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Stock Market Outlook

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2016: Part 2

2016 STOCK MARKET OUTLOOK – PART II

Executive Summary

Global markets rallied in Q1's second half, erasing an early-year slide to finish the quarter down just slightly. While sharp downswings like January's are uncomfortable, strong returns in late February and March show how quickly corrections can reverse, rewarding disciplined investors. We believe stocks will keep rewarding discipline as the bull market continues this year.

2016 seems set to become the Year of Falling Uncertainty. (Appendix II) The year began with huge uncertainty surrounding US elections, low oil prices, China, negative interest rates and the UK's looming "Brexit" vote on staying in the EU. None are disastrous, but combined they fueled massive fear.

The year's early downturn may be over—it will only be clear in hindsight—but another correction later this year is always possible. Corrections (short, sharp downturns exceeding -10%) result from sentiment's unpredictable whims. They don't operate on schedules, so the fact we just had one doesn't prevent another. In our view, the best course of action when sharp downdrafts strike is to stay calm. It can be tempting to try to time corrections for fear they'll fall further, but such moves often backfire, and can jeopardize your long-term goals through missed opportunity. We recommend reducing equity exposure only if we forecast a bear market—a long, fundamentally driven downtrend exceeding -20%. It takes a negative surprise quashing trillions in economic activity to drive a bear market. We don't see a sufficiently powerful, surprising negative lurking unnoticed to end the bull market right now.

America's election is seven months away and still impossible to handicap, but markets will steadily gain clarity. The field has narrowed. Hillary Clinton is the likely Democratic nominee, and Donald Trump leads the GOP delegate count. Yet events could derail either campaign, so uncertainty persists. Most of this fog should dissipate by convention season, giving markets fewer wild scenarios to fret and helping investors narrow their focus and price in the outcome. On November 8, uncertainty evaporates, letting investors get on with life—a powerful positive.

While politics are worth assessing, we believe it's crucial to accept that no party is superior, and no candidate is automatically good or bad for markets. Politics are emotional, and bias blinds—hence our political agnosticism. Markets have performed well and poorly under both Democrats and Republicans. Headlines speculate on whether Trump, Clinton, Bernie Sanders, Ted Cruz and the rest will be good or bad for markets—all bluster, no substance. Campaign rhetoric rarely becomes law, as presidents moderate or hit a Congressional brick wall. Moreover, stocks price all opinions, good and bad. Fear will be baked in soon enough, allowing markets to warm to the eventual winner. The closer the election, the more markets will embrace the victor.

Other lingering questions should similarly fade. "Brexit" will be clear after the June 23 referendum. If the UK stays in the EU, markets will likely cheer the status quo. If it leaves, at least we'll know, and after some uncertainty, markets will see it isn't the disaster most presume.

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Fears of China, negative rates and low oil prices lack fixed end dates but are either misinterpreted or small, and investors should get over them soon enough. China is growing, not collapsing. The eurozone has had negative rates since June 2014, yet it has grown, with lending and broad money growth improving. Energy earnings and investment have already fallen, but the detraction from earnings will soon cease, making growth elsewhere more apparent. As earnings and economic growth beat dour expectations, uncertainty should fall.

Soon investors will see plenty to cheer. The world continues growing, powering profits in most sectors. Broad money supply growth has accelerated throughout the world. Central banking is flawed but not choking off growth. All augur well for capital markets and the global economy. Politically, gridlock has escalated in much of the developed world, reducing legislative risk. Annoying as the in-fighting might be, stocks love it, as it reduces the risk of sweeping change creating winners and losers.

The world is full of unseen positives, with extant negatives too small or too widely known to wallop stocks. Investors aren't euphoric or complacent. Rather, expectations are too dour. This isn't a time to be fearful. This is a time to appreciate what the uncertain masses miss and enjoy a continued bull market.

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Appendix I: The Correction and Beyond

Global markets rebounded from their rocky start in 2016's first six weeks to finish the quarter down just -0.3%.[1] While the ride inspired bearish headlines and drove several pundits to downgrade their 2016 forecasts, Q1's big swings don't alter our view: We still expect a fine year, coupled with volatility. The latter has occurred in spades already, both down and up—and more could await. But as 2016 progresses, we expect markets to reward disciplined investors with positive returns.

How high stocks rise in 2016 likely hinges on sentiment. As 2016 began, several wild cards (like the US election and UK vote on EU membership) combined with China implosion worries, falling oil prices, negative interest rates and eurozone bank fears to create a pea-soup-thick uncertainty fog. Uncertainty can roil stocks, as evident in January and February. But we expect this fog to gradually burn off, allowing investors to see relatively bright fundamentals. (Appendix II) The US and UK votes happen this year, bringing clarity. While oil fears lack an expiration date, oil's drag on earnings and economic data should wane, barring another big drop. Negative rate fears already seem to be fading. The fog should lift, boosting sentiment in the process. How quickly it does so likely determines return magnitude this year.

Fundamentals Suggest More Bull Market Ahead

Fundamentals suggest a bear market is unlikely this year. Sentiment is far from euphoric. Many developed world governments are gridlocked. Despite recession fears, the global economy is growing. Many bears cite recently weakening industrial or trade data, but these are skewed by oil and commodity prices. Consumption and services drive growth in the US, UK and eurozone, and Leading Economic Indexes suggest growth will continue. (Appendix III) Even commodity-heavy developed economies like Canada and Australia aren't collapsing, as their services sectors offset weak resource sectors. Japan is a quagmire, but an outlier. Emerging Markets (EMs), too, continue growing. Many fear China's slowdown, overlooking its strong growth rates. While Russia and Brazil are in deep recessions, their economies are largely weighed down by weak commodity prices. India, Indonesia, Malaysia, Peru and other EMs are growing apace; Thailand, Mexico, Korea and Chile aren't far behind. Emerging Markets aren't uniformly sagging.

Extreme Legislation Is Unlikely

Politically, most major developed countries remain bullishly gridlocked, mitigating extreme legislation risk (which stocks hate). US election years typically feature little sweeping legislation, as politicians don't want to risk upsetting voters with unpopular bills. In the UK, Prime Minister David Cameron's Conservatives have a slight majority, but deep intraparty divisions over issues like Brexit and budget cuts suggest fractious new laws aren't likely. After messy elections, Portugal has a fragile government with little ability to pass material legislation, while Spain and Ireland don't even have governments yet—hampering their ability to undo prior economic reforms. These reforms have greatly aided their recoveries and partly explain Spain's relatively quick recent GDP growth. France and Italy are struggling to pass labor market reforms

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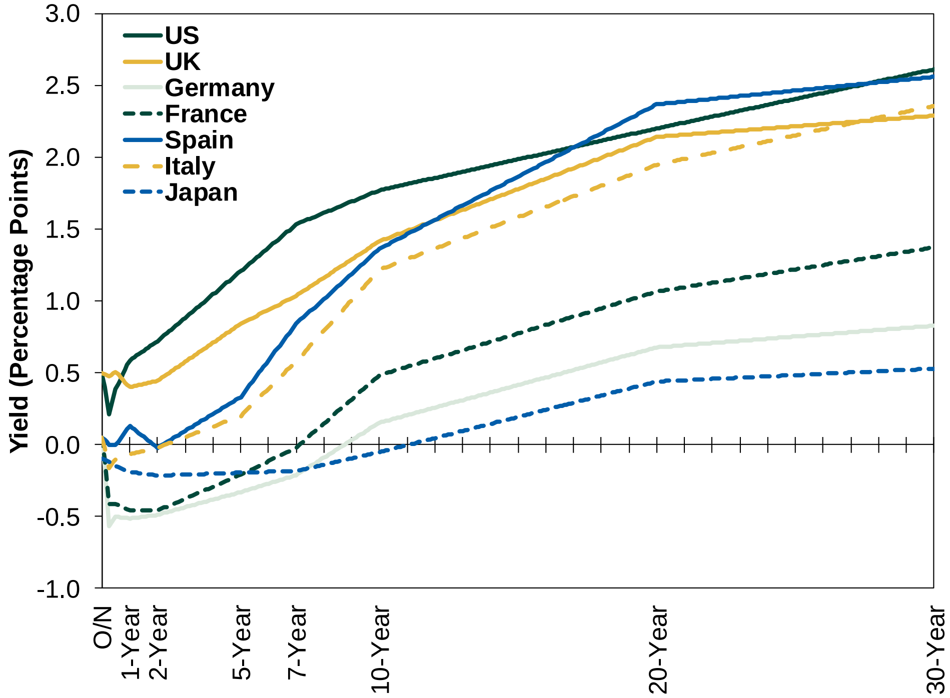
to enhance competitiveness, but they also aren't enacting measures hurting growth, and both economies are growing (albeit modestly). While Japan would benefit from enacting structural economic reforms, this is tied more to Prime Minister Shinzo Abe's unwillingness to advance contentious reforms than gridlock.

