Ashdon Investment Management

Q3 2016 ECONOMIC COMMENTARY

April 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.

- *The economy was largely unchanged during the quarter*
- *We continue to believe that imbalances in the global economy must be rebalanced*
- *We expect broad equity indices to move sideways*

Third Quarter 2016 Economic Commentary

Our Second Quarter commentary was focused on the evident shift toward weakness in the US and global economy. We believed that the central bankers would be forced to blink – that is, admit that their actual policy aims were at odds with their stated aims – they would keep rates low. Since then, we have evolved our view modestly based on the incoming data: US economic growth, global growth, rates, jobs and earnings. Broadly, things didn't change during the third quarter.

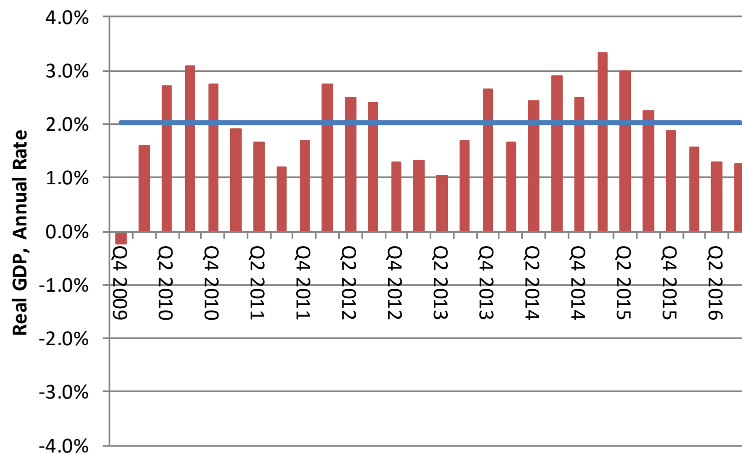
During the current quarter, US and foreign stock markets rallied on the new highs. The S&P 500 Index was up 3.9% and the international MSCI EAFE Index was up 4.5%. Bonds returns were muted with the Barclays Aggregate Bond Index flat (+0.5%) as bonds broadly retreated modestly from the historically low levels seen in Q2. US government bond yield have begun to move modestly higher and spread securities moved to higher yields as well, though yields were still very low at the end of the quarter. It was clear that the trend of higher yields was driven by improvements in incoming data, particularly for the US economy. The situation was largely unchanged at the end of Q3. At the quarter end, bonds were expensive – at or near record-high levels. But stocks had moderated somewhat as earnings stabilized.

Our advice for client portfolios has changed little from previous quarters. Even though the economic picture has changed in a positive way in the US, downside risks still outweigh upside risks. Earnings improvements during Q3 incrementally improved market valuations, but individual companies within the market have been rerated downward, some significantly. Index levels do not do a good job of informing investors. We continue to expect that the broad equity indices will move "sideways" ahead – neither gaining nor losing meaningful value. Our expectations of forward earnings remain muted (even factoring the presidential election results). We continue to believe that the imbalances in the global economy must be rebalanced. A weakness in fundamentals and a rationalization of prices could come about via a meaningful sell-off, it is still possible for the stock market to rally to new highs. We think such a rally would be short lived. What we want to emphasize that even in this environment, it is possible to find attractively priced companies in the US and abroad. Good managers are always innovating and adapting. Those kinds of companies are still available for patient, informed investors. While we continue to advise the following portfolio positions, we are now actively finding and buying new positions:

