Quarterly Economic Update

March 17, 2016

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

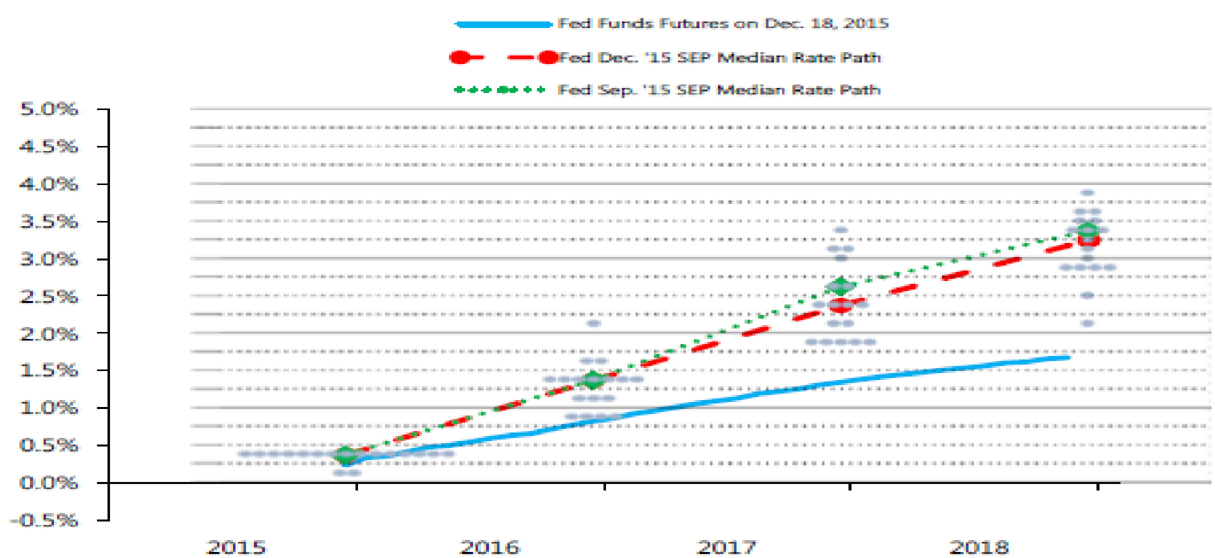
After seven years of extraordinary accommodative monetary policy, the Federal Open Market Committee (FOMC) has finally lifted the federal funds rate off its zero bound range. At their December meeting, Federal Reserve Chair Janet Yellen and the FOMC voted to raise the federal funds rate by a quarter percent to the target range of 0.25 - 0.50%. The increase in the federal funds target range represents a significant shift in policy. It is not necessarily a shift to an aggressively tighter policy stance given the continued low level of the federal funds rate, but it is a shift in view and a vote of confidence that employment and inflation have and are expected to continue to move in a direction that no longer warrant the extremely accommodative policy that has been held in place over the past seven years. The increase at the December meeting was not unexpected and while the decision always remained data dependent, it had been well telegraphed to the market. The FOMC cited further improvement in employment, including the underutilization of labor resources, which has remained stubbornly high and been a source of frustration for some committee members. They were less certain on the inflation side of the equation, acknowledging that inflation continues to run below their two percent longer-run objective, market-based measures of inflation compensation remained low, and that some survey-based measures of longer-term inflation expectations had edged down. However, with these concerns, they expressed they were *reasonably confident* that inflation would rise toward their objective as the transitory effects of declining energy and import prices dissipated.

The initial rate increase was symbolic in some regards with the pace of future increases being much more important. The FOMC statement repeated that future adjustments to the rate will be data dependent, but expectations were that "economic conditions will evolve in a manner that will warrant only *gradual* increases" and that the "federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." With inflation continuing to run low and not showing improvement towards their target currently, the statement noted that they would "carefully monitor actual and expected progress toward its inflation goal." At her post-meeting press conference, Yellen reiterated a dovish tone towards the pace of rate increases going forward. She emphasized that despite the initial increase in the federal funds target range, monetary policy remains extremely accommodative supported by both the continued low level of the federal funds rate and the elevated level of securities held on the Federal Reserve's balance sheet. The FOMC intends to continue reinvesting maturities and principal payments to hold the balance sheet elevated "until normalization of the level of the federal funds rate is well under way."

Yellen and the FOMC view the recent rate increase more as normalizing policy. From their view they are not necessarily tightening policy at this point, but removing excess accommodation with the mindset that it takes time for monetary policy actions to affect future economic outcomes. They prefer to start early and move slowly, versus a more reactionary role of abruptly tightening policy to keep from overshooting their objective and increasing the risk of committing a policy error that could send the economy into a recession. The gradual approach is also supported by their view that the neutral nominal federal funds rate, which they define as the level which would be neither expansionary nor contractionary if the economy were operating near potential, is historically low and will only slowly rise towards its more normal longer-run level as some of the lingering headwinds from the financial crisis decline. Yellen describes these lingering headwinds as tighter underwriting standards and limited access to credit for some borrowers, deleveraging by households, contractionary fiscal policy, weak growth abroad combined with dollar strength, slower productivity and labor force growth, and elevated uncertainty around the economic outlook. The neutral nominal federal funds rate should rise as these headwinds dissipate, but this continues to unfold slowly despite the progress that has been made over the past several years.

While the FOMC presented the initial rate hike wrapped in a dovish tone, the dots representing the FOMC participants expected path for the federal funds rate did not necessarily communicate the same tone. As shown in the chart below, the median rate path versus September's projections remained the same for the end of 2016 and only shifted down slightly for year end 2017 and 2018. Market expectations remained significantly lower, both prior to and following the FOMC meeting.

Fed SEP rate path v market expectations

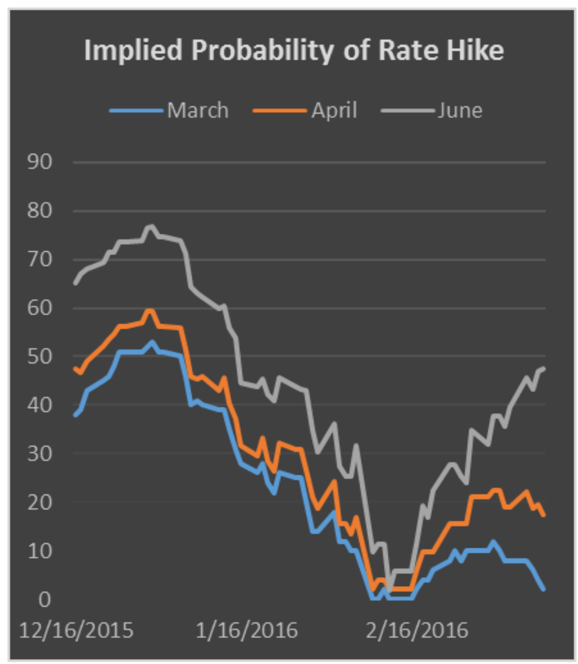


Source: Federal Reserve, Bloomberg, Evercore ISI

The divergence between the FOMC participants projected path and the market's expectations expresses a disagreement on the appropriate pace of rate hikes to be implemented. The median path from the FOMC projections suggests four rate increases over the course of the year, which carries a relatively hawkish tone compared to market expectations. It should be noted that while the median path remained largely unchanged, a few dots did shift down some suggesting that the median could follow as projections are updated.

As we know now, uncertainty around global economic conditions and volatility in financial markets increased post the December rate hike as we moved into the new year. When the FOMC met again in January, how these weaker conditions would affect economic activity in the US and labor markets was unclear. There were no expectations for another rate increase coming out of the January meeting as the FOMC's *gradual* guidance indicated they would give the market time to digest the initial rate increase. While the FOMC did not significantly adjust their outlook provided in the post meeting statement, they did remove their statement that risks to their outlook seemed *balanced* in light of the recent uncertainty. They added the sentence that "The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook." The January FOMC minutes confirmed an elevated level of uncertainty, but gave no indication of a shift in policy to not move forward increasing the federal funds rate towards a more normalized rate. The minutes did suggest a patience to better understand the balance of risks and an unwillingness to push forward with tighter policy in the face of uncertainty. This seemed to communicate that the prospects for another increase to the federal funds target range was unlikely at the upcoming March FOMC meeting and that participants would likely seek more clarity before moving forward.

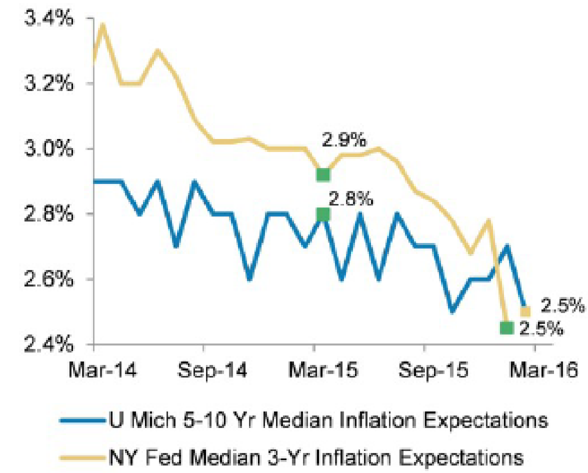
The chart on the right shows the implied probabilities of another rate hike at each of the next three FOMC meetings and how these probabilities have fluctuated since the December meeting. Market expectations currently reflect almost a zero percent probability for an increase at the upcoming March 16th meeting. Expectations place the odds of an increase at the April meeting around 18% and around 47% for the June meeting. These implied probabilities have fluctuated significantly over the past three months and as recently as 30 days ago reflected virtually a zero percent probability of another rate increase at any of the next three meetings.



Source: Bloomberg

While there is some uncertainty around how recent weakness may affect US economic activity, Yellen and the FOMC have maintained their expectations that employment is moving in the right direction and that weaker inflation trends are transitory and as these pressures dissipate inflation will move towards their 2 percent target. Recent minutes indicate that the lack of improvement towards their inflation goal is becoming a growing concern, and they have committed to monitor *actual* and expected progress towards their inflation goal when considering how to proceed with policy decisions. In a recent speech, New York Fed President and FOMC Vice-Chairman William Dudley stated that "evidence on the inflation expectations front suggests some cause for concern." He noted both market-based measures of longer-term inflation compensation and some survey measures of household inflation expectations had moved lower recently as shown in the charts below.

Source: Federal Reserve Board, Morgan Stanley Research



Source: University of Michigan Survey of Consumers, Federal Reserve Bank of New York, Morgan Stanley Research

Dudley expressed that these declines were worrisome and seemed to infer that this could indicate that the risk of inflation expectations becoming unanchored could be increasing. He did reiterate his view was still that inflation would move towards the FOMC's 2 percent objective, but admitted he was "somewhat less confident than I was before" and that his balance of risks to his growth and inflation outlooks "may be starting to tilt slightly to the downside."

For now, the FOMC seems intent on moving forward to gradually remove accommodation and increase rates toward a neutral nominal federal funds rate. The pace may just be a little slower in light of the recent uncertainty and persistently low levels of inflation. Should global economic weakness begin to exhibit a greater negative effect on domestic economic activity and labor markets, they maintain that tools are still available if conditions did warrant additional accommodation. Those could likely take place in the form of additional quantitative easing or even negative rates on excess reserves. The FOMC's current view is that policy remains extremely accommodative despite the recent increase in the federal funds target and simply not moving forward with rate increases or slowing the pace of increases would be supportive.

The FOMC meets again on March 15-16th and will include an updated Summary of Economic Projections. It appears very unlikely they will increase rates at this meeting, but the updated projections on the appropriate level of the federal funds rate will provide some clarity on participants' thoughts around the pace of increases. It is likely some of the dots/projections on the updated chart have moved lower, allowing the projected median path to shift down.

