Q4 2015
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

SLOWING TIGER: China in Context

Although August 2015 brought us the worst monthly market performance since 2011, we believe LNWM portfolios are well-prepared for this type of environment. As you may remember, we discussed the increasing likelihood of a pullback in our *Q3 Economic Outlook*. Because of our views about market volatility and risk, LNWM portfolios have been built as "all weather" vehicles capable of producing attractive relative returns over a full market cycle.

Let's examine the current situation. Most asset classes are in negative territory so far this year (see below). While market pullbacks are normal, a major new fear for many investors is that we are on the brink of a global economic downturn, driven by the slowdown in China.

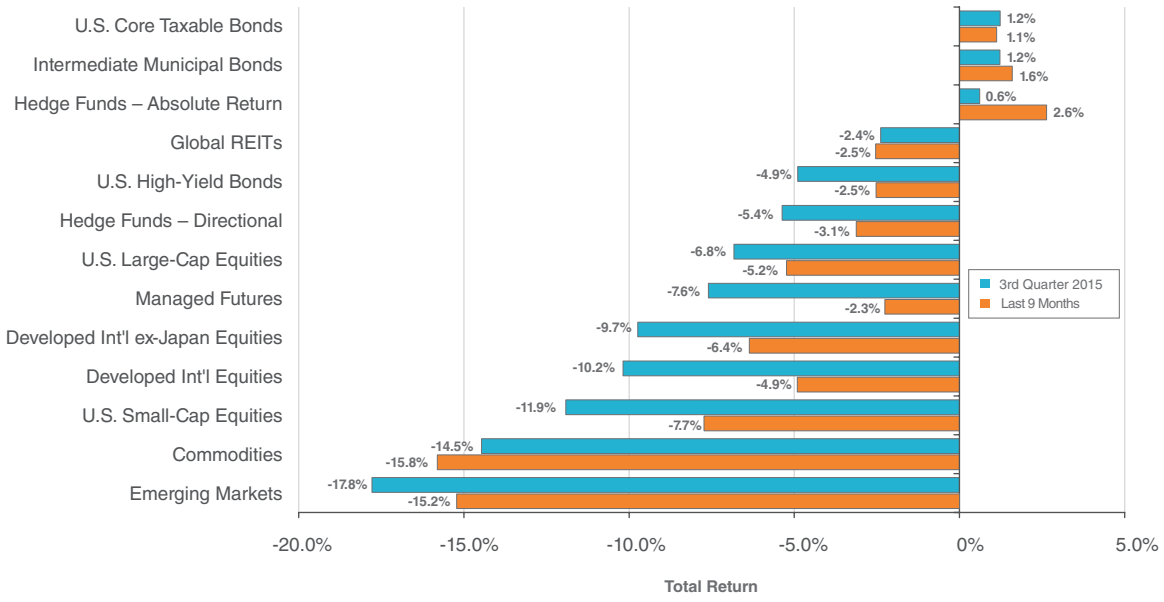
China's consistently high economic growth – averaging 10% annually for nearly 30 years – has until recently lulled most investors into thinking that this fast-growing economy is somehow immune to overcapacity, waning growth and fiscal/monetary policies that don't always work as intended. It is not. China's current slowdown is real, as we point out later in this Outlook.

Between now and year-end there are several triggers for higher market volatility, including: (1) Skepticism about whether the "Slowing Tiger" can engineer a soft landing (Chinese GDP growth of 6% to 7%); and (2) a likely interest rate increase by the Federal Reserve that will start what we think is the necessary process of weaning the U.S. economy off of zero-based interest rates, which have distorted the pricing of risk.

Due to the potential for higher near-term volatility, we have adjusted our portfolio allocations slightly, decreasing our exposure to emerging markets in favor of developed market equities. We believe developed markets are better positioned to handle the ramifications of higher interest rates in the U.S. as well as a slowdown in China.

PERFORMANCE OF ASSET CLASSES

3rd Quarter 2015 and Last 9 Months (As of September 30, 2015)



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

U.S. ECONOMY: Still a Bright Spot

In second-quarter 2015, we finally saw growth that is typical of U.S. economic recoveries – a nearly 4% annualized gain in GDP – as the economy rebounded from a bad winter out East and a port strike out West. But we don't think the 4% will last, given these two headwinds: A stronger dollar that is worsening our trade balance; U.S. business inventories that were built up to service a stronger China that must be worked down in light of weaker growth.

