Q4 2016
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

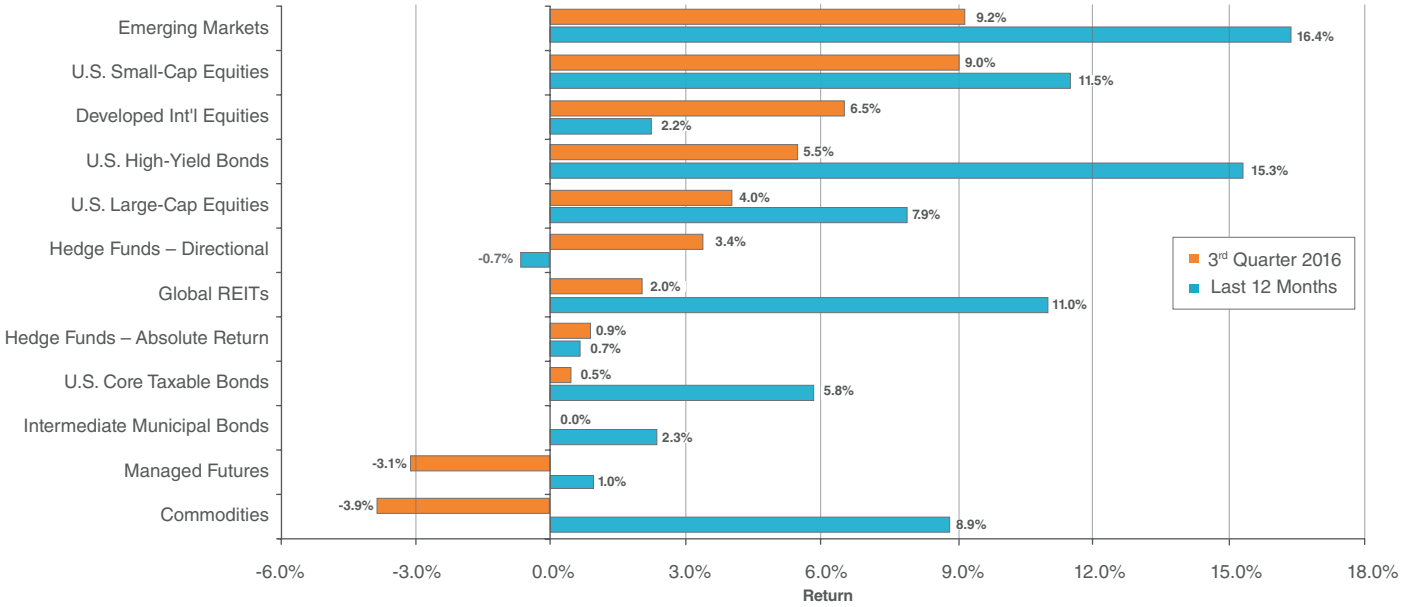
WHERE WILL GROWTH COME FROM?

Economic growth around the world is weak and getting perhaps weaker. Forecasts are for world GDP to be around 3% this year, having trended down from 5% in 2010. Yet most asset classes – from stocks and bonds to real estate – continue to perform well (see chart below). How can this be? The answer is extremely low interest rates, which have driven asset valuations higher. Currently, nearly 40% of the government bonds issued worldwide have negative yields. What this means is that investors are finding so few good places to put their money that they're willing to pay their government to hold it for them. This is unprecedented.

As we noted in the previous Outlook, we're in a low-yield environment worldwide. Even though we think the Federal Reserve is likely to raise interest rates this December, rates will remain low relative to historical levels. The US economy, according to the Fed, is likely to grow only 1.8% in 2016, about half as much as the Fed was expecting back in 2015. Asset prices cannot in the long run continue to rise without a real increase in GDP growth and corporate profit growth.

