The Fed Awakens

The recent U.S. Federal Reserve ("Fed") action to raise rates in the U.S. for the first time since 2006 ushered in a new regime of less-accommodative policy. A prolonged period of heightened volatility, resulting from investor apprehension about a rate rise, began in the spring of 2013 with the "Taper Tantrum" that increased long-term rates and rattled the emerging markets. With each successive Fed meeting, investors counted down with nail-biting anxiety to see if a rate increase would come, but when the Fed finally made its move, the markets took the news in stride and moved forward.

While the Fed's 0.25% hike may seem inconsequential, markets are reading the move as a signal to prepare for a changing environment. In anticipation, lending standards for commercial and industrial (C&I) loans have recently begun to tighten, and the high yield bond market has been experiencing considerable stress largely due to higher exposures to the troubled energy sector. While the energy sector contends with sector specific issues, the rest of the economy is showing signs of sustainable, if not robust, growth.

As the Fed begins to unwind its zero interest rate stance to a more conventional policy, the European Central Bank (ECB) and the Bank of Japan, as well as the other central banks across the world, continue to be accommodative. Many engaged in their own versions of quantitative easing. Diverging monetary policies favor a continuation of the dollar's uptrend early in the coming year, but the pace of dollar appreciation is likely to slow versus the blistering rise of 2015.

Looking ahead, as the current market rise continues, and as the cycles mature, overall growth will be harder to find and likely command a premium. Equity markets around the world are likely to experience more turbulence stemming from geopolitical uncertainty, monetary policy adjustments, and China's economic transition, but broadly speaking, investors have many opportunities to consider. As business conditions in the U.S. currently favor the strongest competitors and beneficiaries of the network effect and of economies of scale, equity returns are likely to continue to be led by a narrow group of industry leaders. Small U.S. companies may have been oversold and present an interesting return opportunity, particularly at their current valuation levels. Europe is in an expansion phase. The ECB appears to still be in the early innings of quantitative easing, and valuations appear more attractive compared to U.S. counterparts.

In the environment we anticipate—moderate global growth with heightened volatility—we would not be overly aggressive or overly conservative in equity allocations. We favor domestic equities and have a slight growth bias, but we are beginning to see improved potential in European equities. In fixed income, we still favor credit-sensitive bonds and shorter duration, but in the changing environment, including a possible "lower for longer" interest rate environment, we will be revisiting our positioning and looking for signs to reduce the defensiveness of our stance in the coming year. Lastly, with volatility a near certainty, we look to alternatives to mitigate that risk and provide diversification.

Global Economy

The past twelve months have been a choppy and generally disappointing period for the global economy. The first quarter of 2015 saw a number of headwinds develop for domestic growth, including a West Coast port shutdown, harsh winter weather, and a surging U.S. dollar. The first quarter's economic weakness was eventually confirmed by the final gross domestic product (GDP) reading, which showed the U.S. economy contracted modestly during the quarter. Growth rebounded robustly in the second quarter before again moderating in the second half of the year. The latest year-over-year (YoY) growth rate for the domestic economy was 2.2%, which is also the average gain of the current expansion. In 2016, the average estimate from the Survey of Professional Forecasters is for growth to rebound modestly to 2.6%. Outside the U.S., another European fiscal standoff over Greece and a growth slowdown in China, which has persisted despite a myriad of stimulus attempts by policymakers, weighed on growth. A by-product of China's growth concerns and the strong U.S. dollar was a plunge in the value of most commodities, which created severe stress for many commodity-exporting, emerging economies. The latest International Monetary Fund (IMF) estimates are for global growth in 2015 to be 3.1%, which would be the slowest rate since 2009. More optimistically, the IMF expects the global economy to grow 3.6% in 2016. Developed economies are expected to continue to lead. Given their limited upside growth potential, another year of well below average global growth is a possibility that cannot be dismissed.

The latest IMF estimates are for global growth in 2015 to be 3.1%, which would be the slowest rate since 2009. More optimistically, the IMF expects the global economy to grow 3.6% in 2016.

The strong U.S. dollar and falling commodity prices weighed heavily on the manufacturing sector in 2015, and they may remain headwinds in the first half of 2016. The ISM Manufacturing Index weakened throughout the year and fell to a cycle low of 48.6 in November. Although its importance has diminished over the past three decades, the manufacturing sector still represents an important cyclical indicator for the domestic economy, and its weakness suggests that near-term growth is likely to remain somewhat sluggish. The abating pace of dollar appreciation going forward should result in a diminishing negative impact on manufacturing. An end to the soft patch in manufacturing, which thus far has remained elusive, would set the stage for better global growth in 2016.

Domestically, weakness in the manufacturing sector has been offset by impressive strength in the service sector, rising housing and auto sales, and persistent strength in the labor market. The unemployment rate in the U.S. fell, from 5.7% in January to 5.0% by December. A broad set of indicators, such as the level of unfilled job openings, has only recently begun to suggest that labor market momentum may have peaked. As the economy approaches full employment, it is reasonable to expect that employment growth will slow and inflationary wage pressures will finally begin to emerge. The recent upward pressure on wages shown in Exhibit 1 is one indicator that suggests labor market slack has been greatly diminished. It is a key piece of data that supported the Fed's recent decision to begin its tightening cycle.

Exhibit 1. U.S. Compensation per Hour, 4-Quarter Average, Year-Over-Year (%)

Source: Bloomberg

While monetary policy from the ECB is now diverging from the Fed, ECB President Mario Draghi disappointed markets with his December policy announcement. The announcement was less aggressive than most analysts expected, based on his recent history. It appears on both sides of the Atlantic, falling headline unemployment numbers and stabilization in the measure of core inflation may be bolstering the influence of monetary policy hawks, at least at the margin. In short, investors may have to grapple with the first indications that policymakers are growing more comfortable with the idea of slowly unwinding the unprecedented monetary accommodation of recent years.