Interest Rates Are Benign

Interest rates remain benign, with yield curves positively sloped in most of the developed world.

Exhibit 1: Major Developed World Yield Curves



Source: FactSet, as of 4/6/2016. Rates on 3/31/2016.

US 10-year Treasury rates, which started 2016 at 2.27%, fell alongside stocks in January and early February, hitting 1.66% on February 11.[2] But by quarter-end, rates had reversed much of the drop. As discussed last quarter, we expect long-term interest rates to finish 2016 near where they started, with volatility along the way. Improving US labor markets and rising wages should put upward pressure on rates, but low global inflation and unconventional monetary policy in Japan and the eurozone exert downward pull. The ECB's and BoJ's quantitative easing programs and negative interest rates drive institutions to seek sovereign bonds with higher yields—Treasurys. While negative interest rates aren't great, in our view, we don't think their spread is overly bad. (Appendix II)

While Fed moves can't be forecast—they are an opaque cabal of humans acting on biased interpretations of data—we don't expect much action this year. As we've written, the Fed claims its decisions are apolitical, but this is a fallacy. The next president will decide whether to reappoint Fed Chair Janet Yellen, and hiking rates close to an election invites controversy.

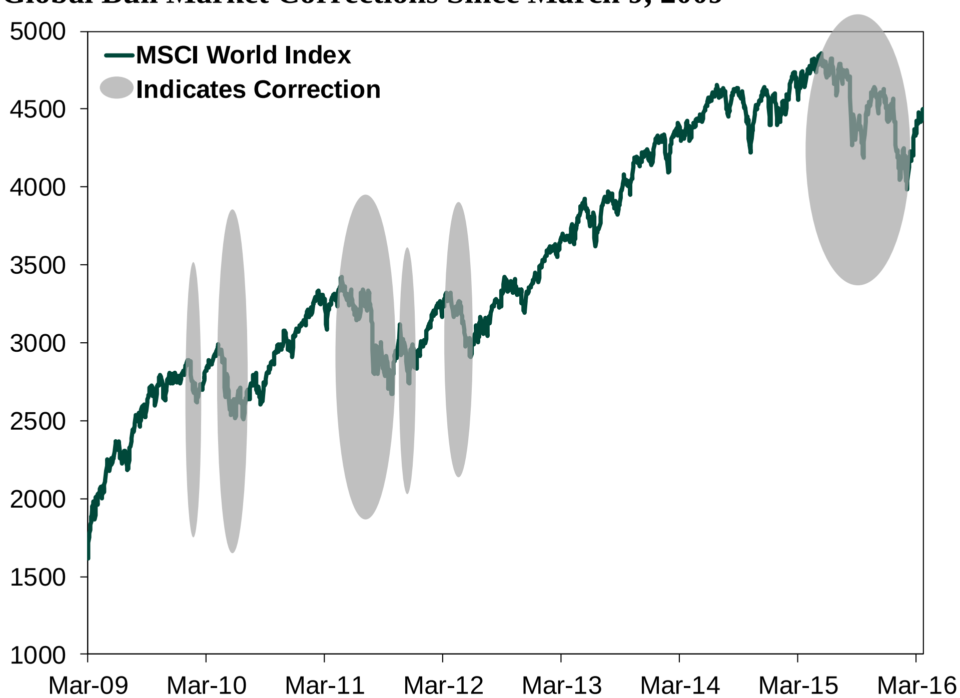
Hence, barring runaway inflation or economic implosion, Fed heads tend to do little as elections approach, as doing nothing gets scant attention. Few see inactivity as the active choice it is.

This year, the UK's "Brexit" referendum on EU membership adds a wrinkle. The Fed has referenced affairs abroad often in recent meetings, suggesting it may not want to hike just before a major event—doing so could cost it credibility. There is no Fed meeting in May, and June's session lands one week before June 23's Brexit vote. If Brexit considerations preclude a June move, then half the year will have passed with no hike—and Democratic and GOP conventions about to start.

Correction, Not a Bear

We believe the negativity at the year's outset was a correction—a short, sharp, sentiment-driven drop exceeding -10%—not a bear market. Corrections are normal in bull markets—the latest is this bull market's sixth since its March 9, 2009 birth.

Exhibit 2: Global Bull Market Corrections Since March 9, 2009



Source: FactSet, as of 4/6/2016. MSCI World Index with net dividends.

The latest correction was long by historical standards and, given its two sharp downdrafts (one in August/September 2015, the other in January/February 2016), it felt more like two. Even so, this correction was fairly archetypal. As usual, volatility was accompanied by fearful stories pundits presumed "caused" the swoon, but were actually false and relatively easily disproved. This time, China, EM currencies, negative rates, oil and European banks took turns in the limelight. While it is too early to declare the correction over, the rally off February 11 (the lowest point to date) looks like a typically sharp correction rebound. Sharp volatility usually reverses suddenly, with

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no discernible catalyst or all-clear signal—leaving pundits scratching their heads, claiming the rally is false and the alleged cause unaddressed. Such stories dominate the financial press today.

Early-year volatility doesn't preclude another correction later. While it would be somewhat unusual historically for another to strike soon, it isn't impossible. Sentiment can swing at any time, for any or no reason, but positive fundamentals suggest a bear market is highly unlikely.

Considering Bear Markets

Because we anticipate a continued bull market, we don't believe reducing exposure to stocks currently makes sense. Studies have shown asset allocation—your portfolio's mix of stocks, bonds, cash and other securities—is the primary determinant of longer-term returns. If your goals require equity-like growth over time, that in turn requires owning stocks the vast majority of time. Making short-term moves in an attempt to dodge corrections and other pullbacks raises the risk you miss upside and fall short of the returns required to reach your goals. As such, we believe reducing equity exposure is wise only if your personal circumstances change or if we believe a bear market (a protracted, fundamentally driven decline exceeding -20%) is forming. In any other scenario—whether returns appear likely to be stellar, tepid or even slightly negative—we believe veering from stocks is a huge risk.

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Appendix II: The Year of Falling Uncertainty

Uncertainty was the watchword as 2016 began. Concerns over the US election, the UK's potential "Brexit" from the EU, negative interest rates, China and oil prices flummoxed investors. Most still have trouble seeing through the fog—but the fog should lift soon. Some of these issues have fixed end dates. Thereafter, markets will gain clarity—positive regardless of the outcome. Others lack expiration dates but should fade as data prove them false.

In many cases, markets fear the worst possible outcome. But what markets truly hate is uncertainty itself. Clarity, whatever it entails, is usually better than the worst-case fear baked into stock prices. The accompanying relief can be a powerful tailwind.

The Wild and Crazy Presidential Election

Please note: We favor neither party nor any candidate and assess political factors solely as they pertain to markets.

As 2016 progresses, election uncertainty will fall and markets will gradually price in the greater clarity—but ahead of election results. Remember, markets discount the future and price what is ahead, not what is current. The year began with a slew of candidates—15 in total, including a lot of wackiness and many folks who might have run but in the quarter decided not to, the most famous being Michael Bloomberg. The active candidate field shrank to five in Q1, adding some clarity. But also the likelihood of a viable third-party general election candidacy fell precipitously, because he or she can't get on enough states' ballots now to actually win due to state-by-state registration deadlines. Only an intended spoiler would initiate now; not someone hoping to actually win.

