Q1 2016
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

2016: Will the Fed, China or Oil Drive the Markets?

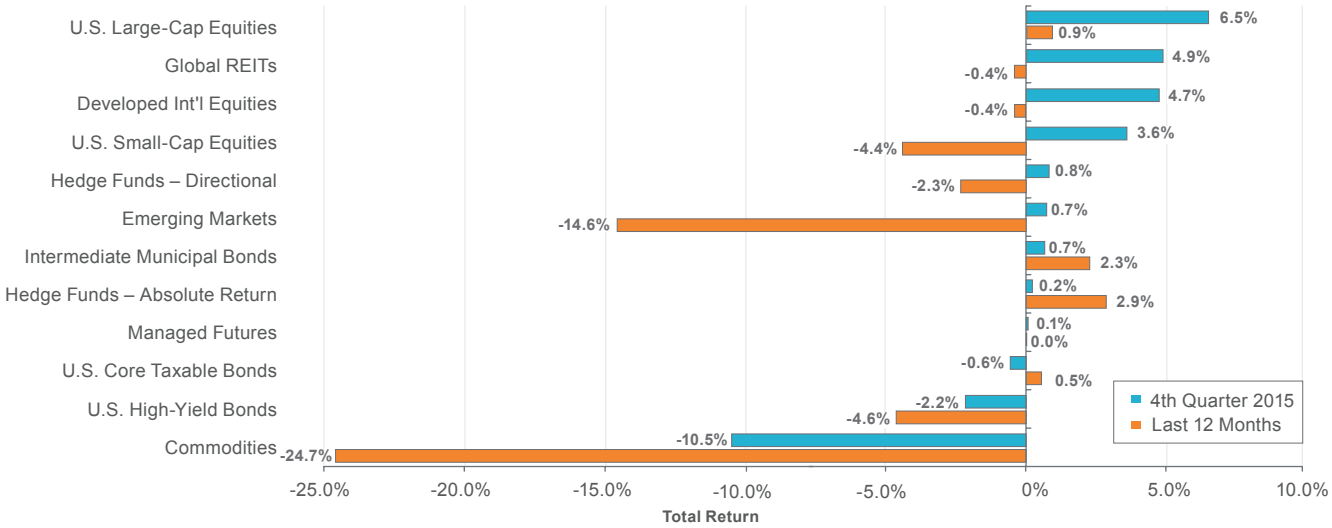
2016, by many capital market measures, has had one of the worst starts to a year on record. The email we sent clients last Friday provided some detail regarding what we think is driving the turmoil. As we indicated in that letter, China growth concerns and energy prices combined are the principal drivers of recent volatility.

Throughout 2015, markets realized that China could not grow indefinitely at 7%-8% or more, and perhaps there was reason to be suspect of the growth estimates. Nevertheless, there is no denying that China has grown to be the world's second-largest economy and will continue to play a larger role in global politics. Along with China's changing role, global oil supply has increased and competing market forces have caused a dramatic repricing of oil.

Overall, LNWM client portfolios have very little direct exposure to China. We are certainly impacted by the 'knock-on' effects of a slowdown in China. But we don't believe there is cause at this time to revise our positive view on the world's other major economies -- namely the U.S. and Europe. Since last quarter, we have made a few adjustments to what is already a small allocation to energy (see Commodities, page 9), and we are watching the markets closely for new opportunities that the recent volatility might present.

PERFORMANCE OF ASSET CLASSES

4th Quarter 2015 and Last 12 Months (As of Dec. 31, 2015)



SOURCE OF DATA: Morgan Stanley, Barclays Capital, Russell Indices, Bank of America Merrill Lynch, Dow Jones UBS, Bloomberg, U.S. Treasury.

All Eyes on the Fed – Liftoff to Where?

As largely anticipated, the Federal Reserve finally raised its target short-term interest rate in December, aka liftoff. Because the move was largely telegraphed by the Fed well in advance, market reaction was subdued. However, the change in stance by the Fed is significant. It marks the first rate increase since the 2008 financial crisis and puts the 'easy money' environment that investors and corporations have become accustomed to at risk.

