Q3 2016
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

BREXIT AND ITS AFTERMATH

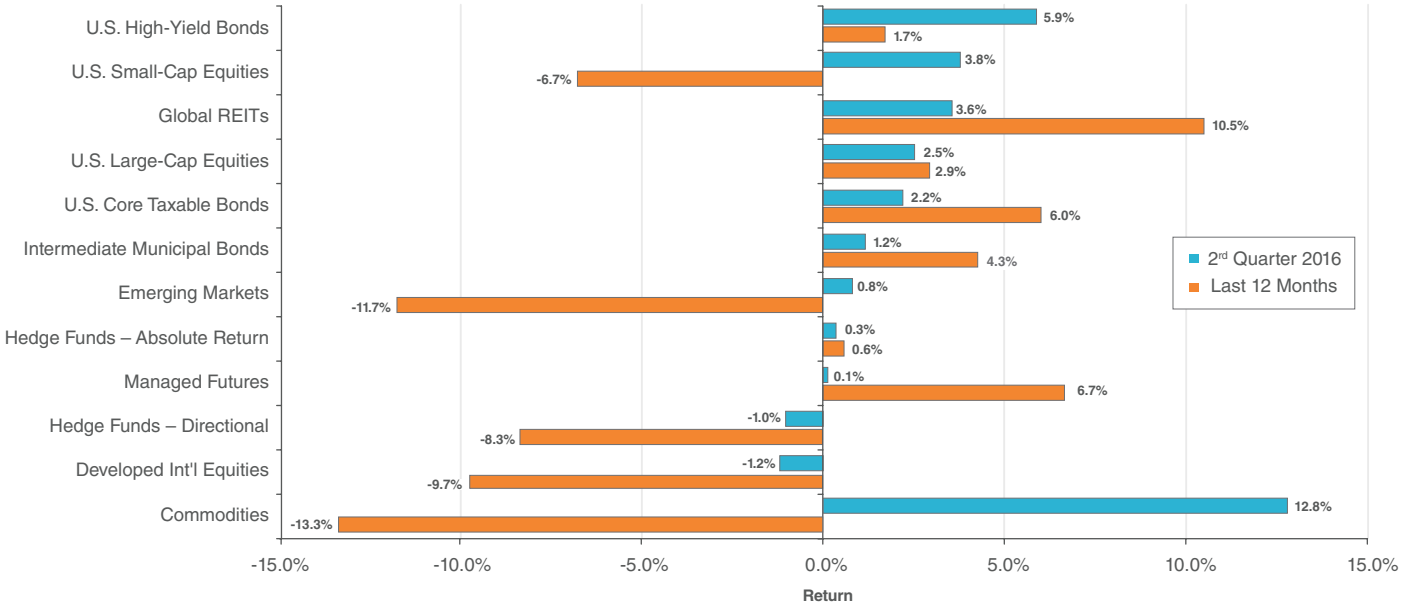
Howard Marks of Oaktree Capital Management once likened the jobs of airline pilots and investment managers. Both take a great deal of training, experience and patience to do well. In the case of airline pilots, "hours of boredom are punctuated by moments of terror." While I believe boredom is never really an appropriate term for investment management, the markets were in somewhat of a lull in the period preceding the June 23 "Brexit" vote, with volatility falling and risky assets repricing higher. Aside from a disappointing jobs report, European and US economic data were pointing toward stabilization and some growth. Capital markets were anticipating that the Fed would raise US interest rates this year and seemed poised to absorb that. Then came the vote that changed everything.

The UK voted to leave the European Union (EU), a major surprise for global markets that resulted in a very negative reaction in equities and risky assets globally. **This is an unprecedented event as no country has ever left the EU**. One day prior to the vote, odds were as high as 90% that the UK would 'Remain' and polls were definitely pointing in that direction. Once the 'Leave' vote was confirmed, European equity markets opened 10% lower, the British Pound dropped 8% relative to the US dollar and any safe haven asset such as US Treasuries and gold moved markedly higher.

While markets have largely recovered since the Brexit vote, the path forward for the EU and UK is murky. Given that markets generally don't like uncertainty, especially of this magnitude, higher volatility could well be the norm this year, as any announced agreement — or lack thereof — will be a key focus of markets. However, we think the separation will ultimately be amicable given the high level of interdependence between Britain and the EU (see chart on next page).