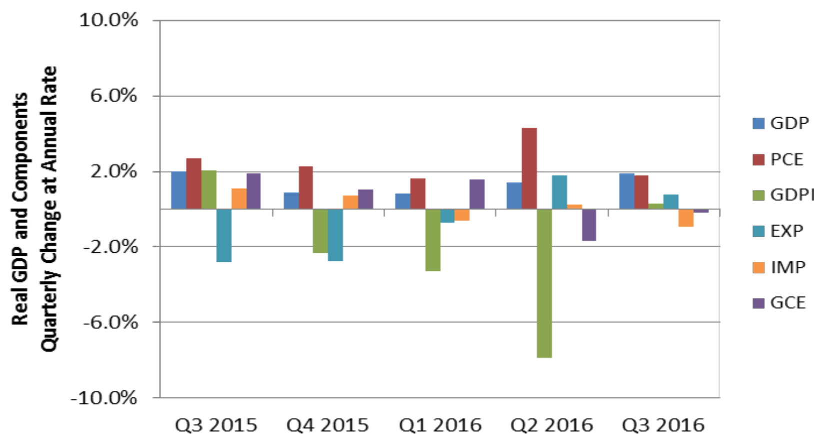
- Maintain allocations to cash and equivalents in all cases.
- Tilt toward low-net, even net-short, alternative strategies, where possible
- Build new positions from "dry powder" slowly. (we have done this in many current portfolios)
- Hold established positions in client portfolios, if they are quality stocks that can be held for the long-term

GDP

The advanced estimate for second quarter GDP growth came in at +2.90% annualized for the quarter. GDP grew by +1.50% from the quarter one year ago. Second quarter GDP was modest. 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.

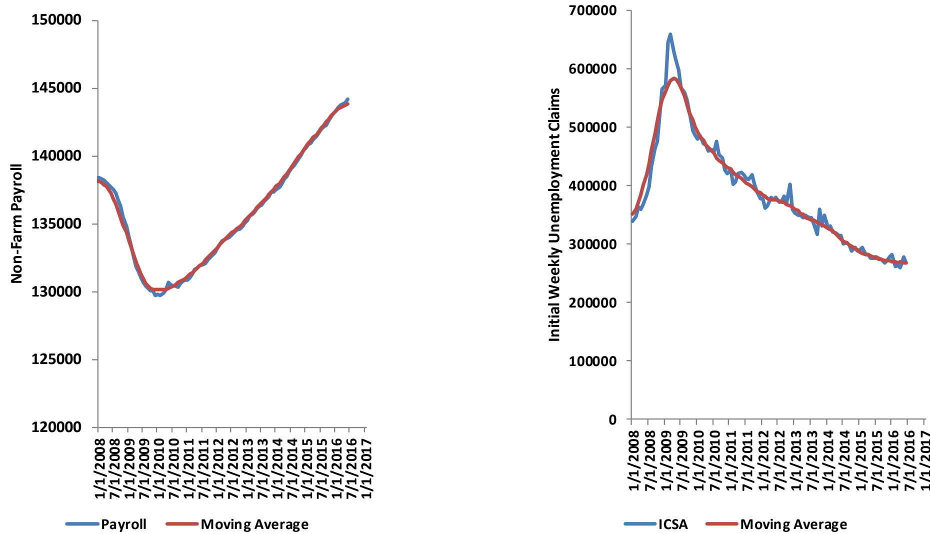


Consumption expenditures continued to drive GDP growth in Q2. Consumption growth (PCE) advanced +4.2%. Government consumption contributed, as did Net Exports. However, the degree of weakness in Private Investment was a surprise. Gross Domestic Private Investment (GDPI) recovered from significant weakness in Q2, +3.2% for the quarter. GDPI was revised upward to -7.8% for Q2. The Housing ("Residential Fixed Investment" a component of GDPI – Gross Domestic Private Investment) was weak again and fell by -4.4%. At this point, we can only say that the recovery in investment was an expected "bounce" in activity after a period of weakness, but the weakness from the first half remains. So far, Consumption (PCE) remains strong. We are watching consumption closely and will continue to do so. Looking more deeply, the trend in PCE shows no signs of change.

