TREASURY | PARTNERS

Treasury Partners Outlook

February 16, 2016

Looking Back at 2015, Looking Forward to 2016

2015 Review—A Long, Winding Road Back to the Starting Line

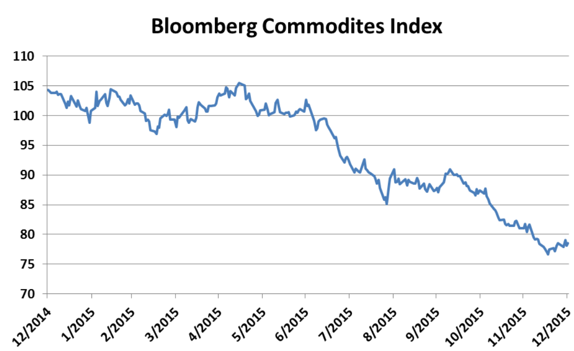
Overview

2015 was a year marked by both significant volatility *and* fundamental stability, punctuated by prominent, headline-grabbing market meltdowns in several key sectors. For example:

China Sneezes, World Shudders. In June, Chinese equities experienced sharp declines, and in August, a surprising currency devaluation of the yuan vs. the U.S. Dollar roiled global equity markets.

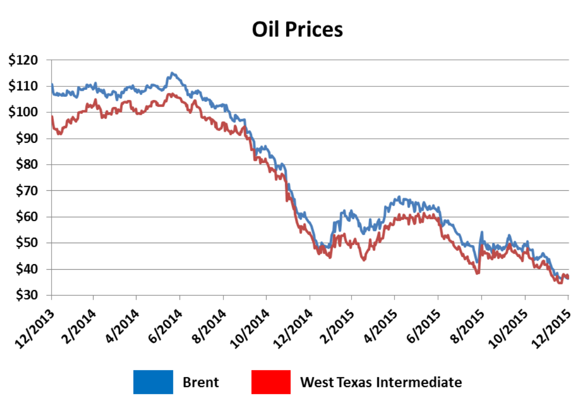
Source: Bloomberg

Collapsing Commodities. Ongoing weakness in most international economies, particularly in China, resulted in lower demand for most commodities, leading to significant declines for everything from oil and copper to soybeans and cotton.



Source: Bloomberg

The Unexpected Fall of Energy. Over the last two years, prices for benchmark crude oil and natural gas declined over 60% from their respective highs, declining to levels not seen in over a decade.



Source: Bloomberg

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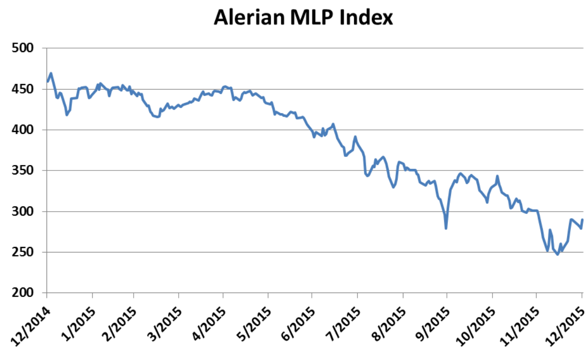
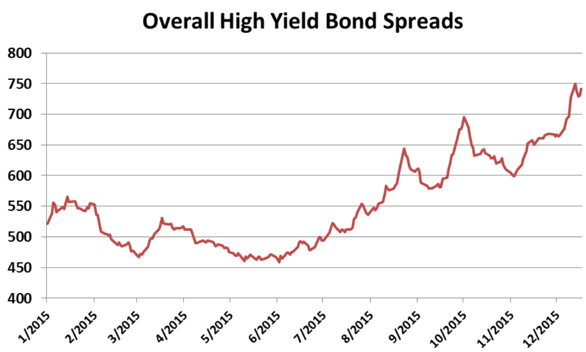


Source: Bloomberg

MLPs Hit Hard. The steep fall in energy claimed a further victim in Master Limited Partnerships ("MLPs"), whose value derives mostly from the pipelines that transport oil and natural gas. The benchmark MLP index mirrored energy, tumbling 37% in 2015.