In the past seven years, the quest for yield in a zero-rate environment has drawn investors to riskier financial assets and allowed even lower-quality corporate borrowers to easily access capital markets. For corporations with healthy balance sheets, a return to more "normal," market-driven interest rates can provide a competitive advantage and may well be a welcome change. For less-healthy corporations and some overly indebted foreign governments, a return to "normal" rates could prove to be a liftoff to a crash landing.

In 2015, market attempts to reprice assets based on "a new normal" did not end well for investors (see chart on previous page). Stocks and corporate bonds suffered as the outlook for corporate earnings growth became murkier. Municipal bonds, a big part of many LNWM client portfolios, were among 2015's top performers.

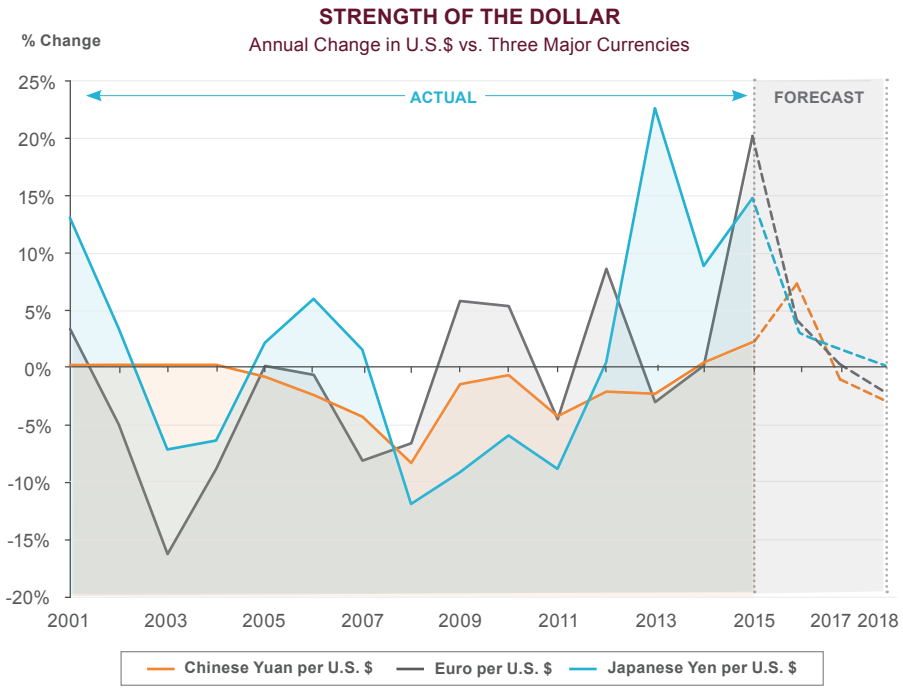
Here at LNWM, we welcome the return to more normalized monetary policy as we believe the resulting uncertainty will translate into increased volatility, which in the long run is positive for our portfolios. In the short run, we acknowledge that we may experience some continued pain. A large portion of LNWM portfolio assets are invested in actively managed funds, not in indexes that track the markets. Sustained volatility often creates discrepancies in valuations, which we think our fund managers are prepared to take advantage of.

LOOKING AHEAD

The Fed's projections call for rate increases totaling 1 percentage point during 2016, which would move the Fed funds target rate up significantly – to 1.25% from 0.25% currently. If this cycle of rate increases proceeds, it will create an environment that investors have not previously seen, in which U.S. monetary policy continues to diverge from that of other major central banks, most of which are still easing, especially in Europe and Japan.

As a result, we are focused on these two aspects of the Fed's upcoming decisions: 1) the pace of further rate increases; and 2) the level of divergence between U.S. monetary policy and the rest of the world.

The Fed's rate trajectory is far from certain. Recent weakness in manufacturing and international trade, as well as continued pressure on commodity prices all pose a challenge to growth and inflation expectations going forward and make future rate increases much less certain.



SOURCE OF DATA: U.S. Energy Information Administration.

Inflation, which the Fed is trying to pre-empt by raising interest rates, may not accelerate as expected, even as the U.S. economy continues to grow. Rate increases tend to strengthen the dollar (see previous chart), putting downward pressure on prices, especially at a time when oil is down 70% from its 2014 highs. Companies then have a harder time raising prices or gaining market share, further pressuring U.S. corporate profit growth and complicating the predicted path of interest rates. And we've not yet seen the full impact of a stronger dollar on U.S. imports, which have become cheaper in dollar terms, further suppressing inflation in 2016.