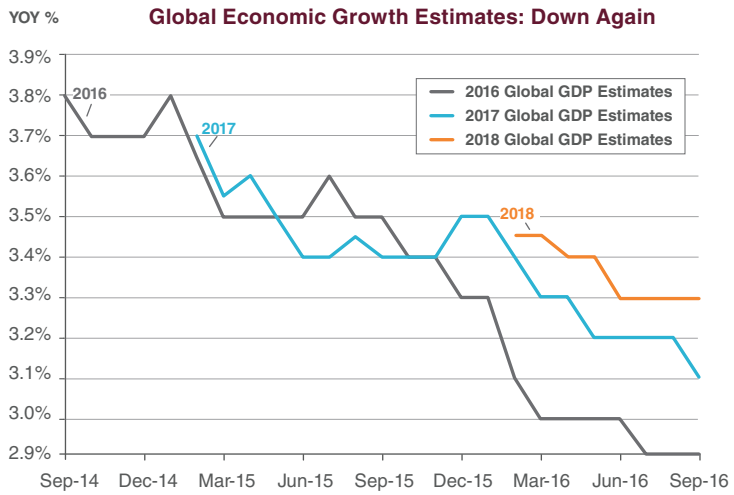
What does this mean for LNWM portfolios? Overall, we continue to be globally diversified with an emphasis in regions we think are underpriced now and offer long-term value. Our fixed income allocation is positioned for a stable credit market and higher interest rates, and our allocation to alternative assets should serve us well in a market decline. We will explore all these areas in more detail later in this report. But first let's consider the long-term driver of market performance: economic growth.

PERFORMANCE OF ASSET CLASSES: Mostly Good
3rd Quarter 2016 and Last 12 Months (As of Sept. 30, 2016)



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

What is likely to reignite growth?
Regardless of who the new US President is, the torch of economic stimulus will need to be passed from monetary policy to fiscal policy — government spending and tax policies. That's because after nearly a decade of monetary maneuvers by the Federal Reserve – very low interest rates, asset purchases, even talk therapy – the impact of monetary policy is seeing diminishing returns.



SOURCE OF DATA: Bloomberg.

Effective fiscal policy, however, requires Congressional cooperation from both sides of the aisle. Given the level of dissatisfaction with both presidential candidates, such cooperation may not materialize. Politicians may continue relying on monetary policy and its diminishing returns. Another major impediment to global growth is the growing political movement, here and abroad, in favor of trade protectionism, nationalism and isolationism.

For an update on what we think are the major risk and return drivers for the markets, please take a look at the "Key Economic Drivers" on page 3.

FIXED INCOME – Not Much Value

We expect the Federal Reserve to increase interest rates this December and then once again in 2017 should the US economy keep growing as it has been – weakly and unevenly. This should result in higher yields on short-term bonds. But long-term bond yields could stay relatively flat due to low US growth and inflation, and strong demand from foreigners. The 10-year U.S. Treasury yield of 1.8% remains quite attractive relative to the very low or negative interest rates in other developed markets.

Except for high-yield corporate bonds, we don't think the fixed income market has much return potential. In aggregate, US municipal bonds are yielding roughly 1.5% and taxable bonds about 2.0%. Meanwhile, the "earnings yield" on US equities (company earnings divided by their stock prices) currently averages 5.8% (for the Russell 1000 Index), indicating equities are a better value relative to core fixed income.

ON EVERYONE'S MIND: THE ELECTION

In the many conversations I'd had with clients, it's clear they're very concerned about the US Presidential Election. While I can't change the nominees, I can offer you our perspective on this nerve-wracking election. As Larry Summers (former US Treasury Secretary) said at a conference I recently attended, there are actually three parties in this election: Democrats, Republicans, and the media. All are incentivized to make the race seem much closer than it is, either to get voters to turn out or to generate headlines. Markets, on the other hand, hate uncertainty. And at this point, we would say that the markets are generally pricing in a Clinton victory. If that is not the outcome, we're likely to see a spike in near-term market volatility, as we did after the Brexit vote in June.

– Gino Perrina

KEY ECONOMIC DRIVERS

Global Monetary Policies

The Federal Reserve is likely to raise rates in December and remain cautious going forward, while globally central banks are easing.

