Ashdon Investment Management

Q4 2015 ECONOMIC COMMENTARY

January 2016

ASHDON
Investment Management

Fourth Quarter 2015 Economic Commentary

Market performance in January has refocused investors' attention away from 2015, the past year was important and bears reviewing. One might think the most significant economic event of Q4 2015 was the FOMC's decision to embark on a process of policy normalization at the end of the quarter. It was the most significant change in policy since the end of Quantitative easing in 2014 and the first rate hike since 2008. The Committee voted to raise the overnight target rate to a range between 25bps and 50bps. However, other events during the quarter might have been more transformational for the global economy.

4th Quarter gains in the US stock market partly offset 3rd Quarter losses. However, stock and bond markets both produced sub-par returns for the year. While negative at the index level, the S&P 500 ended the year 1.38% higher after dividends. The index for international stocks, the MSCI EAFE, ended up 0.95%. Bonds also struggled in 2015, with the Barclay's US Aggregate Bond index producing only 0.55%. Underneath it all, a growing dispersion in performance for both economic sectors and individual companies continued to unfold. Evidence of this was notable at the sector level (energy, materials, industrials down -23.6%, -10.4% and -4.7% respectively, versus consumer discretionary, staples and technology up +8.4%, +3.8% and +4.3% respectively). However, dispersion of returns were felt even within winning sectors, with companies such as Walt Disney (DIS), Gilead Sciences (GILD), Amazon (AMZN), Nike (NKE), Apple (AAPL), Netflix (NFLX), Facebook (FB) and Google (GOOGL, now Alphabet) accounting for nearly ALL gains in the S&P 500 and Nasdaq indices.

Bond markets were similarly divergent. US government bonds were largely unchanged through the year as investors anticipated an upward change in interest rates, but with declining inflation and growth expectations. Corporate bonds were weak, and high yield securities were at the center of the commodities price collapse that stressed many companies operating in those sectors – driving bond prices lower across the board.The markets progressed consistently with our expectations for the year. Global stock markets neither accelerated upward nor moved sharply. Bond rates were largely unchanged as well. After a strong multi-year rally in process, we had expected that a flat stock market would allow for earnings to "catch-up" with prices. However, corporate profit growth softened through the year – referred to by some as an "earnings recession". Our focus has shifted to the increasing risk of a selloff. Unavoidable consequences of a long period of global quantitative easing are taking shape.

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 understandably 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.

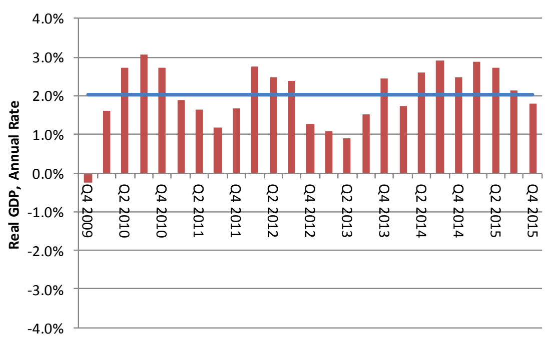
When we look at the world economies through this lens, we can plainly see the building stresses. Quoting a colleague, we cannot be monolithic in this view – diversification remains a fundamental portfolio construction concept. Our bias toward fundamental investing is always in place. No matter what the economic environment, we draw confidence from knowing what we own and why we own it. Our client portfolios are well diversified. Implementation has been done primarily 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.

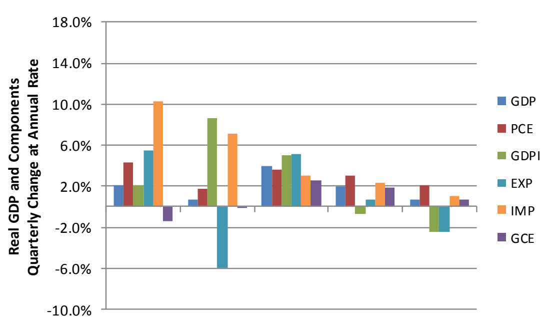
With confidence in our managers and timely portfolio positions, we feel prepared with portfolios that will weather the normalization period. We continue to be focused on our process and fundamentals.