FOR Q1 AND 2016, OUR INVESTMENT DECISIONS ARE BEING DRIVEN BY FIVE KEY FACTORS:

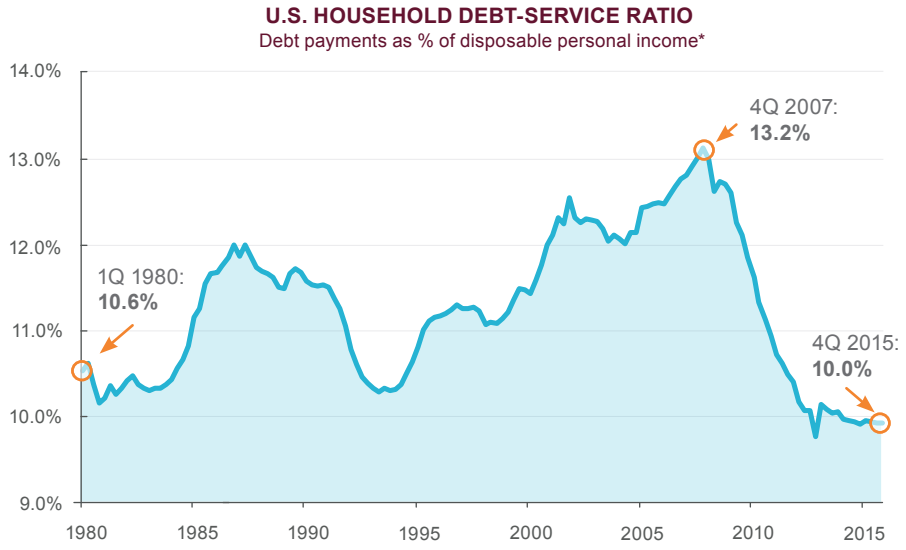
(1) The divergence in global monetary policies
(2) Oil prices and the strength of the U.S. dollar
(3) Pressures on Emerging Markets
(4) The outlook for U.S. corporate profits
(5) Credit market liquidity and the pricing of credit and high-yield debt.

In the remainder of this report, we provide specifics on how LNWM portfolios are positioned taking into consideration these factors, which we continue to monitor closely.

U.S. ECONOMY: Will American Consumers Come to the Rescue Again?

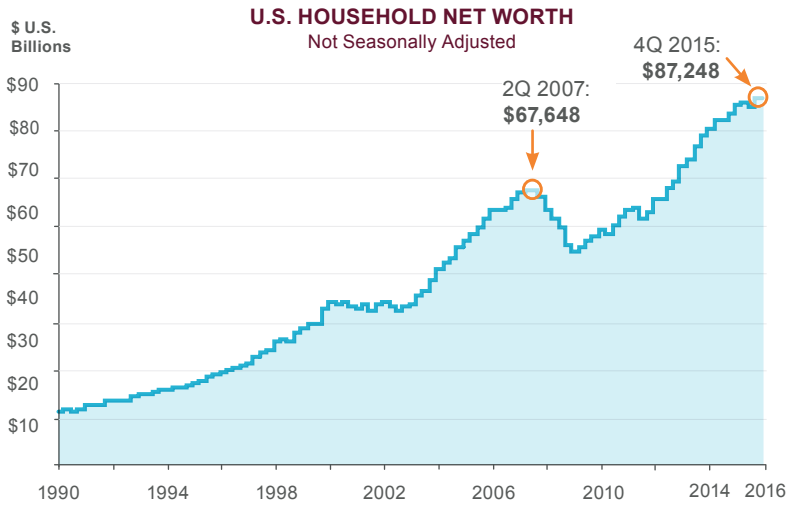
The U.S. economy continues to be the global leader, buoyed by a strong labor market and a recovery in real estate. However, we seem to be moving on two tracks. Consumer spending and employment have been strong while the manufacturing sector is struggling with a stronger dollar and high inventories. Employment growth has been healthy, although that has not resulted in wage pressures as one would expect.