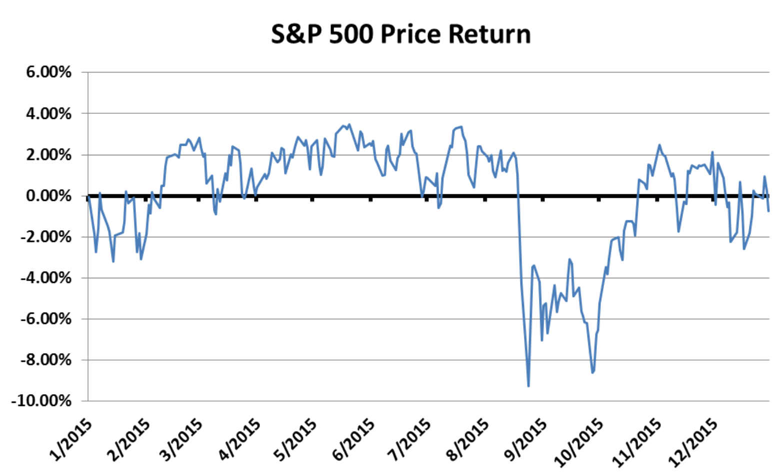
Source: Bloomberg

Credit Cycle Rolls Over. While years of ultra-accommodative monetary policy had encouraged the reach for yield and tight compression in credit spreads, in Q4 market sentiment reversed. This led to a sharp increase in high-yield credit spreads and corresponding price declines in high yield bonds.

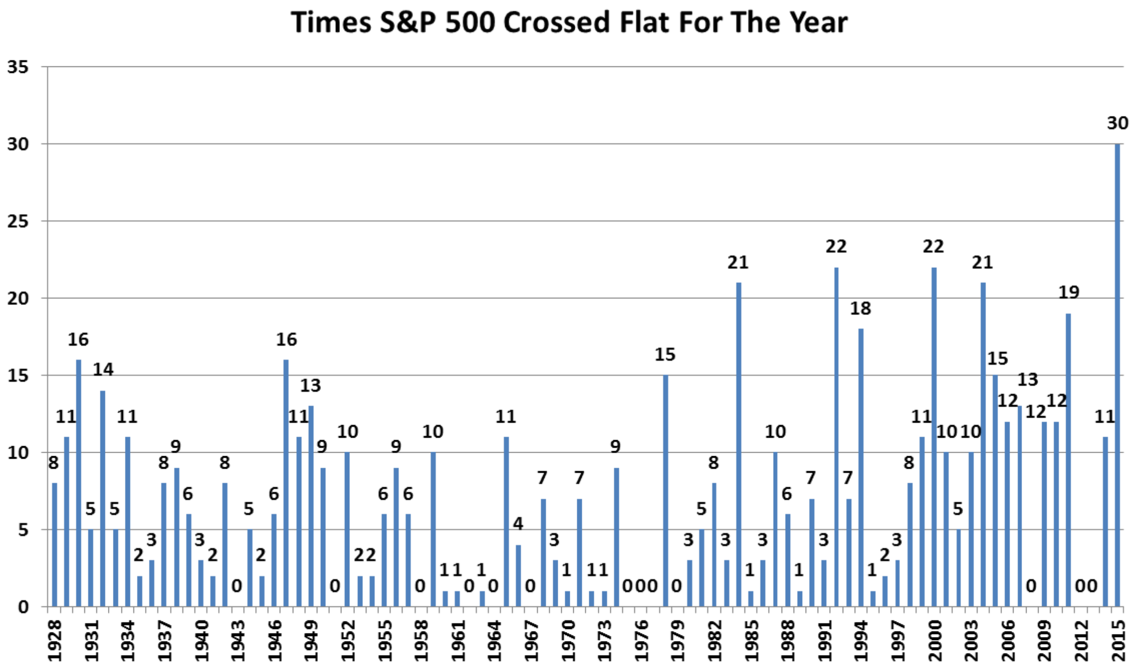
However, volatile global financial markets obscured the solid fundamental reality: that a resilient US economy continued a sustained, if unspectacular, post-crisis recovery. Annualized GDP growth trended between 2-3%, and the labor picture brightened, with unemployment ticking down to 5% and initial jobless claims hitting a 40-year low. However, noticeable headwinds persisted. Although the domestic services sector continued to grow, the manufacturing sector appeared to be slowing. Measures of inflation stayed low, signaling muted global demand. Overall, the balance of evidence showed enough continuing progress to convince the Fed to end its historic Zero Interest Rate Policy ("ZIRP") era with the first rate hike since 2006.