For all of 2015, we expect U.S. GDP growth to average 2% to 2.5%, with slightly higher growth in the 2016 election year, as the buildup in inventories is worked down.

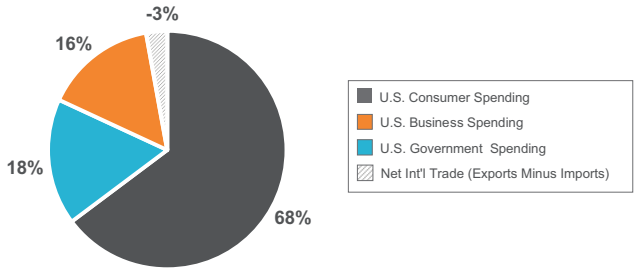
Driven mostly by consumer spending on U.S. goods and services (see pie chart), the U.S. economy is in good stead to weather a moderate slowdown in China and emerging markets. U.S. consumer confidence and spending continue to rise incrementally, buoyed by low interest rates and a rebound in real estate.

Importantly, the employment situation continues to improve. We are nearing full employment of the labor force, which is unfortunately smaller than it used to be. About 38% of work-eligible Americans ages 18 to 65 are opting not to work or look for work (vs. about 33% before the Great Recession). The silver lining: a smaller labor pool means the U.S. unemployment rate could fall below 5%, making wage increases more likely.

LARGE/MID-CAP U.S.STOCKS: 2015 Earnings Under Pressure

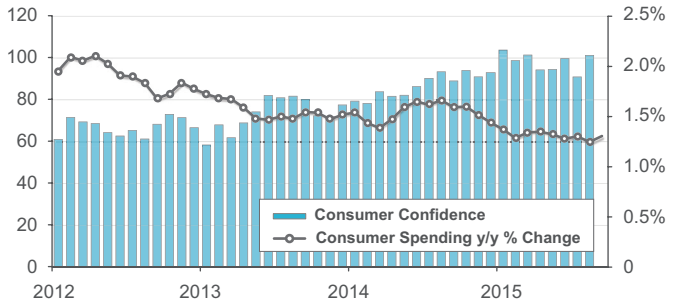
For 2015, earnings for the S&P 500 companies as a whole are expected to be flat – no higher than 2014 — as the stronger dollar and the global price drops in commodities hurt the energy sector, industrials, and the foreign operations of multinational companies. While China accounts for only about 1% of S&P 500 revenue, emerging markets as a whole bring in an estimated 25% of S&P 500 revenue.

U.S. ECONOMIC GROWTH: CONSUMER DRIVEN
As Percentage of U.S. GDP*



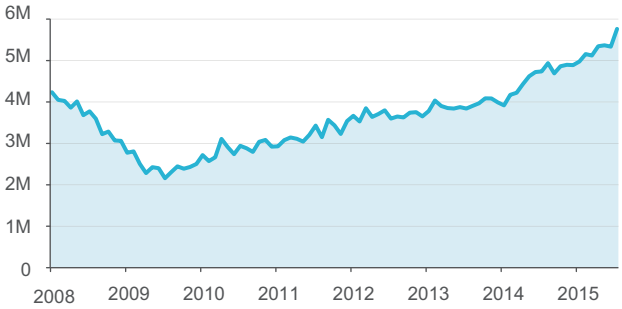
*Does not total 100% due to rounding. As of September 25, 2015.
SOURCE OF DATA: Bureau of Economic Analysis.

U.S. CONSUMER CONFIDENCE AND SPENDING



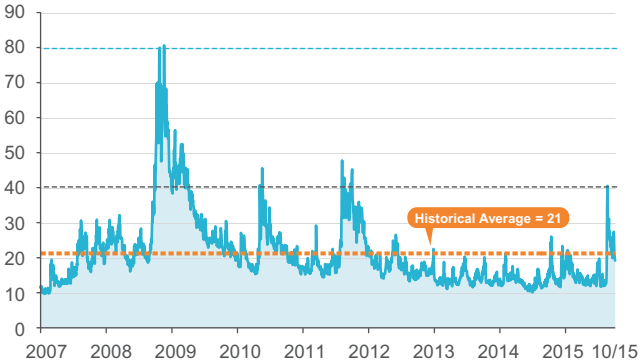
SOURCE OF DATA: Conference Board, Bureau of Economic Analysis.

U.S. JOB OPENINGS*



*Seasonally adjusted. As of September 25, 2015.
SOURCE OF DATA: Bureau of Labor Statistics.