Energy and mining companies, along with their many suppliers and contractors, are being negatively impacted, as expected, given the drop in energy prices and resulting layoffs and lower investment. Overall, however, we think U.S. employment continues to be robust, which we believe will help maintain consumer spending and ultimately be supportive to U.S. GDP growth, albeit at a continued moderate pace — between 1.5% and 2% in 2016.



*Seasonally Adjusted.
SOURCE OF DATA: J.P. Morgan.

U.S. household net worth is at, or near, all-time highs, and consumer spending (about 70% of U.S. GDP) remains buoyant. Household debt-service ratios have decreased (see chart) to well below historical averages, as consumers have taken advantage of low rates to refinance and pay off debt. The strong dollar, which makes imported goods cheaper, is also benefiting consumers. We think all this supports our belief that consumer spending will sustain U.S. growth in the coming year, despite continued weakness in U.S. business spending and exports.

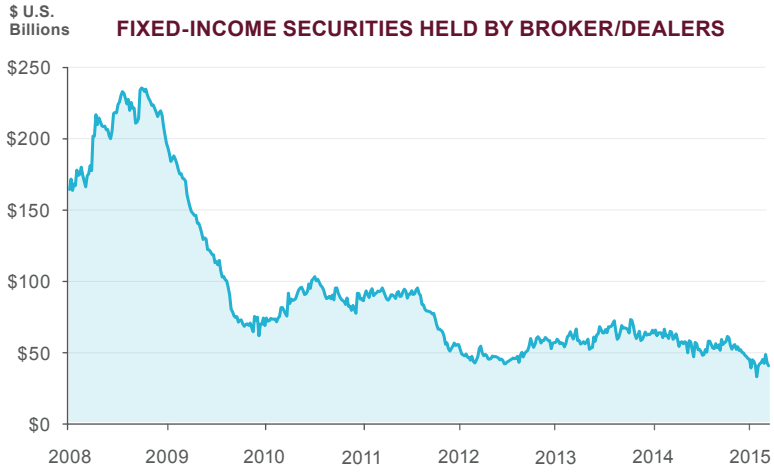


SOURCE OF DATA: J.P. Morgan.

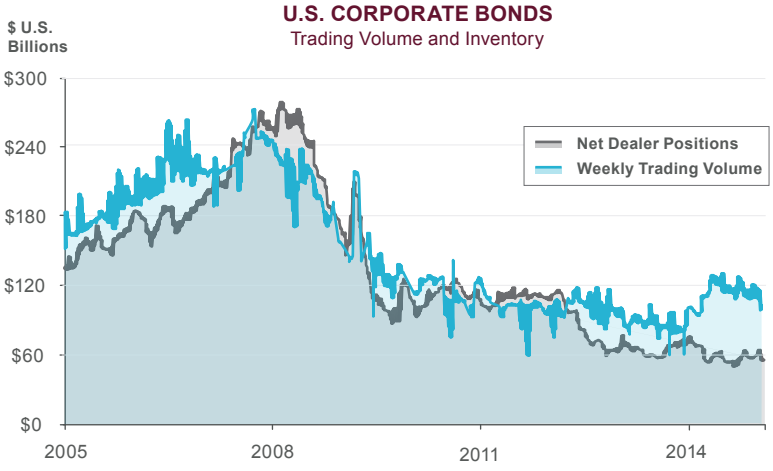
FIXED INCOME:
Liquidity and Credit Quality Are Key

The end of the "easy money" era is very much evident in the bond world. While most of LNWM's fixed-income portfolios are in investment-grade government and corporate bonds, we have a small allocation to higher-yielding debt, which has faced pricing pressure as of late. We think much of that pricing pressure is due to liquidity concerns in the bond markets, especially regarding debt rated less-than-investment grade.

The Volcker Rule and other regulatory changes in the Dodd-Frank Act (2010) changed the underpinnings of bond trading, namely broker/dealer participation. Higher capital requirements and limits on proprietary trading have severely limited the ability of traditional bond dealers, especially banks, to hold bonds in inventory in order to trade them, and thus to act as market-makers. Given the strong inflows into bond funds in the past five years, liquidity was not a concern until the flows started to ebb in late 2015.



