INVESTMENT HIGHLIGHTS

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LOSING CREDIBILITY AND ITS NERVE

The Federal Reserve began 2016 with an expectation it would raise rates by 1%, presumed to hike every other meeting with a scheduled press conference. The FOMC[1] voted to pause in March, instead of maintaining a steady path to normalizing interest rates. We believe the committee made a mistake that will increase market volatility and further undermined its credibility. To get back on track requires recycling uncertainty that contributed to the very equity volatility that gave voting members pause. The markets tendency to overreact to changes in monetary policy increases the cost of policy mistakes. Efforts to be more transparent have only confused investors and increased uncertainty, while undermining confidence.

The FOMC published its consensus, suggesting a level of 1% by year end, equivalent to 2-3 hikes this year and four next year. Yet, more troubling is the unnoticed material shift in the long-run median, which plunged from a historical average of 4.0% to just 3.3% in a year. Such a secular change is ridiculous, unless core inflation miraculously evolved. Equilibrium may be ¼% less than assumed for decades, but not ¾% less. Expectations are likely skewed by persist low inflation over a long period of record innovation, but cyclical inflationary risks are increasing faster now.

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

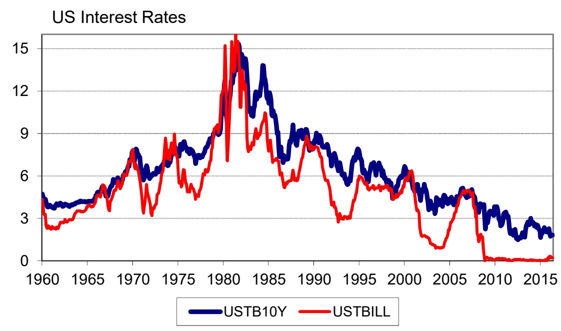
Source: FOMC Economic Projections for March 16, 2016

So what spooked the FOMC? Their statement and press conference suggest lower inflation expectations and "global economic and financial developments of recent months." The committee seems more timid with heightened market volatility, plus weaker exports and capital investment. Lower energy prices and net exports are not rooted in slowing growth, but other transitory drivers, including a stronger U.S. dollar and oil supply increases. Lower commodity prices can be a precursor to recession, but in this case heightened conservation, substitution, and innovation are at work.

The FOMC's rationale for pausing normalization is flawed, and has further undermined its credibility after years of manipulating market rates and increasing moral hazard for business, households and investors. U.S. interest rates have been too low for too long. Interest rates must normalize at a steady pace for the foreseeable future, particularly given a bond-bloated balance sheet. Reducing holdings includes refunding $1.36 trillion of maturing Treasuries within the next five years. With moderate growth and rising inflation, the issue is no longer "when", but how fast rates normalize.

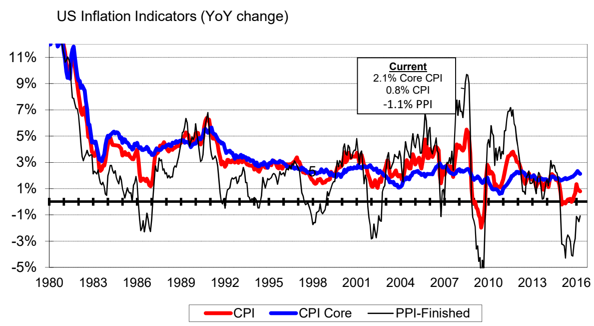
It is dangerous to assume the economy is too fragile and inflation too low to raise interest rates. In our opinion, raising short-term rates by 1-2% would still be stimulative, and below a prudent Taylor Rule target. Deviation from this guideline, which empirically traced sensible interest rate policy for decades, should only occur at points of extreme risk, such as 2008-2009. Emergency monetary stimulus is no longer needed.

While unusual to raise interest rates with such low inflation, inflation risk is increasing at 2% core inflation (ex-food, energy) and near full employment. Initial unemployment claims normalized to workforce is at record lows. Thus, as oil price declines and U.S. dollar strength sunset and labor cost increases take hold, inflation (0.7%) can increase rapidly toward 3%. Thus, interest rates need to rise at least 1% per year for several years, well ahead of an inevitable next recession. We should expect interest rates to begin increasing again in June, but no later than July.