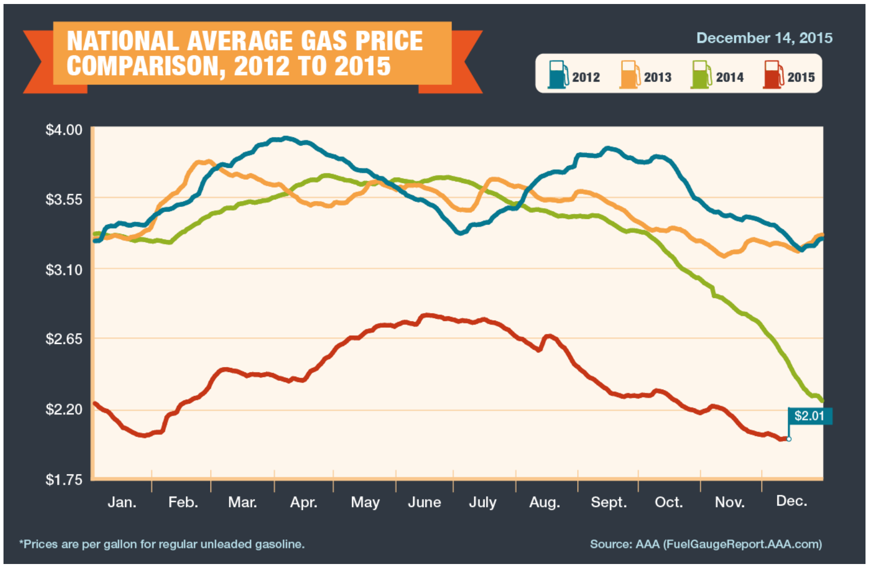
With regard to inflation, we enter 2016 in an unusual environment that poses risks to both the upside and to the downside. The risk of a global deflationary spiral cannot be completely dismissed, and a lack of recovery in global inflation measures is somewhat concerning. One risk worth watching that could enhance global deflationary pressures would be a move by China to allow further devaluation of its currency. It may be necessary for China's leaders to meet their growth targets while maintaining their commitment to liberalize the country's financial system. A recent move by the People's Bank of China signaled its intention to shift towards managing the Renminbi against a trade-weighted currency basket rather than pegging against the U.S. Dollar was viewed by many analysts as paving the way for a significant depreciation of China's currency. In the near term, however, our view is that the risk associated with a deflationary scare is fairly low in light of improving growth and bank lending in Europe and global monetary policy which is still highly accommodative. According to data from Ned Davis Research, the GDP-weighted global central bank interest rate remains extremely low at 1.88% as of November 30. While the Fed has just begun its tightening cycle, rate increases are expected to be gradual and the ECB and Bank of Japan (BOJ) are expected to remain anchored near zero percent for the foreseeable future. A growing number of emerging market central banks are being forced to raise interest rates to defend their currencies. It is recent trend and another risk we will watch, but in the near term, global monetary policy remains at least a modest tailwind for risk assets.

A bigger risk for the first half of 2016 is the potential for a surprising recovery in U.S. core inflation measures, which would increase rate hike expectations. With the Fed recently commencing a tightening cycle by announcing its first rate hike since 2006, monetary policy is entering a new phase. The slow shift away from ultra-accommodative monetary policy may lead to heightened financial market volatility. Further tightening of financial conditions in the coming months could dampen the intermediate-term growth outlook.

As previously mentioned, housing and auto sales provided a key boost to the U.S. economy in 2015, and it helped to offset weakness in the manufacturing sector. However, both industries are traditionally considered to be sensitive to Fed hikes. With total light-vehicle sales near the highs of the last cycle and lending standards in the auto industry already easier than historical norms, a slowdown in response to the Fed's rate hikes in 2016 appears likely. We are optimistic about the housing sector, however. Single-family housing starts remain depressed by historical standards and housing affordability remains supportive. While momentum may slow, we believe the uptrend in new home construction is likely to remain intact in 2016.

Meanwhile, as shown in Exhibit 2, multi-year lows in gasoline prices may also provide optimism in 2016. While the plunge in oil and commodity prices, which began in the summer of 2014 and accelerated in 2015, weighed heavily on earnings for the energy and materials sectors, consumers have benefitted from a sharp drop in personal gas expenses. Travel-related industries have also received a direct cost-reduction benefit to their earnings. As of December 14, national average gas prices were at the lowest level since 2009 and may help provide a boost to holiday retail spending and overall consumer sentiment.

Exhibit 2. Gas Prices at Multi-Year Lows



In summary, although this expansion is now the fifth longest U.S. expansion in the history of the data—and some potential pitfalls are lurking—the risk of recession still does not appear elevated heading into 2016. We do expect further dollar strength in the near term, but the magnitude is likely to be less severe and its impact to earnings and economic growth should subside. By mid-year, growth expectations in the U.S. may fall in response to Fed tightening, which would provide a headwind to the dollar's uptrend. Recovering housing starts are likely to continue providing support for U.S. economic growth and offset a potential peak in auto sales. Overall, risks to the expansion are rising but the weight of the evidence points to a modest rebound in global growth over the first half of 2016.

Equity Markets

Global financial markets oscillated between risk-on and risk-off periods in 2015, resulting in heightened volatility and ultimately very minimal gains in most equity asset classes. Following an impressive surge in October, markets settled back into a volatile trading range over the remainder of the fourth quarter. As shown in Exhibit 3, in U.S. dollar terms through December 14, the international developed-market MSCI EAFE Index was down 3.4% on the year and the MSCI Emerging Market Index was down 17.3%. Domestic equities again fared better than international stocks, with the S&P 500 slightly positive on the year. However, the gains in the U.S. came from a relatively narrow group of stocks in the mega-cap growth portion of the market. By comparison, the Russell 2000 Index of small-cap stocks was down more than 6%, and the Russell 3000 Value Index was down 5.83%. Growth stocks tend to command a premium when earnings growth becomes scarce, and this trend was particularly true in 2015 as more cyclical sectors suffered through a very challenging period. Meanwhile, the equal-weighted S&P 500 trailed the market-cap weighted index by more than 4% through December 14, an indication of the degree to which market gains primarily came from a limited-number of very large companies. In short, while the S&P 500 looks like it could post another annual gain, it was a generally weak period for equities and, broadly speaking, the worst year of the current bull market which began in 2009.

Exhibit 3. Equity Market Performance

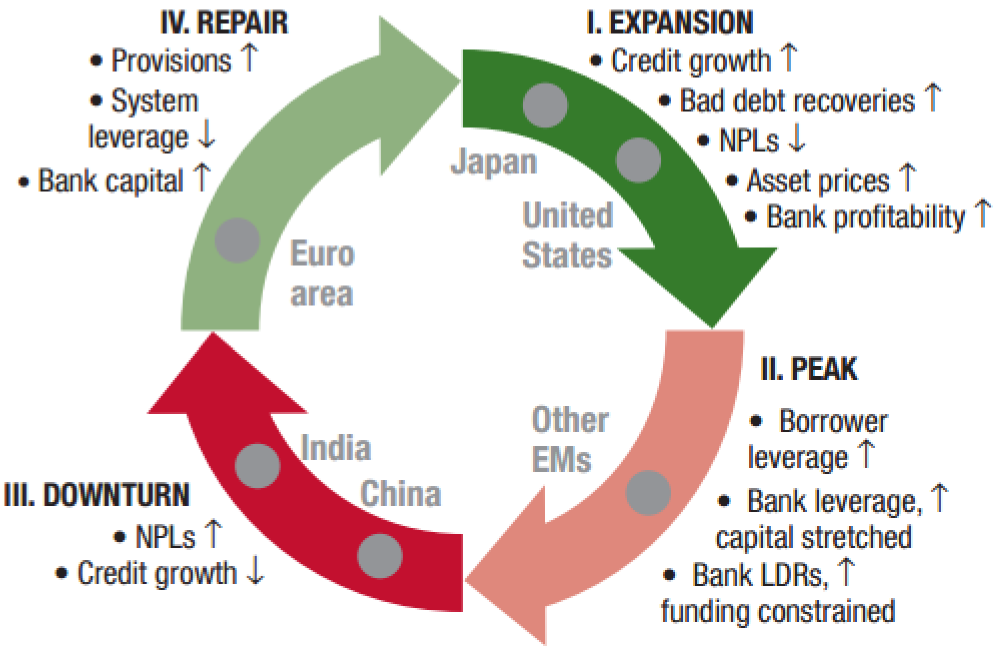
	Fourth Quarter	2015
Developed Foreign Equities – MSCI EAFE Index	1.6%	-3.4%
Emerging Market Equities – MSCI Emerging Market Index	-17.3%	-2.4%
Global Equities – MSCI World Index	3.6%	-2.2%
U.S. Equities – Russell 2000 (Small Cap)	1.7%	-6.2%
U.S. Equities – S&P 500	5.8%	0.2%