Focus on Equities

The broad US equity market, as represented by the S&P 500 index, experienced an exceptionally volatile year. Ultimately, the S&P 500's year-on-year price return crossed between positive and negative territory an astounding 30 times. This was record breaking; in its nearly 90 year history, the S&P 500 never recorded as many intra-year swings between positive and negative returns as it did during 2015.



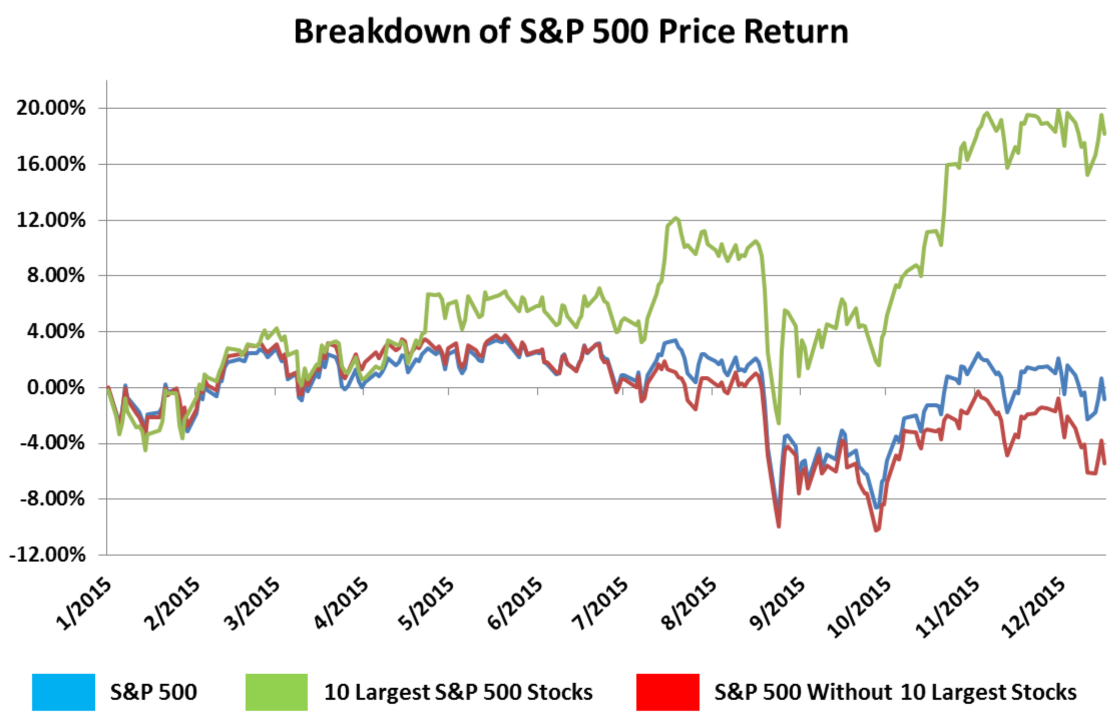
Source: Bloomberg



Source: Strategas

Just as astounding, for all this seeming instability, the S&P 500 (excluding dividends) ended the year down less than 1% - essentially flat!