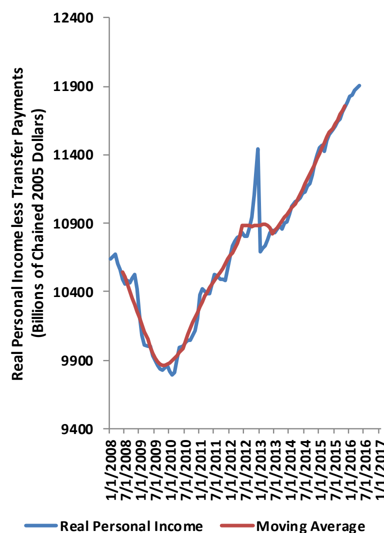


Unemployment

Labor data continues to support the view of a stable economy and consumption. 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 (4
.9%). 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.

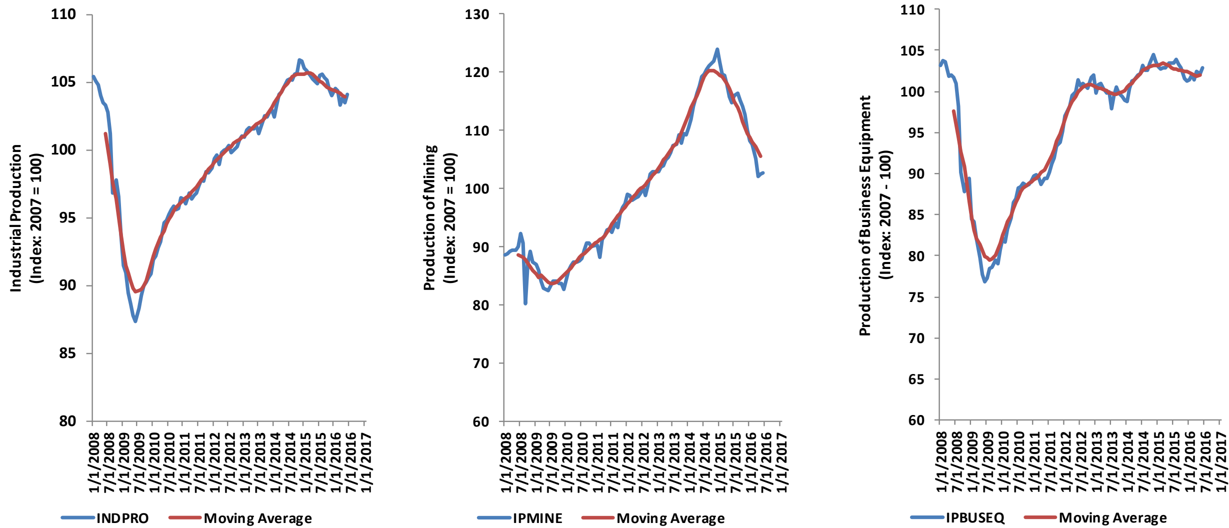


Finally, worker wages in the US continue to grow. Real Personal Income (less Transfer Payments), the key measurement of salaries for workers, has continued to grow at an attractive rate. RPI is important for those assessing the economic condition of the economy. In times of weakness, RPI will flatten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

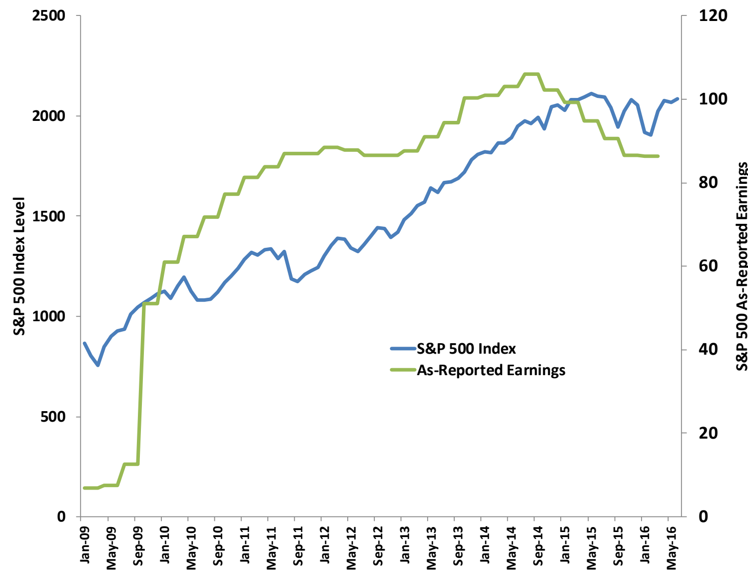


Industrial Production

The slowdown in Production data that we have discussed over the last several quarters has not abated. 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 for Business Equipment are also soft. Output per Hour, the most watched measure of productivity, declined.