As we write, Hillary Clinton and Donald Trump lead their parties' delegate counts, but wild cards could still derail either campaign. Election uncertainty fog remains, but it is beginning to lift. In July more clarity comes. The conventions will clear up lingering uncertainty, leaving us with two candidates. Markets will focus on these two, and weigh the likelihood they win and actually act as they talk. While we can't know today who wins, after the polls close November 8, we'll have a president-elect. And the market likely will have priced that president over the August to September period. Again, markets move in advance; they don't wait. They're really good at it.

Waiting for the election to yield a president-elect means missing the bullish force of fading election uncertainty. We believe this, combined with the government's typical unwillingness to pass extreme legislation in election years, partly explains why 82% of election years since 1928 have been positive—exceeding non-election years' 71% frequency of positive returns.[3]

Political bias for almost all of us makes it hard to fathom how certain candidates could be ok for stocks. Financial media has alternately portrayed Clinton, Trump, Sanders and Cruz as terrible for markets. You likely have your own views as to who would be terrible and why. But you

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likely disagree with many other investors. Political bias is strong and blinding. Policy fears include trade wars, prescription drug price caps, tax hikes, high deficits and more, with rhetoric stoking uncertainty. And so many people have so many conflicting views on all these. But markets see all these more clearly than almost any of us can individually and do so in advance. It's what they "do for a living."

Whether you love or loathe any candidate, always remember: The president has far less influence over the economy than you or most people think. Regardless of your feelings for President Obama, pro or con, the bull market didn't start or run seven years and counting because of him. It might have been stronger or weaker with another president but would have happened anyway.

The private sector accounts for 87% of all economic activity and nearly 85% of existing jobs.[4] People overrate executive power, which is deliberately limited by the Constitution. Most of the candidates' flagship campaign pledges require legislation, and Congress often ignores or waters down sweeping proposals. Investors typically overestimate the impact of what presidents do outside of legislation. What seems big is often small relative to global GDP and markets. Then, too, new presidents typically moderate, scrapping most radical campaign pledges, lest they alienate mid-term or re-election voters and ruin their future re-election chances. The executive branch and its various agencies can tweak rules by reinterpreting existing legislation, but the reach is usually limited, and court challenges are common.

Congress seems likely to remain controlled by Republicans. Despite all you will hear in the media, Congress hasn't actually changed hands in a presidential election year since 1952. That should be more true now than in the past. In the House, gerrymandering and incumbency favor fewer potential seats changing. It's just hard to swing many seats in a single election these days. In the Senate, the Democrats technically have a strong structural edge in this year's race: As we've discussed in past Reviews, the Republicans must defend more seats in typically blue territory. But seizing control will require virtually flawless campaigning. Flawless rarely happens in elections. Some suggest a flawed GOP presidential candidate could trigger a Democratic landslide and deliver them Congress, but this is overstated. Few Senate seats have changed hands in past landslide presidential elections. Big Congressional shifts in postwar history have been in the midterms, like 1994's Republican Revolution, the Democrats taking Congressional control in 2006 or the 2010 and 2014 shifts to the Republicans in the House and Senate, respectively.

Hence, if a Democrat (most likely Clinton) wins the White House, she or he will likely face gridlock—bullish. If a Republican wins, the gridlock markets have enjoyed since 2010 could vanish, with a possible exception for Trump. If Trump wins we could actually see a new form of gridlock—one where the president fights with his own party—an interesting spectacle to be sure but also gridlock. In some respect this is similar to the multi-party new gridlock phenomena occurring throughout Western Europe. Still, for stocks, gridlock is good. The biggest 2017 and 2018 US political market risk with a Trump victory is if he reconciles with the GOP. Then gridlock vanishes. If you're Republican you likely see that as good for the long term, and maybe it is (or maybe it isn't), but in terms of intermediate-term markets it increases risk due to legislative changes and markets hating change relative to stability.

Stocks typically post above-average returns in a year the GOP wins the White House as the majority-Republican investment public cheers pro-business campaign talk. In the inaugural year, when the new president proves to be a mere politician, one who can't or won't enact much pro-business legislation, disappointment contributes to below average returns. For the Democrats, it is the reverse—where markets underperform historical averages in the election year when a Democrat wins but then outperform in the inaugural year. (Exhibit 3)

Exhibit 3: The Perverse Inverse

	Election Year	First Year
Republican Elected	15.5%	0.7%
Democrat Elected	7.4%	16.2%

Source: Global Financial Data, as of 4/20/2016. S&P 500 total returns, 1928 – 2013.

What If We Don't Get a New Supreme Court Justice Until Next Year?

This would be fine for markets. Few fathom this, but a split Supreme Court enhances gridlock even more, reducing the risk of sweeping change. For one, a split court may choose not to take on major cases. Two, a 4-4 ruling means the lower court's ruling stands in the jurisdiction where it applies. By definition, that ruling is already a known quantity, with little to no power to knock stocks. But also, most contentious cases are sociological and not very market-related. And even then, most rulings are not divided along ideological lines, so the eight-member court probably won't often come into play. Again, most people tend to think of the Supremes as "right" when they decide like you like it and wrong when they go against your views. To markets, usually, any decision that upsets the apple cart is rotten apples.

Brexit—Tempest in a Teapot

In 2013, UK Prime Minister David Cameron pledged to renegotiate Britain's membership in the EU, repatriate some powers from Brussels, and hold a referendum on continued membership under the revised terms by 2017's end. Cameron and EU leaders reached a deal in February, securing some opt-outs on political integration and benefits payments for migrants. The referendum is scheduled for June 23.

The vote is impossible to handicap. Polls imply a close race, yet online betting sites and prediction markets give the "Remain" campaign a strong edge. Independence votes have a limited history, but voters have picked the status quo much more often than not—Scotland (2014) and Quebec (1995) are two high-profile examples. Voters usually select the status quo when something significant is at stake in referendums in general.

With polls tight, campaigning loud and both sides playing fast and loose with facts, uncertainty likely lingers until the vote. But that vanishes June 23, once the results are in. Just knowing whether the UK will remain in or leave the EU will bring relief. If Britain stays, life proceeds as normal—the status quo is a known quantity, and markets have enjoyed it for decades. If Britain leaves, things will change, but the aftermath likely won't be anywhere near as bad as many

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presume. It will also be a slow, public process, sapping sudden surprise power. A Brexit that goes fine would bring markets relief.

Stocks move most on the gap between reality and expectations, and many see Brexit as the worst-case scenario, but a disastrous Brexit is highly unlikely. Most claims overrate the benefits of EU membership on things like exchange rates and gilt yields. Trade is a wild card, but Brexit shouldn't cause surging protectionism. If "Leave" wins, the UK doesn't sever EU ties overnight. Rather, the vote triggers a two-year exit process, during which the UK and EU will negotiate a new relationship, including trade terms. Both sides benefit from free trade, making the incentive to preserve it strong. Britain can also use that window to ink free-trade agreements with the EU's existing free-trade partners, and it will be free to pursue new bilateral trade agreements for the first time in decades. Even if negotiations take longer than two years, the UK has "most favored nation" status at the World Trade Organization, so it faces relatively low tariffs globally.

The likelihood of a major negative resulting from Brexit seems low. But even if you assume the worst-case scenario of Brexit triggering a UK or continental European recession, regional recessions amid a global expansion and bull market aren't uncommon. Japan—an economy slightly bigger than Britain's—has been in and out of recession three times since the global downturn ended in 2009. The eurozone, vastly larger, was in recession from late 2011 through early 2013. Both Asia and the EU suffered regional recessions during the go-go 1990s. In all these cases, stronger nations pulled the weaker along. Regional weakness can impact stocks in the affected region, but global investing helps mitigate this risk. That said, we believe the positive power of falling uncertainty is likely the dominant force after June 23.