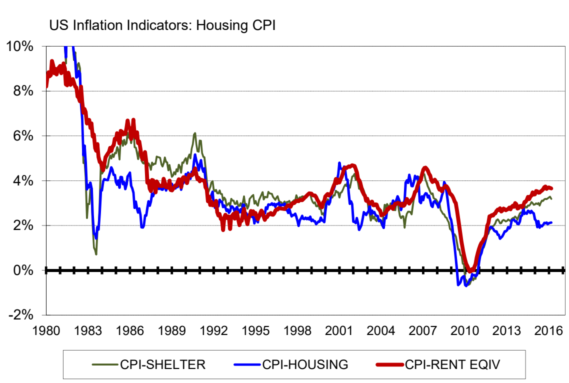


[1] Federal Open Market Committee of the Federal Reserve

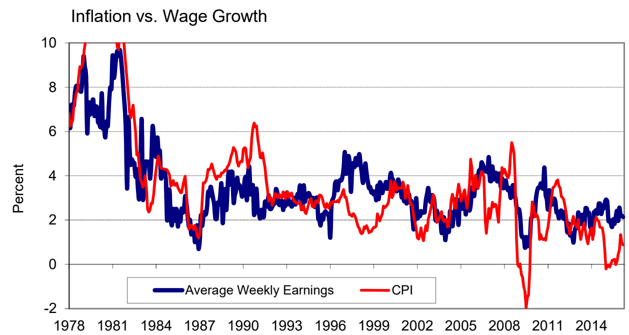
Pushing on a string for years with aggressive monetary stimulus hasn't helped jump-start growth in any country, although helpful during the Financial Crisis. Unwinding years of market manipulation is a greater concern than fears of another credit crunch. Bond volatility should increase with expectations for a period of multi-year bond market losses as interest rates normalize. A yield risk premium of ~0.5% persisting over several years may be needed given stretched bond valuations, increasing the cost of capital. This would be a difficult legacy to over six years of dysfunctional fiscal and monetary policy. Investors should be vigilant about the global impact of bond market losses as yields rise. The next financial crisis will be quite different from any other, probably rooted in unsustainable sovereign debt and fiscal deficits.



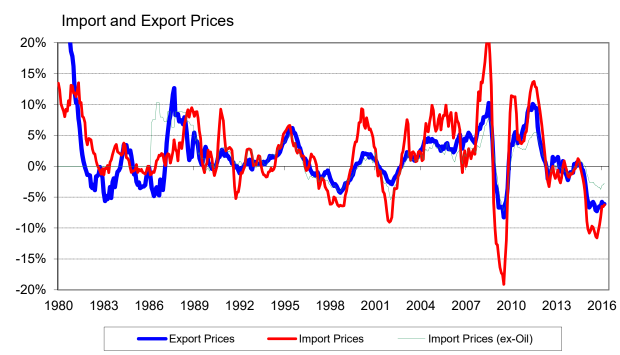
Rising inflation is not required to justify normalizing interest rates, although inflation seems to be gathering strength. So, there is nothing comforting for naysayers in the charts above or below. Inflationary risks are typically dismissed although rising cost of housing and wages are cause for concern. Transitory effects of plunging oil prices and U.S. dollar appreciation will reverse as these forces sunset. Recent equity-oil correlation also seems spurious if lower natural gas and oil prices closer to equilibrium (WTI oil: $50-60) helps global growth. As housing demand strengthened and rental vacancies declined, home prices and rent has increased. Rent equivalent inflation is 34% of CPI and 42% of core CPI, so this effect is meaningful.



Labor costs are rising with higher wages and benefits, including health care costs. Declining unemployment and shifting skill demands drove up job openings. Wage growth is highly correlated with inflation, so 4.0% average wage growth has tracked CPI inflation of 4.2% over the last 50 years. Wages increased 2.3% over the last five years, exceeding CPI inflation of 1.8%. Wages didn't decline, although slowing wage growth has been simply a function of moderating inflation. Indeed, wages rose, even exceeding inflation since 2010. As minimum wage and overtime regulations increase, wage plus benefit costs can exceed inflation, thereby undermining productivity and margins.



We have enjoyed stable consumer prices, particularly for imported goods. A strong U.S. dollar deflated import prices and increased the cost of exported goods and services. The effect of the chart below is intuitive, yet we haven't seen it published anywhere, despite its significance to notable disinflation and currency effects.