Source: Morningstar, as of 12/14/15

Hurt by notable strength in the U.S. dollar and a severe plunge in energy sector profits, operating earnings for the S&P 500 are on pace to decline 5.7% for 2015. Excluding the energy sector, however, operating earnings are expected to grow 6.0% for the year, according to data compiled by Standard & Poor's. Although earnings have been buoyed by a potentially unsustainable level of share repurchases and growing at a rate far below the double-digit rates experienced earlier in the recovery, it is clear that the earnings recession of 2015 was largely attributable to the woes within the energy sector. Looking forward to 2016, analysts are calling for a big rebound in earnings and for profit margins to surge back to record levels. According to data from Standard & Poor's, analysts expect an 18% gain in S&P 500 operating earnings, an earnings surge that could prove unjustifiably optimistic, even with a stabilization in the energy sector. Among the most optimistic earnings projections for 2016 are expectations for health care sector earnings to leap by 26.0%, technology earnings to surge 17.1%, and discretionary earnings to grow 14.1%. With operating leverage for the S&P 500 now very low by historical standards (i.e., fixed costs are low), the record margins analysts are forecasting may be difficult to attain if wage pressures continue to build. In our view, a more realistic expectation for earnings growth is in the high-single digits, which assumes average GDP growth, stable margins, continued share repurchases that add 1% to annual EPS growth, and a modest uptick in inflation. With the valuations of U.S. stocks already somewhat elevated by historical standards and the Fed now tightening, we do not expect price-to-earnings multiples to expand much in 2016. As a result, our base case expectation is for mid-to-high single digit returns for U.S. equities with significant volatility.

Looking globally, Europe is one region where conditions seem supportive for robust equity market gains over the intermediate term. First, while the credit cycle is maturing in the U.S., bank lending has just started to accelerate in Europe. This pattern suggests the Eurozone economy is in a relatively early stage of the business cycle and lending should be set to accelerate in the coming quarters. By contrast, emerging markets have yet to work through the structural changes needed to address growing debt challenges and appear to be entering a credit cycle downturn.

Exhibit 4. Credit Cycle: Characteristics and Country Positions



Source: IMF Global Financial Stability Report (October 2015)

Note: Credit cycles describe the consequences of credit growth on economic growth, asset quality, and leverage. In expansion, borrower profits and asset quality are robust, but high credit growth also increases banks' and borrowers' leverage. Leverage in banks and borrowers then peaks, followed by a contraction or slowdown in credit growth, downturn in asset quality, and rising nonperforming loans (NPLs). The process culminates in balance sheet repair and recapitalization, which sets the stage for a new credit cycle. The credit gap is calculated using a one-sided Hodrick-Prescott filter with a smoothing parameter of 400,000. EM = emerging market; LDR = loan-to-deposit ratio.

Several valuation measures also indicate European equities remain attractively valued relative to U.S. equities. For example, the trailing twelve month price-to-earnings ratio is now lower for the Eurozone (MSCI EMU Index) than for the U.S. (MSCI USA Index). Meanwhile, a weakening trend in the euro currency and improving bank lending has provided a big boost to the earnings growth of European firms, a trend that should remain intact in the first half of 2016. The influx of refugees in Europe will continue to increase political tension, but it also may encourage more fiscal spending. Such a shift away from austerity could help short-term growth prospects and provide an additional boost to corporate profits. Finally, monetary policy remains supportive of European risk assets with the ECB committed to maintaining its large-scale asset purchases at least through March of 2017. The biggest risk to a bullish outlook for European equities may be that this is now a consensus view, but valuation metrics do not yet suggest optimism has become excessive. Longer-term, the demographic outlook for Europe is among the most challenged in the world. But for 2016, the outlook for European equities appears favorable.

While U.S. equities appear fully valued on many metrics, exceptionally low interest rates and inflation still largely mitigate valuation concerns. For example, the earnings yield of the S&P 500 still appears very favorable relative to Treasury yields. Along the same lines, the percentage of stocks with dividend yields higher than the 10-year Treasury yield remains very high by historical standards. In short, the high absolute readings for U.S. equities on traditional valuation metrics can be justified by the current backdrop of extraordinarily low inflation and interest rates. However, should inflationary pressures rise and bond yields move significantly higher, current equity market valuation multiples may prove difficult to sustain.

One way of viewing the macro backdrop provided by inflation and employment trends is the so-called misery index. Developed by economist Arthur Okun and gaining popularity during the high inflation environment of the 1970s, the original misery index is simply the sum of the inflation rate and the unemployment rate. When applied to markets and combined with valuation metrics, the concept seems to have solid explanatory power for long-term equity market returns. For example, an indicator which simply adds the current price-to-earnings (P/E) ratio of the S&P 500 to the misery index shows a fairly strong relationship with market returns over time. Particularly noteworthy, returns have been very subpar on average since 1929 when the S&P 500 P/E ratio plus the misery index has been above 30 (Exhibit 5). The current misery index remains near all-time lows and the sum of the S&P 500's P/E ratio and the misery index remains below 26, which is the threshold below which the market has historically had above average returns. With the unemployment rate not expected to fall significantly from its current level of 5.0% and the P/E ratio already above its historical average, this measure suggests continued low inflation will be a key factor for U.S. equities going forward. YoY core inflation did pick up to 2.0% in November, the highest reading since July 2012, and headline consumer price index (CPI) is likely to rise from its current very depressed level once energy prices stabilize. A substantial rise in inflation would make the valuation case for U.S. equities far less compelling.

