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INVESTMENT STRATEGY QUARTERLY

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RAYMOND JAMES®

The UK's upcoming European referendum – 'remain' or 'leave'?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

All investors are likely to agree that 'Brexit' is an ungainly word that is likely to be heard far too often in the remaining time before the European Union 'remain/leave' vote on 23 June. But what should voters – and investors – think? Here we make the case for both sides… and leave the ultimate decision up to you. Possibly and ultimately the biggest investor risk from the Brexit debate, irrespective of the final result, is boosted uncertainty and too much talk (and not enough economic dynamism action) which typically heightens general volatility. In other words, 2016 in the UK is turning into an investing environment where you have to stay flexible and understand the fundamentals and valuation assumptions underpinning your portfolio – skills the mid-1970s fund manager would have taken for granted at the time of the last UK referendum on Europe.

THE CASE FOR 'REMAIN'

It is certainly true that meddling from Europe wide regulators and legislators is on the increase but there is a method in the madness: such standards help facilitate pan-European trade which is today hugely important for the UK economy.

Over 45% of the UK's exports go to the European Union and such rules and regulations have helped this grow in both absolute and relative terms over the last generation. The biggest risk of a Brexit is the uncertainty around the new trade laws that would replace the current crop. There are enough trade rumblings between the US and Europe to show that stepping away from the European Union would boost uncertainty on this issue. And less trade in an open economy like the UK inexorably leads to less economic growth – and lower economic growth is not good for the broader economy. No wonder the Pound has been weak since the referendum was announced.

> "The biggest risk of a Brexit is the uncertainty around the new trade laws that would replace the current crop."

Additionally, the economic case for the 'remain' camp is in the attractions of the status quo and in avoiding potential scenarios sketched out by business groups like the CBI in its recent study, noting that the UK economy could lose up to 0.5m jobs by 2020 in a Brexit scenario, which could cut GDP 3.5-4% and potentially could take 15 years to fully recover as global businesses reconsider whether they should have the UK as their European headquarters. Such economic impact losses vastly outweigh any current contribution costs of European Union membership.

> "The UK's global influence would wane and that typically impacts both the local economy and the national psyche."

Supplementing economics, are politics and diplomacy. The UK may sit on the top table at G7 gatherings but increasingly international diplomacy is region-by-region centred especially as the Eurozone collectively accounts for far more heads of population. The UK's global influence would wane and that typically impacts both the local economy and the national psyche.

A 'remain' vote should also not be confused with a vote for the euro. The European Union and the Eurozone are two quite different legal entities and being a member of the former does not lead inexorably to the latter. The key to the UK's current EU membership is much more trade and diplomatic based.

Finally, the case for 'remain' rests on the positive case of what the UK can do for the rest of Europe. It is abundantly clear that the European Union is a better, more rigorous and dynamic area with UK participation – which is why Germany among others do not want the UK to leave. The UK has led Europe in supply side changes resulting in its economy growing far faster in recent years than the European Union norm. A 'remain' vote gives an opportunity to change the whole of Europe for the better rather than bemoaning a lack of decision-making and sniping about meddling or migrant policies. It is always better to try to leave rather than going off in a

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huff – and the UK would gain economic, political and diplomatic bonuses as a result from being stronger together.

KEY TAKEAWAYS - 'REMAIN':

- The status quo lessens the probability of a big economic shock
- Europe accounts for a near majority of UK trade
- Germany wants the UK to stay in the European Union to help push through reform

THE CASE FOR 'LEAVE'

The UK is not part of the euro zone but the main fear driving the 'leave' campaign is creeping harmonisation of rules and standards which threatens to subvert the power of the UK Parliament in favour of institutions in Brussels. Liberation from such rules, laws and membership contribution costs – sourced from one of the slowest growing regions of the world over recent years – would offer a clear flexibility dividend and an opportunity to differentiate the UK economy in today's competitive world.

"Having left the European Union but recast itself as a truly global economy once again, the entrepreneurial spirits of UK business could once again be put to work all around the world."

Striking trade deals should be relatively easy for the UK economy given the two year window before existing trade deals roll off, a reality that would also placate corporations considering leaving the UK's shores. As a growing and dynamic large economy in a good time zone, and open for business, much of the fear about being locked out of trade opportunities will diminish. The UK, after all, has a trade deficit with Europe, indicating a vested interest in the European Union exporting countries to strike a deal.

There is a much bigger world outside Europe. Let's not also forget that the FTSE 100 in particular is not the UK economy, with a clear majority of earnings coming from outside our shores and over half of those coming from outside of even Europe. Which source of earnings is going to grow faster over the next generation? Having left the European Union but recast itself as a truly global economy once again, the entrepreneurial spirits of UK business could once again be put to work all around the world.

"Seeing a flexible and more independent UK economy could act as an inspiration for other countries to induce economic reform – to the benefit of all."

A 'leave' vote would also liberate the UK financially from contribution costs to a region with clear structural challenges, such as an ageing population and high debt which looks towards a select number of creditor countries (like Germany and the UK) to pay most of the bills. Such an event would also help to concentrate the mind of the European Union faced with a reality that their political and economic edifice was crumbling. Seeing a flexible and more independent UK economy could act as an inspiration for other countries to induce economic reform – to the benefit of all.

KEY TAKEAWAYS - 'LEAVE':

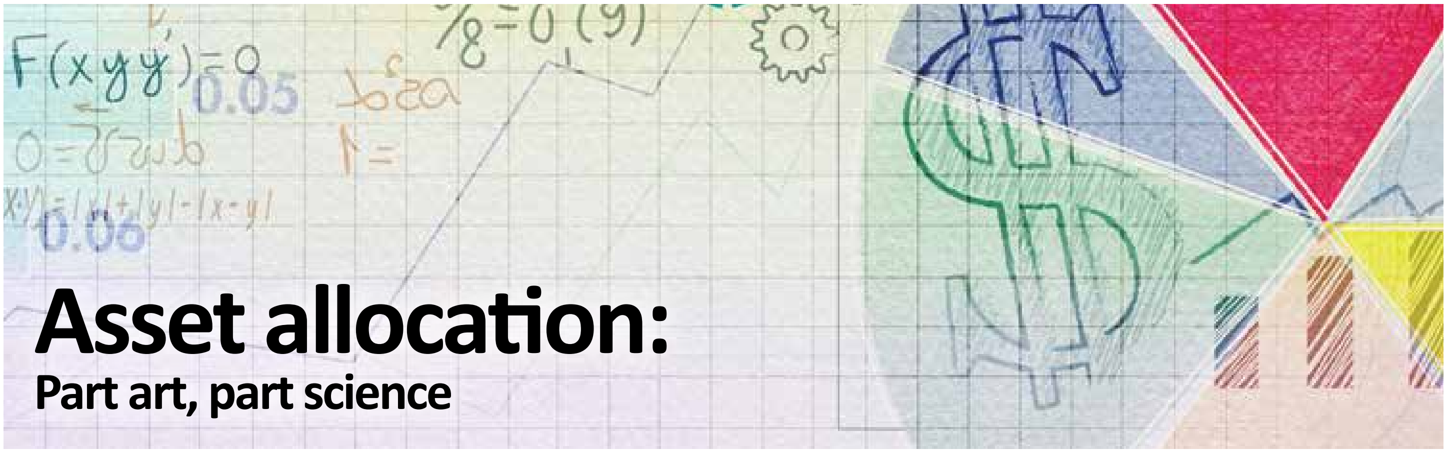
- The UK has an opportunity to recast itself as a flexible, global trade partner
- Greatest uncertainty rests with striking new global trade deals
- FTSE 100 earnings increasingly are sourced from outside Europe

