Ashdon Investment Management

Q4 2016 ECONOMIC COMMENTARY

January 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.

Fourth Quarter 2016 Economic and Market Commentary

- *The stock market rally may be sufficient to impact the real economy in a positive way*
- *Investors' preference for US dollar assets was a clear investment theme through 2016*
- *The terms of globalization are likely to change*
- *Our concerns for a rationalization of prices through a sell-off are decreased*

The year that began with a notable stock market sell-off, ended with a notable stock market rally. The S&P 500, including price appreciation and dividends, returned almost +12% for the year. International stocks were down -1.88% in US dollar terms, but up +2.5% in local currency terms. The strong US dollar was a reflection of strong global demand for US debt, as yields stayed low and broad bond indexes were positive (+2.7%) for the year. The stock market rally may be sufficient to impact the real economy in a positive way. Recent economic data show a stronger economy and the Fed's decision to raise rates another +25 basis points supports the view.

Investors' preference for US dollar assets was a clear investment theme for 2016, as the US dollar rally from 2015 continued through 2016. In retrospect, the trend can be understood as a result of increased political and economic uncertainty, in which case, the US has always been a place to "hide" during periods like these. Starting with the mid-year BREXIT vote and ending the year with the US election, it became clear the world is beginning a shift away from "globalism", or the near completely free cross-border trade, towards a "nationalistic", or bi-lateral environment of quotas, tariffs and/or closed borders. The implications of this shift are not yet known, but a change from the current economic environment is almost certain. With this view, a strengthening US dollar makes sense – for the short term. We have been in the camp of those who believed that the US dollar was overvalued and was likely to weaken (for more on this please see the "Why The USD Could Weaken "market view on our website). This was the correct view for the first half of 2016. Our portfolios were well positioned to avoid the weak sectors of the economy and remain positioned for further weakness in stocks. However, that positioning contributed to a performance lag in the second half of the year, as the shifts previously described revealed the possibility that a new economic environment is upon us.

We believe that the technology enhancements in communications and transportation we have all experienced means that globalization is almost assured to continue for the long haul. However, the extent of globalization ebbs and flows on long cycles historically, and we have entered a period where the terms of globalization are likely to be re-negotiated. For us, the paradox of the current environment was captured in the commentary of one of our long equity managers:

- *"Against this backdrop the key question must be -- have we seen the end of globalization? Ironically perhaps, the anti-globalization backlash is an increasingly global phenomenon."*

As local investors are turning inward, US equity market investors will be focused on how the relationship between the new administration and congress develops. The popular reaction post-election tells us many investors expect the administration will put forth policies that will successfully stimulate economic growth. If this is the case, inflation will return and rates will rise. If the consensus is disappointed, then we will all have to wait and see.

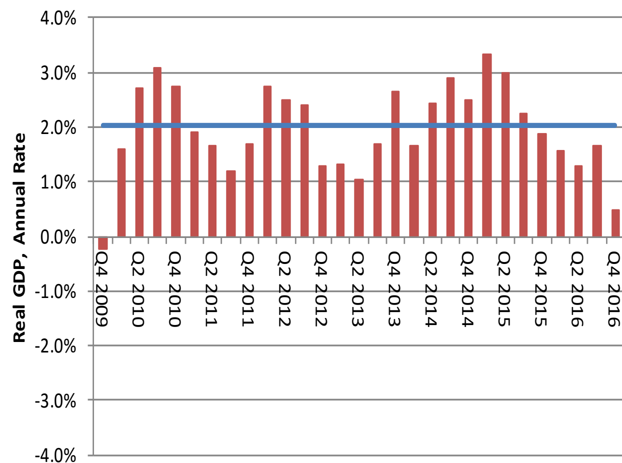
While predicting the economic environment ahead is a challenge, we find ourselves becoming more optimistic. For example, we are finding US stocks that are trading at prices reflecting a base case of 5-7% returns. While that may seem low by historical standards, those are attractive returns when compared with any another asset class. Most importantly, these returns are a base case, and opportunities from market volatility and/or upward surprises in global growth rates could boost this return. At the same time, the companies we are looking at have stable balance sheets and proven track records of operating through tough economic periods.

Our expectation over the last two years has been that the broad equity indices would move "sideways" – neither gaining nor losing meaningful value. We believed that there was a chance that earnings would grow to meet prices, keeping valuations reasonable. The weakening trends seen early in 2016 have changed for the moment, so our concerns for a rationalization of prices in the form of a meaningful sell-off are decreased. As always, our investment philosophy demands that we stay focused on "knowing what we own" and keeping options open. Our advice for allocation has changed only modestly:

Maintain allocations to cash and equivalents and deploy that cash patiently.
Tilt toward low-net, even net-short, alternative strategies, where possible
Build new positions from "dry powder" carefully.
Hold established positions in client portfolios, if they are quality stocks that can be held for the long-term

