Labor costs will rise with higher wage minimums and high demand for specific skills. Regulatory costs and higher taxes also are driving up inflation. Commodity prices tend to increase 2-3%/year, but inflation will increase if commodities remain level.

Plunging oil has freed up disposable income, but also severely impacted Energy sector earnings. Weaker global demand was a function of efficiency gains, as much as faltering economic growth. Global supply soared with increasing production from the Middle East and North America. What has been *unauthentic* is the perceived correlation between oil and equity markets reinforced by trading algorithms. Relative to oil's equilibrium of $50-60, a plunge below and subsequent rebound was a coincident outlier with equity indices, not causality of an emerging recession, as feared.

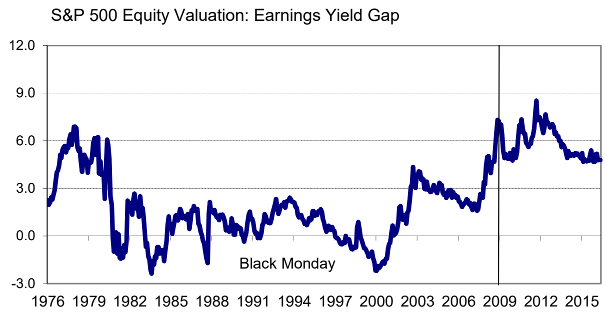
Economic Forecasts	2012	2013	2014	2015	2016e	2017e
U.S. GDP (Y/Y Real)	2.3	2.2	2.5	2.0	**2.1**	**2.4**
S&P500 Earnings	6.0	5.7	8.1	-0.9	**3.0**	**7.0**
U.S. CPI Inflation (Y/Y)	1.8	1.8	0.7	0.7	**1.5**	**2.5**
U.S. Unemployment	7.8	6.7	5.6	5.0	**4.9**	**5.0**
Fed Funds Target	0.25	0.25	0.25	0.25	**1.00**	**2.50**
10y Treasury Notes	1.85	3.00	2.17	2.27	**2.75**	**4.00**
S&P 500 Target	1426	1848.	2059.	2044.	**2150.**	**2300**

Source: Strategic Frontier Management

While there has been stability in growth, changes in inflation and earnings are more interesting. Earnings growth is below average, and limits upside to equities.

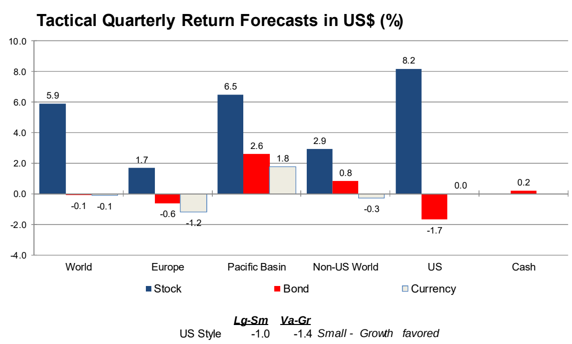
Capital Markets

Global equities are still reasonably priced based on our valuation factor. Expressed concerns about U.S. valuations aren't *authentic* as reflected in preferred measures, such as earnings yield (below). Our 2150 S&P 500 target implies a total return of 7.4% with a 2.2% dividend yield. Low volatility and high dividend yield equities are expensive and likely will underperform as interest rates rise. Europe is cheaper, but growing more slowly than the U.S. However, Japanese equities could be a value trap without sustainable growth and subject to great fiscal peril if rates rise before labor and fiscal reform.



Source: Strategic Frontier Management

Expected returns from our Global TAA models are summarized below. Australia, Switzerland, and the U.S. are our top ranked equity markets.