Fiscal Policy

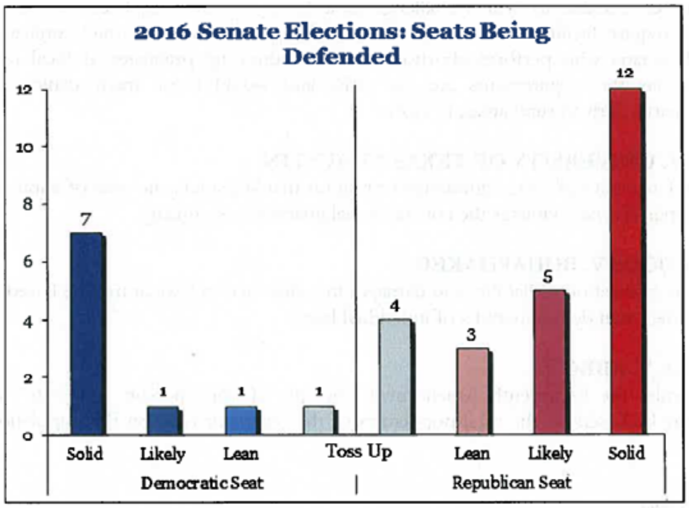
By Michael McNair

It was only a few years ago that the ruling political parties in developed economies around the world were pushing an agenda of fiscal austerity as a way to jumpstart economic growth. The idea was that economic growth was low because the government was overburdening, or crowding out, the private sector and private sector spending would accelerate if the government reduced the deficit. In the Fiscal Policy Report, we were always quite confident that this policy prescription would lead to disastrous results because there is mountain of historical evidence showing that fiscal austerity in times of weak economic growth is only a recipe for even slower economic growth and unfortunately we were proven correct. The evidence is now clear that fiscal austerity widely contributed to slow economic growth since 2010.

Austerity has always been a failed political strategy because fiscal contraction reduces economic growth and when economic growth is slow voters increasingly turn against incumbents. As a result, politicians are now suffering the consequences of their failed fiscal policies as ruling parties are being voted out of office in countries around the world.

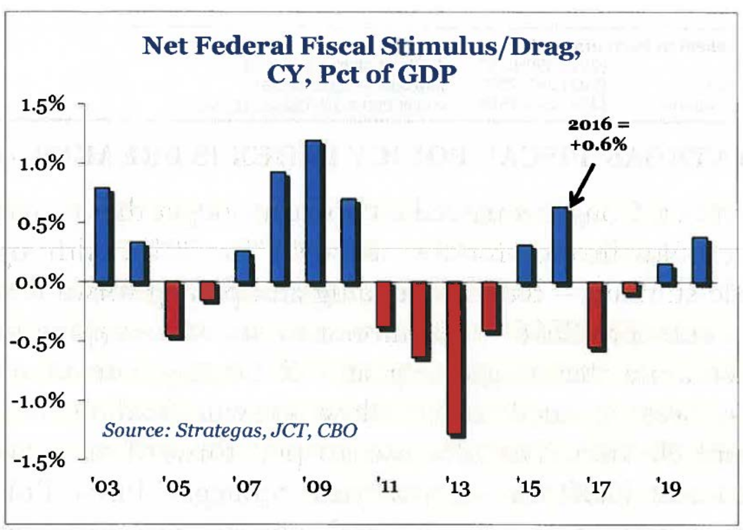
It is important to note that this turnover is not being driven by ideology. In the past decade both conservative and liberal parties have lost control of the government in many countries, including the US. Instead, this trend is due to the fact that when economic growth is slow, voters blame the incumbents for a bad economy and react by voting them out of office, regardless of ideology.

Economic growth in the US has remained weak over the last several years; therefore, we believe that voter backlash against the incumbents will continue. If the economy continues to slow in 2016 it will be difficult for the Republicans to maintain control of both houses of congress. The Republicans are particularly vulnerable to losing the Senate, as they are defending more seats in highly contested districts than the Democrats. Dan Clifton, of Strategas Research Partners, categorizes each Senate election by likelihood of the incumbent party retaining their seat. As you can see below, Republicans have 12 seats up for reelection that are considered less than solid, while Democrats are only defending three such seats.



Source: Strategas

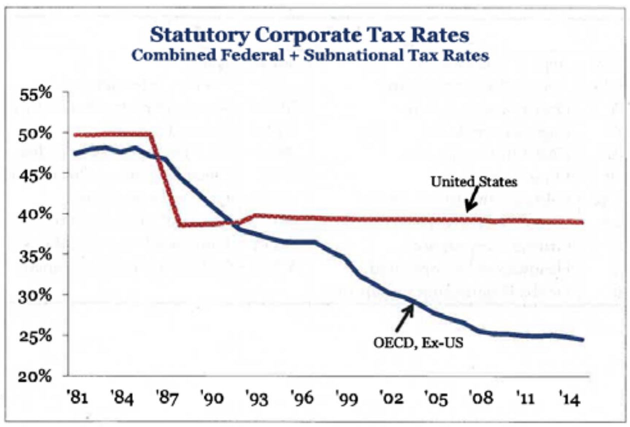
The Republican Party is fully aware of the recent trend of incumbents being replaced and they understand that a slowing economy presents a major risk to their ability to retain control of congress. As a result, the Republican leadership has not only removed deficit reduction from their political agenda but are even pushing for fiscal stimulus. This December, Paul Ryan and Mitch McConnell partnered together to pass a two year budget that considerably increased the amount of fiscal policy stimulus for this critical election year. Before the passing of this most recent budget, fiscal policy would have been neutral in 2016. As you can see in the chart below, fiscal policy is now expected to add 0.63% to US GDP growth in 2016. 0.63% might not seem like a large contribution but when you consider that the economy is only growing at 2% the impact of the fiscal stimulus becomes crucial for economic growth in 2016.



Source: Strategas

You can also see that fiscal policy is projected to again reverse to a large fiscal drag in 2017. While the recently passed budget increased the fiscal stimulus in 2016, it did so by pulling forward scheduled tax cuts in 2017 into 2016. This was by design, as the Republicans know that they must do what they can to support economic growth in this election year or risk losing control of congress as voters once again revolt against incumbents.

It should be noted that the current fiscal stimulus/drag projections seen in the above chart are based on the current budget but is subject to change. Should Republicans gain control of congress and the White House, it is highly likely that a new budget containing significant stimulus measures for 2017 will be passed.
Under the scenario of a unified Republican government, we also believe that major tax reform will be at the top of their agenda for 2017. There is also a strong possibility that we will get major tax reform in 2017 with a Republican congress and Democratic President. A main area of focus will likely be on corporate tax reform and specifically the lowering of corporate tax rates. US corporate tax rates are now much higher than in other OECD countries and congress is worried that this is harming the ability of the country to compete globally.

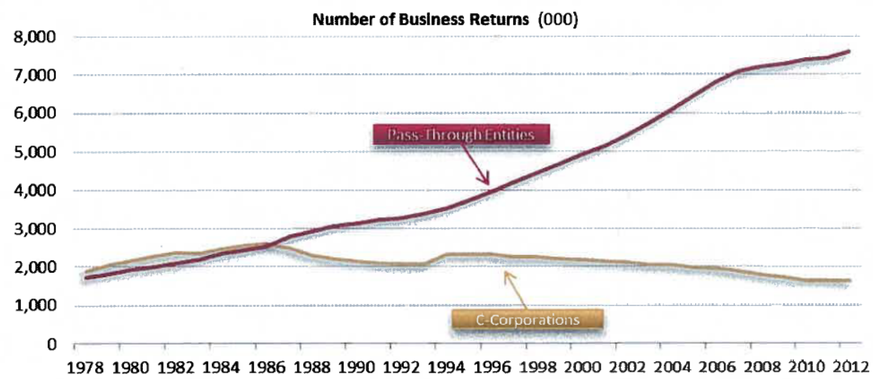


Source: Strategas

There is also a wide divergence between the tax rates for different business organizations in the US and there is a growing bipartisan concern that current US tax policy is creating economic distortions as business organization decisions are increasingly being driven by tax policy and not fundamental economic reasons.

Business Organization	**Average Tax Rate**
C Corps	32%
S Corps	25%
Partnerships	16%
Sole Proprietorships	14%

One piece of evidence supporting these concerns is the rise in “pass-through” entities (companies that are subsidiaries or at least partially owned by C corps) relative to C-corporations. These pass-through entities act as a form of tax arbitrage for the C-corps and reduce the companies’ tax bill but they are likely creating large inefficiencies and waste in the economy.



Source: Joint Committee on Taxation (IRS published & unpublished data)

Talk of tax reform is likely to pick up over the course of the year but we believe that there is little chance for success in 2016. Renmac’s policy strategist, Kim Wallace, explains, “Adjusting corporate or business tax rates would necessitate eventual agreement on winners and losers, an exercise politicians loathe generally and have even less appetite for in presidential election years.” It is for that reason that no major tax bill has passed during a presidential election year in the post war period.

Economic Outlook

By Trent Green

The U.S. economy grew at an annualized rate of 1.9% in 4Q 2015, slightly missing consensus expectations of 2.0%. There has been a noticeable deceleration in growth over the last year, with the year-over-year figures at 2.9% in 1Q, 2.7% in 2Q, and 2.1% in 3Q. Quarter over quarter, the U.S. economy grew at a revised 1.0%, exceeding the advance estimate of 0.7%. The change is mainly attributed to an upward revision of the inventory valuation adjustment and imports. The 4th quarter GDP figure reflects positive contributions from personal consumption, residential investment, and federal government spending. Offsetting these positives were net exports (revised to a decline of 2.7% from 2.5%), lower nonresidential fixed investment, private inventory investment, and state and local government spending. Inflation changes in the revised report rose from an original 0.1% reading to 0.4%. GDP has expanded at a mean rate of 2.1% per quarter thus far in the economic recovery with the private sector expanding roughly 2.4% per quarter and government spending detracting roughly 0.2% each quarter.

Concerns over global growth have expanded, and major central banks including the BOJ and the ECB have gone as far as adopting negative interest rate policies in an effort to stimulate growth and fight disinflation. These policy measures are occurring at a time when the U.S. is beginning to tighten after seven years of near zero interest rates, making dollar strength a continuing issue, which is a key cause of lackluster net export figures. However, the U.S. appears to be showing some resilience against foreign headwinds that have become rather familiar with a reorientation to more domestic demand. Overall, the consumer, employment/wages, and housing continue to appear favorable while the net exports/ manufacturing story is a bit bleaker.

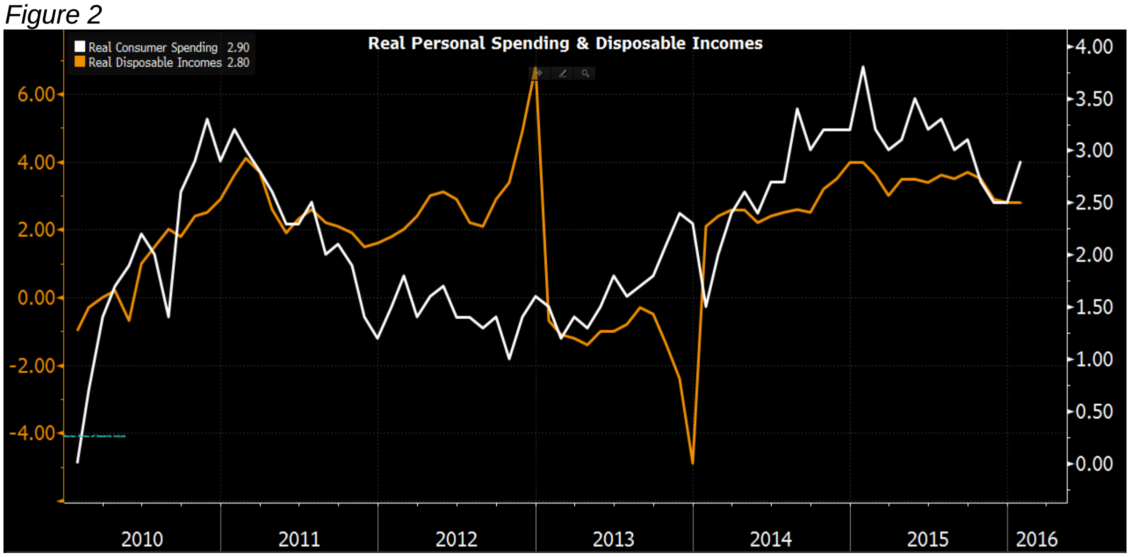
Figure 1

Source: Bloomberg

The Consumer

Although consumer spending did not remain as robust in 4Q15, it was the main contributor to GDP growth for the period, growing 2.0% since 3Q 2015. This compares to 3.0% in 3Q, 3.6% in 2Q, and 1.8% in 1Q. The personal consumption expenditure revision included an upward revision to service consumption versus declines for durable/non-durable goods consumption. This reinforces the recent trend of consumers preferring to spend more on experiences versus material goods. Although spending slowed marginally in the quarter, consumers should continue to benefit from a benign inflation environment partially due to very low oil/gasoline prices accompanied with high household net worth and low financing costs from continued low interest rates. Disposable income growth remains above the ~1.5% level that has traditionally signaled trouble for consumers. Spending/income growth should be poised for further acceleration as inflation remains low and labor momentum continues.