Exhibit 5. S&P 500 Performance vs. Sum of Misery Index and P/E Ratio (12/31/1929-9/30/2015)

Indicator Reading	% Gain/Annum	% of Time
Above 29.92	1.39	25.09
Between 26.52 and 29.92	8.93	25.11
*Between 23.5 and 26.52	12.97	24.73
Below 23.5	15.19	25.07

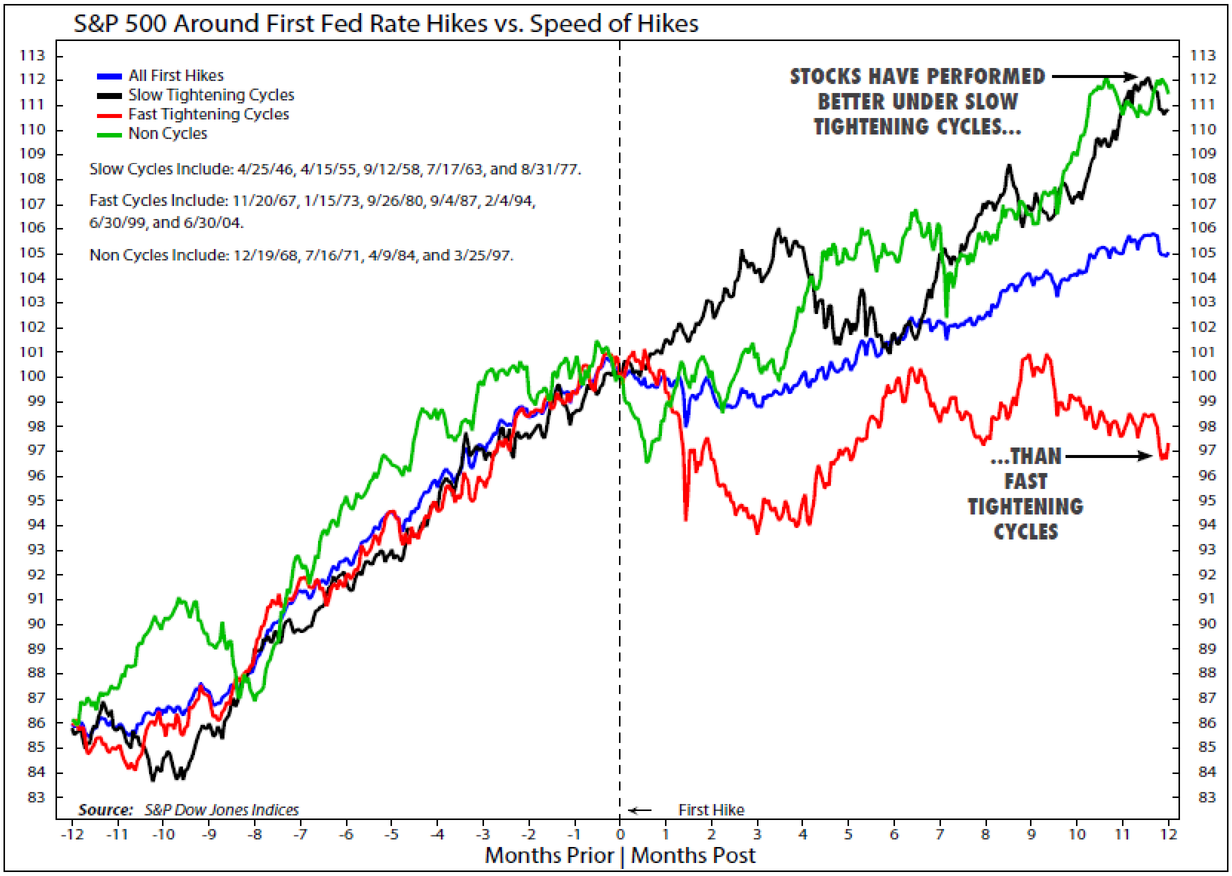
Source: Ned Davis Research

**current reading is 25.2 as of 12/14/2015*

In all likelihood, the market headlines over the first three quarters of 2016 will include a fair amount of presidential election coverage. Looking at the Dow Jones Industrial Average since 1900, election years have seen choppy market action over the first two quarters followed by solid gains in the second half of the year. This pattern may be explained by investor preference for policy certainty, regardless of what the policy may be, resulting in market rallies once the outcome of an election is clear. In the post-WWII period, the average presidential-election-year gain for the S&P 500 has been only slightly below the average return for all years and the majority of strength has come in the second half of the year.

In addition to the presidential cycle, Fed policy will shape the market's macro backdrop in the coming year. With the Fed now officially in tightening mode, it is worth revisiting historical market patterns during the early stages of Fed tightening cycles. As illustrated in Exhibit 6, equity markets have historically performed much better in the first year of slow tightening cycles when compared to the first year of faster-than-average tightening cycles. The Fed has signaled its intention to pursue an extremely gradual tightening path, and we expect the Fed funds rate will finish 2016 between 1.0% and 1.25%. A faster-than-expected pace would likely prove a major headwind to equities unless earnings growth far exceeds our expectations. One caveat is that the market has been behaving somewhat less robustly than normal heading into the first rate hike and a soft form of tightening arguably began nearly two years ago when the Fed first started tapering its asset purchases. As a result, even though the current tightening cycle is likely to be exceptionally slow, market gains may be somewhat more muted than in prior slow tightening cycles.

Exhibit 6. Stock Have Performed Better Under Slow Tightening Cycles



Source: S&P Dow Jones Indices as of 9/30/15.

Conditions are still supportive for growth stocks performing well relative to value stocks, although the magnitude of growth outperformance is likely to be more subdued. Growth has tended to outperform value when overall earnings growth for the S&P 500 is below zero and value, on average, has outperformed when aggregate YoY earnings growth is positive. This relationship is intuitive because the earnings of value stocks tend to be cyclical while growth stocks offer more stable earnings gains. Although we do not believe earnings are likely to rebound to the degree that consensus analyst estimates are forecasting, a return to positive YoY earnings growth is likely. That said, even after a 10-year period of outperformance, the valuation of growth stocks does not appear abnormally high relative to value stocks and our expectation for somewhat sluggish global growth supports continued outperformance for growth. A slight growth tilt remains prudent in our view.