Oil Prices and the US Dollar

Oil has stabilized, although recent events have moved the price above $50. The dollar has remained steady or weaker in 2016. We expect it to resume strengthening, although at a slower pace, next year.

Emerging Markets (including China)

Emerging markets have surged in the second half of 2016, on strengthening currencies and commodity prices. China performed as expected and did not suffer from a credit-fueled collapse.

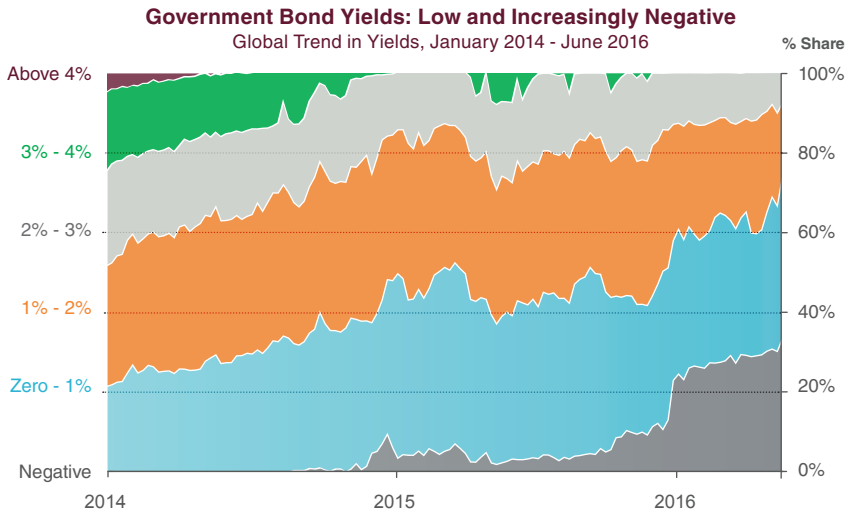
US Corporate Profits

Profit growth has stalled. Corporate balance sheets remain healthy but sources of growth remain elusive.

US Corporate Credit

Credit spreads have remained tight while interest rates have moved higher. This has led to a partial recovery in the credit side of our fixed income allocation during the second half of 2016.

High-yield corporate bonds. High-yield corporate bonds were recently yielding 4.9 percentage points more than US Treasuries with similar maturities, vs. 5.5 points historically. This suggests decent value in taking on high-yield risk, especially since most of the bond defaults are in the energy sector, and overall default rates are forecast to fall to 3% next year (from slightly above 5% this year).



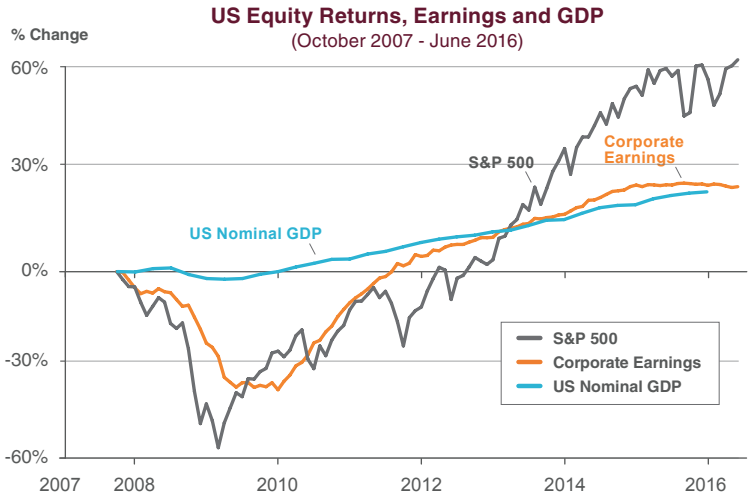
SOURCE OF DATA: BlackRock Investment Institute, J.P. Morgan and Thomson Reuters.

Credit-risk oriented strategies, which aim for higher yields and reduced interest rate risk, have struggled over the last few years. However, returns have outpaced the general bond market since February, as interest rates have risen. Within LNWM portfolios, we have "multi-strategy" managers who can benefit from credit trading strategies as well as market volatility. We continue to think they are a valuable addition to our fixed-income allocations in today's environment.