Figure 2



Source: Bloomberg

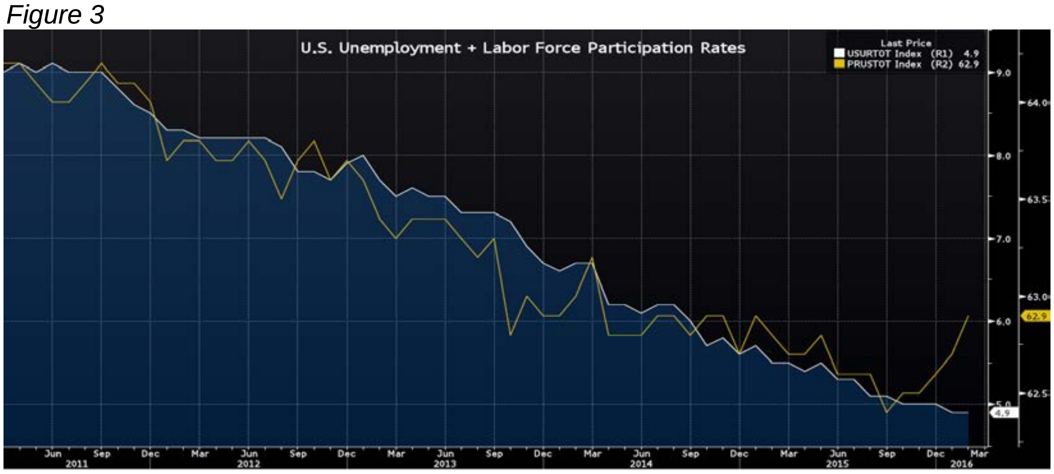
Employment/Wages

The strong case for the U.S. consumer stems largely from positive employment and wage trends. Overall, U.S. nonfarm payroll gains continued in 4Q 2015 with 295k, 280k, and 271k jobs added in October, November, and December, respectively. These continued strong quarterly figures were supported by robust construction hiring while hindered by mining and logging job losses.

The unemployment rate improved further over the 4th quarter, dropping from 5.2% at the end of 3Q to 5.0% at the end of 4Q and has since dropped to 4.9% in 1Q 2016, very close to the Federal Reserve's natural long-term target. The labor force participation rate also ticked up nicely in 4Q 2015 and into the first part of 2016. Historically, limited scope has existed for robust job gains once the unemployment rate reaches this level, and we would expect that to be the case going forward. However, given certain technological and demographic changes in the labor markets, it is prudent to also consider the "slack" in the labor market such as involuntary part-time workers, the quit rate, and long-term unemployed. Progress in each of these has been slower than the headline unemployment rate.

As the unemployment rate hovers around levels that are usually associated with full employment, we are at the point where we are noticing some stable wage growth, albeit at a fairly slow rate compared to traditional standards. Average hourly earnings increased by roughly 2.7% in 4Q15 while the Employment Cost Index increased 2.0%. Over the medium-term, we would expect to see most job creation rely heavily on domestically oriented private services.

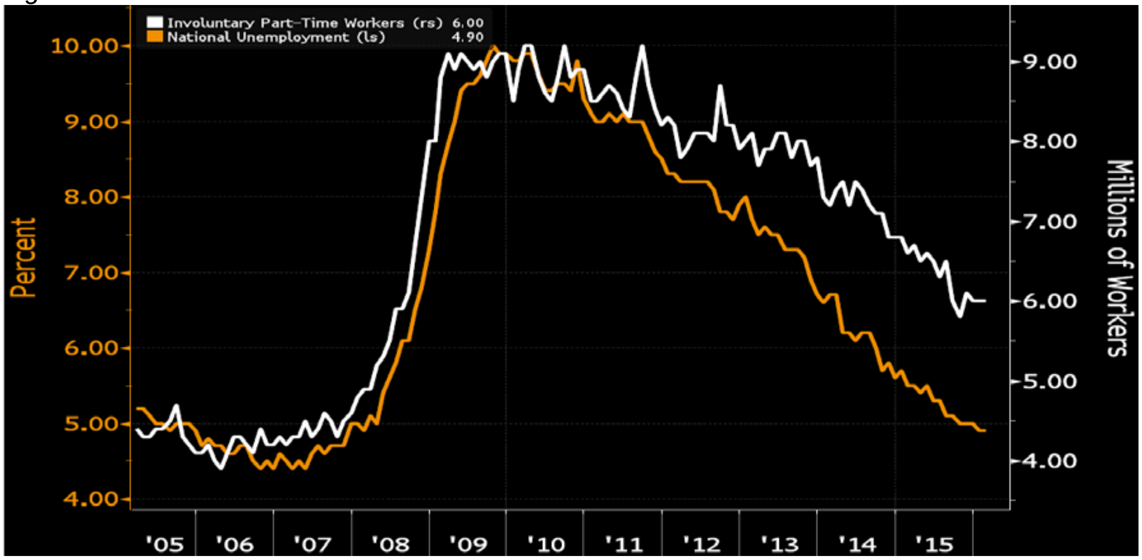
Figure 3



Source: Bloomberg

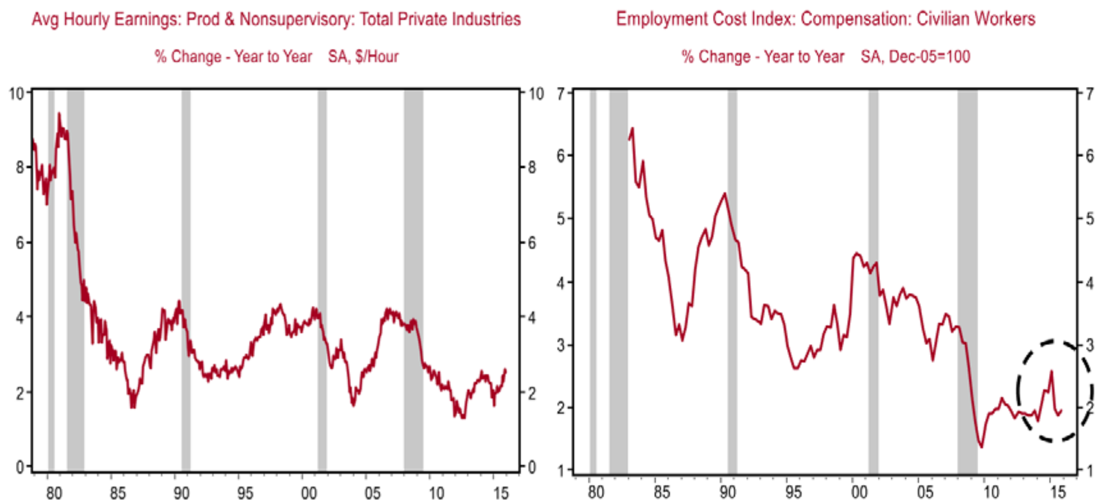
Productivity remains one aspect of the employment picture that remains questionable. The final estimate of 4Q 2015 productivity showed a decline of -2.2% compared to +2.2% in 3Q, 3.5% in 2Q, and -1.1% in 1Q. Overall, productivity growth remains sluggish and quite erratic, reflecting the pattern of GDP growth. Economists attribute lackluster productivity to a lack of investment, likely stemming from the relatively weak manufacturing environment in the U.S. Weak productivity has somewhat aided employment growth as more workers are brought on by companies to raise output, ultimately keeping wage growth lower. Productivity will likely continue to be unpredictable, and quarter-to-quarter swings in the data are difficult to decipher.

Figure 4



Source: Bloomberg

Figures 5 & 6

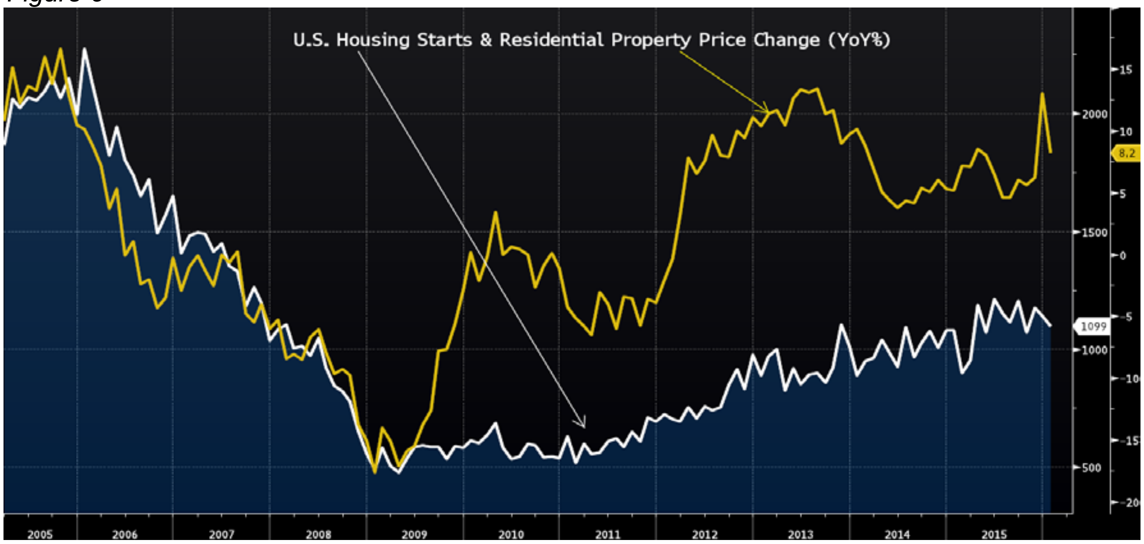


Source: Strategas, Bureau of Labor Statistics

Housing

The encouraging U.S. housing environment stems from continuing positive employment and consumer trends. Housing demand has been rising concurrently with U.S. household incomes. Consumer balance sheets continue to strengthen along with the labor market, leading to rising demand and prices for homes. Tighter inventories are also a key factor driving rental and home prices higher. Lenders remain quite optimistic and mortgage application activity should continue to increase, but we would not expect to see origination levels that come near the levels of the 2000s with pricing and transaction volumes remaining well below pre-recession peaks. Higher-credit score borrowers have become a larger portion of the housing picture, which has lowered the aggregate interest rate on mortgage debt, making principal a greater proportion of the total. We are also seeing a larger number of first time home buyers, which would lead us to believe that lower priced homes will make up a larger percentage of total sales. Overall, these housing themes paint a favorable picture for the risk environment going forward.