US ECONOMIC SNAPSHOT

SCOTT BROWN
Chief Economist, Equity Research

The mixed nature of the U.S. economy continued into early 2016. Consumer spending growth slowed, but it's hard to get excited about the data for January and February (the fundamentals are sound). Orders and shipments of capital goods, while uneven from month to month, have continued to trend lower. Housing continues to recover, but still faces some issues in both supply and demand. Eyeing a tighter job market, Federal Reserve officials are still planning to normalize monetary policy (that is, raise short-term interest rates) – but given the central bank's limited options to spur growth (if needed), the Fed will be cautious in deciding on the next rate increase. Longer term, market participants may struggle to come to grips with weak earnings and a slow trend in productivity growth.

STATUS	ECONOMIC INDICATOR	COMMENTARY
POSITIVE OUTLOOK	EMPLOYMENT	Job growth has remained strong, but the pace is likely to slow somewhat as the slack in the job market is reduced (and firms have a harder time hiring new workers). Job destruction remains low.
POSITIVE OUTLOOK	CONSUMER SPENDING	Strong job growth and moderate wage gains should continue to support consumer spending growth in the months ahead. A firming in gasoline prices would mean some reduction in purchasing power.
POSITIVE OUTLOOK	HOUSING AND CONSTRUCTION	Strong job growth has provided significant support. Tight credit and home price appreciation remain restraints for first-time homebuyers. Builders continue to note supply constraints. Rents and home prices are rising.
POSITIVE OUTLOOK	INFLATION	There is little upward pressure in commodity prices and only the initial stirrings of labour cost increases, which feed into inflation in services. Shelter costs are rising at a faster pace, lifting core inflation.
POSITIVE OUTLOOK	MONETARY POLICY	Fed officials remain in tightening mode, but are expected to be cautious and gradual in raising short-term interest rates. Global economic and financial developments may keep the Fed passive.
NEUTRAL OUTLOOK	GROWTH	Data available at the end of the quarter suggests that GDP growth was a lot slower than expected in 1Q16. That's not necessarily bad – the numbers do bounce around from quarter to quarter – but there's hope for a spring pickup.
NEUTRAL OUTLOOK	THE U.S. DOLLAR	While the direction seemed right, currency market participants have over-reacted to monetary policy differences. Currencies typically overshoot and we have seen some softening of the dollar as the Fed appears less aggressive.
NEUTRAL OUTLOOK	BUSINESS INVESTMENT	Capital spending has been on a downtrend, reflecting a further contraction in energy exploration. However, fears of a possible recession and political uncertainties may be compounding a sense of caution.
NEUTRAL OUTLOOK	LONG-TERM INTEREST RATES	Long-term Treasury yields have been pushed lower by a global flight to safety, but that ought to reverse somewhat as investors begin to look more optimistically on emerging economies (although that may take some time).
NEUTRAL OUTLOOK	REST OF THE WORLD	China's economic transition will be bumpy, but the country is unlikely to crash. Latin America is a mess. Europe is still slow, facing a number of issues. The U.S. remains an attractive location for global capital.
WILD CARDS		Uncertainty over the election and the priorities of the incoming administration may add to business caution well into 2017. Productivity growth has slowed in recent years and shows no sign of picking up – that has significant implications for the long-term outlook for the economy and the markets.



Asset allocation:
Part art, part science

Nick Lacy, CFA, *Chief Portfolio Strategist,* Asset Management Services
Kristin Byrnes, *Committee Vice-Chair, Product Strategy Analyst,* Wealth, Retirement & Portfolio Solutions

Since the financial crisis, the rumblings of asset allocation no longer working have been plentiful among market watchers. However, the idea that asset allocation should always protect investors from losing money is a false pretence leading to many of these criticisms.

> "Asset allocation should be used primarily for risk management and secondarily for return generation."

WHAT IS ASSET ALLOCATION?

This investment decision involves the division of a portfolio among multiple asset classes – the broadest mix being equity, fixed income and cash – and depends greatly on individual goals, time horizon and risk tolerance.

Simply put, if an investor utilises multiple asset classes that behave differently in any given market, the portfolio will be positioned to potentially avoid significant losses over time, as each piece of the pie should move in a different direction or to a different degree. This phenomenon is called diversification. By choosing the right mix of non-correlated assets, the overall portfolio risk is potentially reduced and its return stream may be smoother. Again, let me point out that portfolio risk is potentially reduced, not eliminated.

Asset allocation should be used primarily for risk management and secondarily for return generation. After all, if you don't have enough risk in your portfolio, you may not reach your financial goals.