Municipal Bonds. There is a major trend now underway in the municipal market: Local and state governments are taking advantage of very low interest rates to issue bonds that can fund long overdue infrastructure projects – new roads, bridges, tunnels, school repairs, etc. In the nine months through September, we've had $334 billion in new muni bond issuance, on pace to set an annual record. Although we're not concerned about the overall creditworthiness of state and local governments at this point, the increase in supply could keep a lid on muni bond prices, despite strong demand from an aging population looking for relatively safe investments.

US LARGE-CAP EQUITIES – Neutral Stance

Typically, US equity returns in the year following a Presidential election have been very good, the only recent exception being 2001, as the technology stock bubble burst. We think such strong returns might be hard to replicate in 2017 given the already high equity valuations and global reliance on central bank monetary stimulus, which is producing diminishing returns.



SOURCE OF DATA: BlackRock Investment Institute, S&P and U.S. Bureau of Economic Analysis.

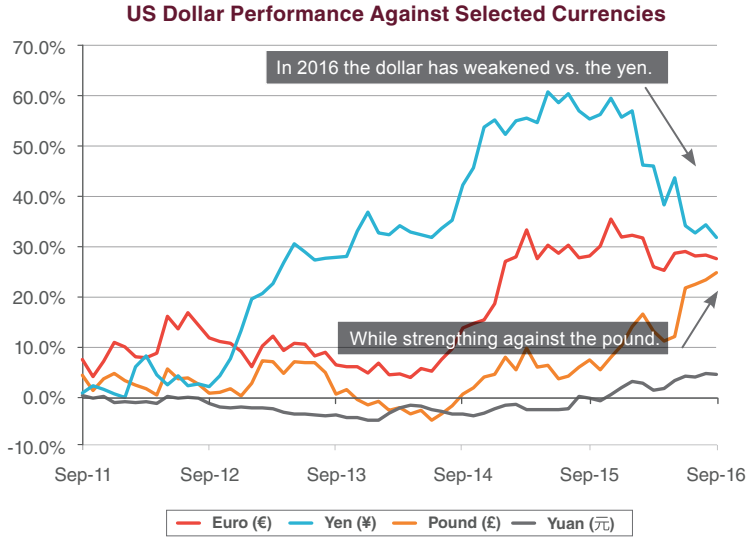
Because of valuation concerns, we have a neutral-weight in US large-capitalization equities. Currently, large US stocks are priced at 17 times what they're expected to earn in the next 12 months, vs. 15 times historically.

We think 17 times is at or near long-term intrinsic value, unless we start to see more companies posting stronger earnings growth from their operations.

Corporate Earnings. As a group, the earnings of large US companies (S&P 500) have not been growing since the middle of 2015. But it's important to note that most of the falloff in earnings has been concentrated in energy related sectors. In most other sectors, earnings (and balance sheets) are generally healthy after years of restructuring, cost-cutting and refinancing at lower interest rates. Service industries (healthcare, technology, finance) are seeing decent earnings growth (4% forecast for 2016), while manufacturing and construction are still seeing declines.

SMALL-CAP US EQUITIES – Care Warranted

Small-cap equities are pricey. As a group, they're trading at nearly 24 times their earnings forecast for the next 12 months vs. 20 times historically. Given these relatively high valuations, we have trimmed our allocation to the more aggressive strategies that focus on rapid-growth small stocks, which trade at even higher multiples – nearly 27 times earnings. We have moved the proceeds to value-oriented small stock managers. This is in addition to a manager change in June, which decreased our exposure to the smallest of small stocks (micro-caps) and tilted our portfolios toward higher-quality companies. As a result, we think we are well-positioned to outperform during volatile periods in the market while keeping pace with the small-stock benchmark over a full market cycle.



SOURCE OF DATA: Oxford Economics/Haver Analytics.