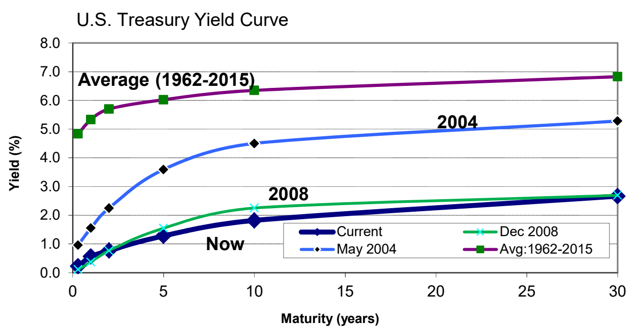


Further Euro and Yen weakness is expected as the BoJ and ECB continue to worry about low inflation and weak growth. Political failure to correct structural fiscal deficits and excessive spending forced central banks to shoulder the burden of bolstering growth. Central banks now dominate buying of Japanese and Eurozone sovereign debt, but capacity for quantitative easing is not unlimited. Interest rates in Japan and Europe have fallen below 0%, and easy monetary policy has had diminishing economic effect.

Low and stable inflation is desirable, even when modestly below an arbitrary target and particularly given global transitory factors. Central bank preoccupation with inflation targeting is misguided and a fool's errand. We think they should instead focus on exceptional growth and inflation, recognizing that monetary policy tools are a blunt hammer that should be reserved for short-lived extreme conditions.

The underlying structural problems that triggered the 2012 European Debt Crisis haven't been addressed, and Japan is now at even greater risk. Deflation is symptomatic of a poorly functioning economy, not the cause. Inflation targeting policies risk stagflation, particularly as moral hazard was exacerbated by explicitly manipulating interest rates over extended periods. Lower credit ratings and bond risk premiums will increase interest burdens and worsen fiscal deficits. These are critical lessons for other countries.

Historical bond risk and return are skewed by a bull market of over three decades of declining yields. Normalization requires steady rate hikes every other meeting or 1% per year, similar to the cycle beginning in 2004. The importance of the chart below is to highlight the divergence from normal, even as the economy is performing relatively well. Unemployment has fallen from over 10% to less than 5%, as steady moderate growth coincides with rising inflation risks.



To return to levels at the start of the 2004 interest rate cycle, 10-year Treasury yields must rise over 2%. This level would still be 2% less than the 50-year average. This raises concern about risk parity and LDI-driven long duration and leveraged bond exposure, orders of magnitude greater than Orange County had in 1994.

Fixed income illiquidity risk seems underappreciated, while difficult to measure and challenging to hedge. High global debt levels and record issuance mask a critical risk for 2016 as interest rates rise. A pause in normalization exacerbates financial imbalances. Higher U.S. rates will increase global interest burdens, so it is fiscally untenable for those with soaring debt and weak potential growth without structural reform. Japanese and European government debt are most at risk.

Final Thoughts

The Federal Reserve has lost credibility in failing to follow through on steady policy normalization, even if ¼% was of little consequence. Global divergences will always exist, but domestic fundamentals need to drive U.S. policy decisions. June provides chance to re-establish consistent policy normalization, and thus credibility. Recognizing 2016 is an election year, delaying rate hikes until September would be politically difficult. Steady ¼% increases every other meeting should begin in June. Recession is unlikely in the foreseeable future whether or not interest rates rise.

Differences unfolding in fiscal, monetary, interest rate and regulatory policy have resulted in greater cyclical divergence. Economic divergences and monetary inflection points are a precursor to increasing capital market volatility and return dispersion. Volatility provides tactical opportunities, and just a 1% rise in a 10-year bond yield results in a -6.8% loss. Currency management has become more crucial.

Greater asset class, country, and risk factor return dispersion should follow economic divergence, increasing investment opportunities and international diversification. U.S. dollar strength reflected greater confidence in growth, currency momentum, and higher yields attracting capital flows, but also remains a headwind to export growth. As gold has plunged 40% from 2011 highs, investors are realizing gold is a flawed hedge, being neither "low risk", nor a prudent "store of value" when inflation is well contained.

Bond volatility is underestimated and asset class correlations are evolving more quickly now, thus risk is difficult to assess. Historic return and risk assumptions can lead to misallocation and disappointing results. Uncertain risk measures impact optimal asset allocations, particularly for those that have embraced risk-focused allocation schemes. Private market risk parameters are acutely prone to mismeasurement given practical difficulties of less than annual valuation.

Risk of fond illiquidity is underappreciated risk, yet it is difficult to measure and challenging to hedge. It will exacerbate volatility, particularly for countries with high debt levels. Higher U.S. yields will lift global yields and adversely impact other rate sensitive investments. Safe haven and income darlings may become toxic with higher rates, including low volatility, high dividend yield, long bonds, gold, risk parity, and certain alternatives.