THE SCIENCE:
ASSET ALLOCATION AS A RISK MANAGEMENT TOOL

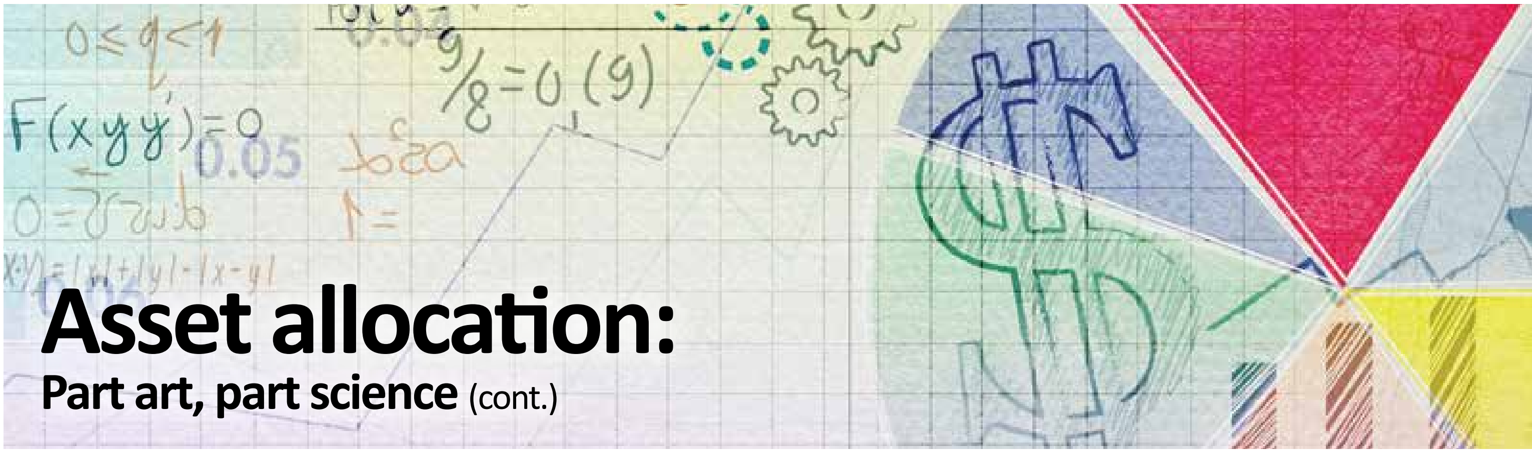
Asset allocation is commonly used to diversify a portfolio, or in other words, attempt to reduce the portfolio's risk and smooth out returns over time. One of the most important decisions to make from a risk standpoint is how much equity to own versus fixed income. The importance of this decision lies in the fact that the majority of your portfolio risk has historically been derived from equity exposure while fixed income has been one of the only traditional asset classes that tends to move in the opposite direction (also known as negative correlation). Historically speaking, investment-grade bonds have generally performed well during periods of equity market stress. Over the last 40 years, when the S&P 500 lost more than 5% in a quarter, the Barclays U.S. Aggregate Bond Index earned a positive average return of 3.4%. While there is no guarantee that this relationship will hold in the future, history demonstrates the likelihood that it should. There have only been three periods out of 20 over the last 40 years when the S&P 500 was down more than 5% in a quarter and fixed income was negative, first quarter 1977, third quarter 1981 and first quarter 2009. In all three cases, fixed income losses were substantially less than that of equity.

There is more to asset allocation than simply owning stocks and bonds; it also involves owning equities that are not perfectly correlated with each other, such as U.S. and non-U.S. stocks. While correlations between these two markets have increased in recent years, there are still meaningful diversification benefits to be potentially gained by owning both. Also, within U.S. equity markets, there has been a benefit to owning both large and small-cap stocks, and correlations between these investments have actually decreased over the last 40 years.

THE ART:
ASSET ALLOCATION AS A RETURN GENERATOR

There are various investing principals that should, in theory, yield positive excess return over the long run. Keep in mind that what markets should do and what they actually do can be quite different. There are other factors that warrant consideration when analysing investments, such as profitability, quality of the market, and current investor sentiment. Just as markets don't operate in a vacuum, investors don't always make choices solely based on "investment sense."

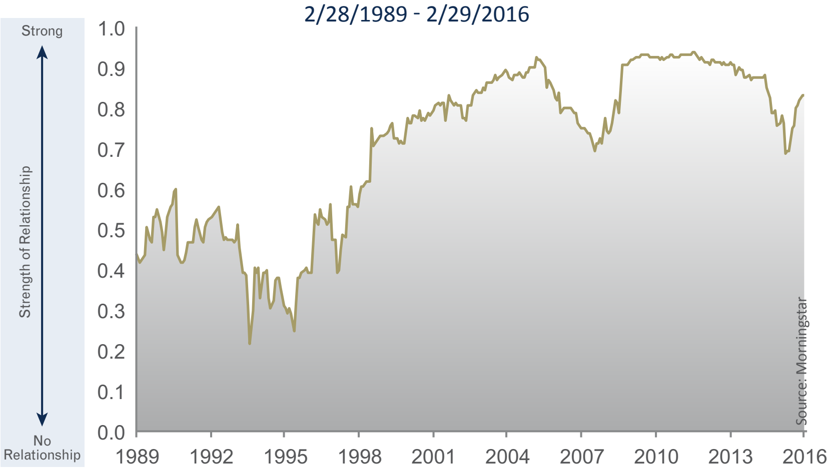
For example, history has taught us that investors can theoretically



Asset allocation:

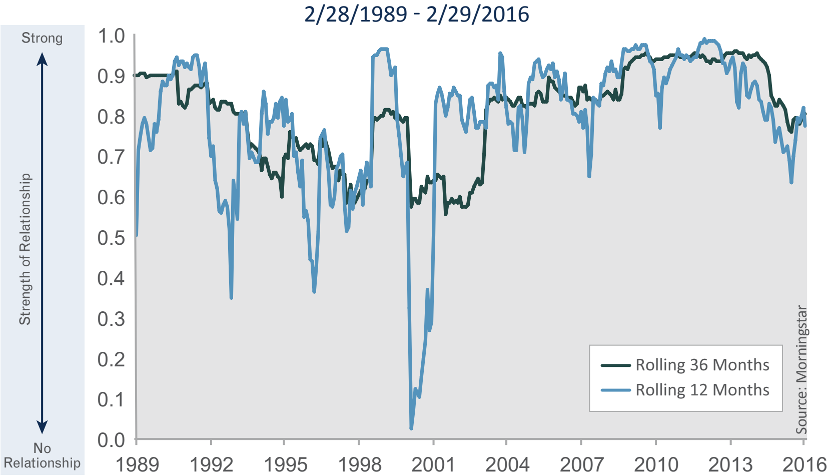
Part art, part science (cont.)

RELATIONSHIP BETWEEN DOMESTIC AND INTERNATIONAL EQUITY RETURNS
2/28/1989 - 2/29/2016



This chart plots correlation data between the S&P 500 Index and the MSCI EAFE Index on the rolling 36-month basis.