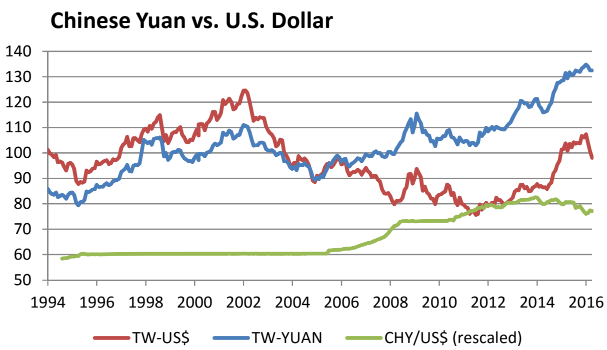


Source: Strategic Frontier Management, 5 / 1 / 2016

The outlook for Emerging Market equities is a challenging question. Equity and currency volatility has increased with uncertainty in global growth. Recent turmoil and uncertainty about Emerging Markets is a consequence of investors re-evaluating their long-term growth potential. The challenge is most invest across broad indices, instead of considering the unique economic conditions and characteristics of each country or region. Investors will increase or decrease exposures mostly in benchmark proportions, although relative growth rates, trade balances, and inflation are varied as relative valuations, sector composition, and interest rate sensitivity. Until investors can efficiently access Emerging Markets in regional or country specific products, volatility will remain high.

Consider Brazil vs. China or Greece vs. Indonesia. India seems economically stable, but was rattled just as much as others. Brazil and Greece remain in recession and continue to struggle under failing Socialist leadership. Indonesia, South Korea, India, and China enjoy strong growth, even if equities retreated from overvalued levels. Developing economies benefited over the last twenty years from a constructive mix of urbanization and industrialization, coupled with an emerging culture of credit fueling insatiable consumption.

The chart below highlights U.S. dollar strength since the 2011 European debt crisis. It also suggests that populist notions of Yuan manipulation are misleading and why China's export growth has struggled. The Chinese yuan has *strengthened* on a trade-weighted basis by 47% over the last decade. Devaluation relative to the U.S. dollar was modest and warranted. In the *Search for Greater Authenticity*, China's financial liberalization is visible. Although difficult in the near term, this transition should be beneficial in the long-run.



The Yen and Euro strengthened in Q1, but a U.S. dollar consolidation is not surprising after appreciating over nearly four years. U.S. dollar strength reflected confidence in growth and higher interest rates attracting capital flows, but this also remains a headwind to export growth. As gold plunged 40% from 2011 highs, investors realize gold is a risky hedge being neither "low risk", nor prudent "store of value".

The Great Inflection Point of Normalization

The Federal Reserve expected to raise rates by 1% this year, hiking every other meeting following December's hike. However, the FOMC voted to pause in March instead of maintaining a steady path to normalizing interest rates. We believe the committee made a mistake that could increase future volatility and undermine its credibility. A ¼% hike at such low rates was of little consequence and only confused investors.

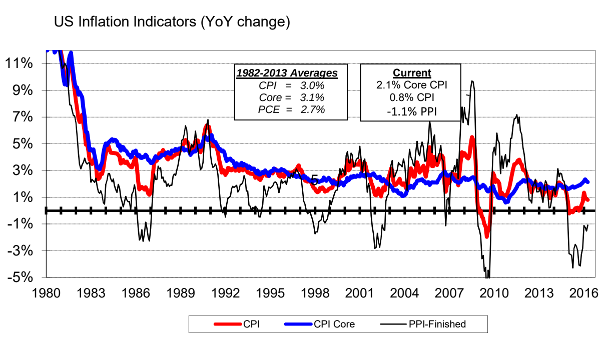
So, what spooked the FOMC? They cited lower inflation expectations and "global economic and financial developments of recent months." The committee reacted to market volatility, weaker exports, and capital investment. Fundamentals should drive monetary policy decisions, although recent statements suggest relevance of global concerns and volatility. Lower commodity prices can be a precursor to recession, but we believe energy conservation, substitution, and innovation were more relevant. Thus, lower energy prices were not rooted in slowing growth, but rather transitory commodity prices and currency.