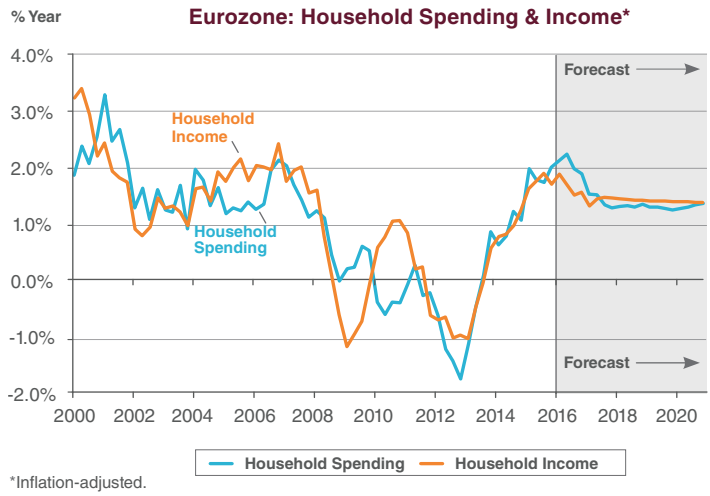
INTERNATIONAL DEVELOPED EQUITIES – Rebound Potential

Equity returns in the Eurozone, which is 67% of foreign developed markets, have been weak so far this year. That's because investors continue to fear Eurozone disintegration, prompted by Britain's vote to exit the Eurozone in June.

In July, we made the point that the interdependence between the Eurozone and the UK provides great incentive for them to find a sensible solution. However, between now and then the market jitters will continue. The big drop in the British pound recently, to a 30-year low (roughly $1.18 per British pound) is one fallout, although this is likely to help boost growth in the British economy.

Meanwhile, the Eurozone faces a bevy of political risk, given major elections in Spain and Italy by year-end, and France and Germany in 2017. This is keeping Eurozone stocks at very low valuations relative to US equities. It's important to note that Eurozone stocks are global operators, whose home markets have been a drag on profits. However, we are starting to see signs of a slow regional recovery, due to extensive monetary stimulus from the European Central Bank, low energy prices

and a weaker euro. Eurozone consumer spending is picking up, along with the job market, especially in the core countries of Germany and France.



*Inflation-adjusted.
SOURCE OF DATA: Oxford Economics/Haver Analytics.

EMERGING MARKETS – Looking Better

Emerging markets have been top performers so far this year, with China leading the group in the 3rd quarter China, which is a catalyst for growth in the emerging markets, does not seem to be heading for a hard landing, and currency and commodity prices have turned favorable. Also, emerging markets arestill attractively priced at nearly 13 times estimated earnings for the next 12 months.

Based on these developments, we are increasing our emerging markets rating to neutral. Although China is a very small part of our portfolios, it is a major growth engine for the sector. Two key things are helping China: (1) Significant depreciation in the yuan; (2) Monetary and fiscal stimulus that is keeping economic growth close to 7% annualized. So far, China's leaders have been willing to implement reforms to make the economy more consumer-driven. Risks remain, however, including the huge amount of domestic debt and potential job losses and social unrest, as China's economy is refocused on higher-growth service sectors and away from heavy industry.

Outside of China, many emerging economies have benefitted from recent weakness in the US dollar and better pricing for commodities, a key export for many, especially in Latin America and Southeast Asia. Earlier this year, we overweighted emerging market mutual funds that are likely to benefit from rising consumer spending, a major growth driver in many emerging markets. India remains a focal point as it has the highest economic growth among emerging markets.

REAL ESTATE – Good Fundamentals

Real Estate Investment Trusts (REITs) continue to deliver strong results. Currently, REITs trade slightly above their historical averages. But they also continue to post impressive earnings increases due to rising residential and commercial rents in many markets, which should help to keep valuations stable or rising, even given a US interest rate increase. In September, real estate became a separate sector in the S&P 500 for the first time. And this should help draw more money to the sector.