Figure 6

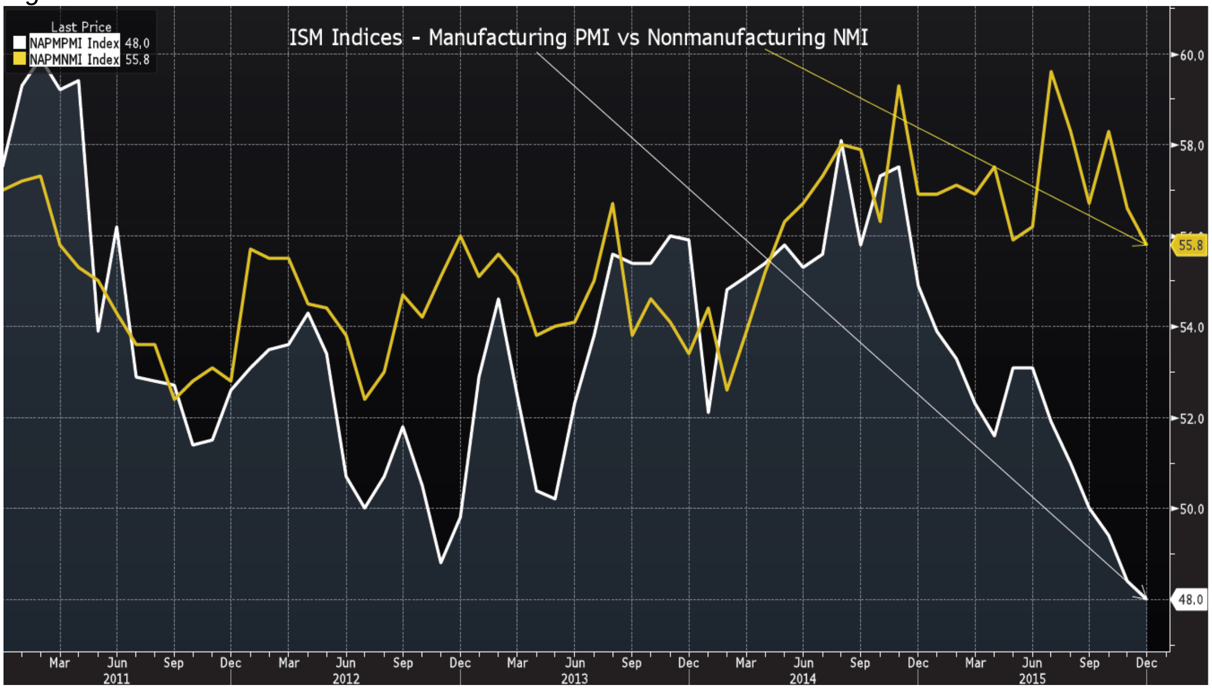


Source: Bloomberg

Manufacturing

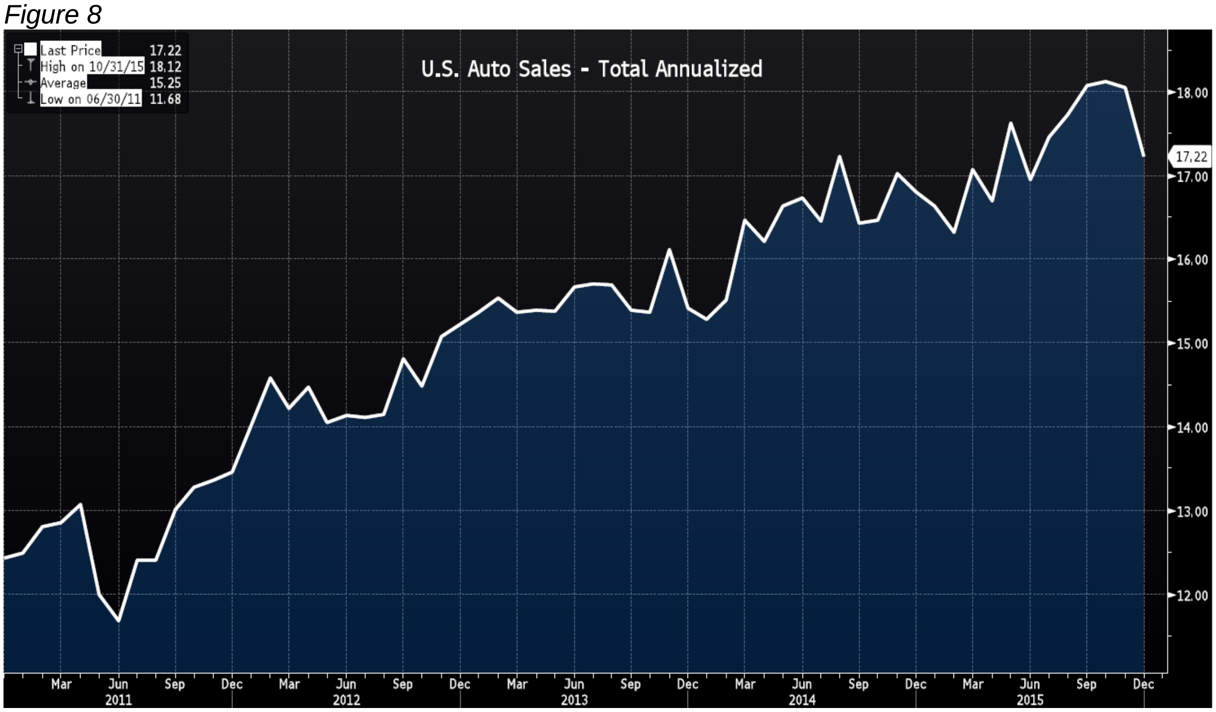
Overall, the reliance on more domestic service activity versus manufacturing/export activity has helped shield the U.S. from some global distress. The ISM Manufacturing PMI finished the year at 48.0 while the Nonmanufacturing index ended at 55.8. For these metrics, a reading above 50 signals expansion and a reading below 50 indicates contraction. Manufacturing activity has been hindered from soft global growth, the strong U.S. dollar, and a downshift in energy-related capital expenditures. Not only must domestic producers be concerned with weakening global demand (especially China), but they also have to worry about being squeezed through increasingly cheap imports. However, there has been a bright spot in the manufacturing story: transportation. Rising auto sales coupled with aircraft orders have helped boost the transportation manufacturing sector. We would expect auto production to continue to rise due to strong demand, albeit at a slower rate, supported by the improved labor market and record high average automobile age at 11.4 years old. The preference for larger and pricier vehicles likely stems from low oil/gasoline prices (and decent consumer confidence) and should be a large contributor to the auto sector making up a greater portion of GDP growth.

Figure 7



Source: Bloomberg

Figure 8



Source: Bloomberg

Outlook

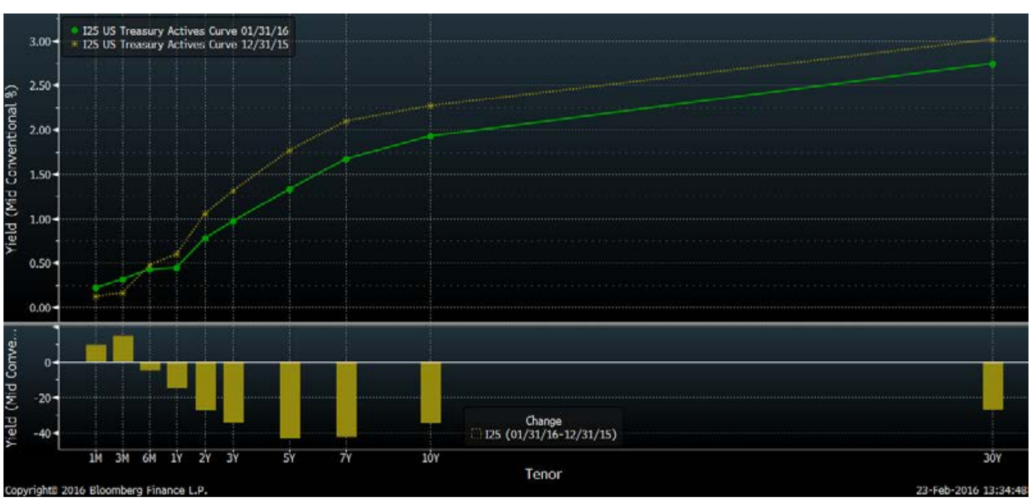
Much of the recent turmoil in financial markets has prompted speculation about whether the U.S. economy is recession-bound. There are a few interesting points that lead us to believe that it is not. In the first 3 months of the previous 5 recessions, we have seen building permits drop an average of nearly 15% and new manufacturing orders, capital goods orders, and job openings deteriorate between 5%-10%. During these periods, we have also seen initial jobless claims increase by an average of 15%, consumer spending tail off slightly, and the S&P 500 drop a couple of percentage points. In the current environment, the stock market has been the only indicator out of this group point decidedly downward compared to historical metrics. The evidence suggests that the U.S. economy continues to progress on the same slow growth trajectory it has over the past few years. If we are headed for a recession, it is not currently showing in the data.

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting, we were a couple weeks from the end of the calendar year. Interest rates had been somewhat choppy throughout December, especially around the Fed meeting mid-month. The Fed did in fact pull the trigger and raised the Fed Funds rate .25%, the first increase in almost 10 years. In her press conference, Fed Chairwoman Yellen indicated that the Fed was confident the economy was strong enough for increases and that as many as 4 more increases could be expected in 2016. Equity and fixed income market performance continued their choppy pattern through the end of the month as flows were light around the holiday season and investors were digesting this increase and the forward guidance provided by the Fed.

January started with a negative tone and this continued for most of the month. From confusing Chinese monetary policy and regulations to further declines in oil and commodity prices and weak U.S economic data, the bad news kept coming and risk assets continued to reprice lower. At the low point in January the markets were pricing in a nearly 50% chance of recession. By the end of the month conditions had improved somewhat after some positive developments including a continued dovish stance from ECB President Draghi, negative interest rates from the Bank of Japan, and better U.S. data late in the month. Despite this, risk assets performed poorly for the month with U.S. equities losing nearly 5% and high yield credit losing 1.58% with most of that loss attributed to the energy and metals and mining industries. High grade credit eeked out a slightly positive return of .45% as the drop in yields helped offset credit spread widening; U.S Treasuries, the safest asset class returned 2.2% for the month. The chart below illustrates the significant decline in Treasury yields just for the month of January; 5- and 7-year yields dropped 40 basis points while the 10-year dropped more than 30 basis points. The 2-year/30-year spread remained fairly steady at 196 basis points as the shift lower was mostly parallel.



Despite the significant market volatility in January new issue supply totaled roughly $125 billion. The bulk of this was Anheuser-Busch Inbev issuing $46 billion across several maturities and another large portion came from the financial sector.
February did not start any better than January. Volatility in the equity markets continued due to lower oil prices as well as weak global economic data. This in turn led to additional demand for safe haven assets and Treasury prices rallied to higher levels. By mid-month the 5-year Treasury yield had declined from 1.32% to 1.12%; the 10-year yield had declined from 1.90% to 1.66% and the 30-year yield had declined from 2.75% to 2.50%. Risk aversion continued to hurt the credit markets; in the high grade corporate sector spreads in general widened to levels not seen since June 2012. Most of this widening came from the energy and basic sectors but the financial sector was participating now as well.

The second half of the month fared much better. Improved economic data led to improved performance within the equity markets. Investors' appetite for risk recovered somewhat and led to Treasury yields rising a bit from their lows. Credit markets started to stabilize and spreads actually began tightening. The most beaten up sectors, namely energy, metals and even financials, saw the most improvement. The new issue corporate market came back to life after a slow start to the month and remained fairly robust through the end of the month. Despite the better tone the second half of the month, Treasuries still outperformed other sectors of the bond market, returning nearly 1% for the month. High grade credit returned .74% while high yield credit returned .47%. The 2-year/30-year spread declined to roughly 185 basis points as the long end yields declined more than front end yields. Despite the stronger tone to the markets, a Fed rate hike in March still seems unlikely; June is doubtful as well as Fed Funds futures currently predict less than a 40% chance of a hike in June. Fed members have communicated a cautious tone since the beginning of the year and while rate hikes have not been taken off the table altogether, it will likely be later in the year before they believe conditions are stable enough for another rate hike.

Economic data and market performance in January and February also led to increased discussion about the possible need for negative interest rates. With other central banks adopting this policy recently to help give their economies a boost, there has been more discussion about the possibilities in the U.S. as well. Negative interest rates are generally used after a central bank has already lowered their deposit rate to zero but still want to further ease policy to fight deflation, or to reduce capital inflows that are leading to undesired currency strength. Central banks would set their deposit rate for banks at a negative level so that the banks would then be paying a fee for holding their reserves at the central bank. The hope is that the banks will spend their cash rather than store it at the Fed for a fee. Some Fed members have acknowledged this policy in recent speeches however it does not seem to be a serious consideration at this time.

The more positive tone in the markets during the second half of February has carried on into March so far. With equity markets and commodities improving notably from their mid-February lows, credit markets have strengthened as well. High grade credit spreads continued to tighten and the new issue market has been strong with roughly $45 billion in issuance the first week of March alone. High yield spreads have seen even more significant tightening as energy and metals and mining names have rallied; through the first week in March the high yield sector return year to date is slightly positive, recouping much of the negative performance of the past few months. With recession risk now much lower and the risk-off move having faded, Treasury yields have been able to move higher. The 5-year Treasury yield is back to 1.47% while the 10-year yield is 1.95% and the 30-year yield is around 2.70%. The chart below illustrates the bounce back in credit over the past few weeks and how spreads have tightened, most notably in high yield:

Source: BofA/ML Indices (C0A0, H0A0), CreditSights

Despite the signifcant volatility in yields that we have experienced over the past few months, we have been somewhat active within the fixed income portfolio. Most of the recent activity has been within the corporate sector and we were able to participate in several deals where we thought pricing was attractive. Names purchased included Citigroup, EOG Resources, Anheuser Busch Inbev and General Motors. We also purchased small positions in some short dated, high quality energy names such as Anadarko Petroleum and ConocoPhillips; these companies have strong balance sheets and have taken measures such as dividend cuts and capital expenditure (capex) reductions so as to improve liquidity. We believe these companies will withstand the weakness in the energy sector and saw their significantly wider spreads as an opportunity to buy. Despite credit spreads recent moves tighter again, levels are still attractive and there are still new deals that need to come to market. There will likely be more opportunities to add quality names at attractive levels.