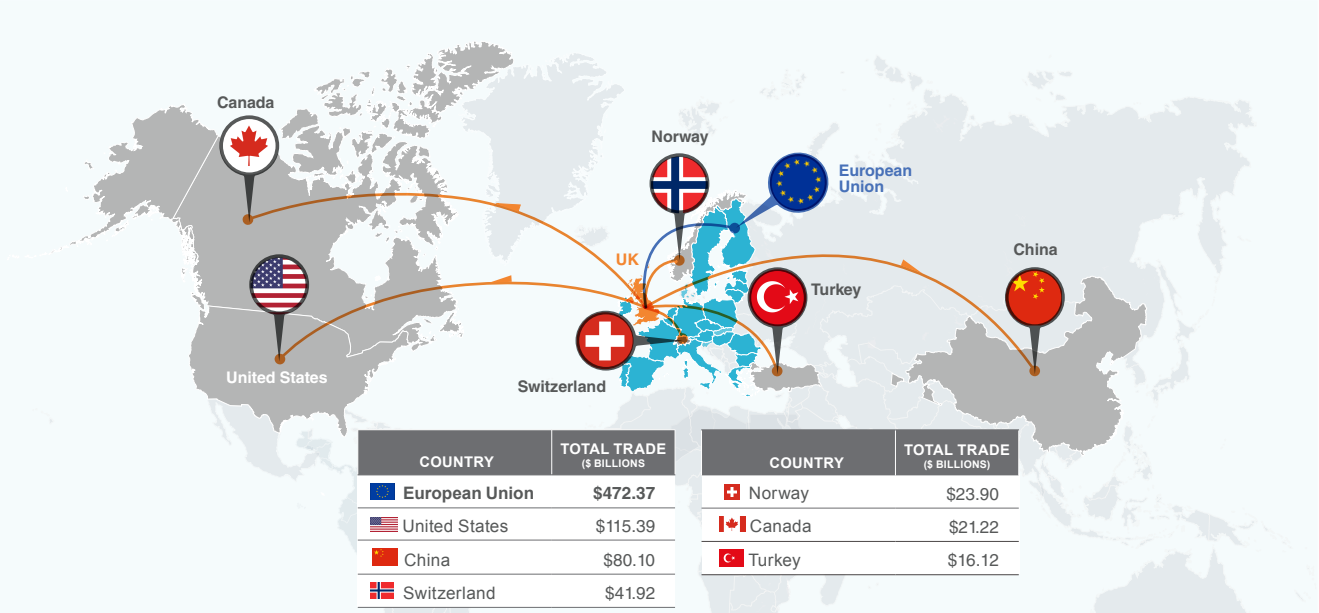
PERFORMANCE OF ASSET CLASSES: Mixed

2nd Quarter 2016 and Last 12 Months (As of June 30, 2016)



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

TOTAL ANNUAL TRADE WITH THE UK



COUNTRY	TOTAL TRADE ($ BILLIONS)
European Union	**$472.37**
United States	$115.39
China	$80.10
Switzerland	$41.92

COUNTRY	TOTAL TRADE ($ BILLIONS)
Norway	$23.90
Canada	$21.22
Turkey	$16.12

SOURCE OF DATA: IMF World Economic Outlook, Oct. 2015.

We don't believe the decision to leave the EU by the UK will have meaningful direct impact on the US economy, and we maintain our growth estimate of 2% for 2016. However, Brexit is already causing global growth estimates to fall and the US dollar to strengthen. In combination, these two things can be a drag on the US economy, especially the outlook for corporate profits. And this is why the US Federal Reserve has already indicated it will put interest rate increases on hold pending further economic data. Tellingly, in the past month, the futures market has repriced the probability of a Fed 2016 interest rate increase to near zero.

Looking out to the fall, we continue to believe that the probability of a US recession is low. However, one must assess Europe and the UK through a new lens as many economists are predicting that GDP in the UK will decline 1 to 3 percentage points — a 50% to 100+% drop, given that UK GDP grew 2.2% in 2015.

Because of the decline in the pound (a boost for UK exporters), and indications of stimulus measures by the UK central bank, we think the revised GDP estimates for the UK are probably too pessimistic. However, we acknowledge there's more potential for increased volatility particularly in European and UK markets. Uncertainty is likely to persist for some time as the UK and EU renegotiate trade agreements and UK companies assess changes to employment contracts. Finally, Brexit increases the likelihood that other countries will question their EU membership. Although we think it unlikely that a peripheral country would drop out of the EU, even the possibility of this happening will weigh on the markets for some time.