GDP

GDP growth in the fourth quarter was reported to be +0.7%. GDP grew by 1.8% from the quarter one year ago. The average year-ago quarter rate of change in GDP has averaged 2.0% since 2009, a clear demonstration of the continued modest pace of growth that has been in place since recovery began. This slow, but persistent growth rate is consistent with the post-credit crisis environment that characterizes this economic cycle.

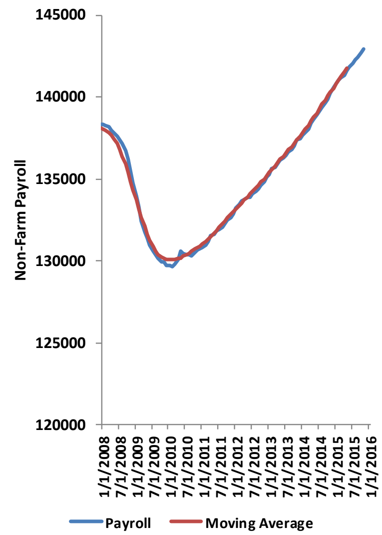
Growth in Q4 was driven by the consumer. Consumption growth (PCE) advanced 2.2%. Housing ("Residential Fixed Investment" a component of GDPI – Gross Private Domestic Investment) grew by 1.6%. However, other investment categories contracted in the fourth quarter and overall GDPI declined -2.5%, due largely to declining investment in the Energy sector. The volatile Net Imports (Imports – Exports) also declined for the quarter.

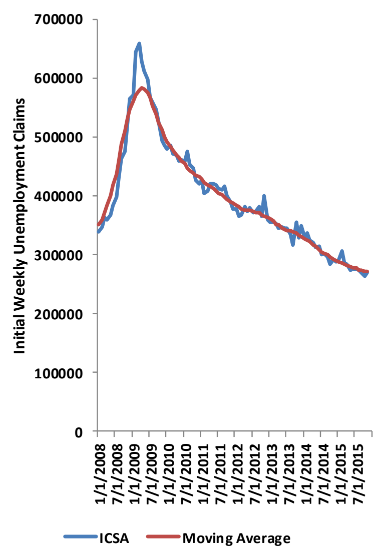




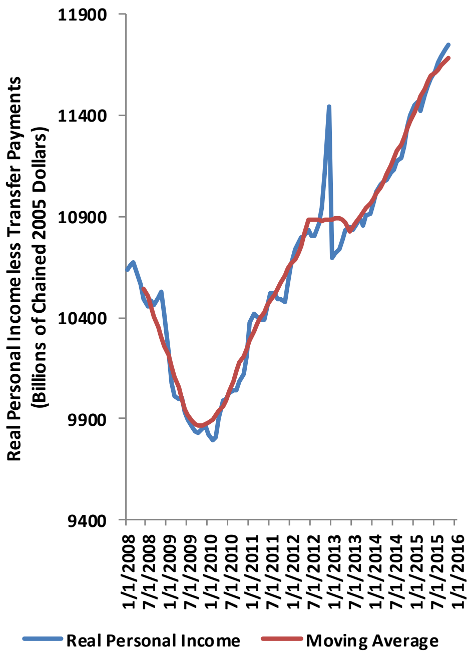
Unemployment

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 Q4 was very low at - 5.0%. The trends in employment growth continue to be one of the brightest lights in the economy. Reliable employment is critical to disrupting the disinflation/deflation forces that are at work globally. There is no evidence thus far that employment is weakening.