The production slowdown is seen in US corporate earnings. The chart below shows the history of the S&P 500 index level and as-reported earnings. The chart shows a modest uptick in earnings for S&P 500 companies. This is an encouraging development, but it is important to temper enthusiasm. Earnings forecast continue to be revised downward, so companies are "beating" increasingly comfortable estimates. There is a tail wind for earnings – consumption is strong and production can recover from low levels. However, that is only consistent with a modestly growing economy, not the robust growth needed to abate the downside macro risks.



Global Economy

The looming US Presidential election dominated domestic and international news in the third quarter, following on the heels of the second quarter's reaction to BREXIT. We stated then that our view was that BREXIT represented a rapidly growing sentiment towards decreased globalism, increased protectionism and internal political tensions that would fuel near-term headwinds to regional and global growth. The impact on global economies is not yet known, but we can look at the UK in the wake of BREXIT to get a feeling for what may be ahead for regional and non-US country economies. The British Pound weakened violently in the wake of the BREXIT vote and lost over 12% of value against the US dollar. That weakness has amplified since and the GBP has no weakened about 25% against the USD. Overtime, the currency may well adjust back toward normal. But the adjustment period may be long and is not good for local workers and consumers. The currency weakness has already spawned inflation for imported goods. And it is important to know that the UK imports about 60% of all its food. The weak currency does make British workers more attractive, but that's because they are cheaper. Their wages have effectively been lowered. This kind of adjustment has typically raised social tensions – and tensions are already high in the UK.

Looking ahead for other EU countries, it appears that the initial reaction of markets and investors to the US election result was a stronger US dollar. That strength is largely driven by expectations of debt-led growth in infrastructure spending and more favorable tax policy for US corporations. No one yet knows the extent of or timing of those policies. The immediate result, beginning in the third quarter, was for the euro and pound to weaken against to the dollar. The weaker euro only strengthens the EU manufacturing and export sector, further strengthening their balance of trade and current account. The EU needs inflation and growth, so the currency trend here is beneficial to the economy and should ultimately benefit the currency. However, EU tensions are high and the status of the EU is once again in question.

The populist/nationalist forces in the West are less obvious in the East. This is in part because the large Eastern economies are highly controlled by a stable, political class.

The Japanese Yen continued its strengthening trend. While the Japanese economy is not vibrant, BoJ policies seem to have stabilized the economy and short-term threats are largely mitigated. While inflation in Japan is very low, prices are stable. As the currency is approaching its long-run level, we wouldn't be surprised to see the Yen level out ahead.

The Chinese Yuan continued to weaken against the dollar. So far, the adjustment has been orderly. This is good for the Chinese banking and finance systems. The high level of debt that the banking system has created makes the Chinese financial system unstable, subject to stress from rapid flight of foreign capital. This sensitivity was amplified by an over-valued yuan. Weakening the yuan in an orderly way reduces those stresses.

In spite of the headline political news, we believe that the global economy continues to make its way through the later stages of a very long cycle of growth built on debt and we continue to emphasize that deleveraging is never a painless process. While the policies of the new and emerging political group are not yet know, we can be sure that their ultimate affects will be a mixture of success and failures. But the context will remain the same. Perhaps the inward focus will result in a productive economic balance and growth. However, we remain cautious. While bonds are richly priced and stock indexes at all-time highs, there are numerous businesses in the market that are not richly priced. We are beginning now to recommend adding to equity allocations while maintaining a cautious stance.