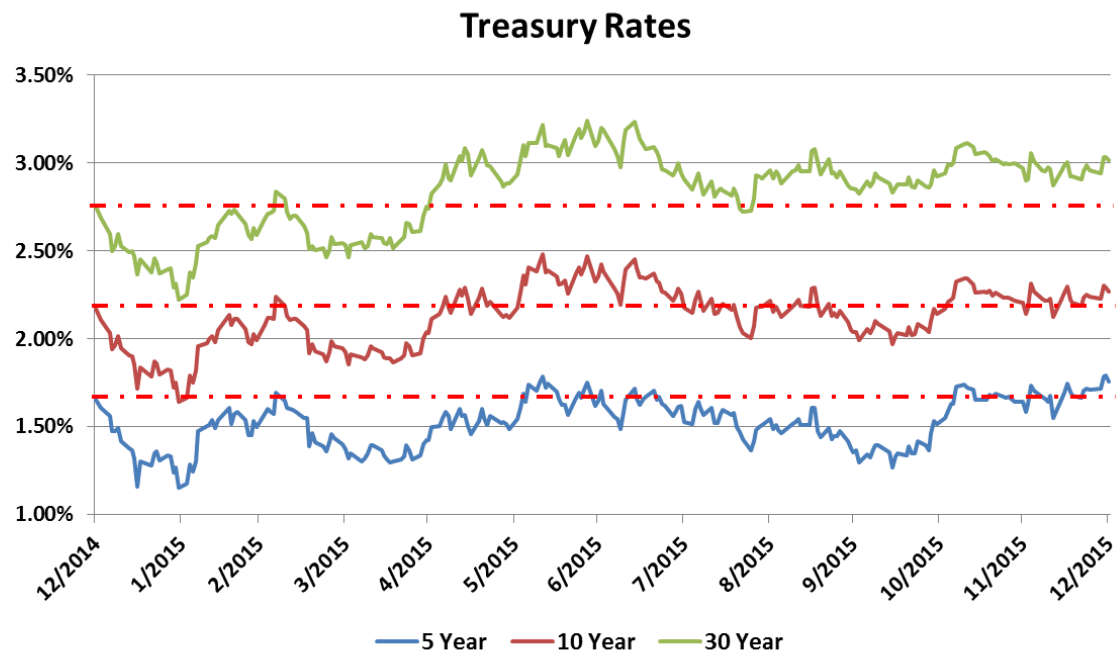
However, it is important to note that this overall number does obscure a troubling amount of market segmentation. The overall -1% result was dominated by the performance of the index's 10 largest stocks, which returned 17%. Subtracting these 10 outperformers, the other 490 stocks within the index had a negative total return, declining more than 5% on the year. This indicates that equities had little "breadth", which would typically be a bearish signal going forward.



Source: Strategas

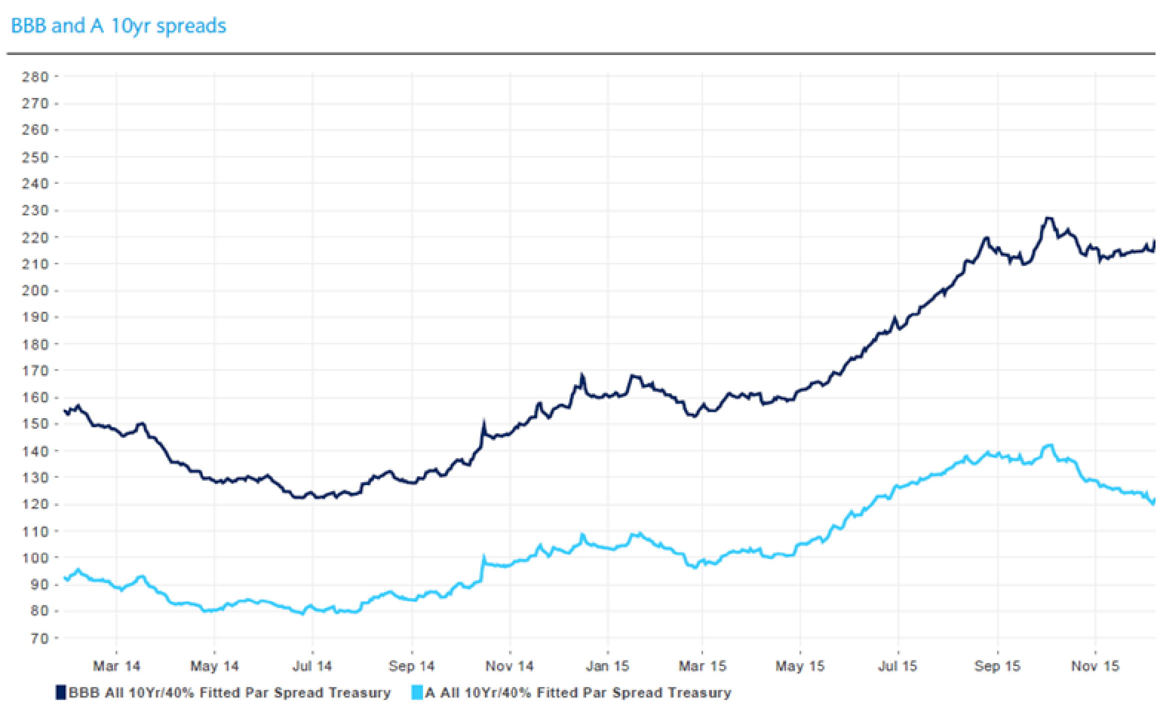
Focus on Fixed Income

This "boomerang" effect was just as pronounced in the Treasury markets. Looking at benchmark 5, 10, and 30 year yields, Treasuries generally oscillated higher and lower throughout the year before ending at approximately the same levels at which they began.