RELATIONSHIP BETWEEN U.S. LARGE CAP AND U.S. SMALL CAP EQUITY RETURNS
2/28/1989 - 2/29/2016



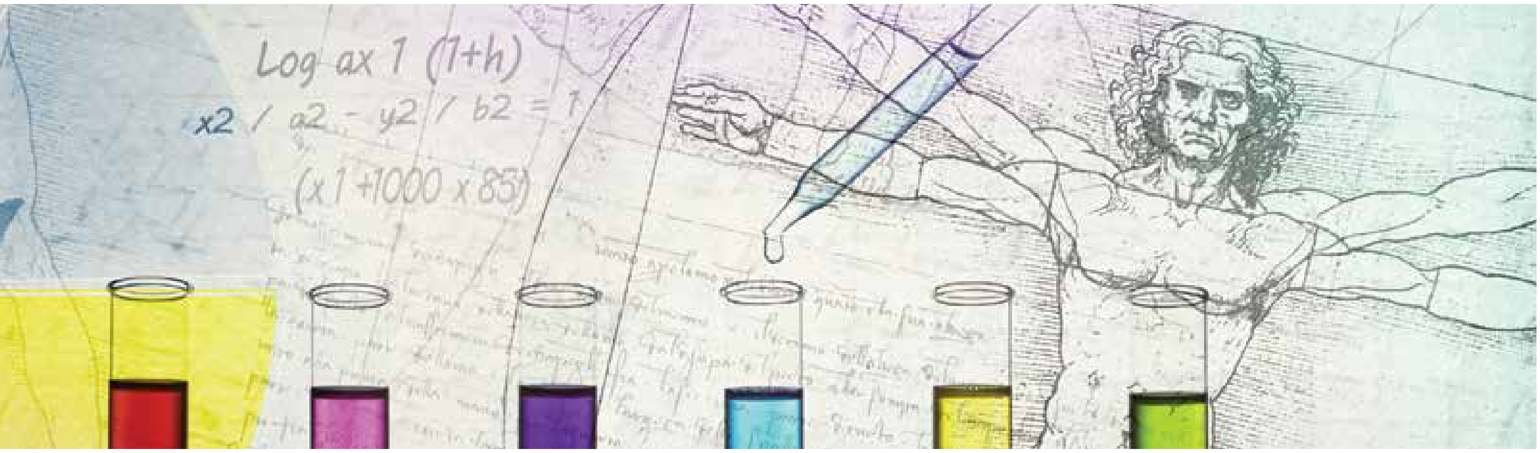
This chart plots correlation data between the S&P 500 Index and the MSCI EAFE Index on the rolling 36-month basis. Correlations range between (-1 and +1), with -1 meaning they move in complete opposite directions, 0 meaning there is no relationship, and +1 meaning they move in the exact same manner.

improve their risk and return profile by allocating to areas of the market that are less expensive and out of favour rather than those that are expensive from a fundamental standpoint. This strategy, known as value investing, has worked over time. However, in the real world, cheap assets always carry the risk of becoming even cheaper, like international equity in 2015, and "expensive" assets may continue to outperform, like domestic equity in the mid-1990s.

Asset allocation analysis typically yields a recommended portfolio containing some level of international equity exposure. Looking back at 2015, this allocation hurt investors relative to domestic equity, regardless of its attractiveness from a valuation standpoint. In this case, exchange rates were a key driver in performance as the U.S. dollar had an unprecedented rally versus other currencies and erased a decent year of returns in unhedged international developed markets. So, just because it makes "investment sense" and you believe it should produce higher returns, doesn't mean it always will. By contrast, in 1994 - 1998 U.S. equity markets, especially large cap, outperformed most investments while valuations continued to rise. Does this mean you shouldn't bother with asset allocation? I think not!

A LONG-TERM APPROACH TO ASSET ALLOCATION

The key to successful investing is formulating a proven process with realistic goals and sticking to it. Abandoning ship in the height of the storm can have catastrophic effects on your long-run performance as you may never completely recover from those losses. Think of the stock market in the same sense that



Milton Friedman thought of the economy in that it behaves like a "plucked string." The farther you pull on it, the more forcefully it snaps back.[1]

A strategic asset allocation portfolio should never generate the highest returns possible and, on the other hand, it should never produce the lowest either. Remember that the primary goal of asset allocation is risk management. Historically, the upside has taken care of itself over time.

KEY TAKEAWAYS:

- By choosing the right mix of non-correlated assets, overall portfolio risk is potentially reduced and the return stream should be smoother.
- Asset allocation should be used primarily for risk management and secondarily for return generation.
- The key to successful investing is formulating a proven process with realistic goals and sticking to it.
- A strategic asset allocation portfolio should never generate the highest returns possible and, on the other hand, it should never produce the lowest either.

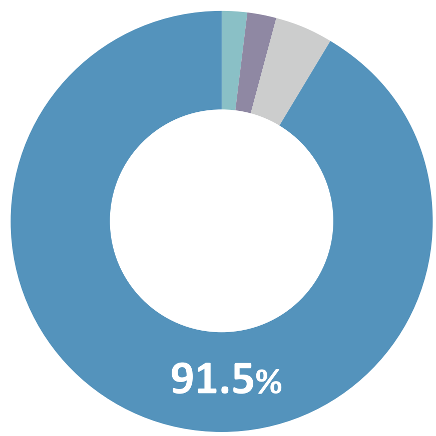
1 Source: The 'Plucking Model' of Business Cycle Fluctuations, Milton Friedman, 1964

Source: Morningstar data using S&P 500 & Barclays U.S. Aggregate Bond Index total returns as of 3/1/1976 through 12/31/2015

Asset allocation and diversification do not guarantee a profit nor protect against loss. Past performance may not be indicative of future results. The performance mentioned does not include fees and charges, which would reduce an investor's return. Investing in international securities involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. Small-cap stock investing involves greater risks and is not suitable for all investors.

VOLATILITY OF PORTFOLIO RETURNS

Asset allocation decisions are among the most important factors affecting total portfolio volatility.



FACTORS AFFECTING PORTFOLIO VOLATILITY	
Asset Allocation Decisions	91.5%
Market Timing	4.6%
Stock Selection	2.1%
Other	1.8%
Total	100.0%

Source: Brinson, Beebower and Associates, "Determinants of Portfolio Return," 1986, updated 1991 and 1995. "Does Asset Allocation Policy Explain 40, 90, or 100% of Performance?" Ibbotson and Kaplan, Financial Analysts Journal, Jan./Feb. 2000. "The Equal Importance of Asset Allocation and Active Management," Xiong, Ibbotson, Idzorek, and Chen, Financial Analysts Journal, February 2010. Asset allocation does not ensure a profit or protect against a loss. All investments are subject to risk. There is no assurance that any investment strategy will be successful.

Active versus passive – what does the future hold?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"I've found that luck is quite predictable. If you want more luck, take more chances. Be more active. Show up more often." Brian Tracy

Extrapolation is one of the seven deadly sins in the finance and investment world. Of course, what some call extrapolation, others call momentum, and in terms of the discernible regime shifts in global fund management currently, the continuing active to passive shift is one of the clearer ones.

Mature regime shifts typically have two major disadvantages. The first is the aforementioned extrapolation into the future, and the second is that faith in the inevitability of the continued regime shift is at its high point just before another change is apparent.