Our REIT managers performed well in the quarter, but lag the benchmark year-to-date. Because investors favored larger REITs in the first half of 2016, our small-cap REIT fund underperformed the benchmark. However, that strategy came roaring back in the third quarter, trouncing the index threefold. We also have a long/short REIT fund (can sell REITs short as well as buy them), which was down slightly in the quarter and remains near-flat for the year. This fund is continuing to perform well during periods of volatility, such as the first quarter of 2016.

ALTERNATIVE ASSETS – Necessary Diversifiers

Given the very strong performance of stocks and bonds since 2009, it's understandable to ask: why bother with hedge funds and other alternative assets? In fact, the relative underperformance of alternative strategies is not surprising given the nearly decade-long bull market in virtually all traditional asset classes. When security pricing is driven to a large extent by central bank policies, as it has been, the "fair value" for each specific security becomes much less predictable. Underperformance by any active management strategy, including hedge funds, is then to be expected. Eventually, however, prices do return to fair value. We continue to believe that select hedge fund managers can generate superior risk-adjusted returns over a full market cycle (including both an up and down period).

WHY HEDGE FUNDS?

Two primary tenets underlie our allocation to hedge funds:

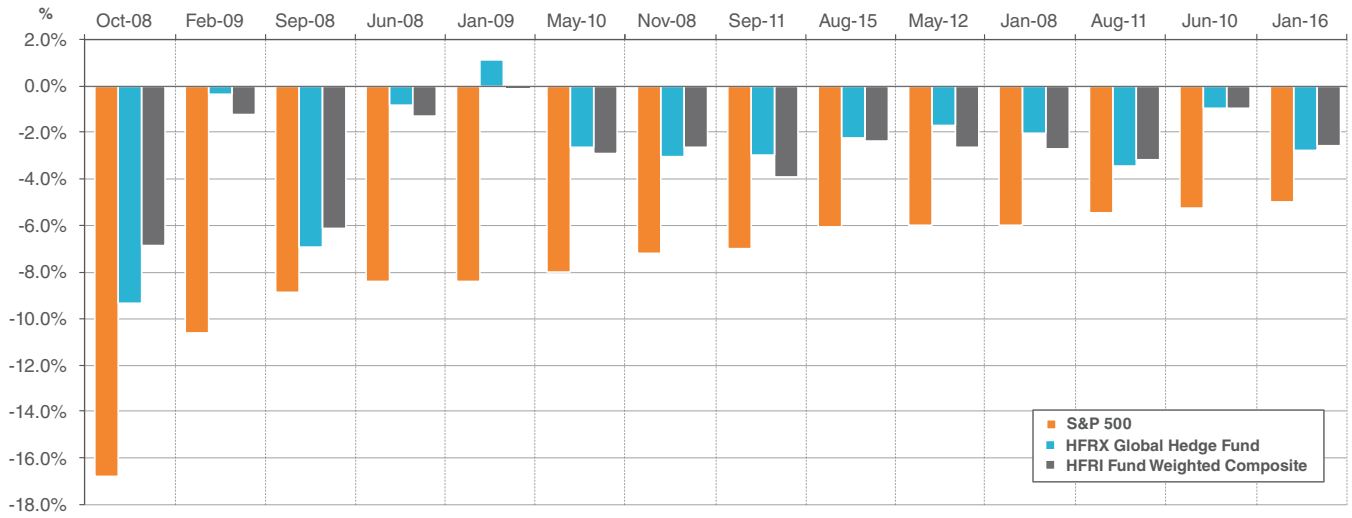
1) Markets are not perfectly efficient (prices do not always reflect all known information), particularly in the short run. It is this inefficiency that provides hedge funds with the opportunity to seek and find return drivers that are not correlated with traditional asset classes.

2) Hedge fund returns should be independent of general market returns, helping mitigate the severity of losses during market declines. During the 14 worst months since 2008 for large US stocks (the S&P 500), hedge funds in general have performed much better than the S&P (see chart).

