Ashdon Investment Management

Q1 2016 ECONOMIC COMMENTARY

March 2016

In the preparation of this presentation, Ashdon relied on data taken from sources it believes are creditable. As such, Ashdon believes such data to be accurate and reliable. While Ashdon has taken efforts to insure the data's accuracy, Ashdon cannot verify that the data used are free of error. Ashdon has relied on such data to calculate and offer hypothetical scenarios in this presentation. Ashdon has presented such data in historical context and for historical hypothetical purposes. Historical results are not a guarantee of future investment performance. Ashdon has not used such data to intentionally mislead, nor has Ashdon intentionally omitted data that is relevant to its hypothetical scenarios. Ashdon assumes no responsibility for errors or omissions that result from the data it has relied on in this presentation, the sources of the data, or the calculation of such data.

This presentation makes no offering of investment. The investment options discussed here must be offered through specific presentation of the terms and risks of the specific offering.

- *In spite of extreme first quarter market volatility markets ended flat*
- *Bonds outperformed stocks with both asset classes "appearing expensive"*
- *US economy may be beginning to show signs of weakness, particularly productivity*
- *Changes in currency trends are signaling increasing risk for Japanese and European financial markets*
- *Chinese weakness is slowing spreading, the PBoC faces difficult decisions*

First Quarter 2016 Economic Commentary

Market volatility has been felt by all investors year-to-date. Through January and February every asset market worldwide was affected by downward price volatility. The S&P 500 Index traded down -10.5% in the depths of this sell-off, and indices of smaller-cap and international companies traded even lower. The S&P 500 Index ended the first quarter up 1% - creating a one quarter trough to recovery price action not similarly felt since the Great Depression. The S&P 500 Index has continued to trade higher as we write this, and is standing near its all-time highs. Even with this strong rally and the possible momentum-style breakout that could follow, bonds continue to outperform stocks year-to-date (the S&P 500 Index has returned +2.83% YTD, while the Barclays US Aggregate Bond Index has returned +2.96% YTD). This is not a particularly bullish signal. Continued market volatility is likely and we could be in the midst of a bear market for stocks.

The "profits recession" we discussed last quarter has intensified. As of this reporting, several of 2015's favorite companies (AAPL, NFLX, for example) have been affected by the growing global economic weakness. Neither the selloff nor rally during the quarter surprised us. In our view, the world economy is held back by the threat of a deflationary trap caused by over leveraged households, companies and governments. The EU and Japanese economies are at the center of the struggle – Japanese banks are struggling and destabilizing while the economy is in outright deflation. Analysis from our partner-managers points to an industrial recession in the Chinese economy, leaving the consumption economy teetering. Emerging markets continue to weaken in the wake of steep declines in commodity prices and large capital outflows. Rebalancing capital allocations and debt levels will take many quarters, even years, and the imbalances will likely weigh on global growth rates for some time to come.

While these changes unfold, our broad portfolio recommendations are:

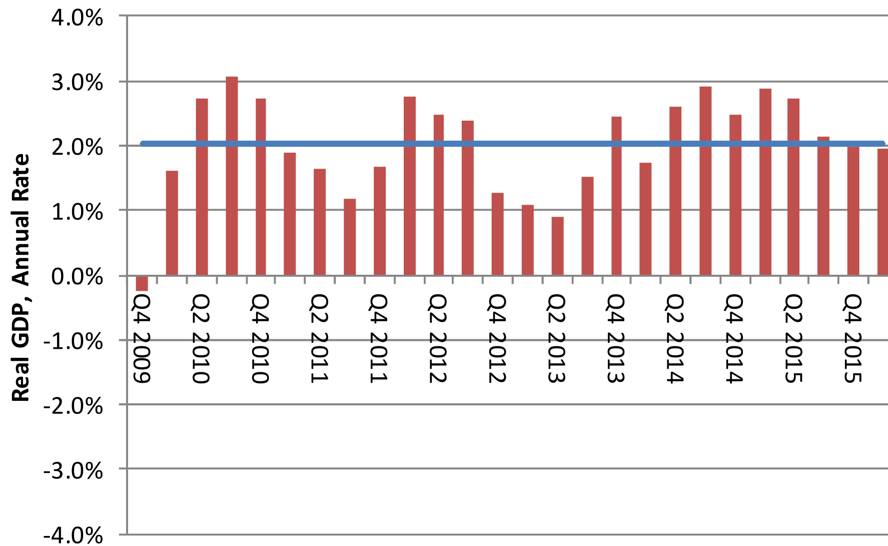
- Increase allocations to cash and equivalents in all cases.
- Tilt toward low-net, even net-short, alternative strategies
- Build new positions from "dry powder" slowly.
- Hold established, quality positions in client portfolios

Our central expectation is that US equity markets will continue to trade sideways, with volatility. We believe these recommendations will work to protect and grow client portfolios in this case while providing good options if the situation changes.