Actual Brexit Is Far Off

The UK is not out of the EU yet. For exit negotiations to even begin, Britain will have to officially invoke Article 50 of the Treaty of Lisbon. This is not likely to happen until 2017, according to Britain's new Prime Minister Theresa May. After that, two years are allowed for negotiations and the parties can agree to extend. In the meantime, delay tactics and tough talk are likely to continue adding to market uncertainty. Germany's Angela Merkel has already warned that the UK cannot 'pick and choose' which parts of the EU they want.

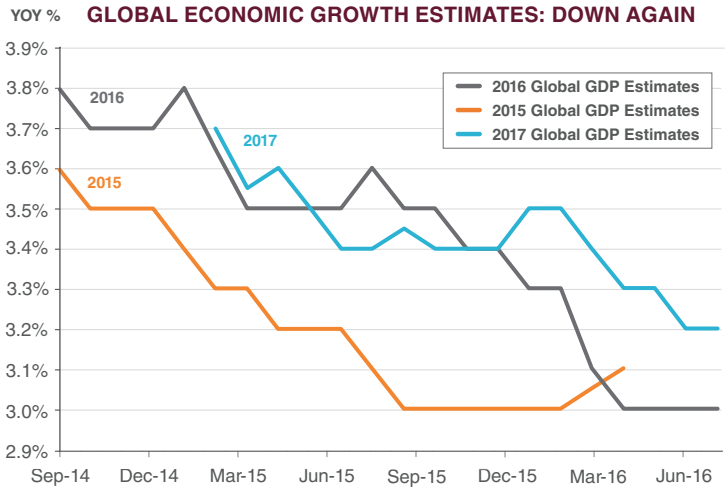
We are not making changes to LNWM portfolios due to Brexit since the effects will not be known for some time. We will, however, continue to diligently monitor the Brexit process and evaluate opportunities as they arise.

KEY CONSIDERATIONS – Revisited

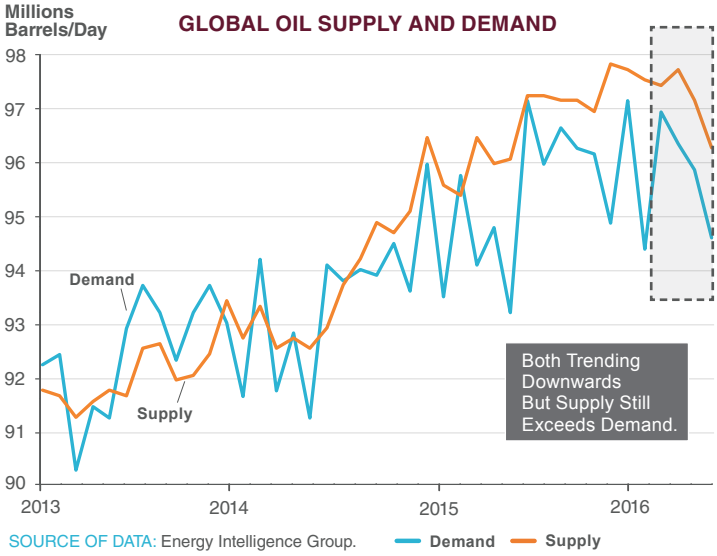
At the start of 2016, we highlighted five factors driving the markets and our investment decisions this year. At our client presentation in April, we added Brexit and the US presidential election as two additional factors of concern. Having just discussed Brexit, we'll now move on to the US presidential election.

US PRESIDENTIAL ELECTION

We now have the presumptive presidential nominees from both parties. Both candidates have somewhat unfavorable ratings — even within their own parties — suggesting voters are not thrilled with their choices. This, and the fact that more than 90% of members of Congress vote in line with their party's majority (per JPMorgan study) suggests continued polarization of American politics regardless of the outcome of the election.



SOURCE OF DATA: Bloomberg.