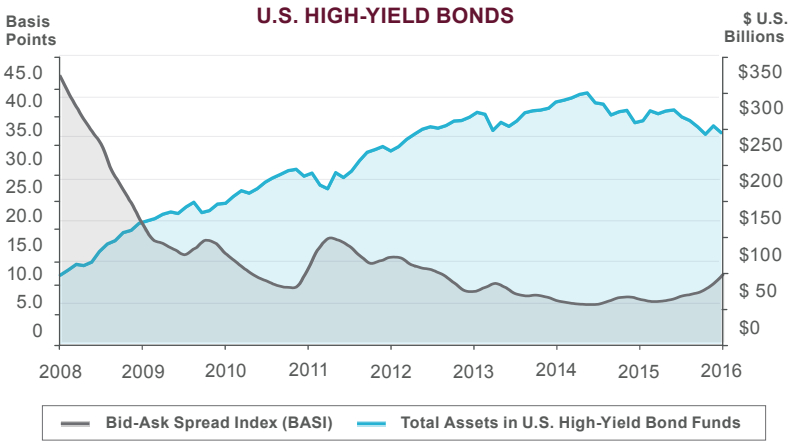
SOURCE OF DATA: MarketAxess.



SOURCE OF DATA: BIS, J.P. Morgan.

Since then, liquidity has become a more significant driver of bond pricing. Ongoing liquidity concerns, plus the prospect of additional Fed interest rate increases, will create a difficult environment for less creditworthy borrowers in 2016. Already in the past six months, yields on less-than-investment grade debt have risen dramatically and now reflect a bond default rate of above 9%. This is much higher than the actual rate of corporate bond defaults, which was about 3% recently, and just 1.5% if the energy sector is excluded.

We are seeing a decline in ownership of fixed-income securities by banks and other major broker/dealers. We think lower participation by banks has begun to manifest itself through wider bid/ask spreads (see chart), higher volatility and larger price swings during liquidity scares. This created a difficult environment for our alternative fixed-income managers in 2015, even though they outperformed the overall high-yield market.



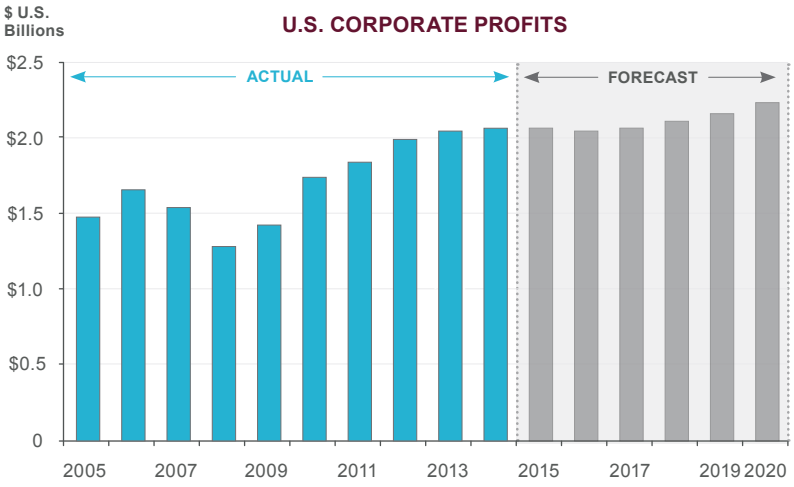
SOURCE OF DATA: MarketAxess.

In 2016, we think individual credit selection will become even more valuable. And we see this as a positive, since we think our alternative fixed-income managers have the deep expertise required to take advantage of pricing discrepancies related to credit.

We continue to think our overall fixed-income strategy makes sense. Since the fall of 2013, we have reduced the average maturity of our bond holdings and marginally lowered the credit quality as protection against potential interest rate increases. This shift in positioning was premature, and we continue to evaluate our view on rates given the low-inflation environment.

LARGE/MID-CAP U.S. EQUITIES: Positive but Slowing Growth in Revenue and Earnings

Corporate profit growth slowed in 2015, which has decreased profit estimates going forward. Further, we've yet to see the full effect of the strong dollar on U.S. corporate revenue. And U.S. stock valuations remain historically high relative to global markets, particularly relative to Europe.