And maybe this latter point holds the greatest relevance today for passive strategies. Press articles in recent weeks have talked about the 'worst performance in two decades' for American active fund managers and bemoaned the dearth of European active managers who had outperformed their underlying benchmarks over the last five or ten years.

The clue to why the luck of the average active fund manager may well change rests on that last five- or ten-year observation period. It has now been seven years since the depths of the global financial crisis induced central banks in the United States, the United Kingdom, Switzerland, various non-euro zone Scandinavian countries and China to take their first radical steps in unorthodox policy. The effect of lifting all boats noticeably suited passive strategies due to – as the econometricians would put it – rising inter-correlations between equities, most notably in anything broadly dubbed large cap and liquid 'high-quality growth'.

Something happened last year, however. UK equity tracker funds in all guises were typically below-average performers against 'all companies' equity benchmarks during 2015. This underperformance was drowned out in the rising inter-correlations of the previous six years, just as the difficulties for the average tracker fund in the volatile 2007-2008 markets has been ironed out of the collective memory bank. And the reason for the relative malaise of a UK tracker fund in 2015? The end of new/expanding quantitative easing monetary policy by the Bank of England. Suddenly, not all boats were being lifted, and picking and choosing like a proper active manager mattered again.

Of course, like any good thriller, there is always a wobble or temporary reversal – and this was in the first three months of this year. In a film, this would be the moment when the hero/heroine realises what they must do despite the pressures, risks and uncertainties… and it is the same in the financial markets. The leadership shift in the financial markets during quarter one, from those aforementioned large cap and liquid 'high-quality growth' names, to the out-of-favour energy and mining sectors, was the

US INVESTMENT INDUSTRY FUND ASSETS

	1985	1995	2005	2015
Passive Fund Market share	0%	4%	16%	34%

Source: Morningstar; Strategic Insight Simfund

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final signal to anyone who had become a closet index tracker that it was time to step up and (re)embrace active fund management.

So, how about the euro zone with its reasonably recently acquired quantitative easing fervour? Surely, in light of the above, this should be a positive for the passive index tracking fund?

That actually is a very reasonable point, and a supportive reason why investors should believe that residual opportunities remain, from a long-only perspective in euro zone equities. However, it is reasonable to wonder if better opportunities, even in the euro zone, exist for the active investors versus their passive counterparts. Leafing through the Oxford Journals (of Social Sciences) and a paper by Alexander Dyck of the Rotman School of Management in the University of Toronto, titled 'Does Active Management Pay? New International Evidence' caught the eye, especially as it noted that active 'outperforms passive management by more than 180 basis points per year in emerging markets and by about 50 basis points in EAFE markets over the 1993 to 2008 period'. However, the second part of the paper is probably the most relevant for the euro zone today, with the observation that 'the value of active management depends on the efficiency of the underlying market and the sophistication of the investor'. The economic growth malaise in the euro zone economy over the last eight years is typically efficiency-reducing as investors – even some of the sophisticated ones – give up hope.

In short, it is very plausible active European investors could get a positive double whammy over the next couple of years as the end of QE in the UK and residual investment scepticism in the Eurozone combine. Active management does not feel dead at all.

KEY TAKEAWAYS:

- Passive strategies have taken a lot of recent market share
- Stimulus policies have been a positive for passive strategies
- 2015 saw active managers outperform and 2016 suggests don't lose the faith!

Emerging markets – hero or zero for the rest of the year?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

Turkey. Columbia. Brazil. Argentina. Thailand. This unlikely quintet were the five strongest performers in local currency terms among global equity markets during the first quarter of 2016. After a few years in the doldrums – US dollar based investors over the last five years have seen over a 50% return from the S&P 500 but a near 30% fall in the MSCI Emerging Markets index – emerging markets are back atop of the performance charts. Is this a flash in the pan or the start of a structural trend?

The structural case for the emerging markets has never gone away. Populations are still growing, urbanising and consuming more. The average emerging market citizen still wants to get rich(er), is more educated and can still be employed at a low proportion of 'western' labour costs. Trade barriers have also fallen and judging by progress in the World Bank's Doing Business annual survey there has even been some sensible progress on structural reform.

What has held the emerging markets back over recent years has been too much, too soon. Before the last five years, emerging markets were the investment theme that always seemed to give. There was always volatility but over longer periods of time material returns too. However just like the 'western' markets hubris started to build in, and when the aftermath of the global financial crisis hit, life became much tougher. Austerity-hit developed markets reduced their previously insatiable demand for cheap imports and the backward multiplier impact of all this exposed emerging market challenges including too much debt, too high commodity price correlation and corruption.

The bad news for emerging markets is that the world is unlikely to go back to the way it was a decade or so ago. The better news for the emerging markets is that it has meant change cannot be fought against, and this will aid their economic development over time by encouraging domestic competitiveness reforms and related policies. Pension fund holdings in the emerging markets still look to be on firm ground.

> "Pension fund holdings in the emerging markets still look to be on firm ground."

SELECTED FIRST QUARTER 2016 LOCAL CURRENCY RETURNS

Turkey	16.6%
Brazil	15.2%
Argentina	11.3%
United States	1.3%
United Kingdom	0.2%
Germany	-7.2%
Switzerland	-10.2%
Nigeria	-10.2%
Japan	-11.2%
China	-15.1%

Source: Pension Partners

However, little of this helps us today. The key for emerging market investment for the rest of 2016 does not lay exclusively with Chinese growth rates, Brazilian political impeachment charges, the level of Indian interest rates or the oil price's influence on Russia. These are all important matters but still subservient to the omnipresent influence of US interest rates.

US interest rates – and its associate, the level of the US dollar – remain the greatest influences on the relative performance of emerging markets. Simply put, the high dollar of the last year or two has dampened commodity prices and raised the burden of global emerging market debts. The reason for the

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outperformance of the first quarter is centred on the wane of the US dollar as expectations at the start of the year of three or four Federal Reserve interest rate increases look increasingly unlikely.

Add onto this the natural sentiment cycle with investments. After years of sustained inflows the last two calendar years have seen sharp outflows from the emerging markets as global investors reappraised their worth, especially as the US dollar rose. Only in recent weeks have outflows turned into inflows. In short, while the longer term 'weighing machine' argument for the emerging markets has never gone away, the shorter term 'voting machine' aspect has suddenly turned positive too. This can only be good news for continued emerging market outperformance during 2016.

There is one other consideration however, and that is mix. We throw around terms like 'the emerging markets' as summary catch-all terms when the reality is far more complex than that, given the wide range of economic styles even in the BRIC (Brazil, Russia, India, China) countries, let alone encompassing other countries in Africa, Asia, Latin America and elsewhere. If you take a look at the aforementioned first quarter local currency equity index league table, packed full of emerging market countries near the top, a quick glance at the bottom of the page shows China, Saudi Arabia and Nigeria. Careful choices always matter and even if a fading dollar helps out there are country specific factors to think about.