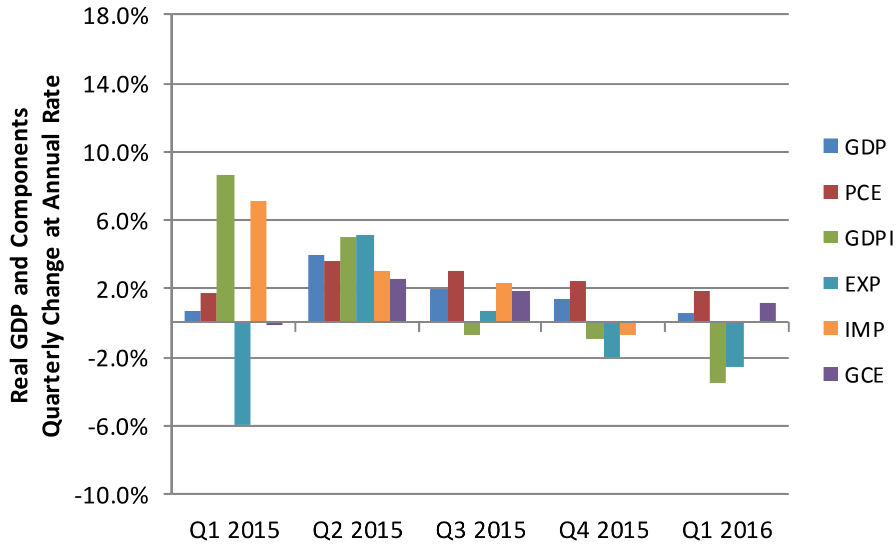
US Economy

GDP

The Advanced estimate for first quarter GDP growth came in at +0.5% annualized for the quarter. GDP grew by 1.95% 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 the recovery began. This slow, but persistent growth rate is consistent with the post-credit crisis environment that characterizes this economic cycle.

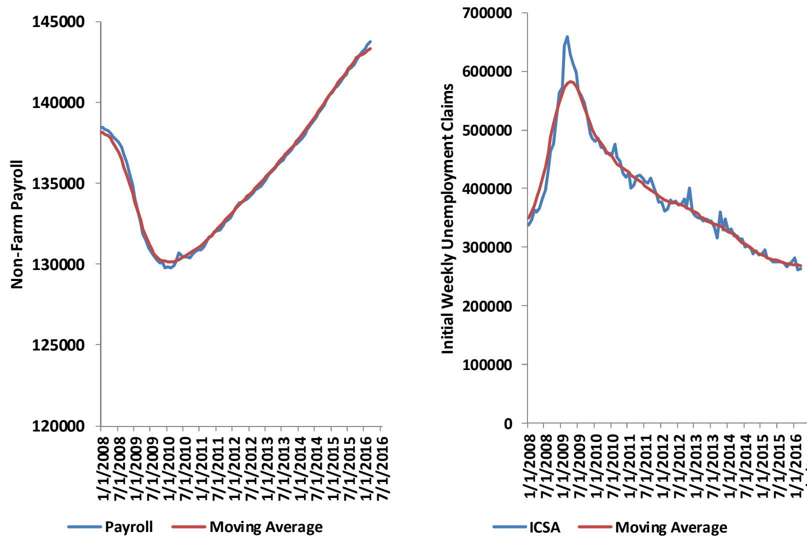


Growth in Q1 was driven by the consumer. Consumption growth (PCE) advanced 1.9%. Housing ("Residential Fixed Investment" a component of GDPI – Gross Domestic Private Investment) grew by 1.7%. However, other investment categories contracted in the fourth quarter and GDPI declined -1.6%, probably due to ongoing declines in the Energy sector as energy companies shutdown projects when prices fell steeply in 2015 and the first quarter of 2016. The volatile Net Imports (Imports – Exports) also declined for the quarter. This Advance release will be revised twice more before becoming final. The direction and size of revision will be interesting.