THE S&P 500 VOLATILITY INDEX (VIX)*



*VIX reflects the pricing of stock options on the S&P 500 Index that mature within 30 days.
SOURCE OF DATA: Chicago Board of Exchange.

Near term, the outlook is worse: Third-quarter 2015 earnings are expected to be down by as much as 5% from the year-earlier quarter. If that proves true, this will be the first time since 2009 that S&P 500 earnings growth has been lower two quarters in a row.

Still, we think U.S. large-cap stocks have several things in their favor:

1. Due to the relative stabilization of the U.S. dollar and commodity prices, 2016 corporate earnings should look much better than 2015.
2. The 6% drop in the S&P 500 in the third quarter lowered P/E (price/earnings) ratios to slightly below historical averages, indicating some opportunity in large U.S. stocks beyond that of being a safer port in a storm.
3. The record number of mergers and acquisitions so far this year — $3.5 trillion in announced deals, including Anheuser-Busch buying SABMiller and Dell buying EMC – could provide a lift to corporate profit margins, now at historical highs.

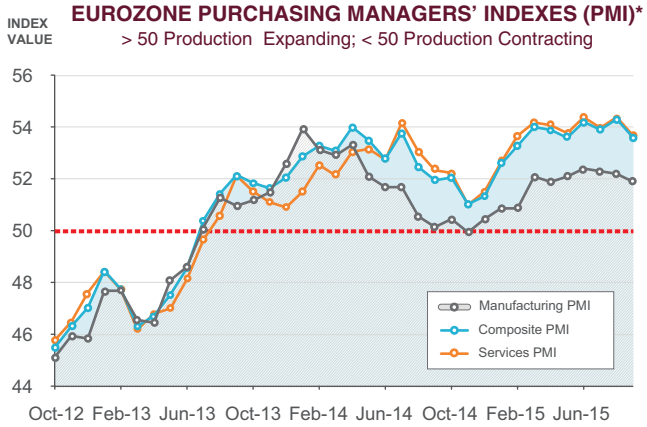
What about small U.S. stocks? They typically outperform after the Federal Reserve raises rates AND the economy continues to grow. We will certainly consider increasing our allocation to small-cap equities once we get past the initial shock of a Fed rate increase. However, with the Fed rate move still ahead of us — and U.S. small stock valuations 13% higher than their historical average — now is not the right time.

INTERNATIONAL DEVELOPED EQUITIES: Looking Better

We are becoming more positive on developed foreign markets, as stimulus programs in the Eurozone and Japan have become more targeted and are having more effect. Eurozone production activity has been strengthening and is now in expansion mode (reflected by a value over 50 on the chart).

In addition to monetary stimulus, Japan is finally implementing structural reforms – such as deregulating certain key sectors and encouraging more women to work – which are necessary for the economy to expand.

At this time, we are maintaining our slight underweight to Developed International markets primarily due to geopolitical risks in Europe (Greek debt, Syrian refugees/immigrants, Ukraine), and the potential for returns in Japan and the Eurozone to be eroded by strength in the dollar.



*Seasonally Adjusted.

SOURCE OF DATA: Bloomberg; Markit.

EMERGING MARKETS: China's Rebalancing Act

What is China's real rate of growth? That question has rattled the markets, especially since China devalued its currency by about 2% on Aug. 11, in what some saw as a desperate move to boost exports.

Instead of China's growth rate – which has always been contested – the more important question is: Can China avoid a hard landing as it reins in a government-supported borrowing binge while encouraging consumers to spend and invest more?

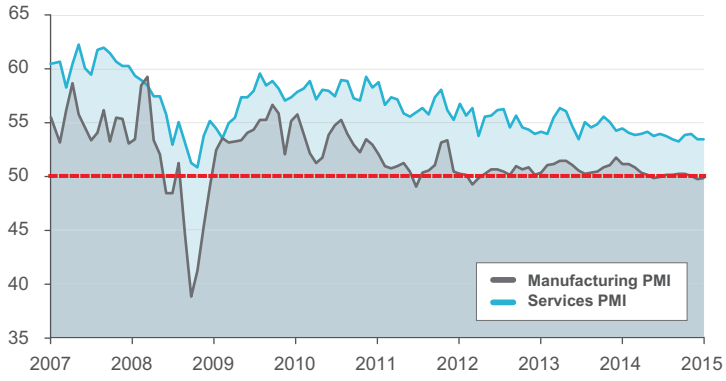
In response to the 2008 global crisis, China encouraged borrowing for investments in key industrial sectors like real estate construction and infrastructure. As a result, investment since 2009 has risen to become nearly 50% of China's GDP (from an already high 40%). This extraordinarily high level of investment has created overcapacity, diminishing returns and a drag on the economy. By contrast, Chinese consumer spending — about 33% of GDP — is rising along with wages, but not fast enough to offset the slowdown in investment.