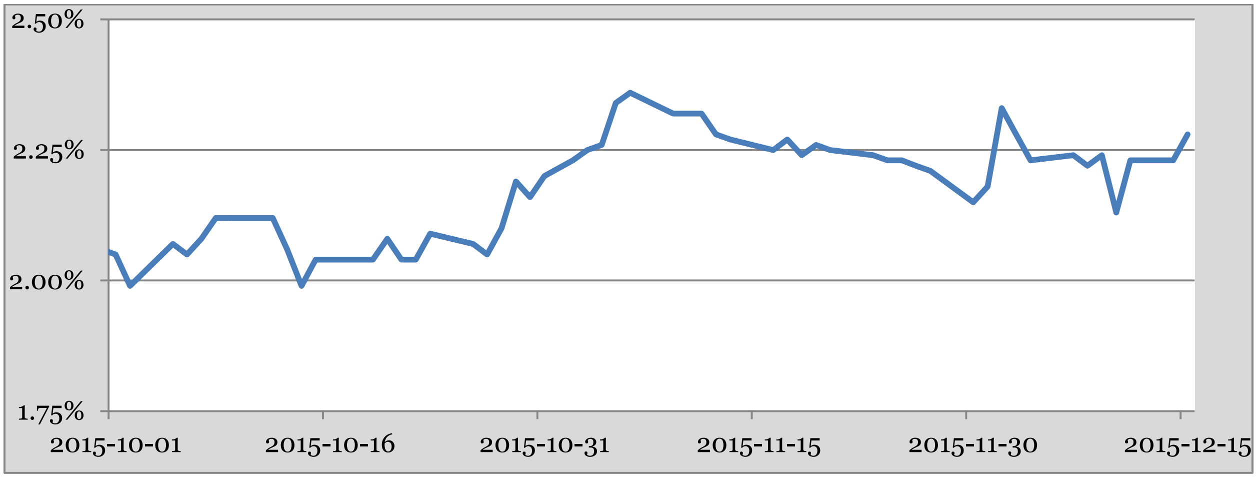
An increasing number of risks indicate we may be entering a more volatile period for equity markets. U.S. equity valuations at the upper-end of historical norms, earnings projections may prove difficult to meet, the Fed has begun its tightening cycle, and an aging bull market is now in the third-longest run in the history of the S&P 500 without a 20% correction. In addition, a potential financial crisis in the emerging world arguably remains the biggest risk to global equity markets, as needed structural reforms have not been implemented and private debt has continued to grow at an unsustainable pace. However, despite these risks, the evidence, in aggregate, still points to a continuing market advance in 2016. Many of the conditions that have typically preceded major market peaks remain absent, including excessive demand, unsustainable bubbly credit growth, surging inflationary pressures, and sharply tightening global monetary policy. To be clear: while we have noted some building risks that warrant close scrutiny, the macro backdrop does not yet suggest a high risk of a sustained global downturn in equity prices, in our opinion. As a result, our base case scenario for 2016 is for moderately positive equity returns accompanied by increasing volatility.

Fixed Income Markets

Late September was a volatile time for risk assets, and a flight to quality briefly drove the yield on 10-year Treasuries to just below 2% at the beginning of the fourth quarter. As U.S. economic data continued to show strength in employment and GDP growth, long-term rates began to trend upward in anticipation of a rate increase by the Fed in December. As shown in Exhibit 7, the 10- year Treasury yield, which began the quarter at 2.05%, peaked at 2.36% in mid-November. Then, it retreated close to 2.15% as concerns regarding riskier mining and energy bonds drove investors to safety. After maintaining the status quo in September, the Federal Open Market Committee (FOMC) voted in December to increase the Fed funds rate. The likelihood of this move was well telegraphed via several press conferences, and, as noted above, bond prices largely reflected these expectations. The Committee voted unanimously in favor of the increase and did not materially change its outlook for the U.S. economy, saying it "sees the risks to the outlook for both economic activity and the labor market as balanced." The committee also stated it is "reasonably confident" inflation will move toward the Fed's 2% target over the medium term.

Prior to the Fed meeting, the intraday rate stood at 2.30%, embedded in which was the expectation for a Fed rate increase. After the FOMC's decision to raise short term interest rates, the 10-year yield moved slightly lower to 2.287% (as of 12/16/2015).

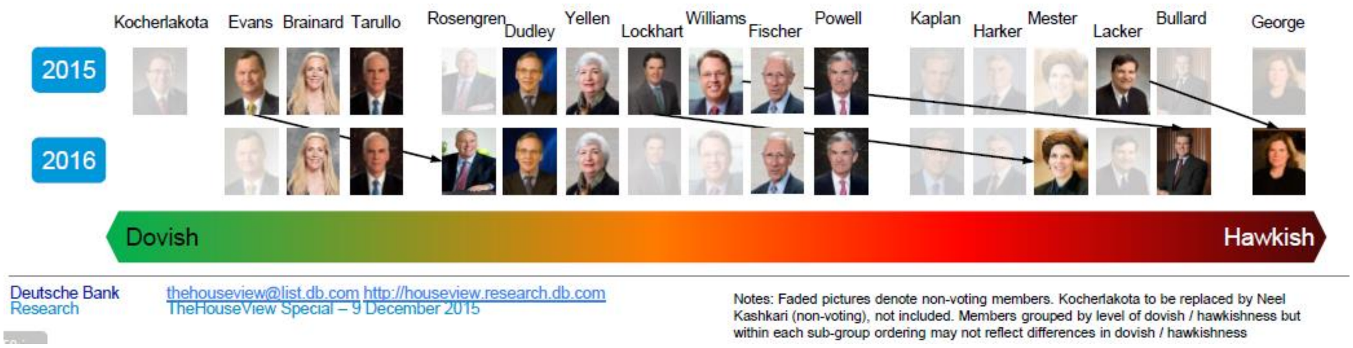
Exhibit 7. 10-Year Treasury Yield



Source: Federal Reserve Bank of St. Louis, as of December 16, 2015

There are a few noteworthy changes to the composition of the FOMC in 2016 (illustrated in Exhibit 8) that may make establishing a dovish consensus more difficult. The hawkish Jeffrey Lacker is being replaced as a voting member by Esther George, who is perceived by many Fed watchers to be even more hawkish. Chicago Fed President Charles Evans, who is widely considered to be one of the most dovish FOMC members, will not be a voting member in 2016 while the more neutral Eric Rosengren will have a vote. Two additional individuals who are considered somewhat hawkish—Loretta Mester and James Bullard—will also become voting members and replace the more neutral Dennis Lockhart and John Williams. Should core inflation begin to tick up in early 2016 in response to rising wage pressures, it may prove surprisingly challenging for Chairwoman Yellen to maintain a consensus message that tightening should remain exceptionally gradual.

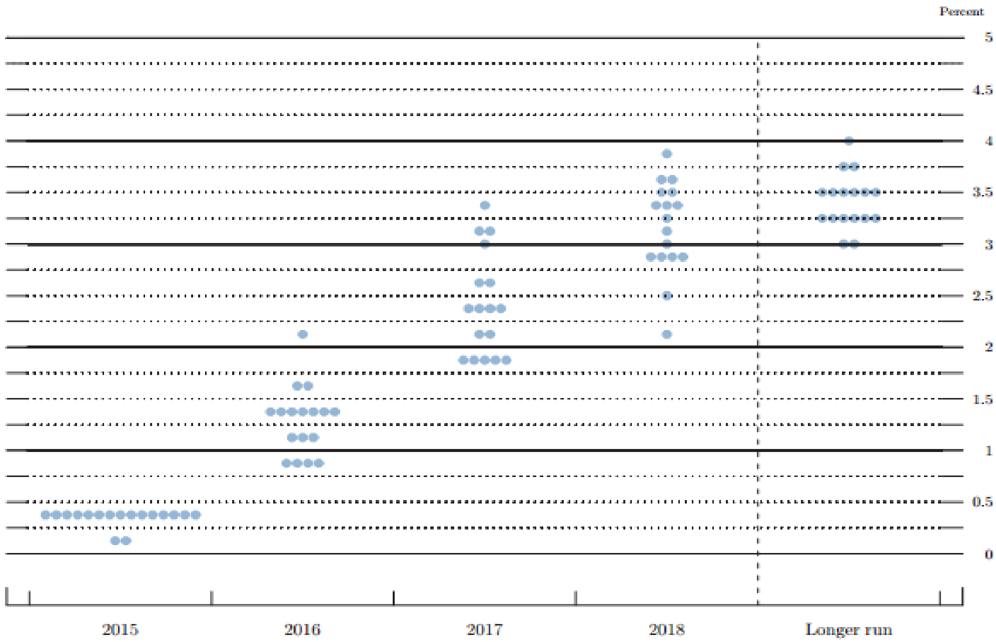
Exhibit 8. Composition of FOMC Shifting More Hawkish



Investor attention in now focused on the relative speed that policy tightening may occur. As shown in Exhibit 9, the FOMC's "Dot Plot" for 2016 suggests there may be four 0.25% rate increases next year, but the path of increases is still likely to be data dependent. As a reminder, the "Dot Plot" indicates where each member of the FOMC expects the level of the federal funds rate to be at the end of each calendar year.