So even if you like emerging markets, make sure you understand carefully what you are investing into.

"Careful choices always matter and even if a fading dollar helps out there are country specific factors to think about."

KEY TAKEAWAYS:

- The emerging markets collectively have led equity market performance league tables
- A lower US dollar has helped create a better backdrop
- Emerging markets are not all the same - mix choice is important

The Fed's dilemma:
Normalisation without the markets' permission?

James Camp, CFA, managing director of fixed income, Eagle Asset Management*, weighs in on new factors affecting policy decisions.

Along with the dual mandate of price stability and full employment, the post crisis Federal Reserve (the Fed) has introduced the idea of a financial market "wealth effect" as a tertiary objective. A year after the sunset of asset purchases (quantitative easing or QE) and weeks after the first increase in the federal funds rate in over a decade, financial markets are pushing back. Policy actions have been highly reactive to market movements in the post-crisis era. Will policy makers tighten without the markets' permission?

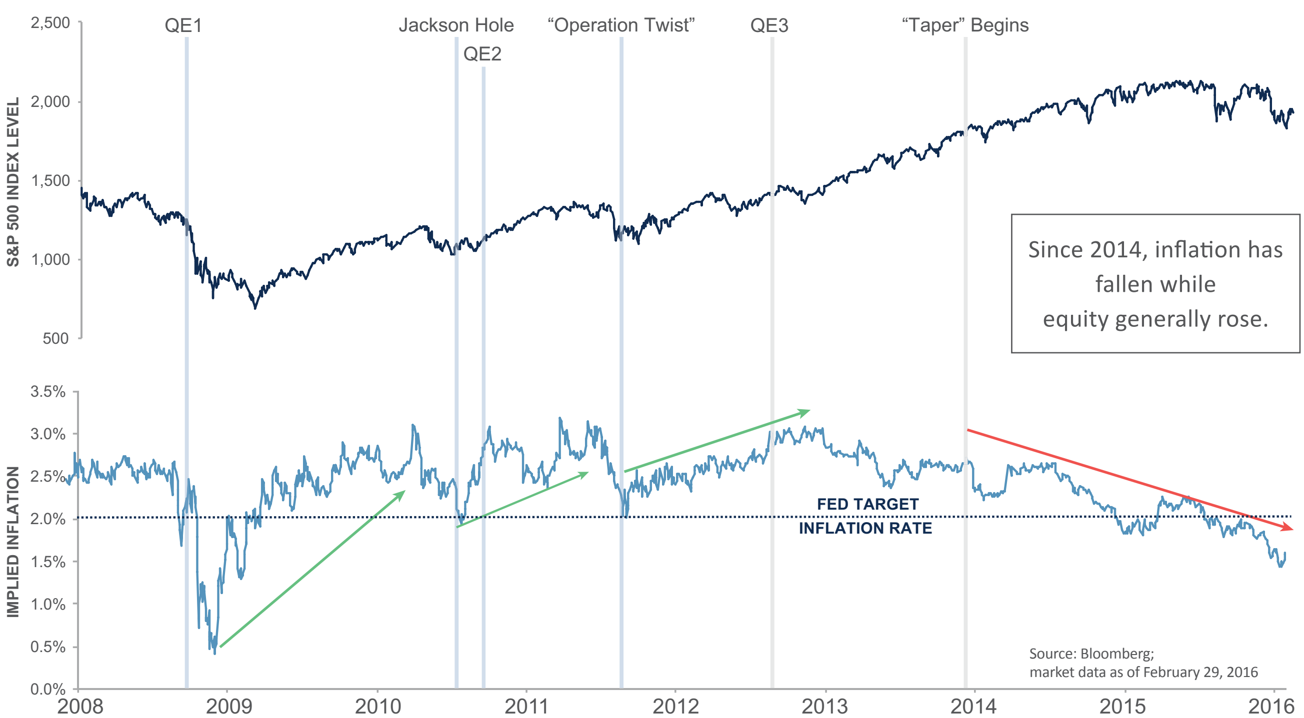
> "We think the Fed will tread very carefully as it relates to markets."

THE PICTURE HAS CHANGED

While the employment picture is decidedly better, meaningful wage growth is slow to materialize. Inflation expectations, on the other hand are rolling over. And, in the face of still struggling commodity prices and the absence of QE, near-term catalysts are missing. The chart below shows the relationship between our risk asset prices (measured by the S&P 500) and inflation expectations. Note that periods of QE were followed by an uptick in both equity prices and inflation expectations, two desired outcomes for the Fed. Now, in the post-QE world, the picture has changed.

So, the dual mandate targets are at best incomplete. But, that does not fully encapsulate modern Fed policy. In our view, the December move was important operationally. The Fed proved to the market (and skeptics including us) that they could affect rate targets despite the massively over-reserved financial system. Though nominal, the move also began a de-leveraging process that may partially explain downward pressure on stocks. For example, New York Stock Exchange margin balances have fallen by 20% over the past quarter.

PERIODS OF QE HAVE GENERALLY RESULTED IN RISING INFLATION AND RISING EQUITY PRICES



Source: Bloomberg; market data as of February 29, 2016

In a speech at Bernard M. Baruch College about the 2015 economic outlook, New York Fed President Dudley stated, “with respect to how fast the normalisation process will proceed, that depends on two factors – how the economy evolves, and how financial market conditions respond to movements in the federal funds rate target.” Moreover, former Fed Chair Bernanke actively supported Fed policy targeting financial markets: “Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher income and profits that, in a virtuous circle, will further support economic expansion.”

The Fed’s reaction to market downturns was more QE. In fact, dating back to 2008, no QE periods coincided with negative equity markets, and conversely, rapidly rising equity prices followed periods of active QE. Recall that the market fully expected a rate hike last September, but the Fed passed at that time, according to Fed Chair Yellen because, “recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.” So, on top of a challenging U.S. equity market, the Fed was now reacting to overseas conditions. In other words, the Fed did not have the markets’ permission to hike.

TIGHTER FINANCIAL CONDITIONS

Risk asset prices across sectors have benefited from the central bank liquidity. The real economy, perhaps less so. We look at corporate behavior during this period and note considerable equity-friendly financial activity. Merger and acquisition activity is eclipsing 2007 levels and share buybacks, funded with debt, continue at record levels. And, investor credit, in the form of margin debt, hit record levels. As normalisation begins, the markets are “pushing back” on this financial activity. Specifically, investment-grade bond spreads have doubled to nearly 200 basis points (2%) while high-yield debt pricing, largely commodity driven, has gapped to nearly 800 basis points (8%). These are recession-type spread levels, and are suggestive of a considerable tightening of financial conditions. Downgrades of debt are accelerating, eclipsing upgrades for the first time since 2008.