In the agency debt sector we have seen spreads remain stable and fairly tight. Earlier in the year as rates were beginning to decline we purchased an off-the- run 6-year agency bullet that was offered several basis points cheaper than comparable maturity on-the- run issues. We also added an 8 year callable issue a little later as the downward trend in rates continued. This purchase replaced a called issue and looked attractive as the call feature added siginificant spread to the issue's overall yield. Both of these purchases allowed us to add a little duration to this sector, which we think has been a prudent move given rate levels over the past couple of months. . We are currently a bit underweight within this sector and would add selectively if an attractive opportunity arose.

Spreads have remained fairly stable within the mortgage sector as well. Lower rates over the past couple of months have kept prepayments steady and our activity during this time period has mainly been the reinvestment of prepayments received. In January we purchased a 3.5% 30-year pool to add some duration as rates were moving down; more recently we purchased a 3% 15-year pool in an effort to keep the duration from lengthening any further. These additions allowed us to keep duration slightly long versus the Index and make sure the portfolio would benefit from the moves lower in rates. We have kept our weighting stable within this sector and look to add selectively as attractive opportunities arise.

Lastly, we executed a swap within our Treasury portfolio. As rates were moving lower in January, we sold out of a portion of our 7-year notes and swapped into 30-year notes. We were underweight 30-year Treasuries versus the Index and with rates moving down we felt we needed to reduce that underweight and add a little more duration. We are still underweight the sector as a whole but the duration remains longer than that of the Index. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

Domestic Equity Strategy

By Kevin Gamble

They say markets like certainty........well.......that is not exactly what we have right now to say the least. For starters, we have an open presidency on our hands with an electorate which is clearly sending a message that they are collectively not happy with the status quo. To illustrate the point, Hillary Clinton is being given a run for her money by a 74 year old Democratic Socialist and Donald Trump is currently leading the Republican primary in delegates by a wide margin despite not having the backing of his own establishment party leaders and despite verbal spats with the likes of Romney, McCain, and even the Pope of all people. To add fuel to the fire, we currently have just 8 Supreme Court justices, North Korea is firing missiles, Japan and Europe have introduced a negative interest rate policy (NIRP), the Fed has started a tightening cycle in the U.S., ISIS is growing in influence in the Middle East, Republican control of the U.S. Senate is likely to be contested this year, and oil and commodity and European banking stocks are in a precariously weak position with associated weak credit. Welcome to 2016!

In many ways, market performance fiscal year-to-date reflects this uncertainty. Sharp move higher, followed by sharp move lower, followed by rebound higher, etc......all in all, we are just slightly ahead of where we started. This type action is not surprising given the backdrop and frankly we would expect more of the same as we move through the year. Given that the dawn of a new baseball season is upon us, perhaps the proper analogy is much like as baserunner with his lead off first. He really wants to steal second base and move forward, but the signals he is getting from his third base coach are too darn confusing, so he keeps leaning back and forth without the propensity to run.

Exhibit 1: S&P 500 Performance Fiscal Year-to-Date

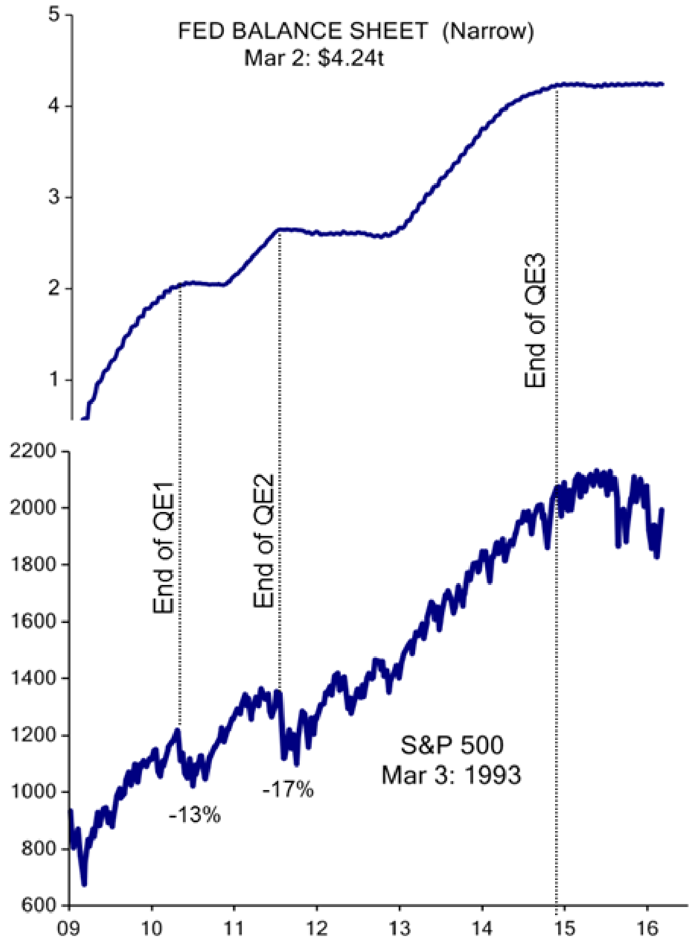
Source: Bloomberg

Is the market a fast runner or slow runner at this point? In some ways, the market itself is arguably not really a fast runner, or in other words, a slower runner. Why slow? Credit conditions are not particularly strong, earnings revisions have largely stalled, the Fed is tightening instead of pursuing an aggressive QE program designed to spur asset prices higher, and the technical picture has deteriorated for the time being as the upward trend line in the markets has been broken and long-term moving averages are turning over. Does the current situation necessarily mean that things are headed south? No, but it means that the market has some work to do to repair itself before it can meaningfully make new highs.

Exhibit 2: A Look at the Deterioration in the Technicals of the US Equity Market

Source: Bloomberg

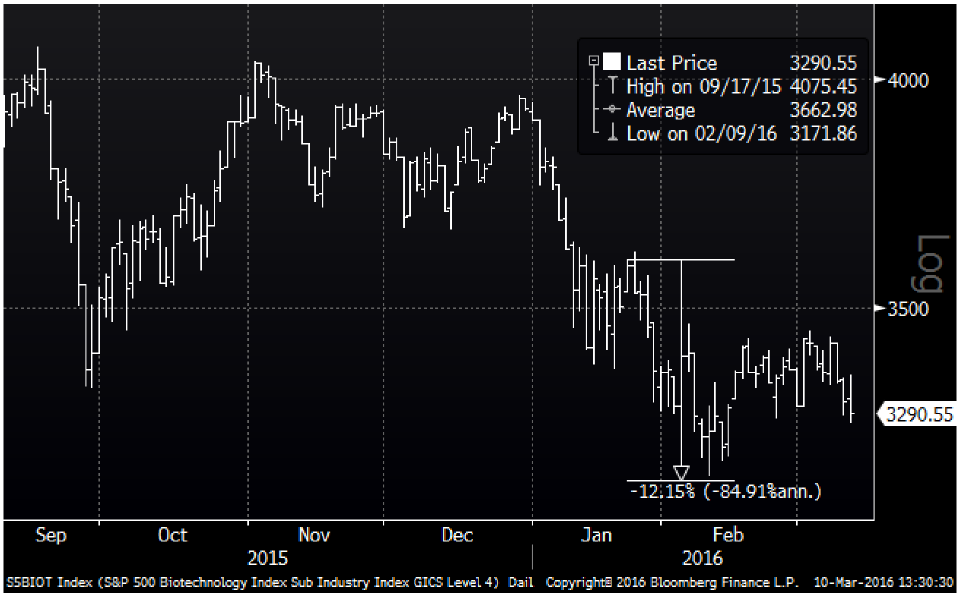
Exhibit 3: Strong Correlation of the S&P 500 w/ Expansion of Fed Balance Sheet



Source: ISI

I must say during our recent meetings as an investment staff, even our typically more optimistic members are somewhat guarded in their optimism for the time being given the above concerns. To give you an example of the uncertainty involved in an open presidential year, take healthcare drug pricing. Many of the biotech stocks recently reacted violently in late January (fell 12% as a group) following comments from Donald Trump supporting Medicare regulating healthcare drug pricing, which is not typically a Republican position, but more of a populist position. These are the type comments that tend to come out of the blue in election years and will inevitably present risk along the way for investors until November.

Exhibit 4: Annotated Performance of S&P Biotech Index Fiscal Year-to-Date



Source: Bloomberg

Given the uncertainty of the current environment, I thought it would be helpful to examine both sides of the investor ledger and then let the reader/listener/investor decide on which path to follow based on the respective arguments. I will sum up our collective stance and positioning as an investment staff at the end.

What would someone who is sanguine on the markets argue?

1) Markets are designed to go higher....over time, the U.S. equity market has always moved from the bottom left to the upper right.....at the midway point of last year (6/30), markets hit an all-time high and longer term investors had a profit on every share of SPX they ever purchased despite the ups and downs

2) Having 7.4 billion people around the world wake up every day trying to make their life better is a powerful force which should not be underestimated

3) While we do have problems, we are at least aware of our problems and we control the world's reserve currency which is a strong strategic position to be in to fight any deflationary forces

4) The fall in commodity and metal prices is a positive on the margin for the large majority of the American economy which is based on services and consumption. The consumer is generally in good shape and consumer net worth is at an all time high.

5) As the market moves from the current uncertainty toward more certainty later in the year, markets will react positively just due to more clarity

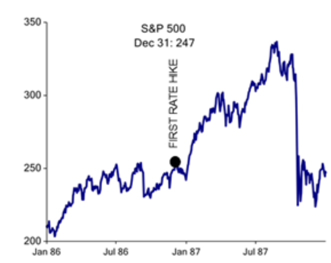
6) Markets are reasonably priced given the extremely low levels of interest rates based on the Fed model. The 1-year forward earnings yield is currently 6% and the 10-year note yield is 1.9%, so equities are priced attractively (Fed model states markets are fairly valued only when these are equal implying substantial upside for stocks)

7) We have never had a recession in the Post WW2 era which was proceeded by falling oil prices.....this combined with fiscal spending which will be stimulative this year should further buffer against recession risk in 2016

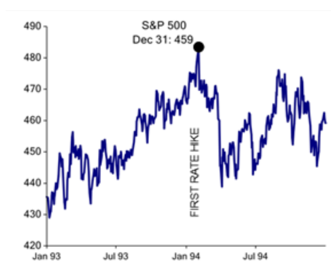
8) Investor sentiment is not excessive by any means

9) Markets tend to fall initially following the first rate hike in a tightening cycle and then tend to move toward new highs before the tightening cycle has concluded. If the Fed has to reverse course for some reason, they are more likely to pursue another QE program instead of a negative interest rate policy

Exhibit 5: Performance of Equity Markets Around First Rate Hike in Tightening Cycle



1986-1987



1993-1994

2003-2004

Source: ISI

10) Earnings are set to rise as the economy grows, margins will hold strong, multiples will hold given low interest rates, dividends will rise, and thus markets will mathematically move higher

What would the grizzly bear argue?

1) The political environment in the U.S. is a toxic mess. The American public is divided and angry and this is compounded by the fact Americans get their news these days from news networks which feed their particular point of view...this uncertainty is not priced into the full market multiple which currently exists

2) Something is not right in Europe as major European banks are trading at precariously low levels, even fell below their March of 2009 levels! Beware of a major European bank failure similar to the Lehman event in the United States! Is there a Black Swan event brewing in Europe?