Exhibit 9. Federal Reserve Dot Plot.

FOMC participants' assessments of appropriate monetary policy: midpoint of target range or target level for the federal funds rate.



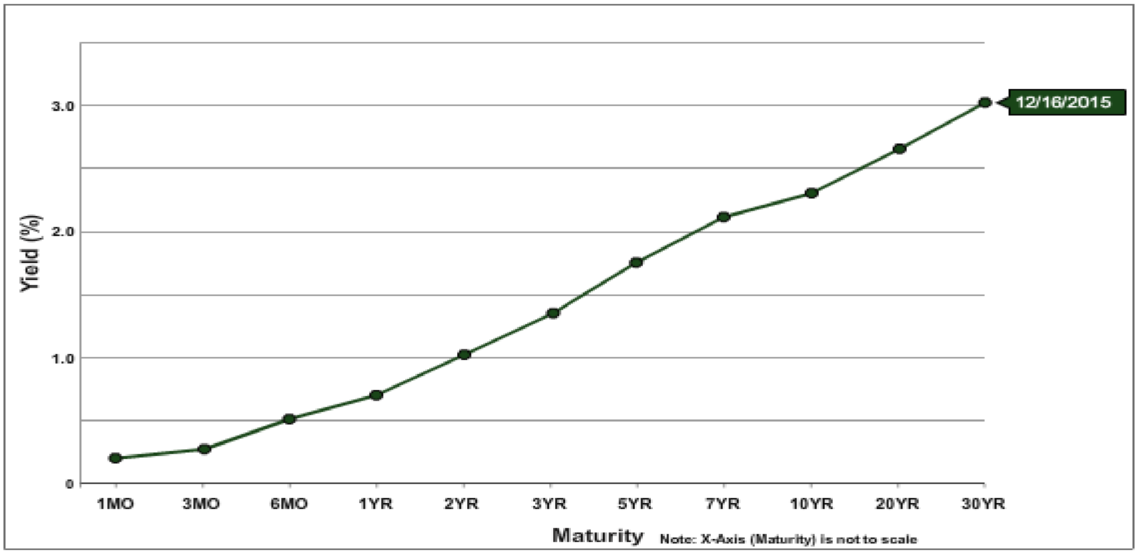
Source: Federal Reserve, as of 12/16/2015

Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate level for the federal funds rates at the end of the specified calendar year or over the longer run.

The path of rate increases is likely to be exceptionally gradual. The Fed would like to start its tightening policy early and allow for a gradual pace of increases, rather than have to act abruptly at a later date. The market expects this approach, and we would not be surprised if the Fed errs toward fewer rate increases if economic data comes in softer than expected.

The removal of stimulative policy may drive shorter-term rates to just above 1.00% by the end of 2016. Long-term rates are likely to move only modestly higher from their current levels, due to substantial demand for Treasury bonds from institutions and from international buyers drawn to the relative safety of the U.S. over other developed markets. The yield curve, shown in Exhibit 10, may flatten in 2016, as short-term bond yields may rise faster than longer-term bond yields.

Exhibit 10. Yield Curve



Source: U.S. Department of the Treasury

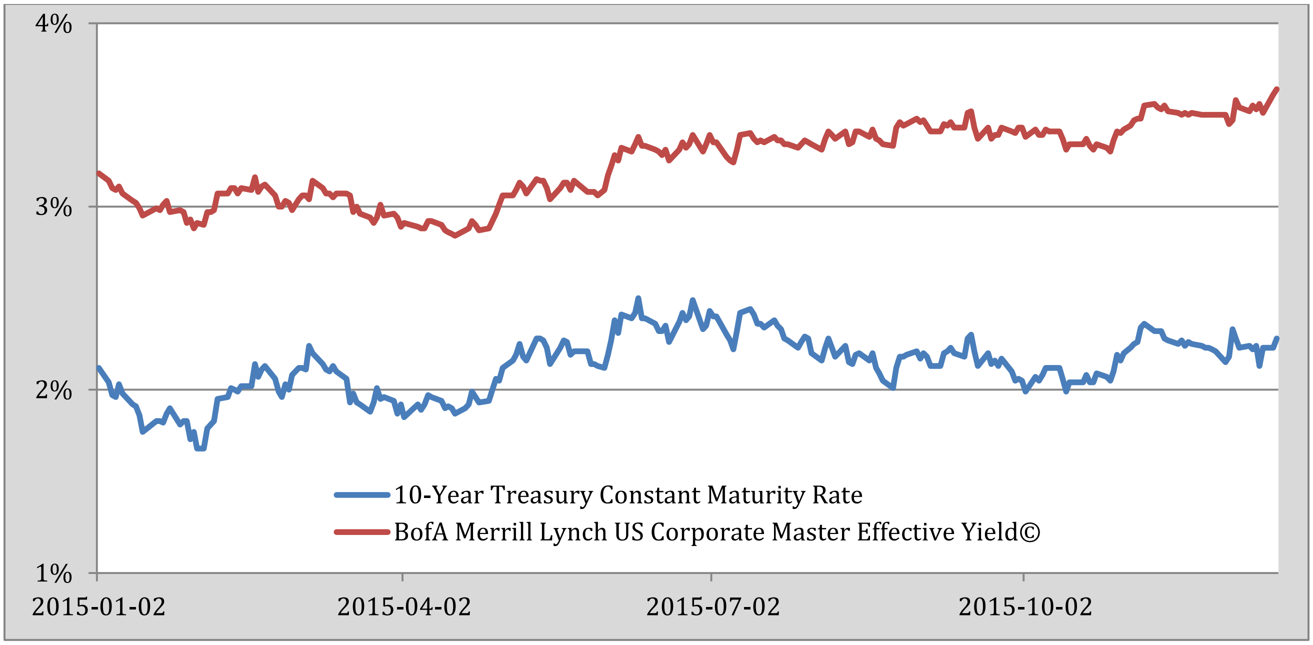
As mentioned earlier, we believe inflation is likely to remain low over the near term. Higher short-term rates in the U.S. and a recent decision from the People's Bank of China to manage its currency in a less dollar-centric manner are both supportive of a stronger dollar, which, in turn, may continue to keep commodity prices low. The resulting savings from lower input prices are likely to suppress inflationary pressures that arise from a tighter labor market and rising wages.