Interest Rates	2015	2016	2017	2018	Longer Run
Average	0.38%	1.02%	2.04%	2.95%	3.31%

Source: FOMC Projections for March 16, 2016

The FOMC's rationale for pausing normalization is flawed, and undermined its credibility. An extended period of manipulating interest rates has induced moral hazard for investors, businesses, and households that predicated decisions on low interest rates. U.S. interest rates have been too low for too long. Interest rates need to normalize at a steady pace, particularly given a bond-bloated balance sheet. Reducing bond holdings includes refunding $1.36 trillion of maturing Treasury bonds within the next five years. The issue is no longer "when", but how fast interest rates will normalize.

To get back on track requires recycling uncertainty, which contributed to equity volatility last year that also gave the committee pause. The markets' tendency to overreact to changes in monetary policy increases the cost of policy mistakes. As an election year, restarting rate hikes again in September would be politically more difficult than June, so odds of a June restart should be higher, as we expect. Raising interest rates steadily to 2% should still be stimulative and consistent with the prudent Taylor Rule. The Fed's consensus for the end of 2017 is also 2%. Some may believe the economy is too fragile and inflation too low to raise interest rates, but aggressive monetary stimulus hasn't helped jump-start growth and inflationary forces are firming. Emergency stimulus is no longer needed anymore with 5% unemployment and greater than 2% real growth.



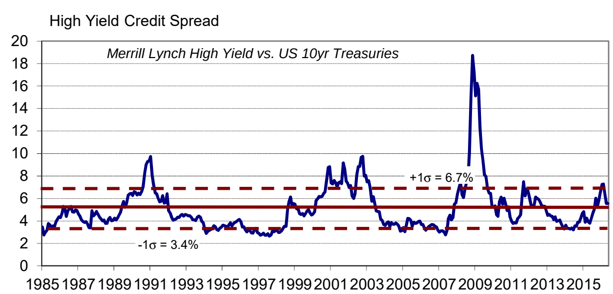
Inflationary risks are increasing with rising cost of housing, wages, and benefits, including health care. Wage growth is highly correlated with inflation, so 4.0% average wage growth tracked CPI inflation of 4.2% over the last 50 years. As inflation declines, wage growth should also slow. Wages increased 2.3% over the last five years, actually exceeding CPI inflation of 1.8%. Benefit costs grew even faster. So, wages haven't declined (when did employers ever lower salaries?), although household incomes can decline for a variety of esoteric reasons. Slowing wage growth was a function of moderating inflation. Promotions and career advancement typically boost compensation well above inflation. As housing demand strengthens and rental vacancies decline, home prices and rent increased. Rent equivalent inflation is 34% of CPI inflation and 42% of core inflation, so increasing housing demand will continue to drive higher inflation.

More troubling is the unnoticed shift in the FOMC's long-run equilibrium interest rate, reduced from a historical 4.0% average over 50 years to just 3.3% or ¾% less. Such a secular shift requires normal inflation to decline equivalently. These new expectations may be skewed by persistent low inflation over a period of remarkable innovation, but cyclical inflationary risks are increasing again. U.S. normalization should lead bond yields higher, and doesn't require high inflation. There is nothing comforting for inflation naysayers below.

We have enjoyed stable consumer prices, particularly for imported goods. A stronger U.S. dollar deflated import prices and increased the cost of exported goods and services. Central bank preoccupation with *symmetric* inflation targeting is unprecedented and misguided—it is a fool's errand. We think they should instead focus on extraordinary changes in growth and inflation, recognizing that monetary policy is a very blunt tool, not conducive to economic fine tuning. They also should avoid meddling with desirable low and stable inflation. While the Fed doesn't target inflation as other central banks, the FOMC highlighted low inflation to justify its pause in hiking rates—this is a mistake.

Fixed Income Strategy

U.S. credit spreads are more reasonable after widening in 2015. Negative high yield returns last year improved odds of credit outperformance this year as defaults remain low, interest rates rise, and oil prices rebound. High yield credit spreads tend to magnify credit effects, cyclical relationships, and the demand for yield. High yield spreads have widened notably since mid-2014, but declined recently as oil prices rebounded. Below investors recently appeared to price high yield credit like the economy was headed into recession (1991, 2001, 2008), but this is why a reliable resource to interpret data is needed. This concern seemed to be reflected in the correction in equities during February.



