Ashdon Investment Management

Q3 2015 ECONOMIC COMMENTARY

October 2015

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Investment Management

Third Quarter 2015 Economic Commentary

Economic developments in the US were benign during the third quarter, but developments in emerging economies and in broad equity markets are notable. The S&P 500 Index achieved all-time high levels in early June to start the quarter. However, a broad sell off in foreign markets, led by emerging market economies presaged the end-of-quarter sell off in the broad US market. By the end of the quarter, the US market was down by about 2%, broad international markets were down 2% and Emerging Markets were down 5% for the calendar year to-date. Underneath the indices, the selloff was revealing.

For most of 2015, market pressure had been absorbed by the Materials, Energy and Industrial sector companies. Many of those companies have traded down substantially while the market index has traded essentially flat. Health Care and Technology companies, along with various dominant product companies (like Nike) had held value, or even advanced, The August sell-off pressure was focused in the Health Care sector, and to a lesser extent, the Technology sector.

Interestingly, investors broadly seemed to treat this selloff as a buying opportunity. The S&P 500 traded down 10% in late August and traded at that level for the remainder of the quarter. However, a rally back to nearly the all-time highs commenced in October. A strong employment report for September and increased confidence that the US FOMC would begin the normalization process before the end of the year seemed to have driven the market recovery.

We have discussed the possibility that broad markets would tend toward a period of flatness or sell off with little risk of a runaway market. To reiterate, we see the broad macro environment as continuing with low but sustainable global growth in the 2% to 2.5% range. We see growth held back by several headwinds including oversupply of many raw goods, constrained access to credit, and broad deflationary pressures. Corporate profit growth has been softening after strongly recovering from the 2008 financial crisis. However, until this year, equity markets had moved robustly higher in spite of the clear headwinds and earnings slowdown. The flat-to-down year so far is consistent with the view that the market was pausing to let earnings catch-up to prices. However, we have been shifting our focus toward risk of a selloff. The two primary sources of new risks are liquidity issues in the fixed income markets and the unavoidable consequences of a long period of global quantitative easing.

The views and portfolio positions of our manager partners are important inputs into our investment process. We maintain very close communications with our managers. These insights form the background for our sense of the specific risks in the environment. Liquidity risks are, at this point, well documented. It is therefore very surprising to see ongoing flows of record asset levels into exactly the kinds of pooled funds of corporate, high-yield and EM bonds that are the center of the risks. Investors, particularly retail investor seeking higher coupon payments, continue to buy the key ETF's that hold these instruments. Emerging market bond funds are the most curious example of this behavior. Given the well-known illiquidity of the bond market now, we believe that the liquidity mismatch between the ETF shares and the underlying bonds is building stress into markets.

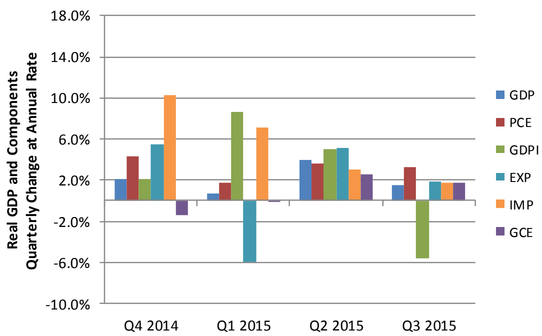
We have also long known that the unknown effects of QE in the global economy would one day have to be dealt with. The FOMC is clearly on the path to initiate normalization of monetary policy meaning that we will begin to see the effects soon. Our macro focused manager partners have all been engaged in defining the risks – and opportunities – in the normalization of policy. Macro managers are understandable working without a well-tested model, but by relying on principles they have made good progress in developing robust portfolios. The overall view is that while EM countries have been able to maintain exchange rates relative to the US dollar, continuing USD strength will ultimately force a devaluation in a broad range of those currencies – including China. The larger risk here is that China's slowing growth, combined with a rapid, wide spread currency devaluation in the EM world, will trigger a significant rerating of equity prices globally. We see this outlook being implemented across the manager portfolios.

When we look at the world economies through this lens, we can plainly see the building stresses. Quoting a colleague, we cannot be monolithic in this view – diversification remains a fundamental portfolio construction concept. However, all our client portfolios now have a tilt toward this view. This has primarily been implemented through increased cash holdings – where cash was raised through transactions driven by other client-specific needs. We have also naturally tilted toward this view through the manager positions. Finally, our bias toward fundamental investing is always in place. No matter what the economic environment, we always draw confidence from knowing what we own and why we own it.

With confidence in our managers and timely portfolio positions, we feel prepared with portfolios that will weather the normalization period. We continue to be focused on our process and fundamentals.