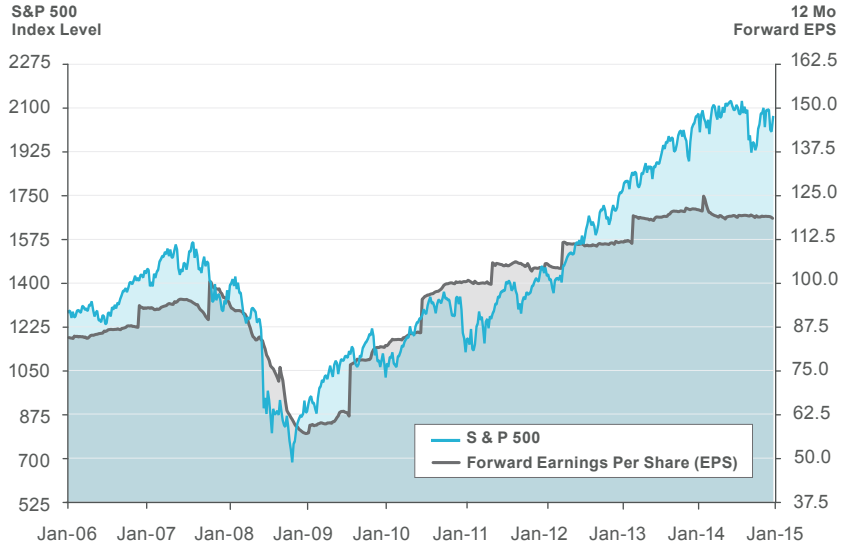


SOURCE OF DATA: Oxford Economics.

We think the key question is this: Can U.S. companies increase earnings from ongoing operations (not through share repurchases, debt refinancing or other indirect ways to enhance profitability)? Mergers and acquisitions are yet another way to boost earnings, and there were a record level of those in 2015, but at some point the actual operations of more companies will need to become more profitable through higher productivity and/or new products and markets. Q4 2015 and Q1 2016 earnings will shed some light as to how corporations are navigating the current environment.

EARNINGS vs. STOCK PRICES

Change in S&P 500 12-Month Forward Earnings Estimates vs. Change in S&P 500 Index



SOURCE OF DATA: Bloomberg.

We believe the recent price volatility in the U.S. equity market, ex-energy (which we'll discuss later) was largely driven by falling expectations for earnings and revenue growth. Nevertheless, corporate profit margins have remained stable, aside from energy, and this continues to provide support for large and mid-cap stocks. Coupled with increases in U.S. consumer spending (averaging 3% - 4% annually) this is likely to provide support for U.S. equity prices.

Therefore, on a relative basis, we continue to have a positive view of large and mid-cap U.S. stocks as we enter what is expected to be a volatile period amid concerns about higher rates, potential geopolitical disruptions and earnings. Analysts expect first-quarter 2016 corporate earnings to decline from the year-earlier quarter, and this has been largely priced in. While we don't expect rapid appreciation, we do expect positive returns, particularly on a relative basis.

SMALL-CAP STOCKS: Attractive But Relatively Less So

Historically, small-cap stocks have outperformed during Fed tightening cycles. **However, we view this cycle differently** given the divergence in global economies. As with large caps, U.S. consumer spending should continue to support incremental increases in revenue and profits, and we think the dollar's strength and downward earnings revisions are largely priced in. However, given the anticipated higher volatility and the relatively high price-to-earnings (P/E) ratio on small caps, we are not as positive on this asset class. We anticipate this will change, as pricing falls to where small-cap stocks once again sport attractive valuations. At some point in 2016, small caps may even provide us with a good buying opportunity.

INTERNATIONAL DEVELOPED EQUITIES: Improving Outlook

In our Q4 2015 Outlook, we indicated a positive view on international developed equities. Our view has strengthened, and we continue to favor this asset class. Improving fundamentals and accommodative central bank policies provide an attractive backdrop for equities, especially in the Eurozone, providing a counter to major challenges: the British referendum on EU membership, the refugee crisis, high debt levels and the threat of deflation.

A weakening Euro, low energy prices and improving corporate earnings estimates should be supportive of Eurozone corporate profits. We saw significant improvement in earnings growth throughout 2015 and expect a continuation, though likely at a slower pace, in 2016. Also supportive of European equities is the European Central Bank's recent statement that it's prepared to continue monetary stimulus through 2017.