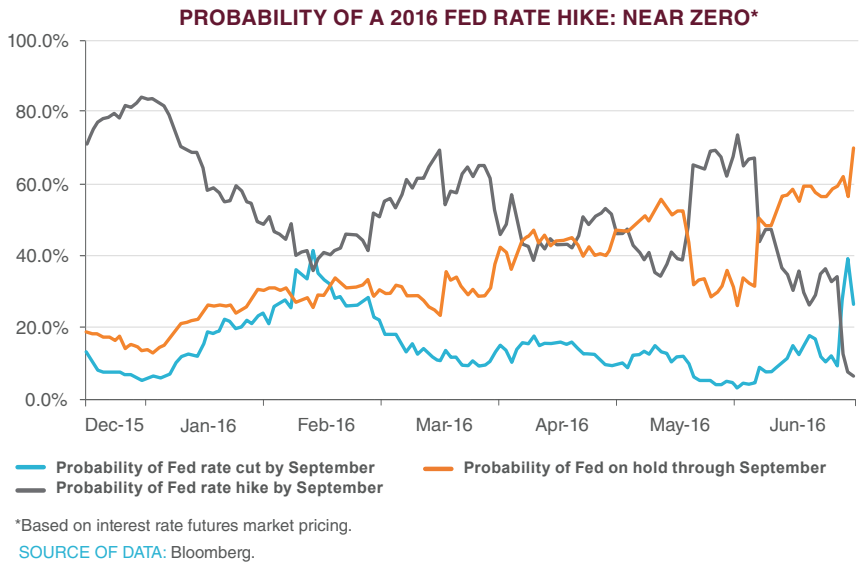
SOURCE OF DATA: Energy Intelligence Group.

What does this mean for US capital markets? Initially, not much. The US economy is growing, albeit tepidly, and central bank policy — here and abroad – remains accommodative. The marginal impact of central bank monetary policy seems to be diminishing, however, which we believe will make government (fiscal) policy more important. Should economic growth in the US slow, fiscal policy will become the focus of economic debate. The current presidential candidates happen to have very different views on fiscal policy. Regardless of who wins the White House, however, actual changes are not likely to happen until 2017. And even then, the party divide in Congress is likely to stymie major changes to existing programs.

OIL PRICES AND THE US DOLLAR

Oil prices seem to have stabilized at $45 to $50 per barrel. Global supply has begun to trend lower, but so has demand, which has kept prices stable (see chart). Because oil is mostly priced in US dollars worldwide, its price is affected by the value of the dollar, although not as much recently. The recent rise in the US dollar is having an impact on US monetary policy, however. A stronger US dollar, combined with the potential decline in global growth due to Brexit, is causing the Federal Reserve to

pause raising interest rates. In fact, the stronger dollar has had some of the same effects as the "monetary tightening" the Fed had been planning for this year. Some economists are even calling for the Fed to now lower interest rates in order to avoid recession. While we understand the argument, we don't see this as likely given the current environment.



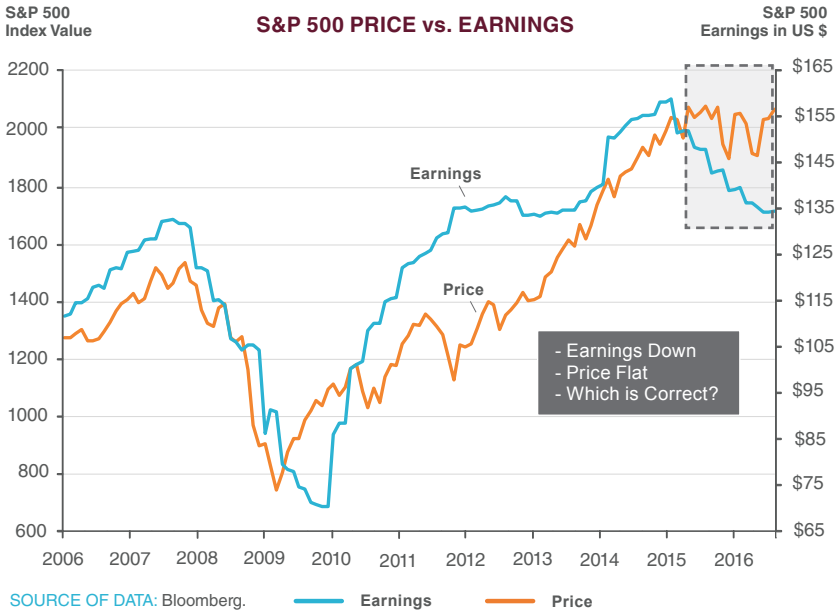
*Based on interest rate futures market pricing.

SOURCE OF DATA: Bloomberg.