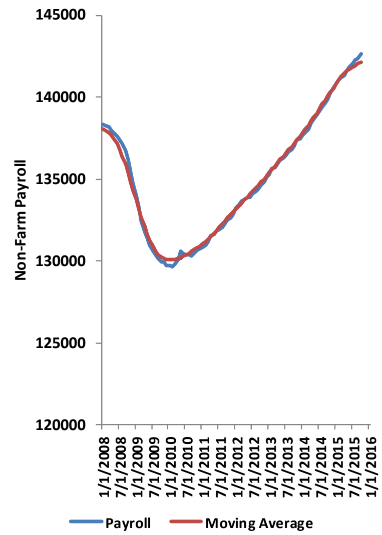
GDP

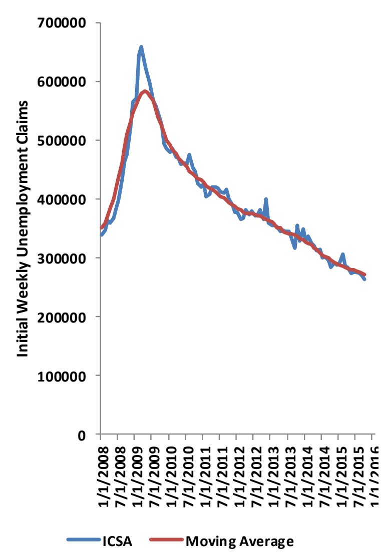
GDP growth in the third quarter continued the modest pace that has been in place since 2009. After a Q1 deceleration, economic growth resumed. Growth was well distributed across the economy and a reduction in private inventories. There are expectations that the final data release will improve the inventory data and GDP will be revised higher.



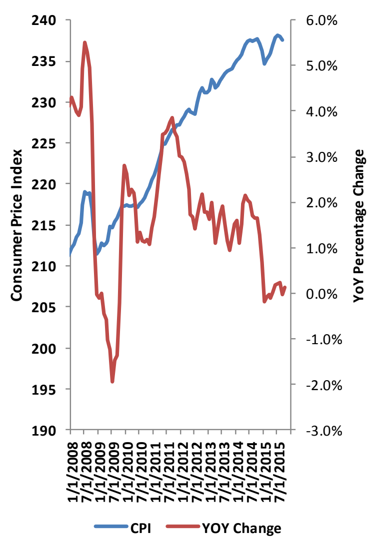
Unemployment

The charts below show trends in total payroll and new claims for unemployment insurance. Total employment continues to grow to new highs. Unemployment claims continue to decline to very low levels. The unemployment rate at the end of Q3 was very low at 5.0%.

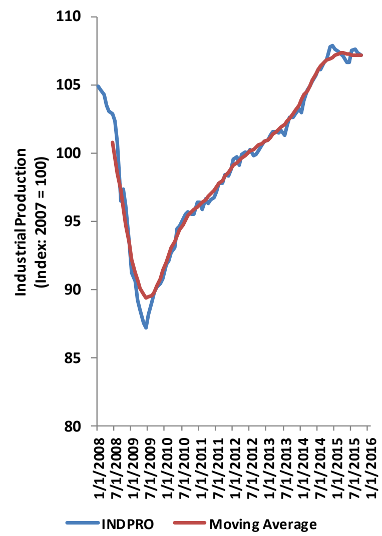


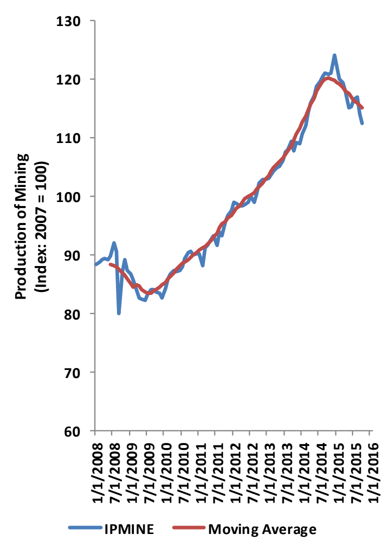


As we discussed last quarter, modest wage growth and moderated economic growth have helped to keep inflation well under control (see Consumer Price Index). This characteristic of the economic expansion is attractive and has enabled the FOMC to maintain accommodative monetary policy for a very long time. However, inflation can be too low triggering other economic risks – deflation. There are significant deflationary forces in the global economy broadly. The data-driven FOMC has not be forced into a rapid normalization of interest rates. We fully expect that US overnight rates will move slightly higher - something like 25 basis points – leaving rates just off the zero bound. Monetary policy will remain accommodative in an attempt to balance the global deflationary forces. This dynamic should maintain a stable economic situation. However, we believe we are seeing the effects of the very long period of global ZIRP.



We continue to look for cracks in the US economy. The recent productivity data showed a down turn and challenged a key component of our view. So far, the data indicate the production slowdown is due primarily to the slowdown in energy extraction after the rapid decline in oil processing last March. We will continue to closely monitor this situation as a production slowdown is a key signal for a coming recessionary period.





As we commented last quarter, neither Japan nor Europe is in a position to begin to normalize policy and the runway ahead seems to measure in years not months. Chinese weakness is now broadly accepted. In my last visit to London, one manager suggested that the industrial Chinese economy had entered a recessionary period. Others noted specific data and analysis to support this contention. The combined news of the recently revalued Renmimbi and the broad economic weakness certainly supports the view that a broader currency devaluation is likely.

Our portfolio recommendations are in line with the views here. Holding higher than normal levels of cash and equivalents, tilting toward low-gross alternative strategies, and building new positions slowly are all in line with this view. While our expectation is that markets will remain flat through the year, we are positioned well for either the case of continued advance or decline.

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