For these reasons, our view is that yields may be sufficient to cover the price impact caused by rate increases, as well as returns of intermediate- to longer duration bonds, may be flat to marginally positive for 2016. A risk of higher volatility in shorter-term Treasuries does exist. However, they are also less sensitive to rate moves, which may limit their downside risk.

Looking forward, we expect that volatility in Treasury rates may remain elevated. An uneven path of rate normalization is still likely, which can contribute to rate variability similar to what we have observed in 2015.

Several risks to the scenario we outlined above include a sharper-than-expected increase in inflation, which in turn may cause longer-term rates to rise faster than we expect. This risk may be caused by a faster-than-expected commodity or energy price increase, or a more rapid increase in wage inflation as labor markets reach full utilization. A weaker-than-expected demand for U.S. Treasuries may also cause long-term rates to be more volatile. We see these developments as less likely than our base case scenario, but possible.

Exhibit 11



Source: Federal Reserve Bank of St. Louis, as of December 16, 2015

In our view, investment-grade credit still offers greater value relative to Treasury bonds. Spreads in investment-grade credit are trading at a level consistent with 10-year averages, and their higher yields may offer better protection in a rising-rate regime. We believe the U.S. economy will continue to grow at a modest pace, which should provide for stable credit ratings and keep default rates in investment grade bonds at lower levels.

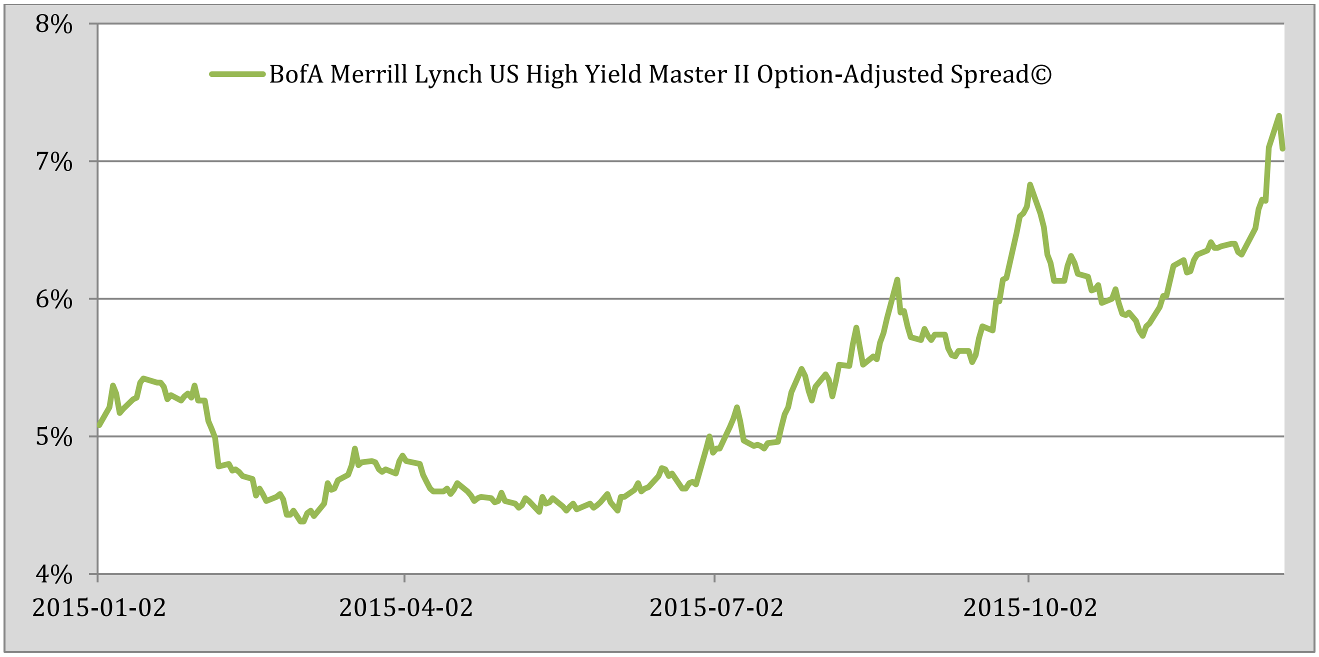
High yield bonds have been more volatile over the past quarter. Crude oil prices have been trending lower based on investor expectations that the oversupply situation in oil production may persist. Consequently, the high yield bond sector, which has approximately 13% exposure to energy, sold off substantially. The negative sentiment has also impacted non-energy sensitive names, and high yield spreads over treasuries are trading a bit higher than historical averages.

While volatility in high yield is unnerving to many investors and may persist for a while, it may also present investment opportunities. We expect that continued economic growth in the U.S. will be supportive for credit and high yield bonds going forward, as their issuers are likely to remain in a position to meet obligations. Finally, while the rate of high yield defaults has been modestly higher this year, our expectation is that defaults outside of the energy sector will be limited, and the current level of spreads offers ample investor protection.

One note of caution is materials and energy sectors. If prices remain at their current levels, this may impact earnings and impact the high yield sector, causing continued volatility in spreads of energy related high yield bonds.

Exhibit 12 shows the current option adjusted spreads (OAS) for high yield bonds, compared to their 10 year averages. The OAS is a commonly used measure for the level of credit spreads, after the effects on yield of optional bond features such as call protection and convertibility are removed.

Exhibit 12. U.S. High Yield Option-Adjusted Spreads



Source: Federal Reserve Bank of St. Louis, as of December 16, 2015

The taxable municipal bond market is benefiting from stronger demand because yields have increased, making municipal bonds relatively more attractive than treasuries to investors in higher tax brackets. Fundamentals, such as increased tax collections associated with an improving economy, combined with decreases in bond issuance (which limits supply) are also positive for municipal bonds. These trends may keep muni yields more stable than treasuries for the upcoming year. However, continued headlines in Puerto Rico, Stockton and Chicago could lead to negative sentiment that may cause municipal bonds to sell down. Currently, municipal bonds are relatively attractive on an after-tax basis, but they tend to be longer in duration than taxable bonds and therefore are more impacted by raising interest rates. Our outlook for municipal bonds is muted, possibly calling for small positive returns in 2016.

Foreign bonds may diversify portfolios against raising U.S. interest rates and unexpected inflation. Several central banks around the world are lowering rates and implementing quantitative easing, thus driving down bond yields and inversely pushing up bond prices. Investors need to beware of currency risk, however. Foreign bonds may appreciate in value in local currencies, but may not appreciate in U.S. dollar terms. The U.S. dollar has increased in value relative to most of the world's currencies over the past year and is expected to continue to increase due to stronger GDP growth prospects and higher interest rates in the U.S.