Exhibit 6: DB Back at Crisis Lows of 2008

Source: Bloomberg

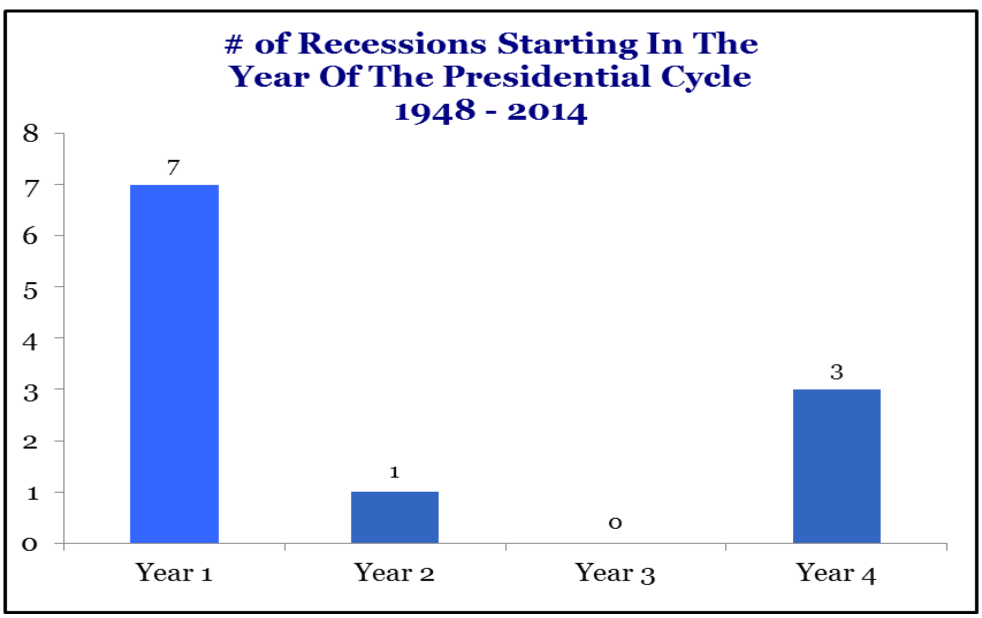
3) Credit is deteriorating and this is often a leading indicator for the equity markets

Exhibit 7: Look at the Deteriorating Credit Picture (JNK)

Source: Bloomberg

4) A recession is a higher probability than the market is currently assigning. While things admittedly look okay on the surface, recessions tend to occur in open political years and leading indicators are confirming some deterioration on the margin

Exhibit 8: Recession Beginnings and Presidential Cycles

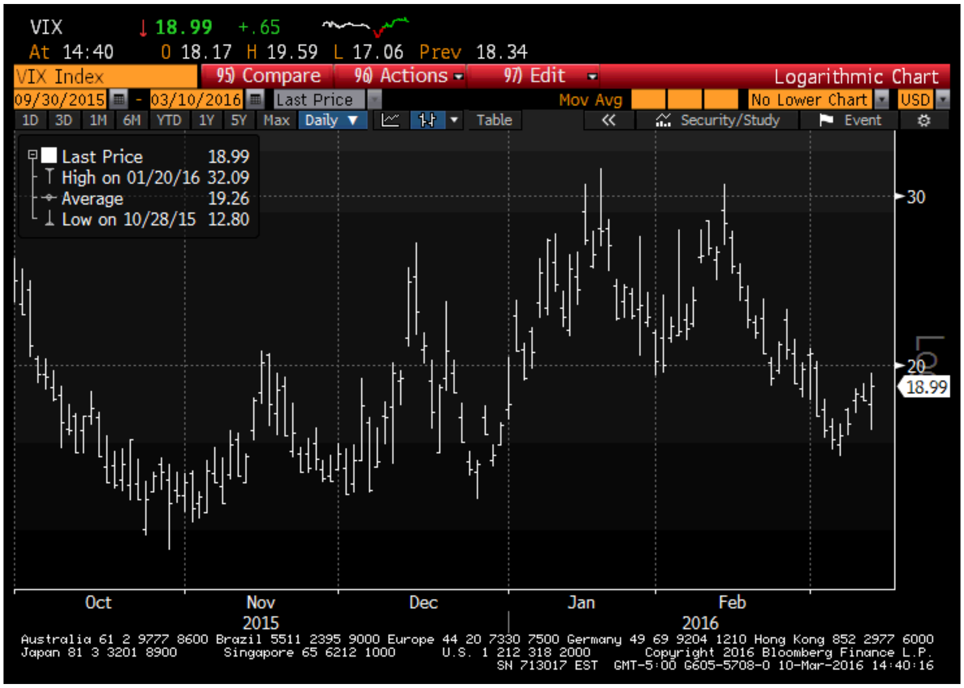


Source: Strategas

5) Margins are structurally too high (Case-Shiller P/E) and will revert to the mean over time

6) The volatility index (VIX) has not spiked like it normally does prior to major bottoms

Exhibit 9: Fiscal Year-to-Date VIX Performance



Source: Bloomberg

7) OPEC does not have the control over energy prices they have had in the past due to increased US production, political rivalries, and the need to continue to produce oil to satisfy their own societies and budget needs

8) Bankruptcies in energy and commodity related stocks will spill over into the financial system which is turn will create more problems for growth

9) Transports are not acting very well which is a concern given the falling input costs thus confirming recession risk in the U.S.

10) The combination of all the above will lead to negative earnings revisions, a falling market multiple, dividend cuts, and mathematically lower equity market levels

The most likely scenario from our standpoint as an investment staff is that elements of both sides of these arguments play out as we move through the year creating a choppy, consolidating market. In other words, it is unlikely the signals from the third base coach clear up in fiscal 2016 and the San Diego Chicken shows up with a sign flashing the word RUN.

Without a doubt, markets are currently focused on the gyrating price of oil given the large amount of credit exposure to the commodity. While it is uncertain what the actual goldilocks price of oil is that best balances growth benefits and credit concerns, the equity market seems to be more concerned with falling prices and the associated credit risk in the system. The ideal porridge is likely that the price stabilize in the $40-$50 range which would better allow companies to generate the cash flow to meet debt obligations while not impeding economic growth with higher gas prices. It will be an important balancing act to see if the powers that be and economic forces can allow this to happen.

Equity Strategy Moving Forward

Given our stance that the market is likely to remain choppy with downside risk and somewhat of a ceiling on the upside potential given the looming uncertainties in this open election year, our investment staff feels the best strategy is to continue to overlay our equity holdings with hedges which allow us to continue to participate in some upside in the marketplace, but which protect us from a drawdown in the markets. These are very conservative hedges as they sell covered calls (in other words, we own the underlying issues which we agree to sell at a specified higher price north of our actuarial rate of return) in return for some downside protection. The cost of the downside protection is paid for by relinquishing some of the gains in the upper tail of the return distribution above our actuarial rate. Given our investment objectives and risk/reward tolerance, we view this stance as very prudent and will be thrilled with upper tail returns should that perceived lower probability event play itself out this fiscal year. In the baseball analogy, a hitter who is batting at the Mendoza line (.200) is unlikely to get a hit (especially a double in the gap), but that doesn't mean it statistically can't happen. We are positioned fairly conservatively at the point in time with our hedges and large capitalization quality U.S overweight.

On a side note, the market recently (March 9th) marked the 7th year anniversary of the bull market move off the Great Recession market lows. That was 84 months ago, which makes this current bull market rally the third longest on record. The average bull market move is 60 months. The S&P 500 is up nearly 200% since the bottom seven years ago. The earnings recovery and the market rally has left the market in a range of fair to full value at roughly 16.5x forward EPS projections of $120 for the S&P 500 in 2016. We are in a fairly low nominal GDP growth economy of 3-4%. The current forward earnings yield on the market of 6% (+/-) the economic growth level of approximately 2-2.5% seems like a reasonable expectation of returns for the fiscal year. But as Yogi Berra, the baseball great who passed away last year, famously said:

"it's tough to make predictions, especially about the future."

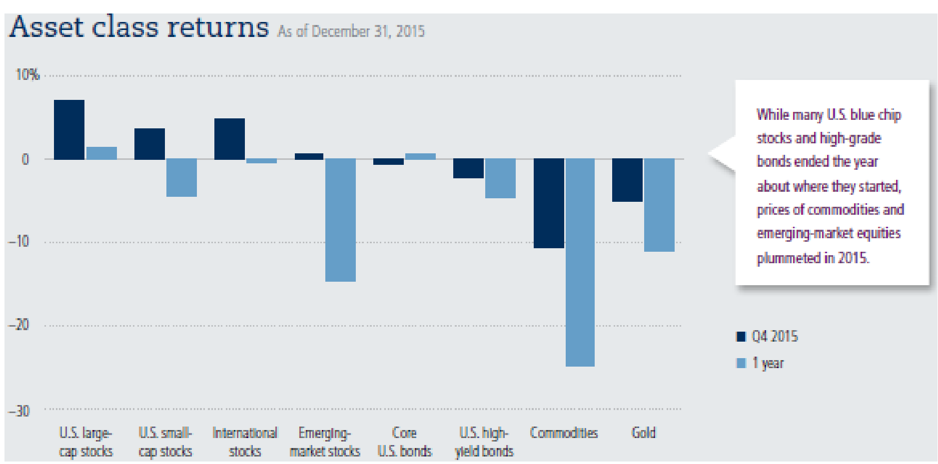
"the future ain't what it used to be."

My personal favorite on the baseball theme: "Little League baseball is a great thing because it keeps parents off the streets"

International Equity Strategy

By Steve Lambdin

After a disastrous third quarter of 2015, equity markets around the globe generally staged a rebound in the fourth quarter to the pleasure of most investors. However, 2015 will still go down as a fairly disappointing year for equity investors, especially in the emerging markets. The list of concerns in 2015 was long for global investors: U.S. dollar strength, China's slowing growth, geopolitical issues in many parts of the world, commodity price weakness, U.S. monetary policy, and overall upheaval in many of the emerging markets. But the tone did change a bit in the fourth quarter, as central bank actions dominated the landscape with investors as actions by the U.S. Federal Reserve (FED), the People's Bank of China (PBOC), and the European Central Bank (ECB) sparked a bit of a return to riskier assets like equities for most. Large cap equities in the developed markets around the globe did quite well and emerging market equities even posted a very small gain in the quarter. Japanese equities were strong in the quarter as improving corporate profits and attractive valuations moved markets higher in this region. In addition, German equities moved higher as the weak euro continued to help export activity in the country. Only an oversold rally in Chinese equities saved the emerging markets, as most other markets posted losses in the quarter. Of particular note was the severe performance of the Brazilian market, as the country's sovereign debt rating was downgraded yet again, pushing the currency to fresh new lows versus the U.S. dollar. As we move into early 2016, investors have plenty on their plate to digest. China remains a wildcard with a very negative bias. The slowing growth and overall debt concerns will extend well into the future from what we can see and could be one of the main drivers of global market returns going forward. It is hard to see much positive sentiment coming from this region. Global interest rates remain in the headlines, as many are trying to forecast the next move by the FED, while many five and even a few ten year yields in Japan and across Europe are in negative territory. Actions by the BOJ and ECB will be heavily scrutinized going forward. Overall, global economic growth seems just okay at the moment, with a bias toward the downside in most investors' minds. No doubt, equity markets will remain quite volatile in early 2016 with this in mind.