While China's debt burden is a concern, we believe that the potential fallout can be limited. It's important to note that China's central government is not debt-encumbered (central government total debt is about 50% of GDP in China vs. 100% in the U.S.), and China has leeway to implement a variety of stimulus measures, should growth falter.

The International Monetary Fund's (IMF) latest forecast for China's 2016 growth rate is closer to 6%, not the 7% rate targeted by the Chinese government. Oxford Economics, the firm we use for economic forecasting, estimates that China is growing 5% to 6%.

CHINA'S PURCHASING MANAGERS' INDEXES (PMI)*

> 50 Production Expanding; < 50 Production Contracting



*Seasonally Adjusted.

SOURCE OF DATA: Bloomberg.

WHY THIS MATTERS

For LNWM portfolios, the concern is not so much China (where our portfolios have very little exposure), but China's effect on the rest of the emerging markets (EM), many of which rely on commodity exports to China, from timber to iron ore. As EM export earnings decline, EM growth rates are coming down. At the same time, emerging market currencies have weakened, further eroding investment returns. Finally, the Federal Reserve is poised to raise U.S. interest rates, making EM returns less attractive by comparison.

EMERGING MARKET OUTLOOK
% CHANGE IN GDP

Emerging Markets	2014 (Actual)	2015 (Estimate)	2016 (Estimate)
China	7.3%	6.8%	6.3%
India	7.3%	7.3%	7.5%
ASEAN 5 Indonesia, Malaysia,Philippines, Thailand, Vietnam	4.6%	4.6%	4.9%
Mexico	2.1%	2.3%	2.8%
Brazil	0.1%	-3.0%	-1.0%
Russia	0.6%	-3.8%	-0.6%

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

Emerging Markets are the world's growth drivers and valuations now are very attractive. However, in the near term, EM volatility is likely to continue as EM dollar-denominated returns suffer from weak local currencies and investment outflows. Nearly $400 billion has been pulled from EM funds so far this year, the most since the financial crisis of 2008. Therefore, we have lowered our recommended Emerging Markets allocation nearer to market weight, down from a slight overweight. And most of our EM exposure continues to be in actively managed funds (not EM indexes) whose managers are investing selectively and can act to limit risk.

FIXED INCOME: Ready for Rising Rates

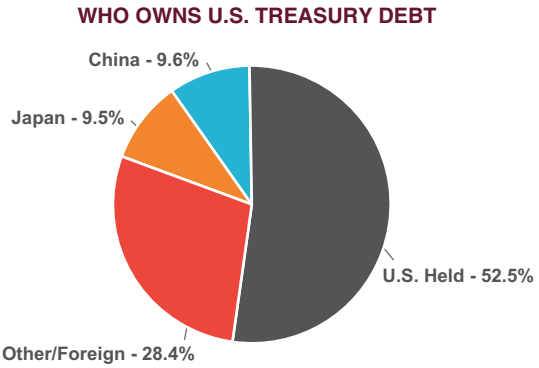
We continue to think the Federal Reserve is likely to raise interest rates soon, if not in December, given a strengthening job market and the Fed's need to maintain credibility after months (if not years) of telegraphing a rate increase.

LNWM's fixed-income strategy is geared to protect portfolios from higher interest rates through shorter maturities and slightly increased credit risk. As such, we continue to monitor credit spreads and bond market liquidity for signs of deterioration. So far, corporate balance sheets are healthy and the increase in default rates is mostly confined to the energy sector. If anything, credit risk is now more attractively priced.

SOURCE OF DATA: Merrill Lynch.

Bonds rated less-than-investment grade are now yielding an average of 7.7% — 6.2 percentage points more than Treasuries with comparable maturities. By our estimates, that 6.2 point spread is pricing in a default rate of 8% to 9% for "junk" bonds, much higher than the current 2.3% default rate.

In high-quality bonds, there's a misperception that the U.S. Treasuries market is overly dependent on China. In fact, China owns about 10% ($1.3 trillion) of total U.S. Treasury debt, nearly the same amount as Japan. Given that and demand for U.S. debt as a safe haven, we believe the market for U.S. debt will remain stable.