For global markets, it matters little whether the UK is in the EU or not. Brexit isn't like breaking up the euro, which markets dreaded in 2011. Europe arguably needs the UK more than the UK needs Europe economically, but given the core's strong will to hold together, it probably survives a Brexit. The UK benefits from the EU's free movement of goods, services, people and capital, but it has strong trade relationships globally. Even if it leaves the EU, geography and tax advantages make it an attractive destination for multinationals. Tax-wise, the UK is now one of the most competitive nations globally. By 2020, it will have the lowest corporate tax rates in the G-20—unthinkable a generation ago.

Negative Interest Rates—All Bark, Little Bite

Negative interest rates have existed since 2012—the eurozone has had them since 2014—so it's odd that people collectively started fearing them in Q1. The eurozone has also grown throughout its entire experience with negative rates, pre-emptively debunking fears. But sentiment is often irrational—if it weren't, we'd never have bubbles or corrections.

Negative interest rates are the Japanese and European central banks' attempts to discourage cash-hoarding and encourage lending. Most central banks pay interest on excess reserves held at the central bank in order to better control liquidity and interbank lending rates. When a central bank adopts negative rates, instead of paying interest on excess reserves, they charge a small fee. In theory, this should motivate banks to lend more, reducing idle reserves and raising the broad

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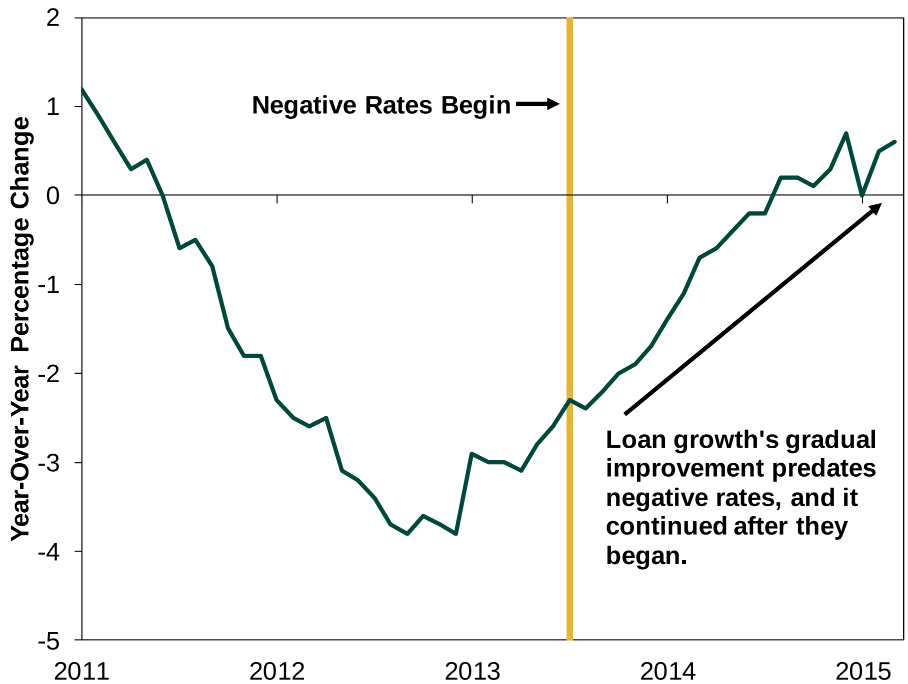
quantity of money (M3 or M4). In practice, however, negative rates are a bank tax. Eurozone banks aren't holding excess reserves for fun. The glut is due partly to low loan demand, partly to reduced loan profitability (thanks to flattish yield curves) and partly to the massive wall of new reserves created by quantitative easing. Hence, to preserve profit margins, banks must either move excess cash into something higher-yielding, like sovereign debt, or pass the costs to consumers. But competition and, in some countries, the law prevent eurozone banks from charging retail customers for deposits, and a large swath of eurozone sovereign debt also carries negative interest rates. As a result, banks' costs are rising.

Yet the impact isn't huge. Only 5% of major global central bank reserves carry a negative interest rate.[5] Moreover, the ECB recently announced it would pay banks with loan growth exceeding certain thresholds, mitigating fears as they pertain to the eurozone. Meanwhile, loan growth continues improving, albeit slowly, and eurozone money supply is growing swiftly. There is also a small silver lining: Negative rates pull down the yield curve's short end, steepening it slightly. There is a downstream effect globally, as negative yields in the eurozone spur demand for higher-yielding sovereigns abroad, driving down medium and longer-term yields in the US and UK. Yet money supply is growing in the US and Britain.

Negative interest rates are counterproductive, but too small to derail growth and credit expansion. In the two years since the ECB unveiled negative interest rates, loan growth has improved. (Exhibit 4) As data disprove the scary narrative, uncertainty should fade.

Exhibit 4: Eurozone Loan Growth Is Up Despite Negative Interest Rates



Source: FactSet, as of 4/21/2016. December 2011 – March 2016.

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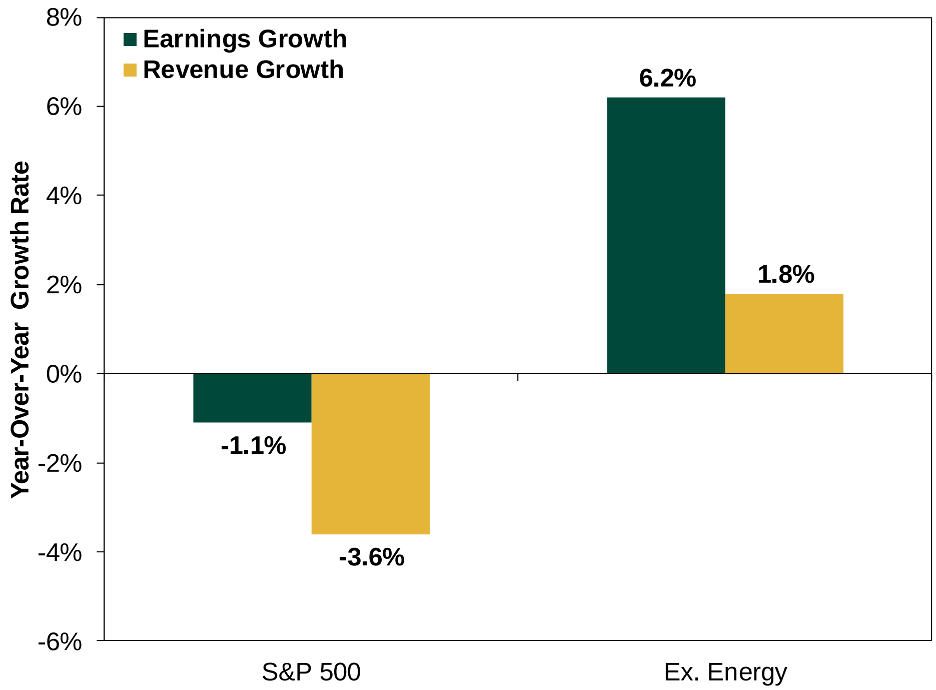
Oil's Sentiment Swing

Oil prices and stocks were highly correlated early this year, leading people to believe oil is driving markets. That oil and stocks have both bounced off February lows has reinforced this perception. While oil and stocks are occasionally highly correlated over very short periods, this is largely a quirk of sentiment, not a fundamental connection. Long-term, there is no discernible relationship between oil and stocks, and oil prices—at any level—have no set economic impact.

Oil has indirectly hurt investor sentiment, but this should fade. As plunging oil prices destroyed Energy firms' earnings last year, it skewed S&P 500 earnings growth downward, driving fears of fading profitability and unsubstantiated valuations. As oil stabilizes, Energy's earnings drag should abate, helping investors see Corporate America is in far better health than most presume. As Exhibit 5 shows, Energy bears most of the blame for S&P 500 earnings per share falling in 2015. Overall, earnings fell -1.1%, yet excluding Energy's -60.6% drop, they rose 6.2%.[6] Overall and on average, profits in the remaining nine sectors are growing ok.

Exhibit 5: 2015 S&P 500 Earnings and Earnings Ex. Energy



Source: FactSet *Earnings Insight*, as of 4/21/2016.