Mortgage and corporate bond spreads are near equilibrium, while default rates are low. Municipal bonds are another matter, and subject to unique risks. Puerto Rico's default (missed payment) raises new concerns because their bonds are widely held in municipal funds. About 75% of tax-advantaged municipal bonds are held by households either directly (financial advisor) or in mutual funds. Puerto Rico provided a supply of critical new issuance to larger funds, but cost of capital for states, counties, and cities could increase if Puerto Rico must restructure its debt. Concerns about Detroit, Chicago, New York, Atlantic City, and Stockton highlight local policy risks of fiscal mismanagement and excessive spending. Issuers with high debt levels and fiscal deficits are most at risk. Security selection likely never mattered more.

Japan's government debt burden is unsustainable with a lower and endangered credit rating. Fiscal imbalance can't support a realistic JGB risk premium with 230% Debt/GDP, even if the BoJ is buying all new issuance. High debt burdens increase in relevance as interest rates rise, while Japan risks further credit downgrade from A1/Moody's (four notches below AAA). Japanese 10Yr. government bonds (-0.07%) opened a wide gap to equivalent A1 ratings for China (2.9%) and South Korea (1.8%). The BoJ has manipulated unsustainable bond yields to the extent this can't end well for Japan.

Historical bond risk and return are skewed by a bull market of over three decades of declining yields. We should expect changes in asset volatility and correlation. Investors suggest they are disappointed with well-diversified portfolio performance, but their outcomes hinge on getting risk measures roughly about right, not exactly wrong. Bond market volatility could be exaggerated in the future by multi-year losses when interest rates finally normalize. We've suggested a risk premium of ~0.5% may be required in the future to clear markets.

Portfolio Diversification Still Matters

Investors need to be reminded every few years of the still remarkable benefits of international diversification. Many have been disappointed that well-diversified portfolios didn't perform well when volatility increased. Seemingly diverse asset classes can experience unexpectedly high correlation during periods of turmoil—a consequence of overlapping common risk factor exposures. Correlation is not constant and can evolve over a longer period, so higher realized correlation reduces benefits of diversification.

Portfolio diversification is not a free lunch. It won't increase total return, but tends to reduce portfolio risk without reducing return. When correlations increase during volatile periods, diversification may become less effective, but investors are no worse of during these periods, and much better off over the long-run. Well-diversified investors find it easier to endure difficult periods if committed to an investing discipline, including defining their rebalancing strategy.

Country and currency return effects remain significant, so *countries still matter*. Country return divergences persist due to a variety of intuitive factors with different sensitivities to economic and monetary factors. Structural differences in industrial composition, regulation, taxes, resources, labor costs, and relative competitive advantages effect growth, inflation, and margins promote diversification.

Increased diversification was an appealing rationale to increase alternative investment exposure, but many investors paid high fees to receive little in return. We believe expectations used for return and risk are misleading and evolving. There is no greater need than *Authenticity* estimating private market risk, which is prone to mismeasurement given practical difficulties of even monthly valuations, required for reasonable risk measurements.

Risk models predicated on historic averages can be misleading at an inflection point after interest rates steadily declined for over 30 years. Implied equity volatility retreats in a bull market, so why wouldn't the same be true for bonds? We should expect higher bond volatility and evolving asset class correlations, which are even more difficult to adapt, in a rising interest rate regime.

How will new risk allocation strategies fare when the primary input is so uncertain? Bond illiquidity may be the most underappreciated risk that could rattle markets. Misguided risk measures impact optimal asset allocations, much to the dismay of those embracing risk-focused portfolio allocation schemes. These issues suggest the need for a simpler and more intuitive approach to portfolio management, returning to first principles. Optimal portfolio allocation is dependent on correctly estimating risk.