Low oil prices now pose significant risks to the financial markets. Mainstream media and outspoken economists assert the effects are undoubtedly positive for growth. In a vacuum, this is true; in the capital markets, however, it is a clear negative. The steep, sustained drop in oil and the subsequent weakness in energy credits has effectively poisoned the well for new debt financing at the low end of the credit spectrum. The ability, or lack thereof, for low-quality credits to refinance maturing obligations will become a solvency issue if the situation does not improve.

Might this lead to a domino effect that ripples up the credit curve? We have seen evidence of this, but the high-grade new issue market is still functioning – for now. If we are experiencing the beginning of a new credit crunch, we think things could get worse before they get better. Further, the persistent weakness in oil pricing is creating a cash crunch in places like Saudi Arabia, which requires high(er) oil prices to fund annual expenditures. As a result, oil-rich countries need to tap the sovereign wealth fund well, which effectively creates a substantial headwind to asset prices. The stock market is taking notice; we have observed spiking correlation between energy and equity prices.

Moreover, with the volatility of equities and collapse of pricing in the commodity sector, equity market pricing is soft. In our estimation, the markets are already facing tightening financial conditions, irrespective of short-term interest rates.

GLOBAL RATES CONTINUE TO FALL

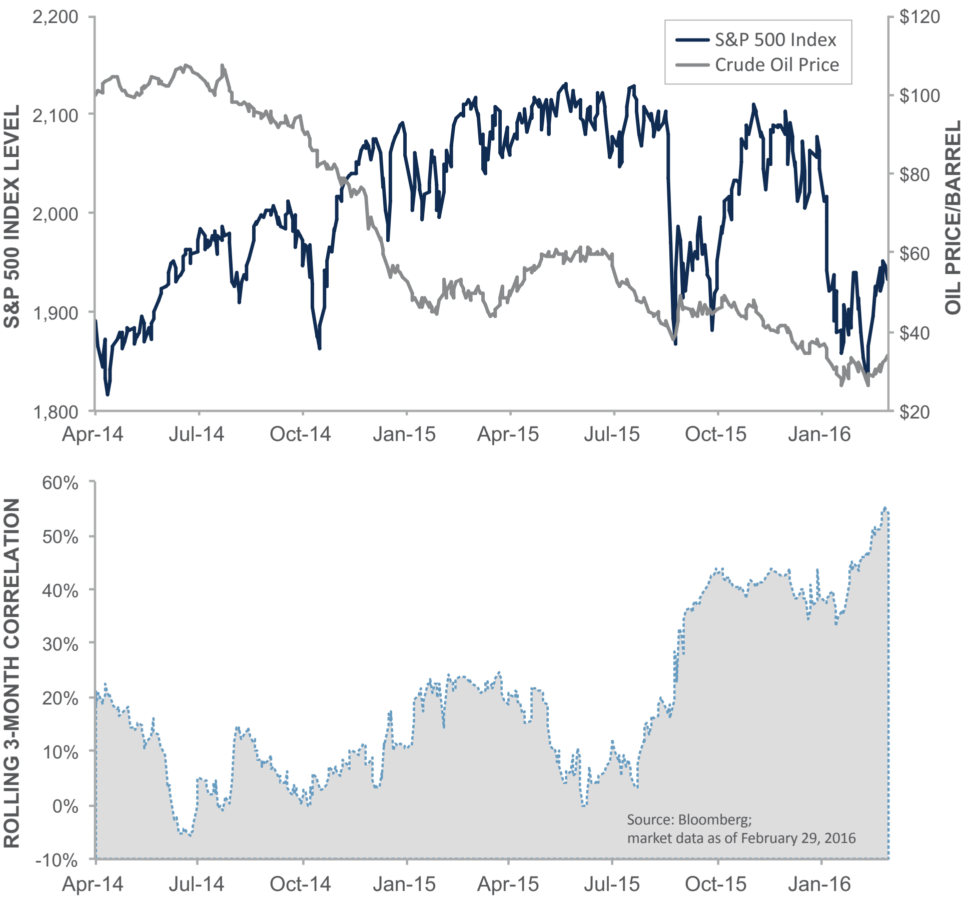
It is estimated that one quarter of the world’s capital now resides in negative rate environments. The U.S. Treasury market has paradoxically rallied after the initial tightening. The yield curve is significantly flatter than it was just weeks ago. There is divergence between economic forecasts for the Fed and markets. The Fed Funds Futures price a September hike at 41%, and only 20% in June, while consensus is still two to three hikes this year. In our opinion this is a critical juncture. Under normal circumstances, the aforementioned tightening of

The Fed's dilemma:
Normalisation without the markets' permission? (cont.)

financial conditions and general economic slowing would be suggestive of more accommodation, not less. But, these are indeed not normal times. We think the Fed will tread very carefully as it relates to markets. A significant equity market correction would jeopardize Bernanke's wealth effect, and with inflation not yet near menacing, they have some latitude. One thing is clear to us. The thematically tired macro "risk on, risk off" market is coming to an end. Normalisation, however gradual, is overdue. Capital markets should be more productive for asset allocation and security selection going forward. The Fed wants out of the market manipulation game.

As long as it has permission.

S&P 500 INDEX / CRUDE OIL PRICE CORRELATION



KEY TAKEAWAYS:

- Policy actions have been highly reactive to market movements in the post-crisis era.
- With the volatility of equities and collapse of pricing in the commodity sector, equity market pricing is soft. In our estimation, the markets are already facing tightening financial conditions, irrespective of short-term interest rates.
- The thematically tired macro "risk on, risk off" market is coming to an end.
- Normalisation, however gradual, is overdue. Capital markets should be more productive for asset allocation and security selection going forward.

Q&A
Committee insight on relevant investment issues

Q. WHAT DOES THE TALK ABOUT CHINA DEVALUING ITS CURRENCY REALLY MEAN?

A. China's economy is undergoing a major transformation. In recent decades, strong growth has been driven by exports and infrastructure spending. Much of that was fueled by an artificially weak currency and a build-up of currency reserves. Looking ahead, economic growth will have to be driven more by domestic demand. Increased consumer spending growth will depend on the development of a middle class. This transition is expected to be bumpy, with possible policy mistakes along the way.

The dollar and the yuan

Since mid-2014, the U.S. dollar has risen sharply against most of the world's currencies. Slower global growth and a stronger dollar have had a significant negative impact on U.S. exporters.