> "If we conclude that the balance of risks to our medium-term price stability objective is skewed to the downside, we will act by using all the instruments available within our mandate."
>
> **Mario Draghi** — President, European Central Bank

In Japan, government intervention trumps macro events. The Japanese economy did manage to grow 1.5% in 2015, but this included quarters with negative GDP. As a result, the Japanese central bank stepped in with a fresh round of monetary and fiscal stimulus in mid-2015, as well as labor market reforms. Cheap oil and a weak yen are further stimuli, which should be beneficial for corporate profits.

EMERGING MARKETS: The Pressure Continues

Recent data has reintroduced warnings regarding the health of the Chinese economy and if growth can continue at the projected pace. The government stepped in recently to stabilize conditions, although we question if this is a viable long-term strategy.

In Brazil, political instability has effectively put the entire economy on hold and no near-term resolution is foreseen. Geopolitical tensions in the Middle East have increased as a result of recent events between Saudi Arabia and Iran. The combination of these developments makes the environment for emerging markets a difficult one to navigate in the coming year.

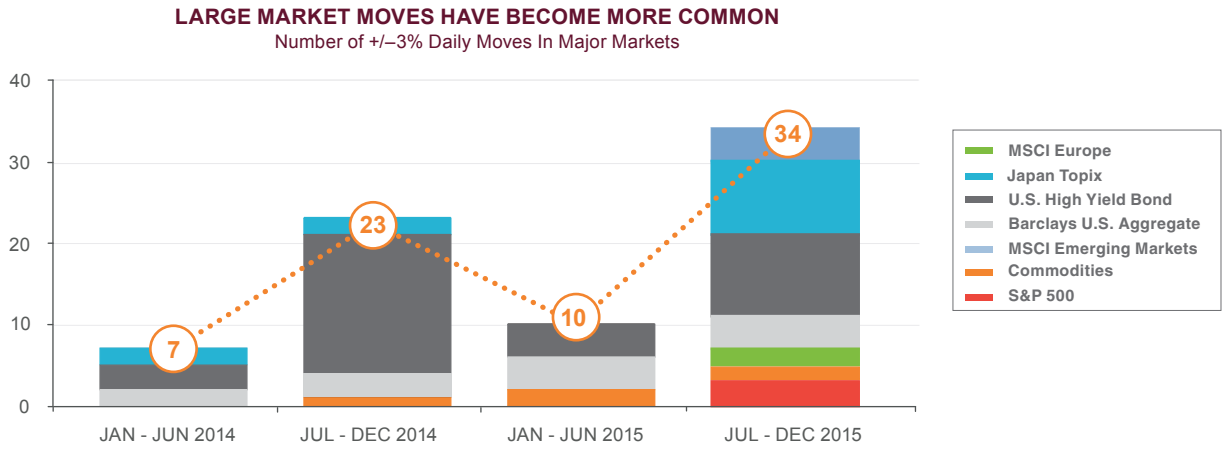
ALTERNATIVE ASSETS: Volatility Welcome

For several years, market volatility has been subdued, and hedge fund managers have remarked that the artificially low volatility has limited their opportunity. We think this is about to change.

Looking forward, we believe uncertainty across all capital markets is increasing, and this will benefit our alternative asset allocations. Generally, investors are by now well aware of the macro risks currently affecting the markets, including China's slowdown, oil and commodity price weakness, and liquidity concerns as the Federal Reserve raises interest rates.

In the coming year, we think volatility will be driven by two things: (1) changes in the macro factors mentioned above; and (2) changes in the correlation of pricing across asset categories, as we come off a stimulus-driven market (see chart below). Periods of sustained volatility tend to cause market participants to behave less rationally, leading to pricing discrepancies that hedge funds and other alternative asset managers can take advantage of in a variety of ways.

Historically, there has not been a direct relationship between rising interest rates and market volatility, since the Federal Reserve has been careful to telegraph its intentions way in advance. This time around, however, we believe there remains a great deal of uncertainty regarding the Fed's projected series of rate increases in 2016 (totaling 1 percentage point). This added uncertainty combined with the challenging macro environment provides plenty of fuel for increased volatility.



SOURCE OF DATA: Thomson Reuters, Bloomberg, CBOE, BlackRock.