Soon, this should be readily apparent. After several negative quarters, the year-over-year base for Energy earnings is quite low. In the coming quarters, unless oil prices plunge anew, that base should get low enough for Energy earnings growth rates to stabilize. Profits won't be huge, but they needn't be. Even if Energy earnings bounce around low levels for a while, without those double-digit slides, their negative impact on aggregate S&P 500 earnings will be limited. Without Energy detracting, strength elsewhere becomes much more visible.

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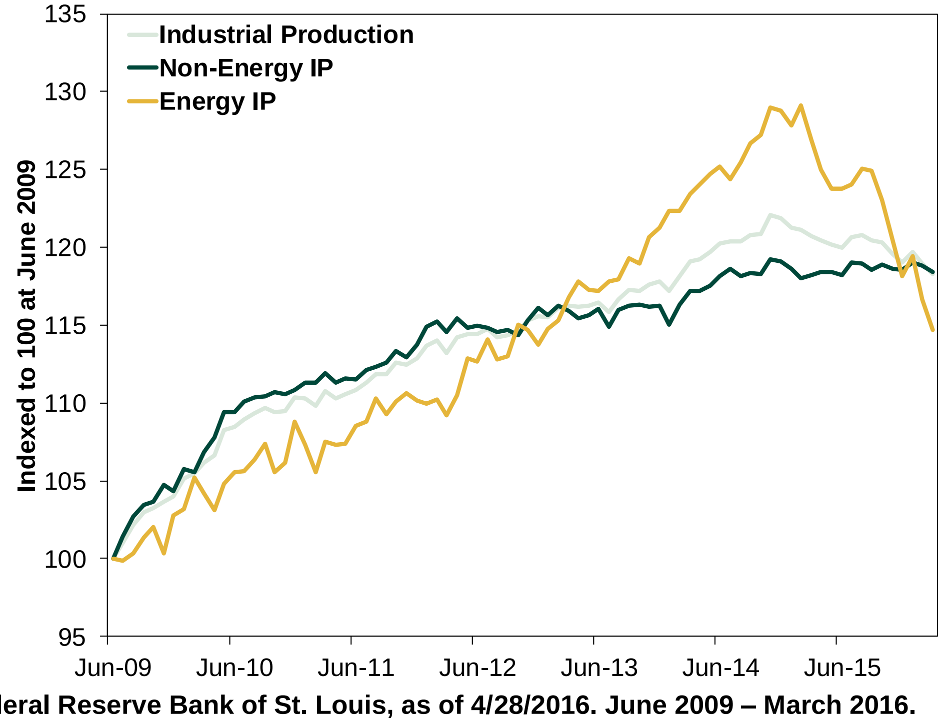
Appendix III: Stocks' Solid Economic Foundation

Recession and weak economic growth fears resurged in Q1, as they have frequently during this bull market. Yet once again, fears seem misplaced. Despite a few weak pockets, the global economy is stronger than appreciated. Led by the US and the UK, most developed world economies are growing apace—as are Emerging Markets like China, India and Korea. While commodity-reliant countries like Brazil and Russia are struggling, they aren't big enough to derail the world. With many leading indicators pointing positively, the global economy likely continues expanding for the foreseeable future.

US: More Than an Energy Story

While several economic indicators have slowed, the Energy sector is primarily responsible. Oil-related items have a large presence in several US economic data series, skewing the numbers downward, as Exhibits 6-8 show. Yet Energy is a small slice of America's economy—services, the lion's share, is growing at a healthy clip.

Exhibit 6: Industrial Production Outside Energy Is Growing



Source: Federal Reserve Bank of St. Louis, as of 4/28/2016. June 2009 – March 2016.

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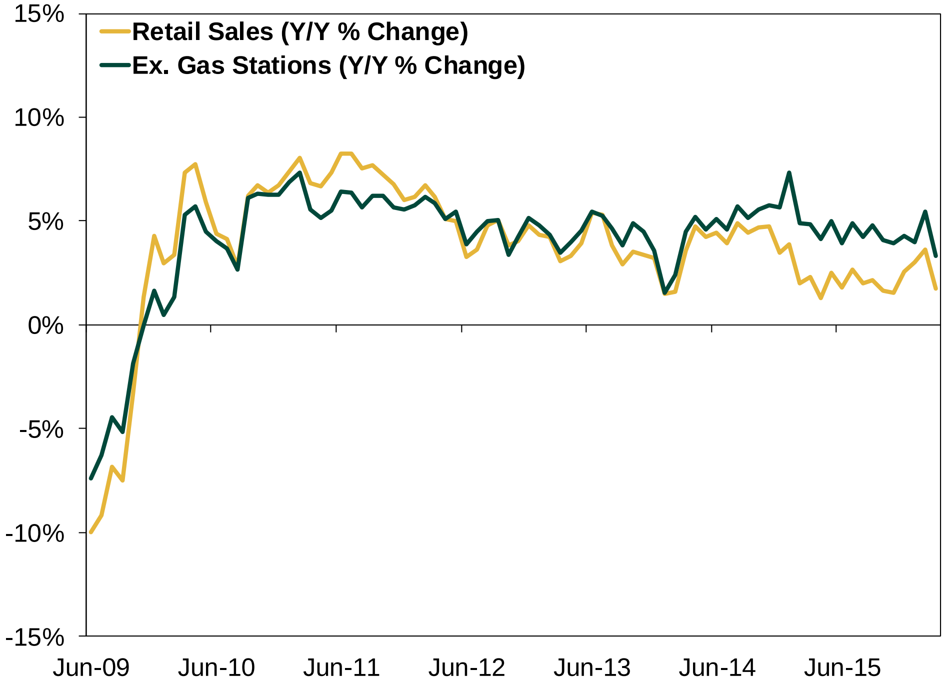
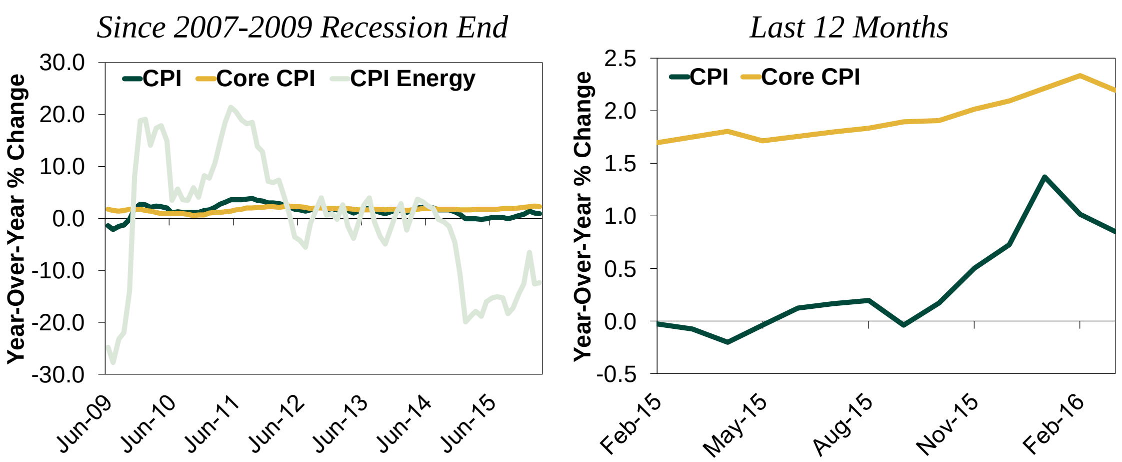
Exhibit 7: Excluding Gas Stations, Retail Sales Are Growing Fine



Source: US Census Bureau, as of 4/13/2016. June 2009 – March 2016.

Exhibit 8: Energy Is Responsible for Deflation Fears



Source: Federal Reserve Bank of St. Louis, as of 4/28/2016. June 2009 – March 2016.

These gauges overstate Energy's role in the US economy (Exhibit 9)—an example of how 20th century econometrics don't perfectly capture the 21st century economy.