The yuan, China's currency, has weakened against the greenback, but it has generally fallen a lot less than other currencies – which means that it has strengthened against those other currencies – and that makes the country's economic rebalancing more difficult. China is currently not expected to devalue the yuan simply to boost exports. Rather, natural forces have been acting to weaken the currency and Chinese investors have anticipated that a further devaluation is coming. That expectation, in turn, has put more downward pressure on the yuan. A devaluation in the yuan would likely lead other countries to devalue as well.

China continues to enjoy a large trade surplus with the rest of the world, but in recent months capital outflows have more than offset that, putting downward pressure on the yuan. Since mid-2014, the People's Bank of China (PBOC), the country's central bank, has depleted its currency reserves by nearly $800 billion to prevent the yuan from weakening against the dollar. By the end of February, the PBOC still had $3.2 trillion in currency reserves and the depletion of those reserves slowed to $28.6 billion per month (vs. an average of about $100 billion per month over the three previous months). Chinese officials have indicated that a devaluation of the yuan is not in the works, which may have reduced capital outflow pressures.

In the U.S., dollar strength has been driven partly by divergent central bank policies (gradually tighter monetary policy from the U.S. Federal Reserve, easier policy abroad). However, that's only part of the story. Concerns about growth in China and other emerging economies, as well as lackluster growth expectations for many advanced economies, have made the U.S. an attractive location for global capital. This flight to safety has also pushed down yields on long-term Treasury securities.

Currencies have a tendency to overshoot. That is, directional moves in the foreign exchange market often go a little too far. At some point, emerging economies are going to look more attractive, but getting the timing right is likely to prove challenging.

– **Scott J. Brown, Ph.D.,** *Chief Economist, Equity Research*

Q. WHAT ARE THE IMPLICATIONS OF NEGATIVE INTEREST RATES?

A. Through various monetary policy actions central banks attempt to control many of the lending rates throughout the economy. Most importantly, they exert significant influence over very short-term, often overnight, lending/borrowing rates for depository institutions (banks and credit unions). In the U.S. this is known as the "fed funds rate," the interest rate at which a bank can loan any excess reserves to the Federal Reserve (the Fed), thereby earning interest, or if needed, borrow funds at this same rate. A negative interest rate policy (NIRP) is a new and unconventional phenomenon in the world of banking whereby banks would pay to deposit funds with their central bank. As a result of the worldwide financial crisis, global central banks pushed interest rates as low as possible, often to zero percent, to spur economic growth and inflation. An estimated $11 trillion was spent on quantitative easing (QE) programs by central banks since the recession, and although the global economy is once again growing, some policymakers still need to combat a combination of weaker than anticipated growth and/or inflation.

Enter negative interest rates; in their quest to spur inflation and economic growth, many central banks have reached the limits of conventional monetary policy. QE has been all but exhausted, and short-term rates were already at zero percent, also known as the "zero lower bound" as they couldn't possibly go any lower than zero.

Q&A

Committee insight on relevant investment issues (cont.)

"THE CURRENT LEVELS OF OIL PRICES AND INVESTMENT WOULD LEAD TO PERPETUAL SUPPLY DECLINES, WHICH OBVIOUSLY CANNOT HAPPEN."

– PAVEL MOLCHANOV

95% of the world's supply is **not** North American shale, meaning that, alone, it doesn't provide a comprehensive picture of the market.

\$50 OIL The U.S. supply would probably be flat.

\$60 OIL Price level needed to generate enough cash flow for achieving meaningful growth in U.S. supply.

\$70 OIL Price that would support broad-based supply growth for the global oil industry.

Or could they? Beginning in 2009 Sweden and Denmark implemented NIRP in their countries, with little fanfare. It was only when the economic behemoths of the European Union (2014) and Japan (late 2015) implemented NIRP that the world really took notice.

Could we see negative rates in the U.S.?

Unless the economic environment in the U.S. changes dramatically we are unlikely to see negative rates. Consider the following; the Fed is committed to raising rates here in the U.S. and moved away from the zero lower bound in December, its first rate hike in nearly a decade. Second, the U.S. is experiencing higher GDP growth and inflation compared to most of the developed world, especially those countries utilizing NIRP. Third, from a legal standpoint, the Fed's charter gives them the ability to pay interest, but there's no mention of their authority to charge interest on deposits. Finally, there is a two-sided argument as to why NIRP may never see the light of day in the U.S. On one hand, should these policies be successful in spurring growth overseas, the U.S. would likely benefit as a trade partner, leaving us less likely to need additional stimulus of our own. On the other hand, if NIRP fails and is proven to be an ineffective tool, why would the U.S. follow suit? For the time being, negative interest rates will remain an overseas experiment that the rest of the world will watch closely.

– **Benjamin Streed,** *Strategist, Retail Fixed Income*

Q. ARE OIL PRICES POISED FOR AN UPSWING BY YEAR-END 2016?

A. Investors often ask, "What gives us the confidence to argue that oil prices will nearly double into the \$60s by the end of 2016?" Both demand and supply trends play a role in the answer, but supply is the more important issue.

Let's address demand first. Global oil demand increased in 2015 at its fastest rate in a decade, more than 2%. While we don't forecast quite as much demand in 2016, even 1.4% would still be an above-trend year, as cheap fuel continues to support strong auto sales and higher vehicle usage. It's a positive sign that demand is growing in almost all geographies, even places like the Mideast with oil-levered economies. Despite widespread economic fears about China, Chinese oil demand is in good shape, and India and other emerging markets are becoming more visible demand drivers.

Although demand is healthy, it will also take a supply response to rebalance the oil market and ultimately push prices higher. It's taken about a year to materialize, but the signs of a supply response are unmistakable. U.S. oil production has been in gradual decline since June 2015, and this past February it turned negative on a year-over-year basis for the first time since the global financial crisis. While U.S. supply is particularly sensitive to the depressed oil prices, other countries are exhibiting their own examples of what we've come to call "austerity on steroids." With global oil and gas investment down approximately 25% in each of 2015 and 2016, it is only a matter of time before supply begins to roll over in countries like Russia and Brazil. It's important to underscore that none of this hinges on whether OPEC governments reach a deal to deliberately cut supply. Such a deal remains a possibility, but even without that, the collapse in investment is resulting in natural supply declines.

Higher oil prices obviously bode well for energy stocks (whose weighting in the S&P 500 is at a 12-year low), but some investors are also wondering whether this will help the broader market. It is true that oil and equities have been closely correlated, but that does not mean that one is directly causing the other. Rather, both are trading on some of the same headlines, including the Chinese slowdown and volatile currencies. Thus, oil in the $60s by year-end would not materially boost stocks in, for example, tech or healthcare. Insofar as non-energy equities might get a small bump from an oil recovery, it would be a function of reduced selling pressure from sovereign wealth funds owned by oil-exporting countries.

– Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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