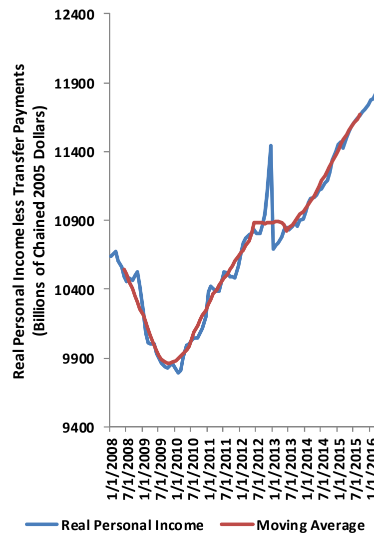


Unemployment

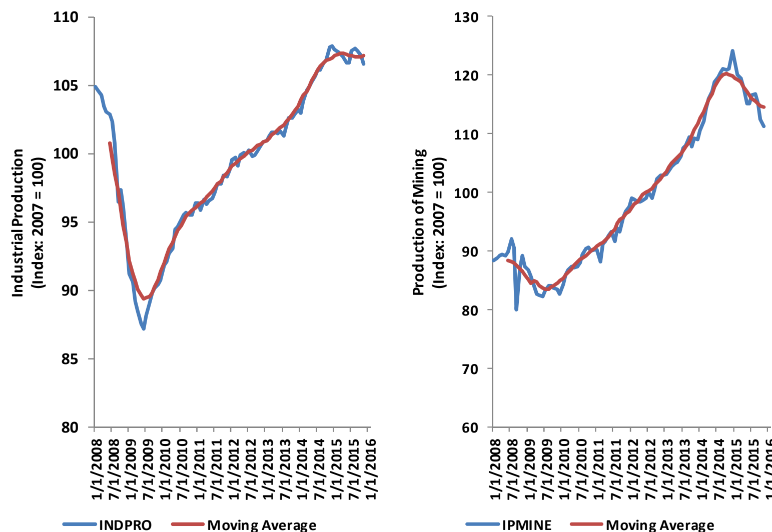
Labor data continues to be the bright spot in the US economic picture. The charts below show trends in total payroll and new claims for unemployment insurance. Total employment continues to grow to new highs. Unemployment claims continue to decline to very low levels. The unemployment rate at the end of Q3 was very low (5.0%). 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.



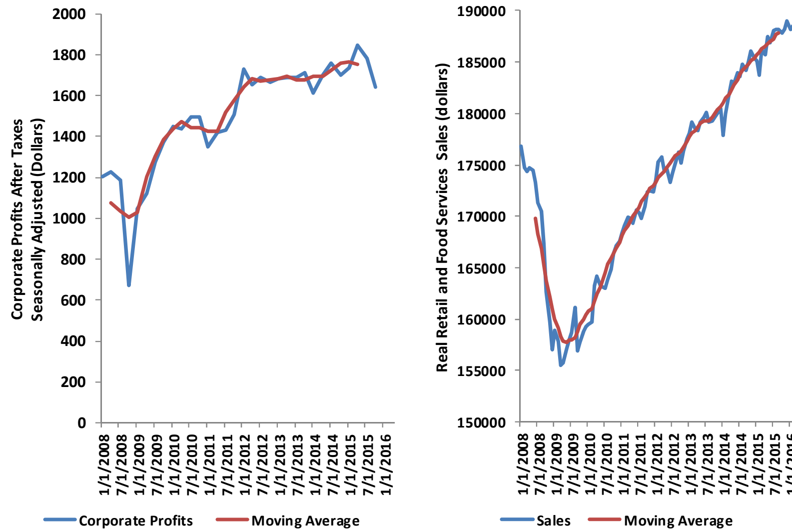
Finally, worker wages in the US continue to grow. Real Personal Income (less Transfer Payments), the key measurement of salaries for workers, has continued to grow at an attractive rate. RPI is important for those assessing the economic condition of the economy. In times of weakness, RPI will flatten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