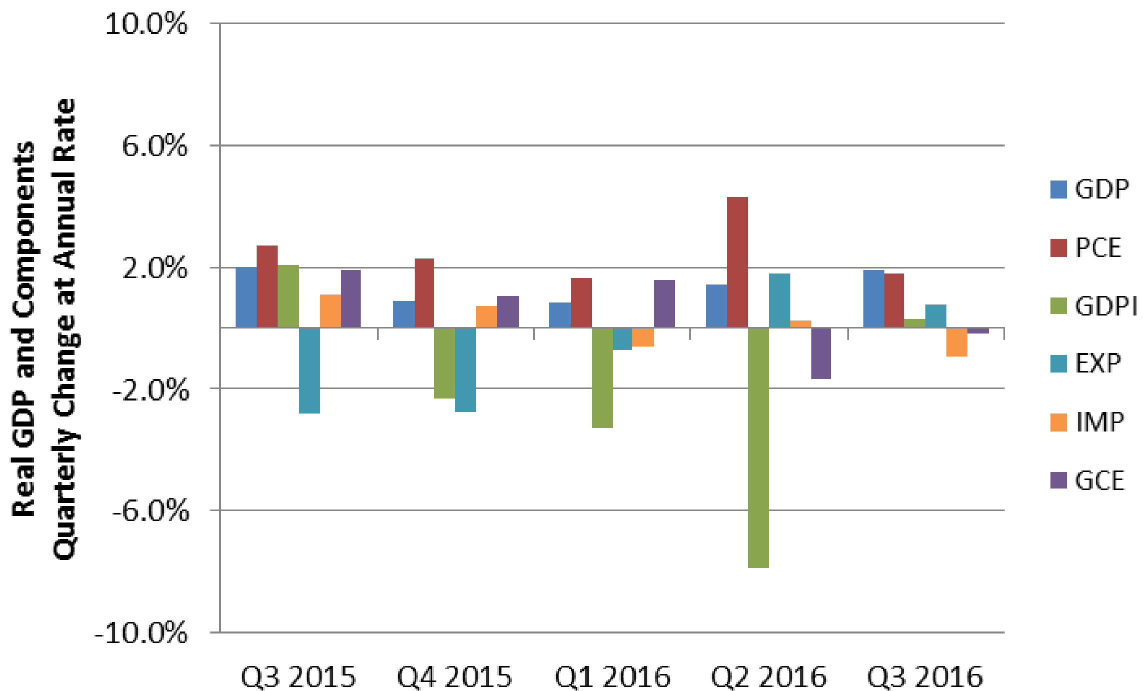
GDP

The Advanced estimate for fourth quarter GDP growth came in at an annualized rate of +1.87% over the previous quarter. GDP grew by +1.90% for the year. This was a disappointing data point – estimates ranged between 2.2% and 2.9%. However, the economy continues to grow at the modest pace that has characterized the post-recovery period. While revisions may well increase this estimate, it is highly unlikely that the economy will move far beyond the 2% rate of growth.



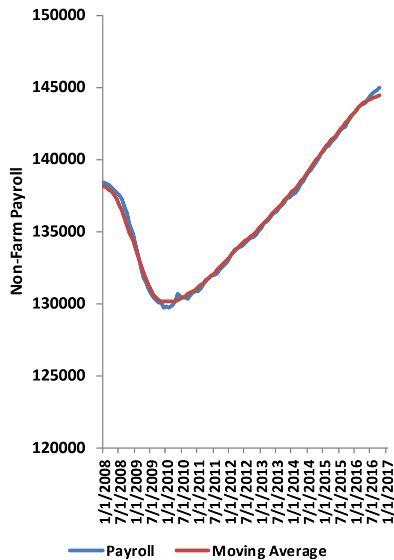
GDP (cont.)

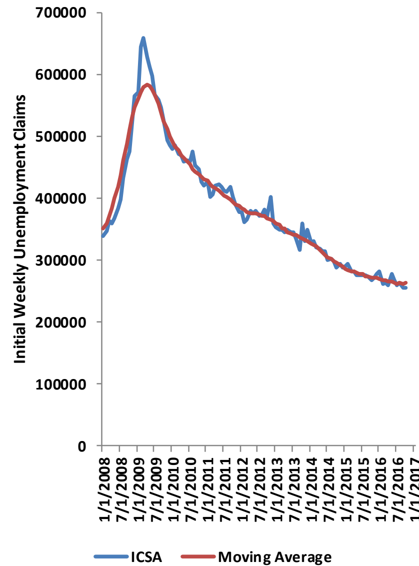
GDP growth rate for the quarter was driven by a significant rebound in Private Investment (GDPI). Private investment increased 10.7% (annual rate) after declining earlier in the year. Non-residential investment grew at +3.4% annual rate, driven by equipment investment growth. Residential investment rebounded as well (+10.2%). Consumption growth (PCE) advanced +1.87%. Government consumption contributed (GCE) advanced 1.18%. Net Exports rebounded as well. The Private Investment rebound is encouraging and is counter to the concerns of a broad weakening trend in the US economy. The year that started with darkening news has ended with brighter incoming data. We will watch the direction and size of revision closely – particularly for consumption - going forward.



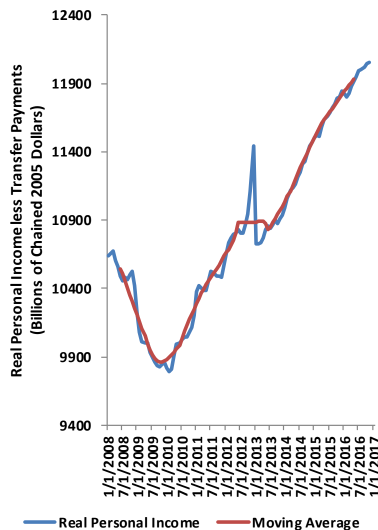
Unemployment

Labor data continues to be a 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 Q4 was very low (4.8%). 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 negative trend in Production that worried us for most of 2016 has now been interrupted and reversed. Overall production has stabilized about 3% below the peak level seen in 2014. The charts below show overall Industrial Production and the sub-industry Mining Production. Mining production (which includes oil production) has rebounded 2.8% after a 17% decline from the highs of the cycle. This recovery is primarily responsible for the stabilization of overall production. Business equipment production remains flat, but business investment picked up in GDP, possibly indicating a higher level of business equipment production. Incremental improvements like these have moved the industrial economy further away from contraction.