Over the past year, we have actively sought funds that are not reliant on market direction. Protection during down markets, especially prolonged ones, is a key reason we added alternatives to LNWM client portfolios, where appropriate. Historically, this "cushioning" function has often been served by bonds and other types of fixed income in traditional portfolios. However, we continue to think that the fixed income market is itself becoming increasingly risky given the historically low level of interest rates. Hedge funds can provide results that are less correlated to both stock and bond returns, especially in down markets, because they have more tools at their disposal.

Hedge Funds Have Provided Downside Protection

Hedge Fund Performance During 14 Worst Months for S&P 500 in Last Decade



SOURCE OF DATA: Morningstar. S&P 500, HFRI Comp.

While we are not predicting a significant market downturn (we are not market timers), we do think markets are pricing in near perfection, as we are coming to the tail end of a nearly decade-long bull market for stocks and bonds. Valuations are high and the monetary policy of the Federal Reserve and other central banks is having less effect.

We believe global capital markets could see periods of higher volatility and bigger differences in the returns of the various asset classes, creating challenges for traditional asset managers. Hence, we do not believe now is the time to trim our allocation to alternatives, particularly hedge funds. However, we continue to focus our efforts on ensuring that our allocation to alternatives meets our and our clients' expectations.

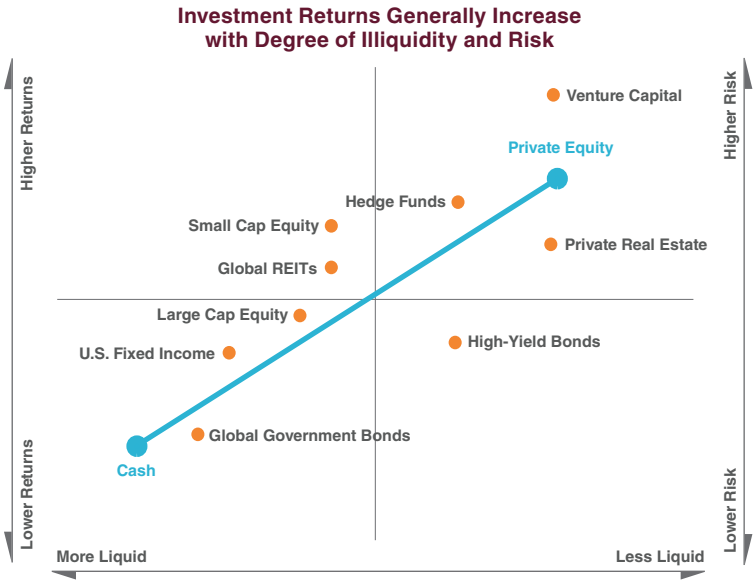
WHAT WE'RE DOING

Performance. We began the year by thoroughly reviewing our hedge fund positions and the underlying managers. Our exposure to alternatives includes a variety of vehicles. The most accessible are "liquid" hedge funds, aka "liquid alts," whose holdings are priced daily. While liquid alts have been around for many years, they gained popularity after 2010. Until this year, our exposure to liquid alts had been mostly through a "fund-of-funds" structure — publicly available mutual funds that allocate money to select hedge fund managers, each with a different strategy. The benefits: diversification and liquidity.

This year, we have made significant changes to our liquid alt holdings (70% of these have been replaced) and have largely moved away from fund-of-funds offerings. We are also reviewing the size of our overall allocation to liquid alts. The main concern is that federal regulations can limit the opportunity set for these types of hedge funds.

We also have significant exposure to limited partnerships (LPs), which are structured in a similar way (a fund that invests in a variety of hedge funds). However, LPs are not as limited as liquid alts in the types of trades they can make, and we have been much more satisfied with the performance of our LPs relative to our liquid alts.

Tax-awareness. We are now focusing not only on performance, but also on the tax-efficiency of our hedge fund allocations. Typically, hedge funds are agnostic to taxes, but once taxes are incorporated, returns for some strategies can become much less attractive. For example, gains on a quantitative equity strategy, which turns over the portfolio very frequently, will almost entirely be short-term. However, longer-term strategies that attempt to benefit from improvement in a trend (an issuer's creditworthiness, for example) can provide diversification benefits and still be tax-efficient.