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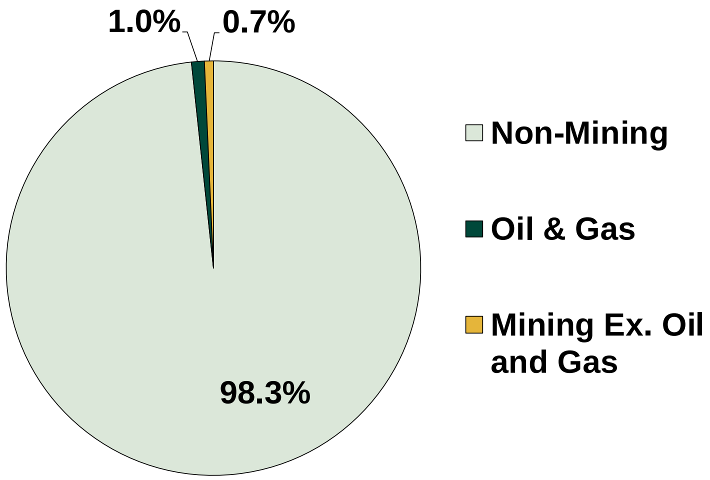
Exhibit 9: Energy's Share of GDP by Gross Value Added



Source: US Bureau of Economic Analysis, as of 4/28/2016. Share of GDP by value added, 2015.

Barring a renewed oil plunge, Energy's data drag should gradually fade, affording investors a clearer view of everything else. Readings like the Institute for Supply Management's Purchasing Managers' Indexes (PMIs) show broad economic strength. The Non-Manufacturing PMI (which includes mining) has consistently topped 50—indicating expansion—since July 2009.[7] Though the Manufacturing PMI posted several slightly contractionary readings in late 2015 and early 2016, the most recent read (March) showed growth, and the forward-looking New Orders subindex posted its third straight expansionary reading—March's a robust 58.3.[8]

Stripping out Energy's outsized impact shows US economic growth hasn't diverged much from this expansion's slow-but-steady trend. Q1 2016 GDP growth slowed to 0.5%, in keeping with most analysts' estimates, dragged down by a -5.9% drop in business investment.[9] However, this was skewed by a massive -86% drop in spending on oil and mining structures—an obvious impact of the sector's widely known weakness. Most importantly, Q1's GDP report is an imperfect attempt to tally past economic activity. Stocks look forward, and most analysts and economists expect growth to rebound. If that holds, 2016's GDP growth trend would look very similar to 2011, 2014 or 2015. Supporting the view that growth continues, The Conference Board's Leading Economic Index (LEI) remains in an uptrend, and no recession in its nearly 60-year history began while LEI was high and rising.

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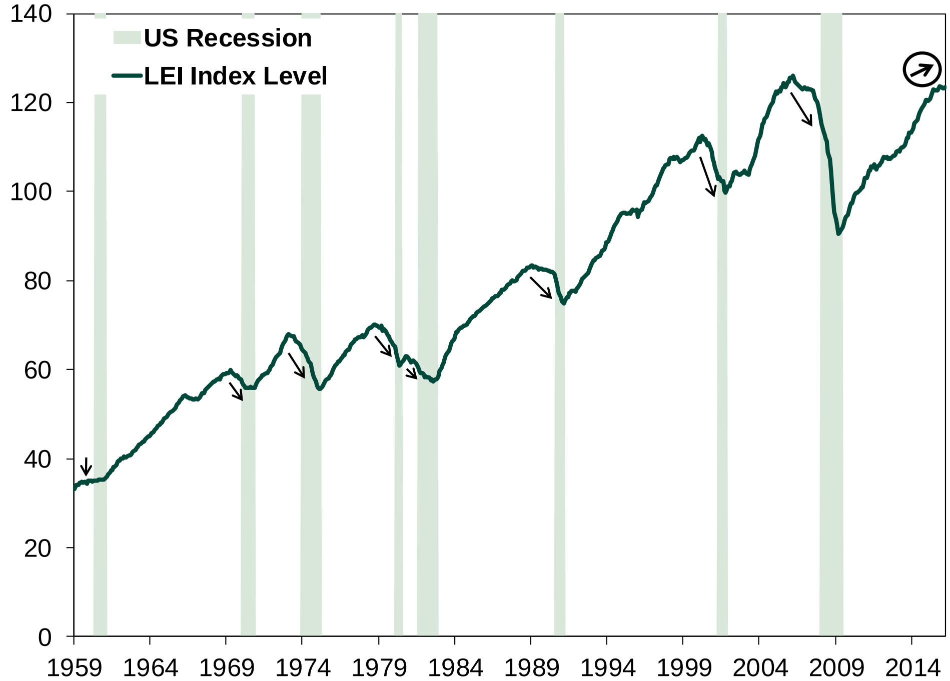
Exhibit 10: US LEI Doesn't Suggest Recession Looms



Source: FactSet, as of 4/13/2016. January 1959 – March 2016.

Eurozone: Growth Still Underappreciated

Despite persistent doubts, the eurozone similarly shows little sign of a recession relapse. The 19-member bloc has grown in 12 straight quarters, accelerating to 0.6% q/q (2.2% annualized) in Q1.[10] Growth rates for most individual member states aren't yet available, but France and Spain's preliminary reports show growth continued in at least two of the bloc's four biggest economies. French GDP grew 0.5% q/q (2.2% annualized), as consumer spending snapped back from Q4's slight contraction and business investment accelerated.[11] Spain grew 0.8% q/q (3.2% annualized), extending the once-troubled nation's strong run.[12] Other data confirm growth is quite broad-based. PMI readings largely exceed 50, particularly in the four biggest economies (Germany, France, Spain and Italy). Industrial production has mostly risen on a year-over-year basis since late 2013, as have retail sales.[13] Eurozone LEI rose in 9 of the past 12 months, suggesting continued growth, however uneven, is likely.[14]

Against this positive economic backdrop, Europe suffered its second terrorist attack in four months in Brussels, Belgium. Like last November's Paris attack, innocent lives were lost and the human impact is terrible. Economic impact, however, is limited—free markets and free people are resilient. Though strikes can briefly interrupt local activity—France's services PMIs dipped slightly after November's attacks—the broader impact is very small. Terrorism has never ended a bull market or caused a recession. The sad reality of more frequent attacks also reduces their shock value.

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There is a risk border controls return, upending Europe's Schengen zone, the visa-free travel area. Though a negative, this needn't stifle economic activity. America's Patriot Act of 2001 caused consternation abroad by adding many restrictions and reporting requirements, but neither retaliatory measures nor a drop-off in economic activity followed.

UK Growth Still Isn't "Unsustainable"

Though critics still call the UK's services-heavy economy "unbalanced," growth is quite sustainable. Q1 2016's preliminary UK GDP report showed 0.4% q/q growth (1.6% annualized), a modest slowdown from Q4's 0.6% q/q (2.4% annualized).[15] Both show expansion, led by the UK's largest sector—services—with heavy industry's slight declines tied largely to North Sea oil's continued woes. Service sector growth outstripped GDP growth in both quarters. Yet pundits focused on stagnant manufacturing, weak trade, the record-high current account deficit and the record-low saving ratio, calling them signs the expansion was faltering. None signal looming trouble. Manufacturing and trade have been choppy, but they haven't prevented growth. The current account deficit reflects the UK's robust, service-driven economy and the Energy sector's struggles, not anything worrisome. Similarly, the low household saving ratio is a flawed measurement with odd inputs that mask rising household wealth. Beyond GDP, Services and Manufacturing PMIs indicate businesses are growing, and LEI remains in its long-running uptrend, suggesting growth likely continues.