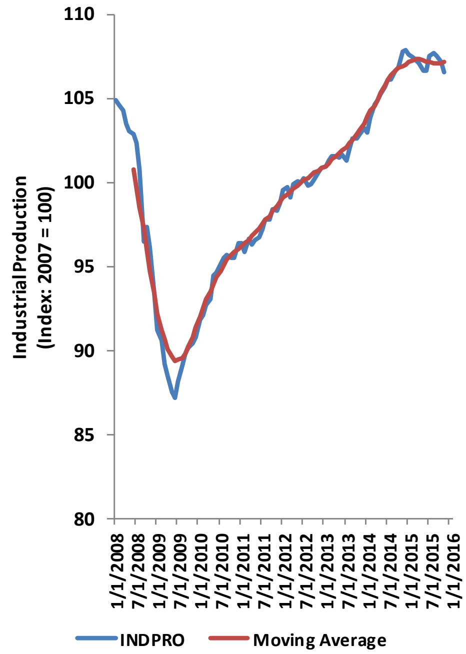


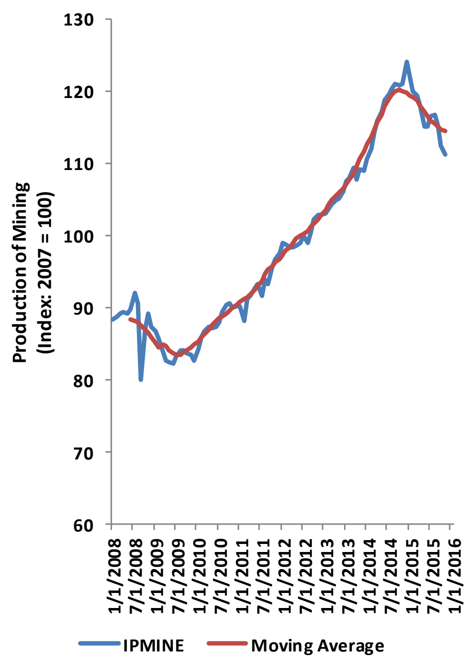


Finally, worker wages in the US continue to grow. Real Personal Income (less Transfer Payments), the key measurement of salaries for workers, has continued to grow at an attractive rate. RPI is important for those assessing the economic condition of the economy. In times of weakness, RPI will flatten or decline in response to a broad downturn in economic activity. RPI shows no weakness at this point in the cycle.

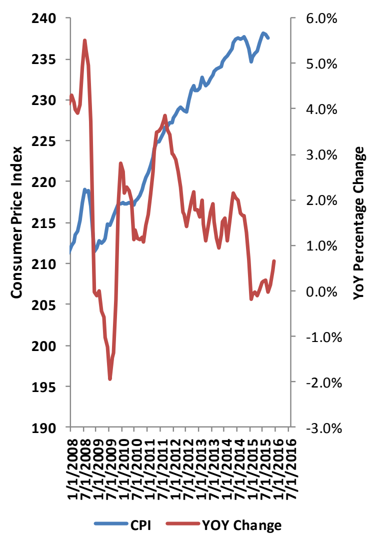


Production continues to be the sole weak data set for the economy. So far, the data indicate the production slowdown is due primarily to the slowdown in energy extraction after the rapid decline in oil processing last March. The production slowdown also shows up in the Business Equipment sector. This is a real economic effect. At this point, it appears to be no more than a “mid-cycle slowdown”. At some point, decreases in the Energy and Materials sectors will come to an end. Even if those sectors don’t begin to grow again, production will reach equilibrium and no longer detract from the production index. We will continue to closely monitor this situation as a production slowdown is a key signal for a coming recessionary period.





Finally, inflation remains strikingly low. More information on the global forces shaping price stability will be provided in a separate white paper.



Global Economy

The state of Japanese and European economies was little changed during the quarter. Both economies remain stable, but face growing headwinds associated with years (or decades in the case of Japan) of poor demographics, poor policy and massive accommodation. As we have previously stated, neither Japan nor Europe is in a position to begin to normalize policy and the runway ahead seems to measure in years not months. In fact, the Japanese announced a return to negative overnight interest rates in their economy in January. The most significant economic developments for the quarter were once again in the emerging markets, especially China.

Chinese weakness is now broadly accepted. The question is: how weak will China become? The Chinese industrial economy appears to be in recession. The Chinese Purchasing Managers Index indicated contraction for the sixth consecutive month for the period ending in December. At the same time, the Chinese private economy (consumers) continues to grow and develop. Our sense is that China is stable. However, the industrial weakness in China has far flung effects in the region. Broad currency weakness in emerging economies, often called resource economies, was persistent through 2015, largely due to declining Chinese demand. The world recognizes that China must adapt to the new economic reality. One part of that adjustment is unpegging the currency from the USD. All parties would benefit if this can be done in an orderly way; unfortunately, the currency adjustment has not been orderly so far. The Chinese government used almost one trillion dollars of reserves to defend and stabilize the currency in 2015. We expect further devaluation in the Chinese currency and in the other currencies of the region.

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.