SOURCE OF DATA: Congressional Research Service.

COMMODITIES: Oversupply Continues

LNWM portfolios continue to have very low exposure to commodities, since an global oversupply is likely to keep pressure on prices. Our exposure is mainly in U.S. oil and gas production, where returns have generally outperformed commodity indexes, and which we think will add value in the long run.

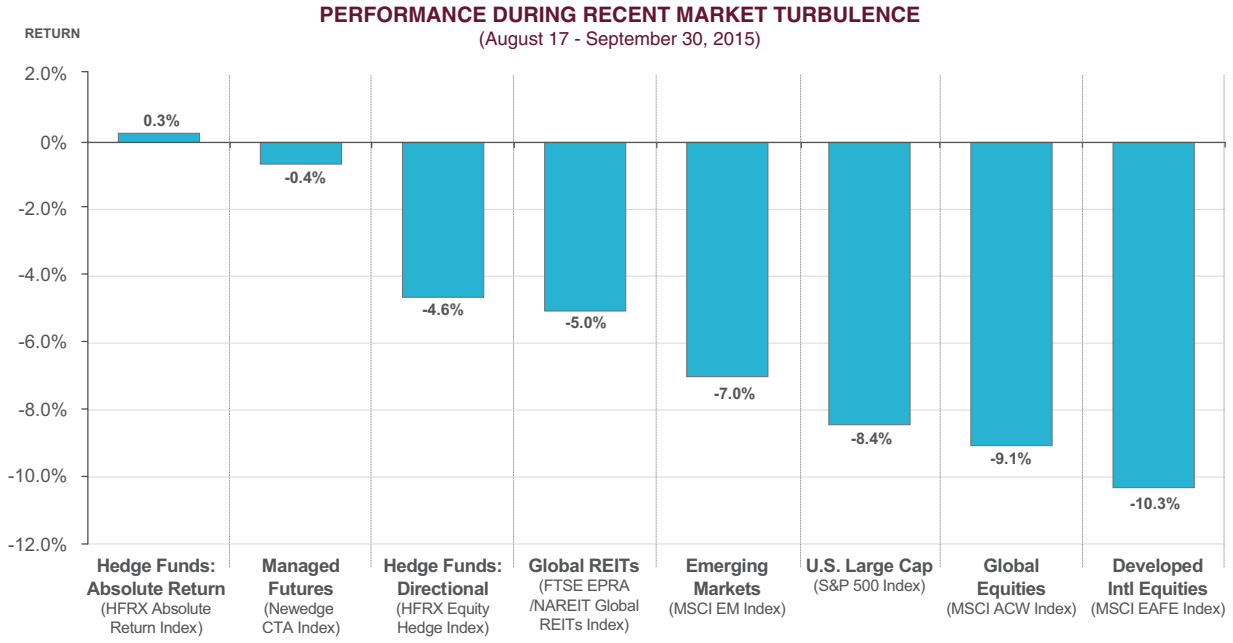
Despite the 50% drop in oil prices since last year, U.S. oil production is holding fairly steady, indicating a sector shakeout, with the lowest-cost producers upping production as others pare back.

Two recent developments are worth noting:
The lifting of the U.S. ban on oil exports – in place since the late 1970s. This seems likely in the coming year, since there's now majority support from both Republicans and Democrats in Congress. Overall, this should be a net positive for the sector and the economy.

A likely negative: Iranian oil exports coming into the world market next year, as the trade embargo is lifted. This should increase global oil supplies by about 2%, which is significant but not likely to greatly affect pricing.

ALTERNATIVE ASSETS: Worthy Diversifiers

With equities at relatively high valuations and bonds vulnerable to interest rate increases, alternative assets have the potential to improve portfolio returns by taking positions that benefit from higher volatility and/or falling prices. As the chart below shows, alternative asset indexes have held up relatively well during the recent market turmoil.



IN SUM

We think the U.S. economy can handle both a liftoff from zero-based interest rates and a moderate slowdown in China. Both of these developments are likely to increase market volatility into next year, especially since U.S. corporate earnings growth is slowing in the near term as is global growth.

Underway in the markets now is a repricing of risk, as investors move away from higher-risk assets in favor of more stability. As we said in this report's opening paragraph, LNWM portfolios are well-prepared for this type of market environment. However, we stand ready to make adjustments should we see indications of stalled growth here and abroad.

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