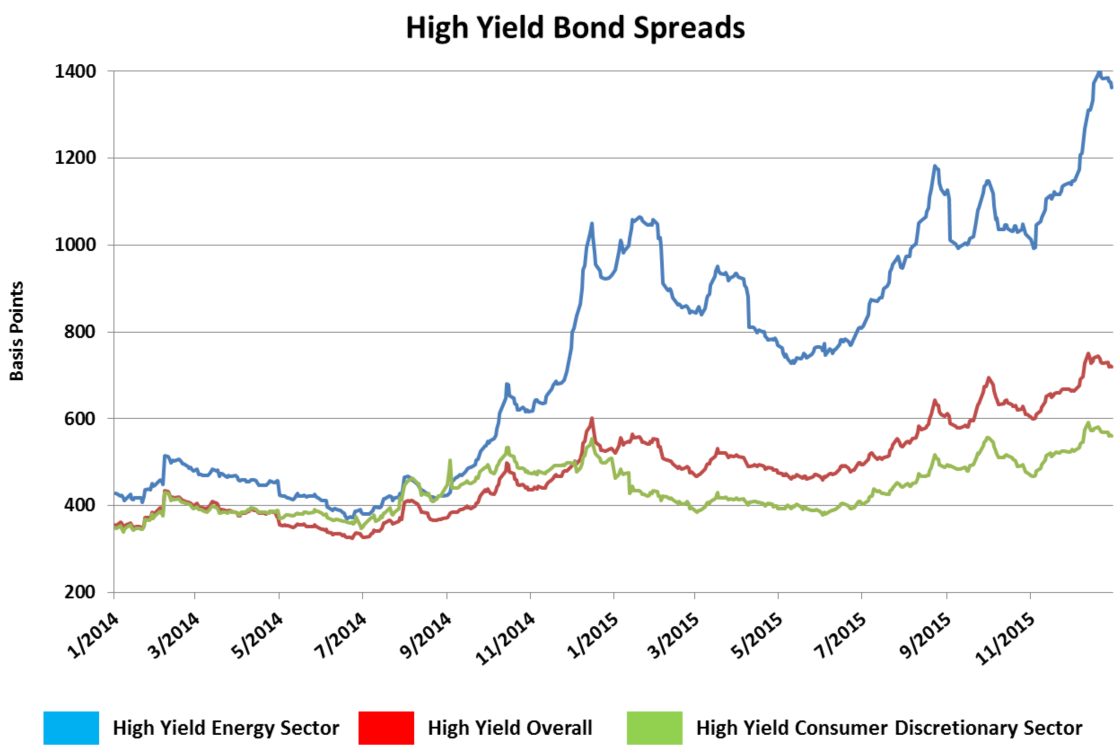
Source: Bloomberg

This was not the case with investment grade corporates, where credit spreads over Treasuries (which reflect the market's perception of relative risk) clearly widened on the year.



Source: Barclays Live

Spread widening in high-yield ("HY") bonds was greater and more sudden. The reversal in market sentiment was most concentrated in the HY energy sector, while spreads for HY consumer discretionary, typically a more stable component, remained below those of the overall HY market.



Source: Bloomberg

2016 Outlook – Fasten Your Seatbelts, There's Turbulence Ahead

Overview

Looking ahead, we believe 2015's volatility is likely to intensify in 2016. The US economy is entering uncharted territory, as the long-awaited Fed "liftoff" and policy normalization fundamentally alters the market's view of risk.

Within the ZIRP, financing was cheap and plentiful, with both investment grade and high-yield companies able to borrow at low rates. Investors unwilling to accept rock-bottom yields were forced down the credit spectrum, further depressing credit spreads. Consequently, ZIRP artificially distorted the price of risk. These conditions have now begun to change. Although the Fed's initial rate hike was small, its implications are large as the unprecedented era of "costless" financing comes to an end. As a result, this step towards market "normalization" should eventually lead to more opportunities.