Broadly diversified portfolios provide opportunity for excess return and active strategy diversification, including Global TAA overlays across countries, currencies, factors, and sectors. Multiple investment strategies that exhibit low or even negative active return correlation can diversify active risk. Combining independent strategies that seek to add value through top-down asset allocation and bottom-up security selection in an overlay structure provide the greatest potential diversification. Our experience suggests active return correlation between security selection and asset allocation strategies is uncorrelated given very different decisions made, even when both approaches are adding value. We call this *Dual Alpha* because underlying assets can fund both strategies in parallel, leveraging alpha potential without leveraging risk.

Ready for What Comes Next?

Imagination is more important than knowledge. For knowledge is limited to all we now know and understand, while imagination embraces the entire world, and all there ever will be to know and understand." —Albert Einstein

Equities should outperform bonds by 5-10% over the next year as Treasury yields rise toward 2.75% and interest rates are hiked 2-3 more times, beginning as early as June. Global equity returns of 7-9% will be more difficult with valuations closer to normal. Investors should maintain shorter fixed income maturity and favor floating rate debt. Just a 1% rise in 10-year Treasury yields results in a -6.8% return at current rates, but we believe a 3-4% higher Treasury yield is required to normalize the yield curve vs. inflation. Normalization requires steady rate hikes every other meeting or 1% per year, similar to the last cycle beginning in mid-2004.

Investors need to be vigilant about the global impact of rising U.S. rates on global bonds, and other rate sensitive investments. Emerging imbalances routinely develop when fueled by low cost money, while the hunger for yield and lower risk priced certain security characteristics (risk factors) at a premium to intrinsic value. Economic divergences and inflection points in monetary policy are a precursor to increasing market volatility and return dispersion. The next crisis may be rooted in sovereign debt impacted by expanding fiscal deficits. Moreover, the widening valuation gap between stocks and stretched bonds could result in a Great Rotation as long as there is no foreseeable recession.

Darlings of safe havens may become toxic with rising interest rates, including low volatility, high dividend yield, long bonds, gold, risk parity, and certain alternatives. Over the long-term, fundamental value and quality never are out of fashion, although lately momentum seems to be the popular obsession. Small-cap stocks are compelling after five years of neglect. Years of anomalous behavior and interest rate manipulation have increased imbalances and skewed valuations. Investor preferences seeking income and risk reducing investments that worked well may perform poorly in a rising rate environment.

Differences unfolding in fiscal, monetary, interest rate and regulatory policy have resulted in greater global cyclical divergence. As economies diverge, monetary policy should diverge too. Greater asset class, country, and risk factor return dispersion should follow, increasing investment opportunities and international diversification. Interestingly, correlations between emerging market economies are declining as they mature and secular themes give way to cyclical forces. Currency management discipline for global strategies has become more crucial recently, as well.

We are concerned about how to restore 5-7% earnings growth as labor, tax, and regulatory costs are cutting into margins, and revenue growth stagnates given just 2-3% real GDP growth. Industrial production and business sales have slumped, while retail sales and particularly construction (housing) is still expanding. Secular consequences of poor policy decisions have taken a measurable toll on economic and earnings growth potential. This is true from the U.S. to other developed and emerging countries. The sovereign debt crisis, municipal defaults, fiscal cliff, faltering Abenomics, and U.S. debt ceiling crisis highlight attention needed on fiscal, labor, and regulatory reform. Our founding values and principles served America well becoming the world's economic, technological, and military superpower, while bankrupting socialist and communist regimes for 60 years. Improving global competitiveness seems critical to bolstering export demand for goods and services. Voters are disappointed and angry with political leadership, thus seek to restore our growth potential and economic security constructively.

In the *Search for Greater Authenticity*, disciplined investment strategy encourages compelling outcomes. Consistent analysis offers a smarter and more productive approach to investing that has stood the test of time. Heightened concern about negative interest rates, extended valuations, stability of credit ratings, and potential for default/impairment at a time of rising inflation increases risk to wealth. Investors seeking Easy Street and Free Lunch Alley should know these places are more dangerous when it's hard to appreciate the risks lurking in the shadows. Investors have forgotten there is a simpler intuitive way to achieve better results that indeed stood the test of time. In the *Search for Greater Authenticity,* contrarian investing is not easy,