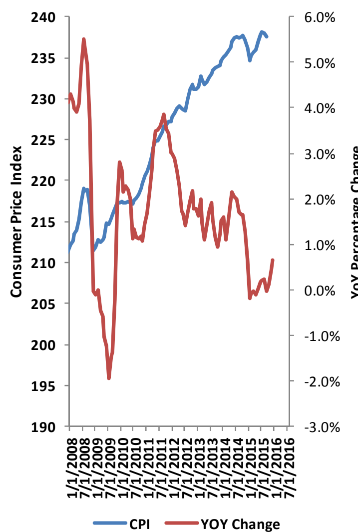
Over the last several quarters, we have noted that Production has been the sole weak data set for the economy. The production slow down appears to be accelerating and broadening. The charts below show overall Industrial Production and the sub-industry Mining Production, illustrating how the bulk of the decline in production is due to the slump in commodity prices. However, production measures in Business Equipment, Durable Goods and Utilities have all now shown some signs of down turn. And Capacity Utilization (a measure of Productivity) has been weakening. The Output per Hour measure is weak, but it has not shown a decline so far. Production and Productivity are important measures of the ability of an economy to grow; these are the first clear signs of a weakening US economy.



We don't normally include Corporate Profits and Retail Sales in this review, but it is important to note that both data series are now signaling weakness. The best measure of corporate profits is provided by the BEA and that data series shows that Profits may have turned over. That data series is more lagged than we would like. However, trends in expected earnings for the S&P 500 are timelier, and support the idea that earnings have peaked and are weakening. At the same time, Retail Sales may be showing early signs of weakness in spite of the recent spike.



The data on employment and inflation are positives for the US economy. However, the combination of weakening productivity – indicating that the economy might not be able to keep up – and corporate and consumer weakness – slowing activity can lead to lower profits and lower employment, ultimately impacting consumption – cause us to believe that a *broader economic slowdown in the US within 12 to 18 months is an outcome we must plan for.*



Global Economy

The world economy entered the first quarter in the midst of a brewing currency crisis. The thesis for the crisis was that Chinese growth was failing and the Chinese authorities would have less control over deleveraging at the corporate and municipal levels, potentially precipitating a deeper crisis. By the end of the quarter, attention had shifted halfway around the globe when the ECB announced several surprise new QE policies. In our view, the shift of focus did nothing to resolve the problems in Asia and the ECB move simply confirmed what we know about European weakness. In particular, changes in currency trends are signaling increasing risk for financial markets.

Our view, constructed from the views of our trusted partner-managers, our industry connections, hours spent in financial centers, hours of diverse reading, and internal debate is that the world is making its way through the later stages of a very long cycle of growth built on debt. Debt cycles never end gracefully. This last decade has shown how far policy makers are willing to go to buy the time to get global economies rebalanced without crisis. However, the task appears to be proving too great for policy makers.

In Japan, the BOJ has so far failed to gain traction in their fight against deflation. In spite of instituting a negative policy rate, the BoJ still has not controlled the Yen. The Yen began a strengthening trend in January – counter to BoJ goals and destructive to the Japanese economy - that has not yet abated.

In Europe, the ECB announced a three-tiered extension of its evolving QE program. In addition to other technical changes, the ECB will purchase an additional $20B of debt, now a total of $80B, each month to help keeps rates low. The changes seemed to give markets confidence that the ECB would underwrite stability, but did little to add confidence that the EU condition was improving. Similar to the case in Japan, the euro began a new strengthening trend in January. A strong euro is no more helpful to the Eurozone than the rising yen is for Japan.

As for China, The message from our partner-managers is that Chinese weakness is slowly spreading. The official data indicate that the "industrial recession" that started in 2015 may have now begun to turn around. However, many believe that Chinese officials have used leverage to stimulate this modest turnaround. Quoting the often understated Financial Times: "*Economists warn that while increased lending supports short-term growth, it worsens China's medium-term debt problems*".

The idea of a painful – potentially protracted - deleveraging process is not new. What is new is the breadth of global weakness (China and US may be weakening) at a time with policy makers are running out of dry powder. We simply cannot predict the exact path ahead. However, we have a clear sense of the shifting balance of risks for investors. With the usual "engines" of growth sputtering, central bankers may not get the help they need from economic growth. The risks of a damaging deflationary period have grown incrementally since we last reported.

214 E Grundy Street • Tullahoma, TN 37398
931-461-5733 phone • 931-461-5735 fax
info@ashdon.com