EMERGING MARKETS

China remains the focus in emerging markets (EM), although it has recently become much less of a driver of volatility. Recent news that China's total debt had reached 250% of GDP had very little market impact, whereas such headlines earlier in the year would have caused EM to pull back. We think this is further evidence that capital markets are learning to price in slower growth in China.

The long-term prospects for many emerging markets remain attractive. However, we have near-term concerns about growth and debt levels, which we think will continue to drive higher volatility. Hence, we are maintaining our underweight position to emerging markets and using mainly active managers in this space, not index funds.



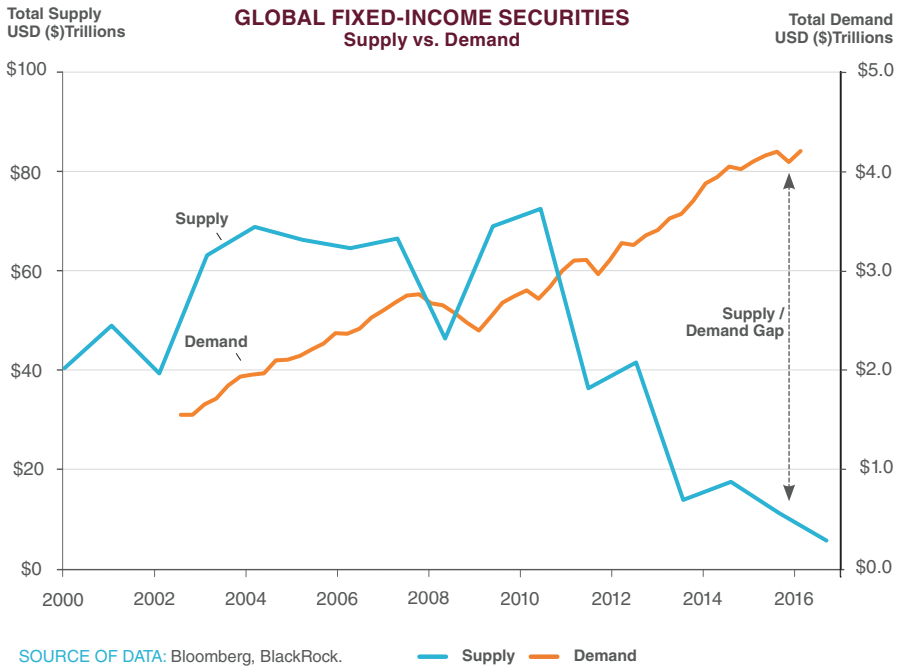
SOURCE OF DATA: Bloomberg.

US CORPORATE PROFITS

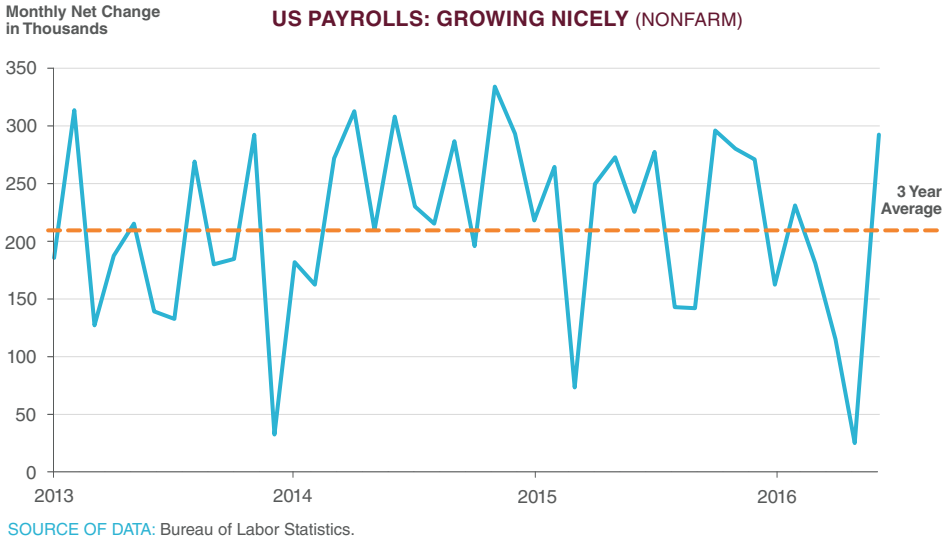
Valuations on large US stocks (the S&P 500) are near the top of their historical range — around the 90th percentile. At the same time, earnings continue to trend lower (see chart).