Risks to Our Outlook

Even with the first rate hike out of the way, a slowly-improving domestic economy and labor market, the Euro area on the mend, and an accommodative international monetary policy, we still note several concerns as we enter 2016. For the most part, much of what created disturbances in 2015 may be similarly disruptive to capital markets in the New Year. Specifically, we have a watchful eye on the tightening U.S. monetary policy, energy and commodity prices, domestic equity valuations, and potential surprises out of China.

Monetary Policy Shifting Course

During the December interest rate hike announcement, the FOMC made clear its expectation that "economic conditions will evolve in a manner that will warrant only gradual increases in the Fed funds rate." As we embark into a new phase of monetary policy, the debate after every release of economic data centers around one theme. *Is* *the economy strong enough to sustain a tightening cycle, and what should the breadth and pace of future rate hikes should be?* On one hand, the Fed tightening amidst weakening global economic conditions is troubling to many investors. Just three months prior, the FOMC stated there was too much global uncertainty to warrant a September increase, sending global markets into deeper sell off. If the Fed strays from its chosen direction, markets may infer that the economy cannot stand on its own.

Implications of Protracted Low Oil Pricing

On the back of a supply glut, oil crossed a key level of $40/barrel in the fourth quarter, down to a seven-year low, while offering few signs of reversal. Many expected to see price stabilization in 2015 when production dropped to meet demand. On the contrary, the Organization of the Petroleum Exporting Countries (OPEC) pumped more oil in November 2015 than any month in the past three years. Production in the U.S., Russia, and Canada stayed resilient as well. The longer oil prices remain low, the greater the implication for other asset classes, most notably high yield fixed income. Reuters estimates the 60% decline in oil price over the last year may place $2 trillion of debt at risk of downgrade and defaults. Normal rules of asset pricing and correlations do not apply in times of market volatility, panic, and forced selling. This was seen in the high yield and MLP markets during the second half of 2015 as fears spread.

Earnings Recession and Stretched Valuations

12-month forward P/E ratios of the S&P 500 are now above their 5-year and 10-year averages, signaling the market may be overvalued relative to their earnings. Major detractors to 2015 S&P 500 earnings growth and the leading causes of the earnings recession in the second and third quarters were the continued weakness in the price of crude oil and other commodities prices, coupled with a strengthening dollar. As of mid-December, the S&P 500 is on pace to report three consecutive negative quarters of earnings growth—something not seen since 2009. However, as discussed earlier, much of this earnings recession is attributable to the energy sector and not indicative of an economy-wide malaise. While we do not expect valuation multiples to expand much in 2016, we remain optimistic for earnings growth in the high-single digits and for mid-to-high single digit returns for U.S. equities with significant volatility.

China Growth Moderating

China is the second largest global economy and the cornerstone of the emerging markets, so we believe that maintaining a close eye on China in 2016 is prudent. Policymakers are working to transition China from an investment-driven system to a market-based and consumption-driven economy, an endeavor which we expect to encounter a number of headwinds along the way. To put the importance of China and its spillover effect in perspective, the IMF estimates every one percentage point slowdown in growth equates to a 0.3 percentage point decline for its Asian neighbors. Even though the concerns over the real estate sector have abated, there has been significant weakness in the export-related industrial and manufacturing industries that have been hurting China and the other emerging markets. The Baltic Dry Freight Index fell to its lowest reading during December 2015. This index tracks transportation costs for cargo (such as coal, grain and iron ore) and is currently 95% below highs reached in May 2008. China accounts for about half the world's steel production. Although China may have the tools to manage through their transition, many asset classes previously bolstered by China's expansion are no longer supported by their demand. In addition, while their emerging market counterparts battle for a currency advantage, one can expect further volatility associated with these asset classes.

Strong Dollar Hurts U.S. Corporate Earnings

A stronger dollar may hurt company earnings because U.S. exports become less competitive with goods produced abroad. If corporations have not hedged overseas profits, they translate into fewer dollars. This situation is especially worrisome to domestic manufacturing companies, which tend to derive a good portion of their revenue from exports.

Investment Implications

The Fed finally raised rates for the first time since 2006, the investment implications of which are numerous. Though we have seen signs of economic improvement, we still believe the global economy will continue to grow below trend. With slower global growth and current market valuations, in general, we would expect long-term returns in stocks and bonds, to be below average, accompanied by higher volatility. Given more accommodative central bank policies in Europe and Japan, coupled with more attractive valuations and their being in earlier stages of economic recovery, potential opportunities exist in international investing for the long term.

In this environment, we continue to maintain an allocation to equities based on long-term objectives, skewing neither aggressive nor conservative in that equity allocation. Within the United States, and in light of the strength of the dollar and increasing geopolitical risk, we still favor more domestically-oriented companies, which suggests a greater allocation to small-cap stocks. Considering their recent relative underperformance to large caps, small cap stocks appear to have more upside potential. They generally tend to derive less of their revenues from foreign economies, they also have less vulnerability to the effects of a strengthening dollar. Additionally, companies that are able to grow despite an anemic economic backdrop are likely to command a premium. As such, we continue to favor growth over value across the market cap spectrum. However, we have witnessed the growth sector outperform value since 1969, so it is possible that value may grow increasingly attractive on a relative basis.

Within fixed income, we continue to maintain a somewhat defensive position, with an overweight to credit-sensitive bonds and a shorter duration. However, with the expectation that interest rates may remain lower for a longer time period, we may observe fewer headwinds for bonds in the near-term. In that case, it may be advantageous to begin reducing the defensive positioning.

Lastly, to mitigate unforeseen volatility in an increasingly uncertain environment, we believe it prudent to retain an allocation to alternative investments that have low correlations to traditional investments. We are slightly underweight commodities, which could come off their lows if the global economy picks up, but they still face tough headwinds from a stronger dollar and excess supply. Finally, from a portfolio implementation standpoint, we prefer managers with flexible investment styles that provide the discretion and ability to move nimbly within their mandates in the face of the changing circumstances that we anticipate going forward.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

Glossary

*The **Baltic Dry Index** is a daily-issued composite of the Baltic Capesize, Panamax, Handysize and Supramax shipping rates indices. Updated by the London-based Baltic Exchange, the index is designed to provide an assessment of the price of moving the major raw materials by sea. It is also the successor to the Baltic Freight Index and was first published on January 4, 1985 at a base of 1,000 points.*

*The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.*

*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.*

*The **ISM Manufacturing Index** is an index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.*

*The **MSCI EAFE** is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted.*

*The **MSCI Emerging Markets Index** is designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index.*

*The **MSCI EMU (European Economic and Monetary Union) Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of countries within EMU. The MSCI EMU Index consists of the following 10 developed market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, and Spain.*

*The **MSCI USA Index** is designed to measure the performance of the large and mid cap segments of the U.S. market. With 636 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.*

*The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

*The **Russell 3000 Value Index** measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.*

*The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.*