Source: John Hancock Investments; Morningstar Direct

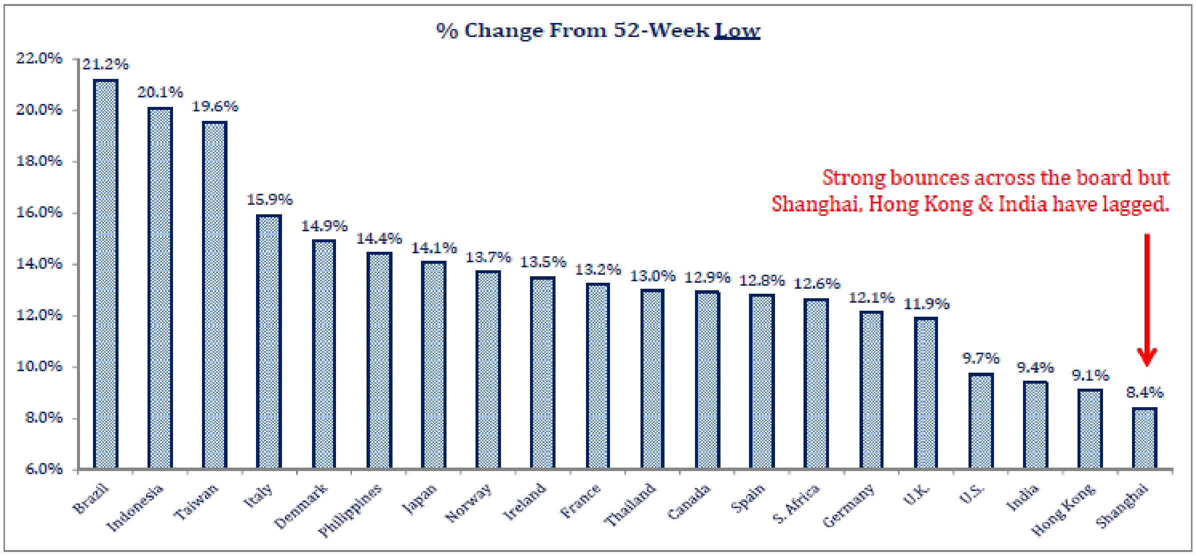
The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +4.71% and +.66% respectively during the fourth quarter of 2015 versus +7.04% for the S&P 500 Index. Unfortunately, the positive performance in the fourth quarter was not enough to offset the rest of 2015, as most asset classes in 2015 experienced negative or only slightly positive returns. As the case from the previous quarter, the U.S. dollar was only a small factor in returns in the quarter, as it rose +2.7% against the Euro and +2.5% vs. the British Pound, and was virtually flat against the Japanese yen. As we mentioned earlier, the Pacific basin led the way with strong performance from Japanese equities as the BOJ continues to provide stimulus to the region. From an economic sector standpoint, technology, healthcare, and industrials were relatively stronger, while energy and utilities were the weakest. The commodity markets continued to be under severe pressure in the quarter, as oil finished 2015 at $37/barrel, down -30% from the end of 2014. The same can be said for natural gas, copper, and a host of other commodities as well.

GDP forecast, annual change (%)

		Forecasted data				
	2015	2016	2017	2018	2019	5-year average 2015–2019
World	2.4	2.8	3.1	3.3	3.5	**3.0**
United States	2.4	2.6	2.8	2.7	2.8	**2.7**
Canada	1.1	2.0	2.2	2.3	2.6	**2.1**
Eurozone	1.8	1.8	2.3	2.2	1.9	**2.0**
Germany	1.7	2.4	2.7	2.3	2.0	**2.2**
France	1.1	1.4	2.0	2.1	1.7	**1.6**
United Kingdom	2.5	2.4	2.2	2.1	2.1	**2.3**
Asia-Pacific	4.0	4.2	4.3	4.5	5.0	**4.4**
Japan	0.7	1.3	0.7	0.7	1.4	**0.9**
China	6.9	6.5	6.4	6.5	6.8	**6.6**
India	7.3	7.6	7.5	8.0	8.0	**7.7**

Source: John Hancock Asset Management, 11/12/15.

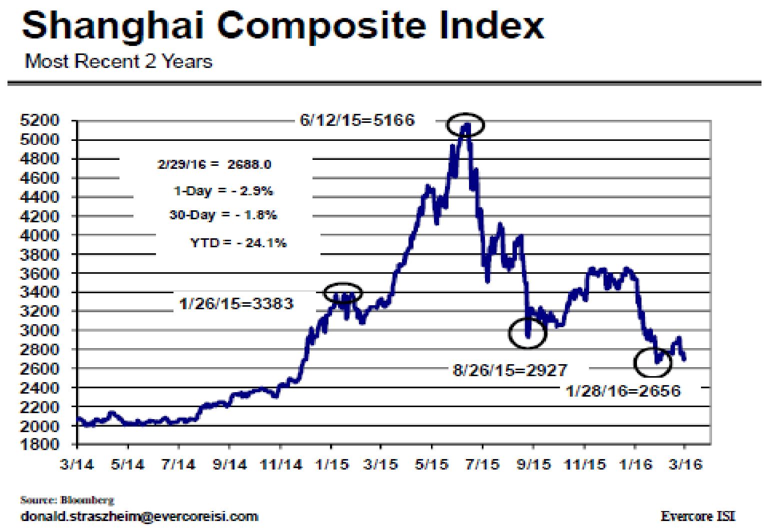
Thus far into the first quarter of 2016, the global equity markets have been all over the place. Volatility has been at a heightened pace, making equity investors very nervous. Continuing fears of a growing economic slowdown and debt bomb in China are in the front of investor minds at this time in addition to fresh concerns surrounding many of the European banks, especially the ones in Italy, as they have put pressure on global stocks. This has pushed the MSCI EAFE Index and the S&P 500 Index down -5.3% and -2.7%, respectively, thru early March in the first quarter. On the other hand, emerging market equities are nearly flat in the quarter, as many commodities are well off the lows posted in late 2015 and this has translated into higher equity prices for these stocks. At this point, it's hard to tell if this is just a relief rally from oversold conditions or whether we have already seen the lows in many commodities this cycle and an important bottom has been reached. We still see the central banks around the globe as key players in investor sentiment going forward as they could hold the key to any gains in early 2016 as expected better economic growth in 2016 is starting to be questioned.



Source: Strategas

Asia Update

On the strength of the Japanese equity market, the MSCI Pacific region finished as the best performing region within the MSCI EAFE Index during the fourth quarter of 2015, rising +9.07% in USD terms. The Japanese equity market benefitted from decent earnings growth and reasonable valuations in the period. Also, being a huge importer of the bulk of its energy needs helped the investment case for equities here. All of this led to a good appetite for these equities by investors. All countries within the MSCI EAFE Index pacific basin finished with positive returns. This was the first time we have seen this in some time. Even Chinese equities performed decently, rising about 4% in the period, while facing a multitude of issues with debt and future growth. Recent interest rate cuts in China and stimulus actions in Japan should give investors a small degree of comfort and perhaps push markets higher as we move through 2016. No doubt, these markets will almost be “week to week” until some level of confidence builds with investors. It’s our view this is going to take some time.

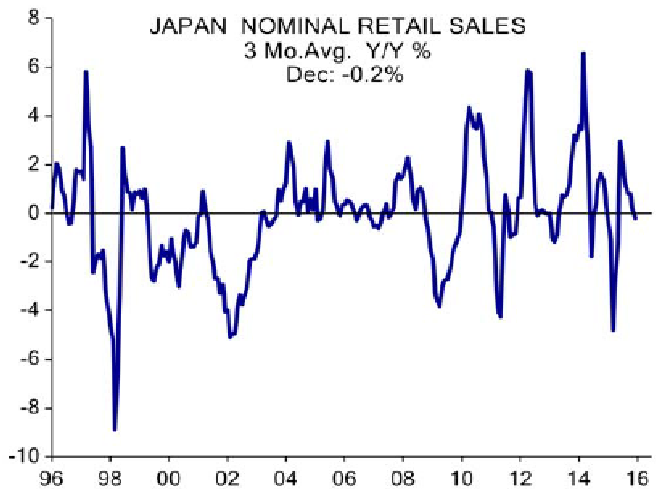


The Chinese economy continued to slow down in the fourth quarter of 2015 as gross domestic product (GDP) in China rose +6.8% from the year earlier period, which was in line with most economists' estimates. This put growth for all of 2015 at +6.9%, which is the slowest rate of growth since the global recession of 2009. China continues to play a delicate game of maintaining growth while trying to reform the economy toward more services. Officials here just don't need to see pressure on the industrial side spread over to the internal consumption and services sector of the economy. Many are also concerned with the decline of China's foreign exchange reserves in 2015, which could lead to another round of devaluation of the Yuan against the U.S. dollar. However, we believe Chinese officials have learned valuable lessons from last year's stock market and currency panic and will proceed very cautiously in bringing down its large FX reserves over time. As always, what happens in China has ramifications for the rest of the world, as it is the largest emerging markets economy as well as the second largest economy in the world. We expect the services sector to continue to expand at a good clip, while the industrial side continues to slowdown. Industrial production rose +5.9% in December, while fixed asset growth continued to slow to +10% in 2015, which continues to be the slowest pace of growth since 2000. The export slump continued in the region as they fell -1.4% in December from the year earlier period, which came as little surprise. Retail sales continue to move higher and were reported up +11.1% in December, maintaining the fastest pace in several months. Inflation remains well in check as consumer prices rose only +1.6% in December from a year earlier, only a slight rise from the previous months. This lack of inflation still leaves plenty of room for more stimulus actions to stabilize this economy going forward, like the 50 basis point cut in the required reserve ratio on February 29th. With official government projections of economic growth of +6.5% to

7% in 2016, it looks like the measured slowing growth of this economy is still in full effect. It still looks like an extended soft landing scenario at this point; however, risks are increasing toward some other conclusion.

Source: Evercore ISI

The economy in Japan continued to struggle in late 2015, as GDP fell a revised -1.1% in the fourth quarter from a year earlier period. This was slightly better than the previous estimate, as upward revisions to inventories and business investment helped on the margin. This reading will probably result in additional monetary stimulus in the coming months, especially ahead of national elections this summer. Abe's plan is aimed at increasing inflation after decades of deflation, stimulate growth, and improve confidence in the future. Thus far we have seen mixed success. Business investment did increase in the quarter, but private consumption fell. Exports remained weak in late 2015 and were reported down -8% year over year in December. However, the trade balance swung back to a surplus as imports fell -18%, as lower energy prices were the main factor. Industrial production continued to struggle in the quarter as December's output fell -1.9% from a year earlier. But most are looking for this key data point to begin to trend upward as global growth is expected to be better in 2016. Small business confidence continues be subpar, falling to 47.9 in February, as many business owners see too many headwinds they are facing to be more positive at this point. No doubt, this data point will have to improve if Japan's economy is to grow more in 2016. Consumer confidence continues to climb ever so slightly, rising to 42.7 in December, the highest level in 2015. This is a good sign as we enter 2016 that the consumer may participate more in the recovery going forward. Even though this has been painfully slow, we may be going in the right direction. Core prices were once again flat in January from the year earlier, which we see as a decent outcome in the face of falling energy prices. We see core prices rising in 2016 as lower energy prices begin to pick up from year earlier periods down the road. The labor market remains fairly stable as the January unemployment rate ticked up slightly to 3.2%, still bumping along multi-decade lows. The labor force participation rate did inch up to 59.7% in January, in a sign more people entered the workforce recently. Also, the jobs-to-applicant ratio continues to improve, rising to 1.28 as well. All of these labor readings should be a positive for rising wage pressure as we move through 2016. At this point, growth in 2016 will probably get off to a slow start, but still should be better than 2015 as Abe should announce more stimulus measures, especially ones aimed at women to get them into the workforce. This should broaden the tax base here and boost household wages as many families will have two wage earners. Many are optimistic these measures could support a stronger equity market in 2016.