This divergence is cause for concern and something we've highlighted in the past. While very low interest rates are supporting today's stock prices, corporations have to ultimately "earn" their valuations via higher profits. In our Q2 2016 Outlook, we indicated that analyst estimates for 2016 earnings growth seemed too pessimistic at 2%. Given profit trends and the fallout from Brexit, we now think we may have been too optimistic. We continue to think the US economy is on solid footing and the job market is healthy (see chart on next page); however, corporate profit growth will continue to be difficult.

Credit Market Pricing and Liquidity



Brexit pushed interest rates lower worldwide, causing a renewed search for yield. We believe yields are likely to remain low because we are in a world where there is too much money chasing too few attractive investments, particularly in fixed income. This is largely a result of global monetary policy, which has resulted in record low and even negative interest rates, in an effort to stimulate economic growth. Due to central bank purchasing of government bonds (and even corporate debt in the case of the Eurozone), the global supply of fixed-income securities has not kept up with demand. In such an environment, prices can continue to rise, driving yields lower. On a relative basis, this means higher-quality corporate credit can continue to be a good source of return with minimal default risk.



Corporate bond markets (except for energy) have remained resilient and have more than recovered from the dramatic oil-driven selloff earlier this year. Corporate balance sheets are generally healthy after years of cost-cutting, restructuring and refinancing at lower interest rates. Recently, high-yield corporate bonds were paying out (on average) nearly 6.2 percentage points more than US Treasuries vs. 5.5 historically, suggesting the compensation for credit risk is reasonable. By our estimates, that 6.2-point spread prices in a default rate of 8% to 9%, which is typical during a recession, something that is not being forecast by any of the credit rating agencies or our fixed-income managers.

FIXED INCOME

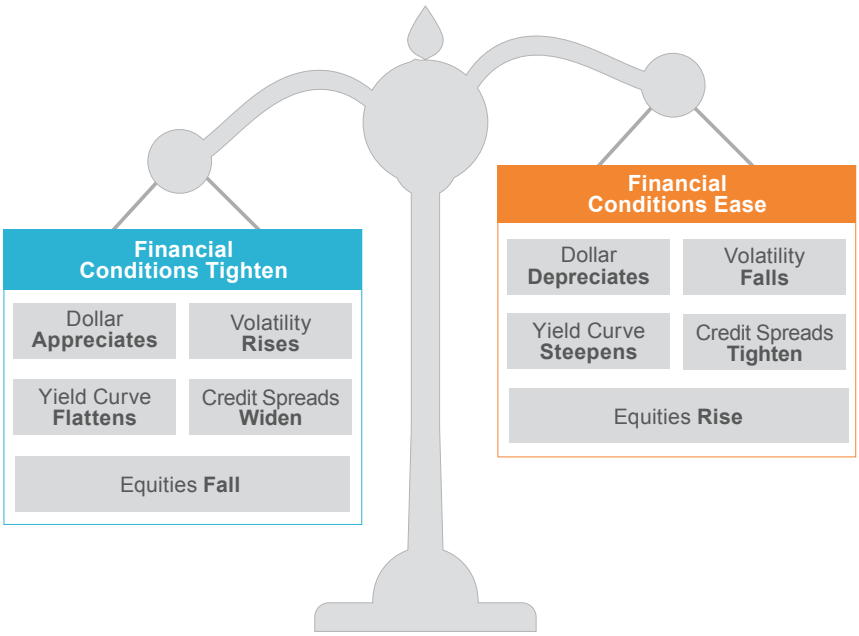
The surprise Brexit vote was the catalyst for record-low yields on US Treasuries (1.36% on the 10-year), driving up bond prices. Since then, interest rates have remained relatively low. We think this is largelydue to a flight to quality and the expectation that the Federal Reserve will not be able to raise rates this year.

LNWM portfolios, which are typically 20% to 40% in fixed-income, have benefited from the price gains in bonds, especially municipals. But we have not kept up with the fixed-income benchmarks. That's because we have deliberately maintained less exposure to interest rates (via shorter maturities) in favor of slightly higher credit risk. While our fixed-income allocation has underperformed this year, we do not think it prudent to extend maturities when interest rates are at record lows.