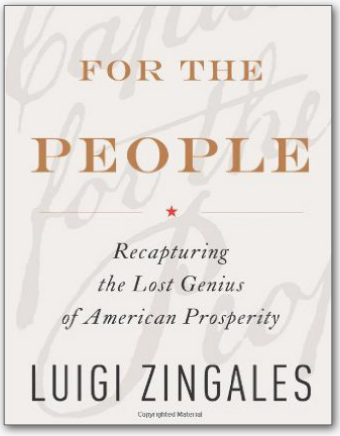
SOURCE OF DATA: Bloomberg, MSCI Barra, Ken French's website, Citigroup, Barclays Capital, JP Morgan, Bank of America Merrill Lynch, S&P GSCI, MIT-CRE, FTSE, Global Property Research, UBS, NCREIF, Hedge Fund Research, Cambridge Associates.

Reasonable fees. This year, we have moved out of higher-fee hedge funds into funds with better long-term returns and lower fees. In one case, we saved nearly 1.5 percentage points annually in fees.

Different levels of participation. There are many ways to participate in alternatives: the liquid alts and LPs mentioned earlier, but also private equity and private real estate. Each of these alternative asset strategies has its benefits and downsides, and we are seeking the best ways to invest using some or all of these categories, depending on the client portfolio.

Across the board, the key question is as follows: Is our expected return compensating us for the risk we're taking on? If not, it's time to look elsewhere. One risk that the market is compensating quite well in terms of return is "liquidity" or how easy it is to buy/sell. For those willing to keep their money invested for up to 10 years, private equity can be worth considering. Private equity funds typically invest in companies (both private and publicly traded) that have the potential to be sold at higher prices.

On the Bookshelf of Gino Perrina



Is "crony capitalism" undermining the US economy and society in general? This is the topic of a book by University of Chicago economist Luigi Zingales, *A Capitalism for the People*. Having read the book, I then attended a talk by Zingales at the University of Washington, where I am an adjunct professor of finance.

By "crony capitalism," Zingales means the cozy relationship that has developed between US politicians, Wall Street and big business. Zingales argues that what we have now is a corruption of the "free market," as Wall Street and big businesses collude with politicians, producing laws and regulations that build up and protect the already dominant.

Zingales cites many examples of rising crony capitalism in the US, which builds on arrangements that have been a fabric of our system for generations: massive farm subsidies (for the likes of ADM), financial subsidies (Fannie Mae, Freddie Mac, etc.) and corporate tax loopholes. Even the regulatory response to the 2008 crisis – the Dodd-Frank Act (2010) — Zingales thinks has fallen short in terms of benefiting US consumers and de-leveraging the banks.

I am not as pessimistic as Zingales when it comes to the overall positive impact of Dodd-Frank and other regulations since the 2008 crisis. They have made a difference in deleveraging our financial system. But I tend to agree with Zingales that cronyism is on the rise and that culturally we are becoming immune to this. As cronyism becomes widely accepted in the US, reversal becomes increasingly difficult.

So what can we do to curb crony capitalism? While Zingales has some interesting suggestions, I think their implementation would be difficult and effectiveness limited: tax on lobbying, stronger anti-trust laws and reining in corporate subsidies. I actually think Zingales' final proposal makes the most sense: widespread acknowledgment that cronyism in the US is at corrosive levels. To me, it seems we are currently on a path of ignorance and one of denial. Zingales' book serves to raise awareness during a very apt time – the US presidential election.

Regardless of who the new US President is, we're likely to see more focus on fiscal measures (government spending and tax policy) to stimulate the economy. As we noted in this Outlook, low interest rates and other types of monetary stimulus by the Federal Reserve are seeing diminishing returns. Given how the current system works, I'm concerned that a large chunk of higher government spending could turn into "crony spending."

Zingales thinks, as I do, that the success of the US economy (and our society) is based on competition, which results in new ideas and better ways of implementing those ideas. Cronyism squelches not just competition but also the opportunity to compete. And the economic results are not good. Case in point is Italy, where Zingales and I both have roots.

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.

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