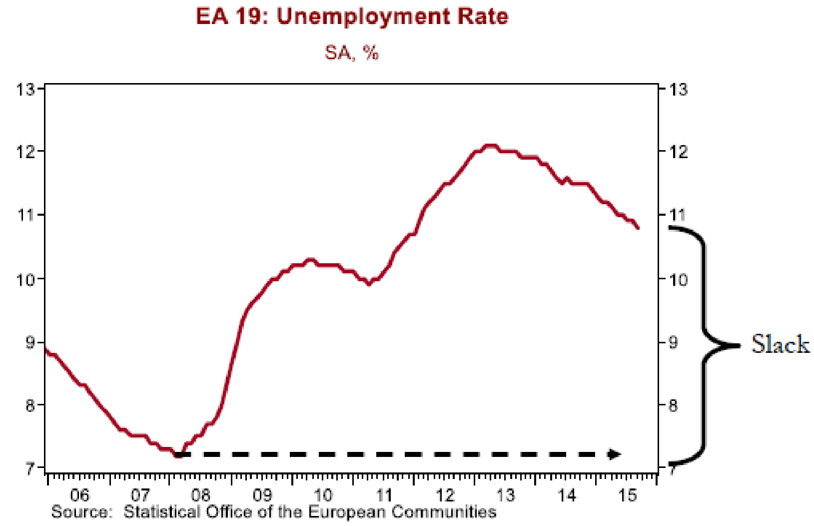


Source: Evercore ISI

Europe Update

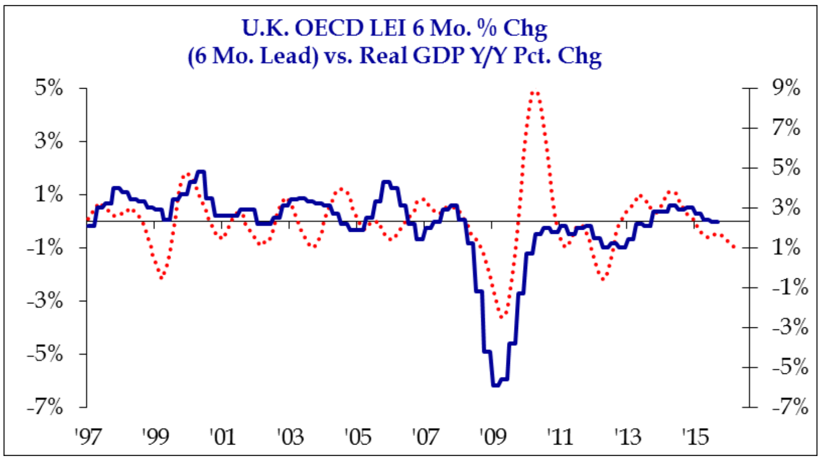
The Eurozone economy continues on the road to recovery behind its main catalyst, the ECB. The ECB continued its easing measures with an expansion of its quantitative easing program recently. As has been the case, President Draghi still remains committed to do what it takes to push this region toward recovery. Lending standards have eased a bit and credit seems to be expanding, which are good signs for the economy. This coupled with better industrial activity and consumer spending in some countries should continue the recovery in 2016. However, investors must be watchful with developments for many of the banks in Italy, Spain, and France, as recent activity in these names seem to indicate worries are ahead. The MSCI European Index (ex. U.K.) rebounded in the fourth quarter and posted a gain of +3.23% in USD as the German equity market was very strong as activity has picked up noticeably here. Looking into 2016, we need to see the Eurozone continue to implement more structural reforms. Steady progress is essential, especially within countries like France and Spain, where labor reform is desperately needed. The influx of refugees from the Middle East also presents a challenge, but could also help in the longer run as replacements for an aging population.

Fourth quarter GDP rose +.3% from the previous quarter, or +1.6% from the year earlier period, which was right in line with expectations and basically the same as the third quarter. Most of the larger economies in the region stayed very stable in the quarter versus the previous quarter, which was a bit better than many were expecting. Most of the expansion came from the services sector of the economy, as the industrial side was a little tough, especially in December. The ECB still sees the recovery as weak and used this as an opportunity to cut deposit rates and expand its quantitative easing program in early March in an effort to push for more growth. As mentioned above, industrial production fell -1.3% in December from the year earlier, as this month was the weakest in the fourth quarter. However, for the entire quarter, industrial production was up +.6% from the previous year. This was right in line with the ECB's weak view, and provided the ammunition for further quantitative easing just announced. We do expect this key indicator to improve as we move through 2016. The index of executive and consumer sentiment has been weak since posting highs back in November and was reported at 103.8 in February. Many saw falling commodity prices as a real concern for growth going forward in the region. We do expect this reading to improve as well in the coming months, in line with our views on the region. Retail sales were up about +2.0% in the quarter from a year earlier, just a slight deceleration from the previous quarter. Inflation is still not much of an issue as core consumer prices only rose +1.0% in January from a year earlier. The risk to this is weak wage growth for the consumer. The employment situation continues to improve as the December unemployment rate was reported at 10.4%, a continued steady improvement over the last few months.



Source: European Commission; Strategas

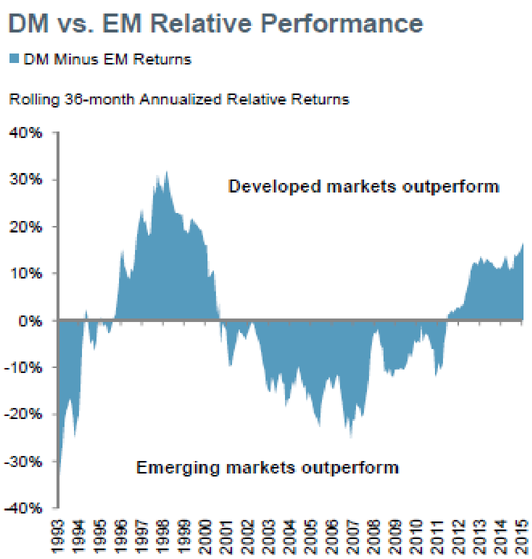
The U.K. economy remained rather resilient in the fourth quarter of 2015 as this economy posted its 12th straight quarter of economic growth. This adds to the longest period of growth since the global recession several years ago. At this point, we still expect the economy here to continue to grow at a near average growth rate for the region, or just a tad below 2015 levels. GDP grew by +.5% in the quarter from the previous quarter, or +1.9% from the year earlier period. We still find this quite remarkable especially with what is transpiring in the Eurozone and China. Household consumption provided the strength and increased .7%, while exports and business investment declined more than expected from a slowing in the rate of credit expansion as well as the appreciation in the currency. Construction contracted again, while manufacturing was basically flat in the quarter. Retail sales have rebounded nicely in early 2016 as January sales were up +2.3%, or +5.0% from the year ago period. Wages have picked up slightly while energy costs are much cheaper. This is a nice recipe for increasing retail sales. Inflation remains well contained and well below policy targets as January core CPI was up +1.2% year over year. We expect inflation readings to remain well below policy levels over the near term. At its February meeting, the Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target still remained at 375 billion pounds, just as it has for an extended period of time. At this point, we do not expect to see higher rates over the next few months as potential headwinds are numerous. In fact, future rate increases may even be more muted going forward than what we were thinking a few months back. The employment situation continues to improve, as the unemployment rate fell to 5.1% in fourth quarter, which is a ten year low. In addition, employment rose by 205,000 in the three month period ending in December to a record employment of 31.4 million workers. Wages should begin to be moving higher at some point, above the +2.0% level reported recently. The employment outlook still looks good over the near term, which should be good news for the consumer. At this time, we expect the U.K. economy to be a bit weaker due to currency movements, but still relatively solid overall as we move through early 2016. The referendum vote on a potential exit from the European Union later this year could be a source of contention and risk going forward, to what degree we just do not know at this point. This could make for nervous equity markets.



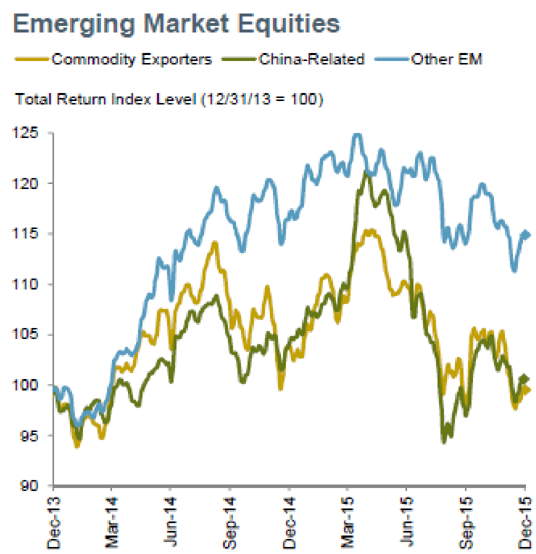
Source: Strategas

Emerging Markets

Emerging markets continue to be under tremendous pressure as we saw significant currency declines, capital flight, budgetary problems, and a host of political instability in recent months. No doubt, a tightening U.S. policy is a very difficult problem for these economies. Currency pressures and terrible market sentiment led to another dismal quarter in these equity markets. Commodities continued to fall in late 2015 as many are near decade lows, putting yet more pressure on a delicate situation. Though the MSCI Emerging Markets Index (net) did manage to post a very small gain of +.66% in U.S. dollar terms in the fourth quarter, 2015 will go down as the fifth consecutive year of underperforming large capitalization developed market equities. In fact, for 2015 emerging market equities lagged the EAFE Index by well over 14 percentage points. As many in the investment world already know, these cycles of underperformance generally last for several years at a time, which has certainly been the case already. Brazil has been a complete disaster in 2015 and China is a complete unknown much of the time. In addition, with many other countries dependent on the commodity cycle, this has been a perfect storm for what investors have witnessed. However, we could be further along the adjustment process regarding the U.S. interest rate cycle than many believe, as the initial moves sometimes prove to be the most severe. Also, economic growth will still be better in these markets in 2016 than in the developed markets, even though China is still expected to slow further. Just as we have mentioned in past reports, the best opportunities are still the "self-help" stories based on some type of stimulus or structural reforms going on inside the country. While we are still cautious toward commodities in general, we do not see another giant leg down in many of these. Key bottoms may have been reached in 2015. Valuations remain at very depressed levels relative to developed market counterparts. We are still looking to add to our emerging markets exposure on downward movements as we could see some rebound in this asset class at some point as we keep a long term perspective in mind.



Source: Fidelity Investments Q4 2015 Market Update

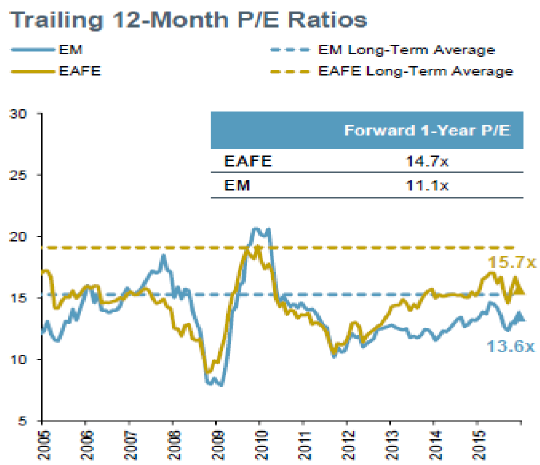


Source: Fidelity Investments Q4 2015 Market Update

International Equity Activity/Strategy

Early 2016 has brought many challenges for equity investors. Central bank policies that vary by region, growth differences in different parts of the world, the continuing decoupling between developed and emerging markets, fresh geo-political issues, China, credit concerns especially in the high yield space, and further European bank credit issues are just a few of the concerns which will forge the direction of equity markets early this year. At this point, most central banks around the world seem to have a fairly well "telegraphed" approach in place. With this in mind, interest rates seem to be in a "lower for longer" scenario to start in 2016. The U.S. Fed looks like one of the few looking to raise rates, but this will be data dependent. European banks are a concern for investors, as credit losses will probably pressure balance sheets and could force equity raising measures. However, earnings expectations outside of the financial sector could be marginally better as we move through 2016, perhaps easing investor anxiety to some level. The ECB still remains in an easing posture as Mario Draghi left the door open for more stimulus action at some point after disappointing many recently that had higher expectations. In Japan, the monetary easing and a weak currency continue to be tailwinds for exporting companies in the region. Also, business conditions are getting a bit better on the margin with non-exporting businesses, which is a nice bonus to see. On a negative note, China and many of the emerging market economies remain a "wildcard" at this point as the outlook for growth continues to shrink. Bad debt and a massive misallocation of capital have no doubt formed a bubble in some of these countries. How government officials handle this crisis makes for some anxious times in these regions as everyone will be watching. With this in mind, we expect markets to be volatile in these regions. As we digest all of this, we still see overall world economic growth just a little better in 2016 vs. 2015, but the gap is closing. With so many things on investors' plates at the moment, we could be in for some tough equity markets over the near term until more clarity develops around some of these points.

We have added approximately $44 million to our Emerging Markets Index (EEM) recently as some of our put options were exercised as the price of EEM finished below their respective strike prices. Subsequently, the price of EEM has moved well above our exercise price making for a good entry point for this addition. We expect to continue to sell put options on the Emerging Markets Index (EEM) at prices below the current price of the security in an effort to buy some exposure into the emerging markets index if the market turns further down from here. However, we don't expect to be too aggressive at this point until the outlook improves. In addition, we have sold some call options on EEM at strike prices well above the current price of EEM in an effort to take advantage of premiums in the marketplace in the current state of heightened equity volatility. Premiums for doing these strategies still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.50% of total assets and approximately 10.6% for MSCI EAFE equities, which still remains below peer group averages. *(Credit is given to the following entities for charts provided: Strategas, Fidelity Investments, John Hancock Investments, Evercore ISI, European Commission, and Morningstar Direct)*



Source: Fidelity Investments Q1 2016 Market Update