Key Themes

In no particular order, here are some of the themes we will keep a close eye on throughout 2016:

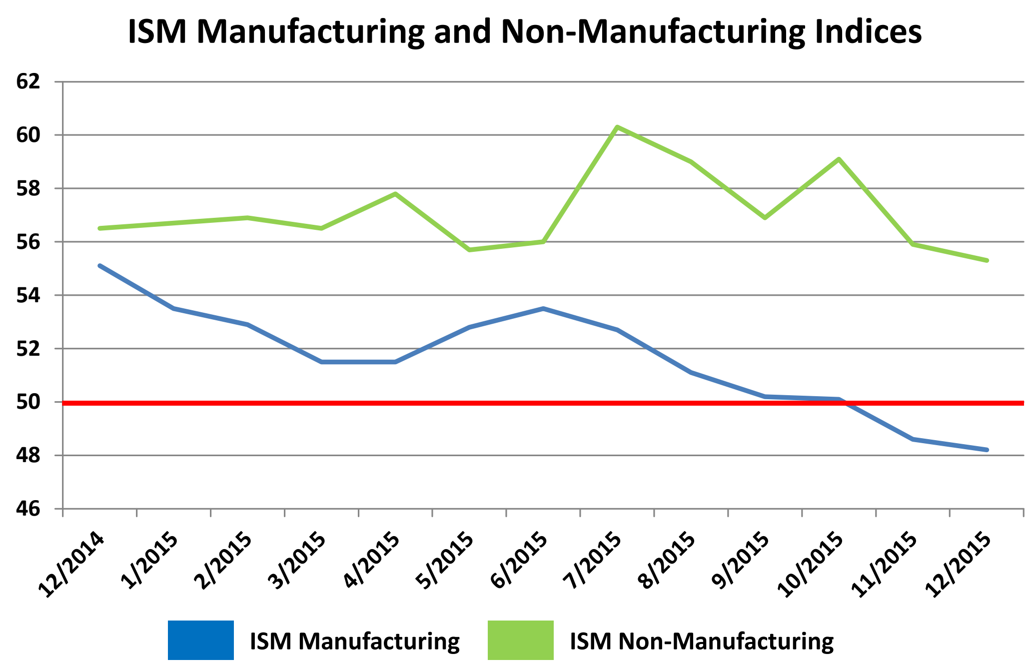
What Goes Down…Sometimes Comes Back Up. There are a number of sectors and asset classes which saw significant declines in 2015:

- High-yield debt (particularly the HY energy sector)
- Emerging market equity and debt
- MLPs
- Biotech

This deterioration in market sentiment has been, in our view, largely justified by the fundamentals, and we continue to avoid positions in these areas. However, capital markets have a tendency to overreact. We continue to monitor for opportunities to purchase sound assets at attractive risk-adjusted values, which may include finding hidden gems in sectors that have fallen on hard times.

Will the Industrial Recession Spread? The solid performance of the overall US economy masks a divergence within its components: the manufacturing sector is in the midst of a slowdown, while the services sector has kept growing.

Closely-watched data from the Institute for Supply Management ("ISM") demonstrate the extent of the separation (a reading above 50 indicates expansion, while a reading below 50 indicates contraction).



Source: Bloomberg

The appreciating US dollar and weak oil and gas-related infrastructure investment have been key manufacturing sector headwinds. The major risk is that manufacturing weakness persists spreading to overall employment and confidence. However, given the solid domestic data heading into year-end, this appears unlikely (for now).

Further Pain in Emerging Markets. EM equities faced a tough slog in 2015, weighed down in particular by the decline in commodity prices and the Chinese construction slowdown. Meanwhile, the continuing strength of the US dollar spelled trouble for EM companies with outstanding dollar-denominated debt, increasing their relative debt service burdens.

Ultimately, we believe EM equities still offer more downside than upside. Additional deterioration in the global macroeconomic outlook and a move higher in the US dollar would further bring down commodity prices, reinforcing a negative cycle.

This deterioration in market sentiment has been, in our view, largely justified by the fundamentals, and we continue to avoid positions in these areas. However, capital markets have a tendency to overreact. We continue to monitor for opportunities to purchase sound assets at attractive risk-adjusted values, which may include finding hidden gems in sectors that have fallen on hard times.

The Fed's Delicate Balancing Act. Bond markets initially took December's Fed "liftoff" in stride, with short-term rates bumping up modestly while intermediate and long-term rates barely budged from their ultra-low levels. The main factor behind the muted response was the market's estimate for a gradual but sustained pace of future rate increases.