Many fret a potential Brexit's impact on trade. While there are some unknowns, it seems premature to argue a Brexit will crush British trade. As noted in Appendix II, a "Leave" vote doesn't immediately void Britain's inclusion in the single market or EU free trade agreements—it begins a two-year negotiation. Though the UK certainly benefits from intra-EU trade, it also trades a fair amount externally—it's a global marketplace. The EU's share of UK exports has declined markedly in recent years. (Exhibit 11)

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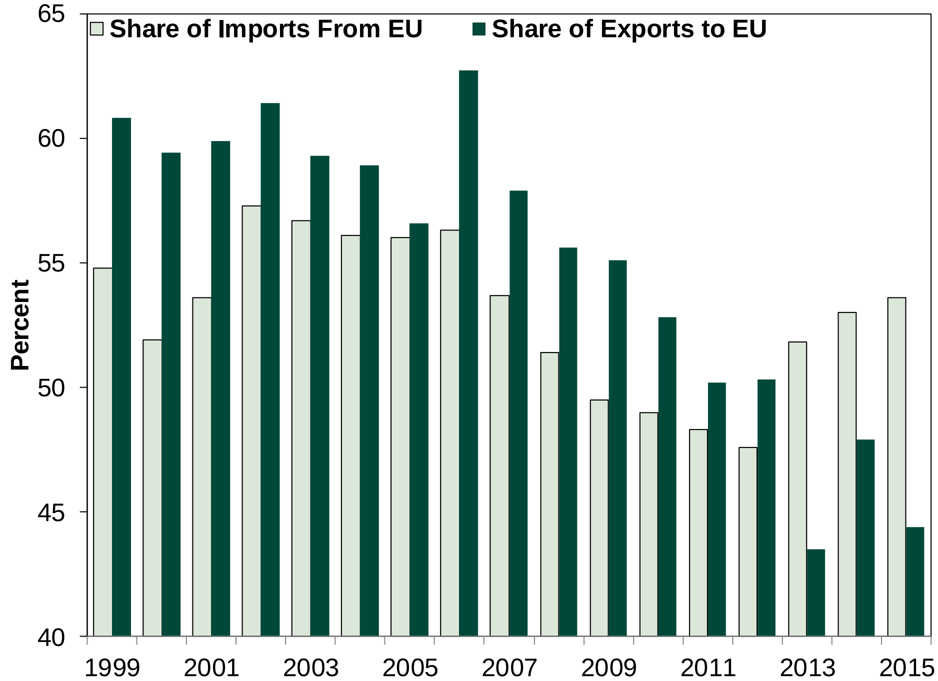
Exhibit 11: The EU's Share of UK Trade



Source: Eurostat, as of 4/14/2016.

What's more, the aformentioned corporate tax cuts will gradually improve competitiveness as they are implemented. The economy should soon benefit incrementally from increased thresholds for the business tax rate, reducing many small businesses' tax bills.

Japan a Weak Spot

Japan's long-running struggles continued, as GDP grew just 0.5% in 2015 (and contracted -1.1% annualized in Q4).[16] The BoJ's attempts to spur growth through monetary policy—resorting to negative interest rates in February—have largely failed. A weaker yen boosted export *values* for a bit, but volumes—the quantity of goods—remain contractionary.

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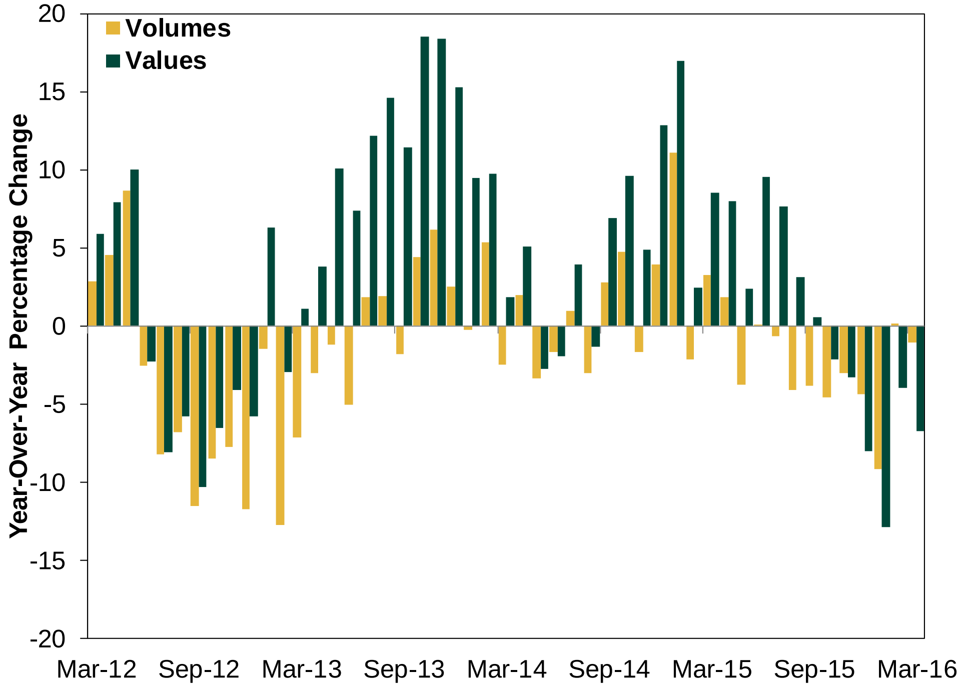
Exhibit 12: Japan's Fake Export Boost



Source: FactSet, as of 4/21/2016. Japan Export Quantum (Volume) Index and Value Index, March 2012 – March 2016.

Outside Commodity-Reliant Countries, Emerging Markets Are Growing

Emerging Markets (EMs) are overall growing at a nice clip. While China's growth rate has slowed, it remains strong by most standards at 6.7% y/y in Q1.[17] Despite persistent false fears of currency devaluations and an economic "hard landing," data don't suggest a crash looms. Heavy industry has slowed markedly, but consumption remains robust—consistent with the long-term transition from industry to consumption-based growth.

Other EMs reflect divergence between commodity exporters and importers. For example, Q4 2015 GDP growth in non-commodity-reliant EMs remains robust, like India (7.3% y/y), Indonesia (5.0% y/y), Korea (3.0% y/y), Malaysia (4.5% y/y), Peru (4.7% y/y), Thailand (2.8% y/y) and Mexico (2.5% y/y).[18] Most of these are spurred by healthy domestic demand, and many benefit from low energy prices. Russia remains mired in recession, with its fate largely linked to oil prices. The same goes for Brazil, presently in its longest recession since the 1930s. But these countries are the exception in EM, not the rule.

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Appendix IV: Sectors in Focus

Throughout Q1, media focused on Financials and Health Care, as fears swirled over banks' capital levels and potential drug price regulation. Meanwhile, Energy's swing from early-quarter drop to late-quarter rebound stole headlines, with many wondering if the long-awaited bottom had arrived. The following sections detail events in the quarter and our thoughts on the three sectors moving forward.

False Financials Fears

Financials were hit hard in the early-year volatility, and despite a significant rebound in the quarter's second half, the MSCI World Financials sector finished Q1 down -6.3%.[19] We believe fears toward the sector are broadly overstated, though in our view, the outlook is brightest for US and UK Financials, while eurozone and Japanese Financials face headwinds.

Large US and UK banks are well-capitalized and have mostly finished post-crisis deleveraging, and growing economies and favorable capital markets offer strong revenue growth opportunities. Yield curves remain positively sloped, helping loan growth rise and remain profitable. Despite some occasional setbacks, bank earnings grew in 2015 and are expected to do so again this year.

In Q1, healthy fundamentals took a backseat to a litany of overstated fears, including Energy exposure and eurozone bank balance sheets—both inciting 2008 redux fears. Neither has much basis in reality. Energy loans account for just 3% of total US loans—most Energy debt (86%) is in the bond market.[20] Hence, rising Energy defaults lack the scale necessary to cause a financial crisis—particularly considering that 3% includes loans to integrated mega-cap Energy firms, highly unlikely to default. As for the troubled, smaller shale producers, risk isn't sneaking up on banks. They were already conservatively positioned, with 1.5% of loans set aside to cover potential loan losses, and have modestly increased these provisions as a precautionary measure.[21] By contrast, banks' real estate exposure in 2007 was 110 times today's Energy exposure. Then, too, loan losses didn't cause 2008's financial panic. FAS 157 forced banks to write down trillions in viable assets lacking a market. No such feature exists today for Energy loans.

While we are less optimistic about eurozone banks, crisis fears there are also exaggerated. Worries over reduced profitability morphed into dread of a Lehman moment, which misses vast differences between then and now. Then, solvency—whether banks could survive—was in question. Today it is whether firms' quarterly profits meet or beat analysts' estimates. Said differently, the issue now is return *on* capital, very different from fretting return *of* capital.