LNWM's allocation to alternatives is geared to seek out alternate sources of return as well as to enhance diversification. It's interesting to note that one of the best-performing asset classes in 2015 was the Absolute Return hedge fund category (the HRFX Absolute Return Index). LNWM's Absolute Return managers underperformed the HRFX Index last year, as price correlation increased markedly toward the end of 2015, especially across currencies, equities and commodities. Our market-directional hedge funds and managed futures managers performed in line with their benchmarks.

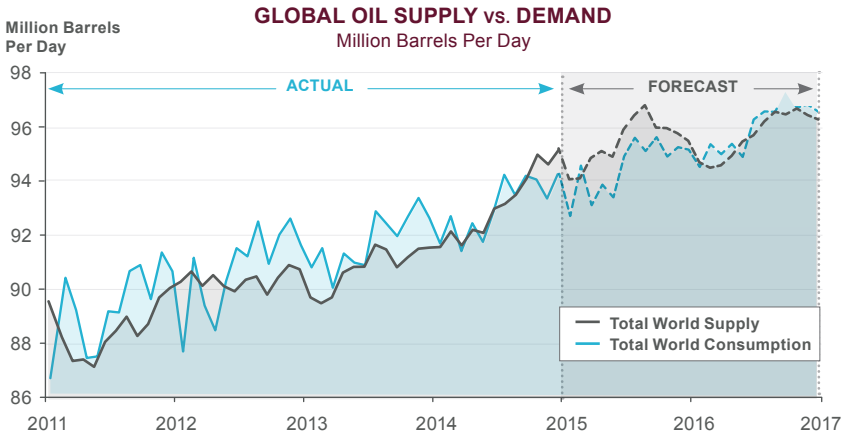
While we continue to believe that alternative assets are worthy diversifiers and return enhancers, especially during periods of sustained volatility, we are currently in the process of reviewing the allocations within our alternative assets category, as well as the managers.

COMMODITIES: Have We Seen the Bottom?

Slower growth in China and commodity prices (primarily oil) have dominated headlines and have contributed to the global repricing of risk recently. The two are intertwined as China is a very large consumer of oil and commodities generally. A slowdown in China's growth might indicate a potential decrease in demand; however, we believe this is mostly a supply-driven story.

Oil production in the Bakken region of the U.S. changed the global landscape for oil and generated a glut in supply. This, in turn, drove oil-rich Gulf nations to maintain, and in some cases increase oil production in an attempt to drive down the price and bankrupt certain producers. Global demand has continued to increase, although at a slower rate, and it certainly has not kept up with the growth in supply. Economics 101 tells us that the imbalance should cause prices to decrease, but to what level?

We think market forces are working to establish an appropriate level for oil prices and other commodities. We believe the market will find equilibrium in 2016. As a result, we are in the process of repositioning our natural resources allocation to benefit from oil price stabilization, rather than price appreciation.



SOURCE OF DATA: U.S. Energy Information Administration.

We think the repricing of oil producers is largely justified and will continue to be volatile in sympathy with the price of oil. However, the share prices of oil refineries, distilleries and pipelines are not directly tied to the price of oil – but rather to demand for oil – and yet they've also been severely impacted. Undoubtedly, there will be some negative fallout for these firms. But because growth in oil demand has remained relatively constant, there has been a bit of 'throwing the baby out with the bath water.' North American businesses that satisfy the demand for oil, such as refiners and pipelines, should benefit from oil price stabilization, and we've chosen a manager we believe is well-positioned to select securities in this space.

IN SUM

Returns in all asset categories were weak in 2015, and it seems that there was no place to hide. **For 2016, we expect a continuation of higher volatility and a relatively difficult investment environment.** Global capital markets are transitioning in many ways: U.S. markets look to be in the later stages of the post-crisis response, inching away from artificially low interest rates and the resulting low volatility; we are learning to assess a slowing China; energy supply is at extremes, changing investment plans and increasing geopolitical risks.

Fundamentals should matter more in such an environment, and the benefits of active management will accrue to investors. We think our portfolios are ready for the transition, but we also remain nimble so as to take advantage of opportunities as they arise in 2016.

ABOUT THE AUTHOR

Gino Perrina, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in Nov. 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed-Income Research at Russell Investments (2010 to 2012) and a fixed-income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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