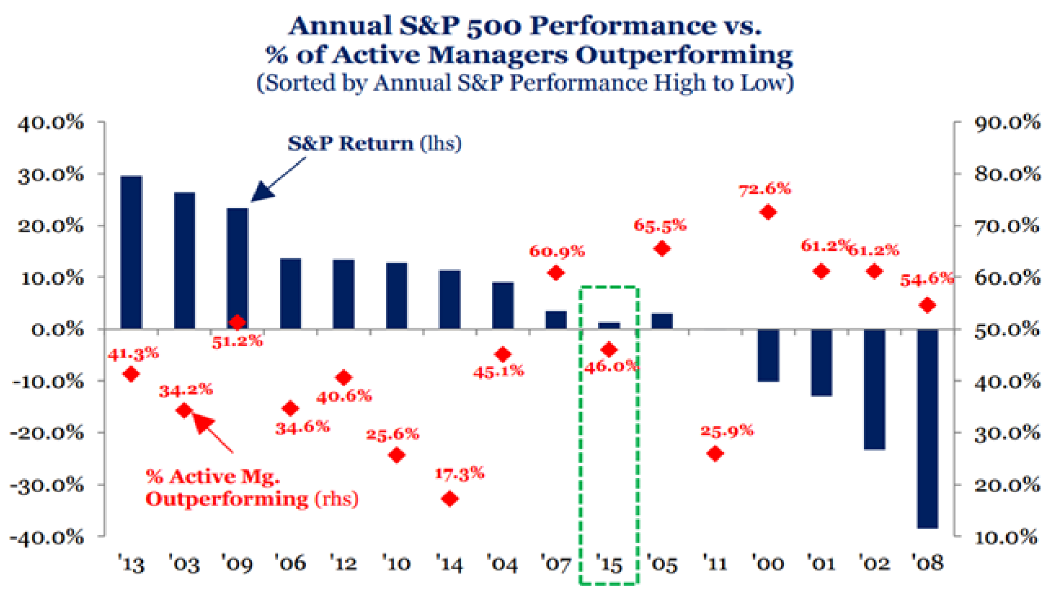
Since the beginning of 2016, however, growing fears that global market volatility and economic weakness could spread to the US have changed the backdrop. The bond market currently forecasts no additional rate hikes until 2018, as short-term Treasury rates have declined to pre-liftoff levels while 10 and 30-year Treasury yields are down even more. This underscores the difficulty of the Fed's task, as it must balance normalizing monetary policy with the need to foster stability, all while not derailing the economic recovery.

Putting It All Together – The Game Plan

How do all these abstract themes translate into actionable investment ideas? We believe 2016 will be marked by both volatility and greater dispersion in returns than we have seen in several years. Adding value will require flexibility to react to market conditions as they evolve.

This will be essential in a year which we believe will prove challenging for markets as a whole. Although domestic equity and fixed income markets ultimately came full circle in 2015, the backdrop now is more *pessimistic* than it was last year. After a volatile start to 2016, the S&P 500 remains fairly valued at only 15.1x forward P/E, compared to their long term average of 15.0x. S&P earnings (ex energy) are holding up, and there are few signs of the market euphoria that typically signals the top of a bubble. However, global uncertainties, concerns about cascading oil prices, and high yield defaults will weigh on investor sentiment.

A supportive environment for opportunism and greater variability in equity prices could be a boon to actively-managed strategies. In particular, recent history supports the notion that active strategies can outperform in difficult years for the equity market as a whole.



Source: Strategas

At this time, we continue to maintain existing allocations to fixed income and equities, albeit with a tilt away from market-directional (index) exposure. In fixed income, we will keep relatively short portfolio durations and take advantage of rolling maturities, with the intent to reinvest at higher rates over the next few years. We simply aren't enthused with the risk-return profile of an ultra low rate environment. We foresee potential opportunities in energy-related bonds and other fixed income issuers.

The flexibility we will emphasize in picking specific managers will also be necessary in monitoring these asset class allocations as 2016 progresses. In particular, we are concerned about the heightened probability of exogenous shocks – e.g. a sharp and sudden devaluation of the yuan, an oil price-related geopolitical accident, etc. – causing extreme market volatility that calls for a reassessment in our approach.

Market volatility should remain high near term, as we look for a *large watershed event* to test investor resolve and create additional opportunities for long term investors.

As always, we're available to discuss these thoughts and how they impact your portfolio.