Yet investors conflated them anyway, fearing one German bank's record loss would force it to raise capital, potentially forcing losses on some bondholders under bank resolution rules that took effect in Q1. (These make Cyprus' 2013 bank resolutions, funded by creditors and large depositors instead of taxpayers, the eurozone blueprint.) This conspired with inconsistency in recent Portuguese and Italian bank resolutions to drive up yields on banks' unsecured convertible bonds, which are among the first to get bailed in. General concerns about inconsistent bank resolutions aren't unwarranted, as haphazard application of the new rules would undermine confidence. But there is little chance Europe's largest banks will test them anytime soon. While eurozone balance sheets recovered slower than US or UK banks, they are better capitalized today than before the crisis, with €235 billion in new Tier 1 capital raised since 2007.

Together, US, UK and eurozone banks have nearly $1.6 trillion in capital. Not only is this nearly triple 2008 levels, on a relative basis, it tops any point in recent history. As markets realize lingering crisis fears are false, they should resume weighing US and UK banks' strengths.

Health Care Sector Spotlight

Health Care underperformed in Q1, but we expect it to improve. Health Care usually shines during mature bull markets, and the sector has plenty of reasons to shine over the foreseeable future.

Q1's underperformance seems sentiment-driven amid persistent political rhetoric about capping and renegotiating prescription drug prices—a hot topic on the campaign trail and among state and national lawmakers. While talk can roil sentiment, it is unlikely to go anywhere. Any relevant bills likely lack the votes to get through Congress—and probably still will after the election, keeping legislative risk low. Presidential candidates might talk tough, but presidents can't act unilaterally. Attempts to circumvent legislative roadblocks and effect change via regulators have failed. For example, at quarter end, a handful of politicians reiterated an earlier request that the National Institutes of Health (NIH, the US Dept. of Health's R&D body) eliminate the patent protection for a costly drug it developed jointly with the private sector and academia, citing 1980's Bayh-Dole Act as legal justification. This act lets the government override patent protection when a drug isn't available to the public on "reasonable terms." But the NIH has never used this power, and considering the latest reiterates a previously denied request, it seems the NIH doesn't want to enter the drug price debate.

With political risk overstated, Health Care firms' fundamentals remain strong, particularly in the Pharmaceuticals industry. They have strong balance sheets, well-known brands and reliable earnings streams, providing stable longer-term growth prospects—a plus in maturing bull markets. Large developed-world firms are making headway in Emerging Markets, where demand for health care and drugs is soaring. Fewer drugs are coming off patent, and new drug development pipelines are robust. Firms should remain healthy and profitable looking forward.

Energy's Countertrend

While Energy has outperformed recently, we expect this to prove fleeting. Energy has underperformed for nearly two years by more than 30 percentage points, despite several countertrends along the way (Exhibit 13). While it is impossible to say when this one will reverse, markets should resume weighing the sector's poor fundamentals.

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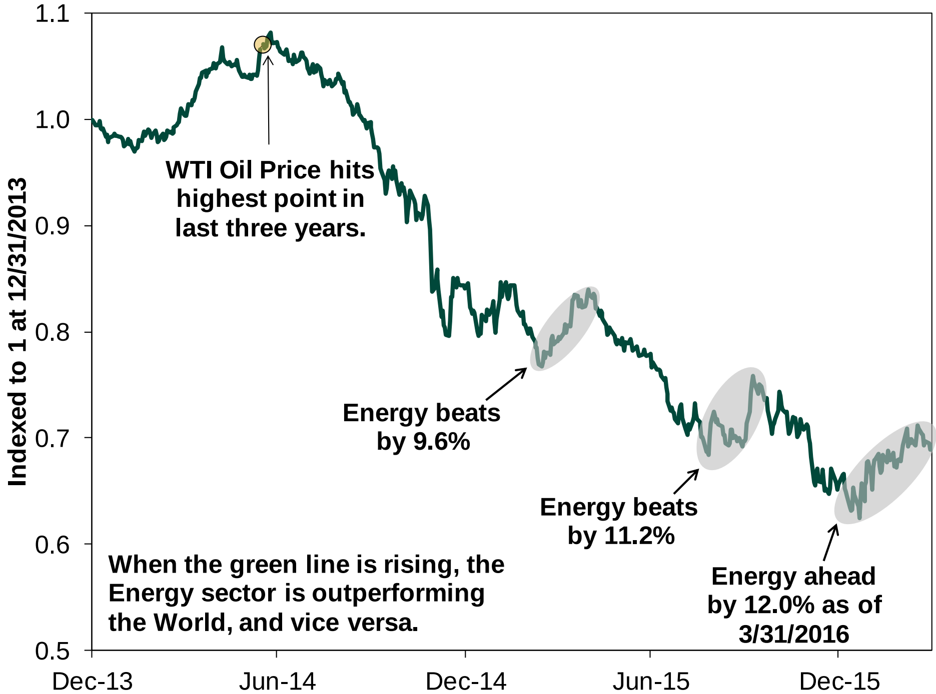
Exhibit 13: Energy Countertrends Are Normal



Source: FactSet, as of 4/14/2016. MSCI World Energy Sector divided by MSCI World Index, 12/31/2013 – 3/31/2016. Returns include net dividends. Shading indicates periods of Energy outperformance exceeding 8%.

Energy revenues and earnings are highly sensitive to oil prices, which likely remain low for the foreseeable future. Global supply remains well above demand, and a near-term reversal is unlikely. While US producers have reduced exploration, efficiency gains let them produce more from existing wells. There is also a sizable backlog of completed shale oil wells that haven't been hydraulically fractured. When prices rise, firms can lock in higher prices via futures contracts and activate this "fracklog," pressuring prices anew. Meanwhile, oil-reliant countries like Russia and Brazil have raised production because government revenues depend on oil rents. While rumored production freezes hound Russia and OPEC, driving hope for higher prices, this seems unlikely as conflicts of interest abound. For example, Russia and Saudi Arabia have said they won't freeze output unless Iran does. But Iran is keen to rebuild market share after years of sanctions and continues refusing requests to curb output—most recently by skipping the much-ballyhooed summit between OPEC and non-OPEC producers in Doha, which didn't yield a deal.

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The Investment Policy Committee

Aaron Anderson, Ken Fisher, Bill Glaser and Jeff Silk

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[1] FactSet, as of 4/6/2016. MSCI World Index return with net dividends, 12/31/2015 – 3/31/2016.
[2] Ibid. US 10-Year Treasury yields, 12/31/2015 – 3/31/2016.
[3] Source: Global Financial Data, Inc., as of 4/20/2016. Frequency of positive S&P 500 annual total returns.
[4] Source: US Bureau of Economic Analysis and the US Bureau of Labor Statistics, as of 4/13/2016. US GDP by value added (2014) and private sector share of US nonfarm payrolls, March 2016.
[5] Federal Reserve, European Central Bank, Bank of Japan, Bank of England, Swiss National Bank, Bank of Canada, People's Bank of China, Reserve Bank of India, Central Bank of Brazil and Swedish Riskbank, as of 2/28/2016.
[6] FactSet, as of 4/1/2016.
[7] FactSet, as of 4/13/2016.
[8] Ibid.
[9] Source: US Bureau of Economic Analysis, as of 4/28/2016. US Q1 2016 GDP growth at seasonally adjusted annual rates.
[10] Eurostat and FactSet, as of 4/29/2016.
[11] National Institute of Statistics and Economic Studies and FactSet, as of 4/29/2016.
[12] Instituto Nacional de Estadística and FactSet, as of 4/29/2016.
[13] FactSet, as of 4/13/2016.
[14] The Conference Board, as of 4/28/2016. Eurozone LEI, monthly percentage change, April 2015 – March 2016.
[15] FactSet, as of 4/13/2016.
[16] Ibid.
[17] FactSet, as of 4/15/2016.
[18] FactSet, as of 4/13/2016.
[19] FactSet, as of 4/12/2016. MSCI World Financials sector returns with net dividends, 12/31/2015 – 3/31/2016.
[20] FDIC and company filings, as of 12/31/2015.
[21] Ibid.

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