Whence the Fed? The Federal Reserve began 2016 by indicating its intent to raise rates up to four times in 2016. Since then, mixed job-market data, low actual inflation and events abroad (Chinese slowdown, Brexit) have caused the Fed to change its rhetoric to indicate just one rate increase, if any. We continue to think the Fed will raise rates at least once in 2016 given the relative robustness of the US economy.

FED IS REACTING TO FINANCIAL CONDITIONS

The Fed is at the mercy of the "policy balance" as financial conditions have moved from tighter to easier.



SOURCE OF DATA: BCA Research Inc, Charles Schwab.

The Fed remains in a difficult position, however. The graphic illustrates that predicament. As the Fed leaned toward tightening monetary policy last year (the left side of the scale), it was met with a stronger dollar, higher market volatility and lower projections for economic growth. To "rebalance" the scale it can't keep tightening, at least not until the looser policy effects on the right scale start to exert themselves (stable dollar, stronger growth, inflation).

Corporate credit. Within high-yield debt, floating rate loans and collateralized loan obligations (CLOs) are the most attractive on a relative basis as exposure to commodity-related issuers is limited, valuations are better and they historically perform well in rising or stable interest rate environments. However, we do think credit markets could see a pullback later this year if corporate earnings forecasts do not improve; hence, we don't think a tactical allocation to high-yield is warranted at this time.

EQUITIES

Britain's surprise decision to leave the EU rocked stock markets worldwide. Most have since recovered. But the US dollar's rise against the British pound and the euro, coupled with slower growth expectation for those economies, has continued to pressure international developed market equities, where we have an overweight.

We think the Eurozone economies, which are close to 70% of international developed market indices, can weather Brexit better than expected. Economic data for Europe through first quarter 2016 was favorable, with Eurozone GDP growth revised upwards and policy shifting away from

austerity and toward reforms. Brexit will only reinforce the importance of monetary policy, and we believe central banks in Europe will continue on their accommodative paths, which will ultimately be supportive of equities.

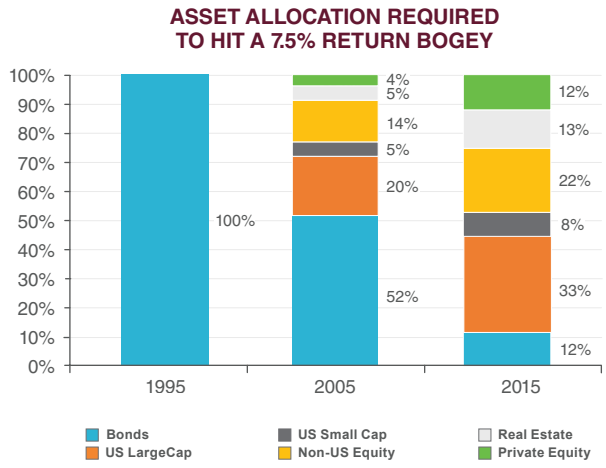
Overall, we are maintaining our developed market overweight relative to emerging markets (EM). Outperformance by EM, led by Latin America, has thus far has been driven by EM currency gains on the US dollar, which we think are not long lasting. EM fundamentals (growth, debt levels) should again become cause of concern as the year progresses.

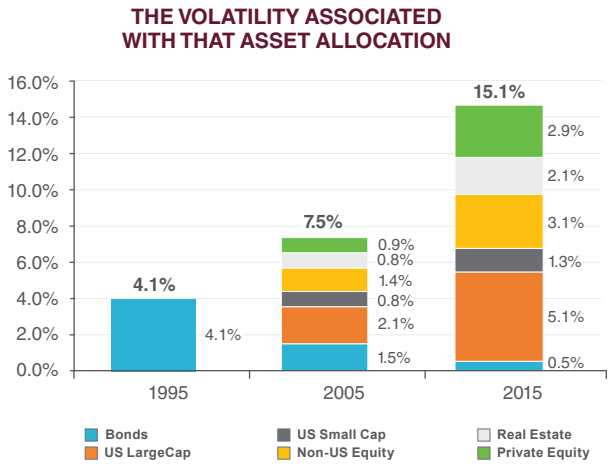
So far this year, our fund managers in both developed and emerging markets have continued to outperform their benchmarks. We made several manager changes earlier in 2016 that are proving to be very additive to portfolios.

PUTTING RETURNS INTO PERSPECTIVE

As we mentioned earlier, we find ourselves in an environment where there is too much capital chasing too few securities with attractive returns. Central bank activities, which include purchases of fixed-income instruments, have increased liquidity while reducing the volume of securities available for purchase. This has resulted in a dramatic decrease in expected returns, as investors are forced to pay higher prices, pushing yields ever lower. In our Q2 2016 Outlook, we discussed the resulting phenomenon of negative rates, which is the latest example of the impact of central bank activities.

We believe we've entered a "lower for longer" environment not only in terms of global interest rates but also overall investment returns. To put returns in perspective, take a look at the chart below. It shows the asset allocation that would have been required to get a 7.5% return based on return and volatility forecasts that would have been in effect for the years 1995, 2005 and 2015. (The forecasts used are those of BlackRock Investments, but ours would have been similar.)





SOURCE OF DATA: BlackRock.

In 1995, an investor could have invested his/her entire portfolio in bonds and achieved a great result — 7.5% return with only 4% volatility. To achieve that same return in 2015, a much higher level of volatility would have been required — 15%. That's because an investor would have had to allocate much less to fixed income (12%) and the rest to other types of investments, including alternatives such as real estate and private equity, all with much higher volatility and potentially less liquidity.

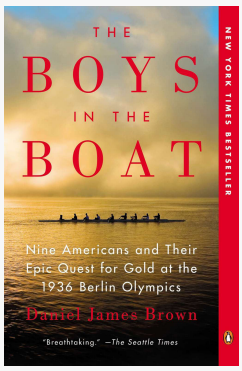
IN SUM

While there are some pockets of optimism, record-low government bond yields and expectations for tepid economic growth combine to make the outlook for returns uninspiring, while one-time events like Brexit will continue to provide both risk and opportunity.

In such an environment, investors often reach for yield and take unanticipated risks that do not manifest themselves until way into the future. We've maintained that diversification is key to avoiding unwanted risk, even as we continue to search for opportunities.

As we enter into what we think will be a more challenging time for the markets, we are confident in our current manager lineup within traditional investments. We also believe that alternatives can play an important role by providing risk reduction and access to opportunities that arise in situations such as Brexit. Our managed futures funds, for one, performed very well during the Brexit vote turmoil. As the year unfolds, we are finding some new opportunities in alternative investments, which we will share with you in the coming quarter.

On the Bookshelf of Gino Perrina



I realize I'm late to the game in finally reading *The Boys in the Boat* by Daniel James Brown. However, in August, KCTS 9 will air "The Boys of '36," an American Experience documentary about this remarkable group of young men. So now seemed like a good time to shine a new light on this fascinating book about nine Americans and their journey from the freshmen rowing team at the University of Washington to gold medalists in the 1936 Olympics in Nazi Germany.

These were mostly working class young men who were unlikely rowers given their backgrounds. Along the way to the gold medal, these boys surprisingly defeated some of the most elite programs from the eastern US and the world, and ultimately the German crew in front of Adolf Hitler. One of the boys, Joe Rantz, is the emotional center of the story as he overcomes a very difficult childhood and makes rowing his purpose and his teammates his family. Also key are Al Ulbrickson, their coach, and the renowned British boat builder George Yeoman Pocock, as they become mentors to Joe and the team.

The story of Joe Rantz is incredible in itself. However, what stood out for me was how teamwork, determination and effort translate to life. Rowing, like many things, requires an inordinate effort for very little glory. When I think about my own kids' sports, the practice to game ratio is probably something like 4:1. In rowing, it must be something like 10:1 – or higher. That coupled with 5 am practices during Seattle winters would test anybody's will.

You might ask what this book has to do with today's investment landscape. For that, I repeat something from the book attributed to George Pocock: "Harmony, balance, rhythm…There you have it. That's what life is all about." That is the great lesson from team sports – knowing your role and how to work as a team. In few other sports is synchronicity more important than rowing.

At LNWM, it's also all about synchronicity. In my group – Investment Strategy & Research – each of us plays a key role in finding the optimal asset mix for meeting clients' goals. Our core strength comes from having dedicated experts in global equities, fixed income, and alternative assets all working together as a coordinated unit. Each of our efforts must be fully aligned with the others – and then with the work of our in-house experts in estate, tax and financial planning — in order to move our clients closer to their life goals. Anything less doesn't really work well.

How well we synchronize all these moving parts is key to our success and our clients' success.

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 November 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.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under management, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 425 individuals, families, business leaders, private foundations and nonprofit organizations.

DISCLOSURE