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October 2016

The Final Frontier?

Market Summary

Equities

S&P 500	2168
Price / Earnings	20.4x
Dividend Yield	2.1%

US Treasury

2 Year Yield	0.8%
10 Year Yield	1.6%
30 Year Yield	2.3%

US Corporate Spreads

Investment Grade	1.4%
Speculative Grade	5.6%

Volatility

CBOE Market Volatility	13.3

US Economic Figures

Real GDP Growth (2Q16)	1.4%
Unemployment	5.0%
Inflation (Core CPI Y/Y)	2.3%
Fed Funds Rate	0.50%
3 Month LIBOR	0.85%

Commodities

Oil (Brent Crude)	$51.77
Natural Gas	$2.91
Copper ($/lb.)	$2.21
Gold ($/oz.)	$1,316

Foreign Exchange

Euro	$/€	1.12
Japanese Yen	¥/$	101
Chinese Yuan	元/$	6.67

Market summary data as of:
September 30th, 2016

Fifty years ago in September, television viewers in the US encountered a strange show about a spaceship and its crew who would explore the galaxy for new life and civilizations. Although Star Trek's original series aired for only two seasons, it continues today with six television series and thirteen movies to date. Although not Trekkies to the pointy-ear-wearing convention-going extreme, we (some of us at least) do confess to be entertained by it and its technology-enabled vison of the future.

Exhibit 1: Starfleet's Finest

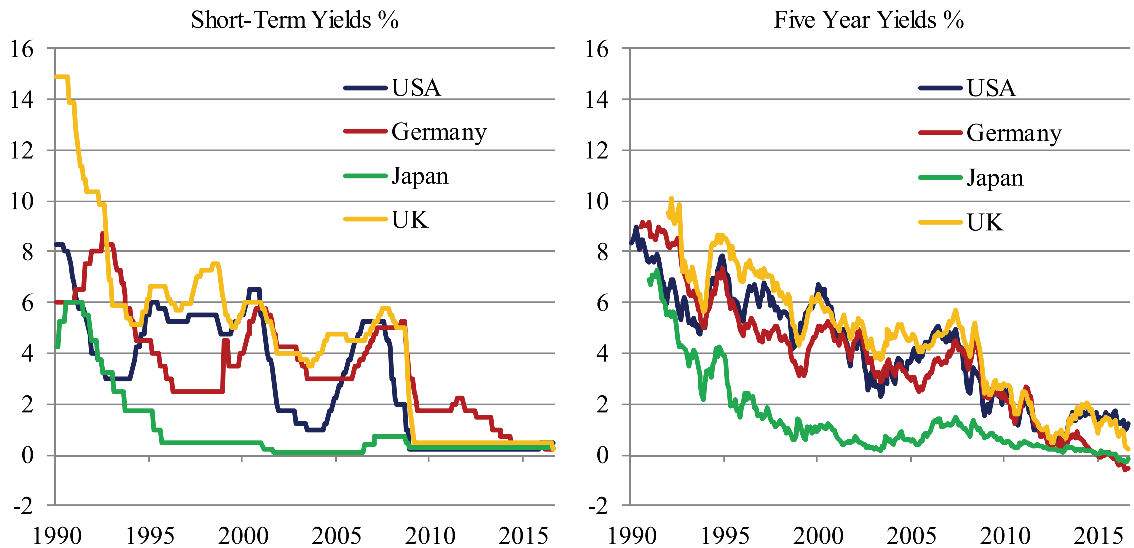
As much as science fiction special effects have evolved from tilting and shaking the camera to today's realistic-looking computer-generated visuals, a lot has changed over the last fifty years in the economy and financial markets.

A major change in recent years is the movement of interest rates to levels previously never seen. In last quarter's letter, we described how interest rates have moved below zero in many developed countries. That condition remains today, and policy makers appear committed to keeping rates below that of inflation and in some cases below zero. The Fed chairman from fifty years ago, William McChesney Martin, Jr.'s comment that

"I'm the fellow who takes away the punch bowl just when the party is getting good" stands in contrast to today governing philosophy among central bankers. Indeed, Ben Bernanke, the former Fed chairman who is intellectually aligned with current Fed chairman Yellen and advises Bank of Japan governor Kuroda, said recently that central banks should give serious thought to implementing negative interest rates and raising inflation targets.

Exhibit 2: To Boldly Go Where No Man Has Gone Before

Developed World Interest Rates: 1990-2016



While these rates were supposed to stimulate economic growth, the actual results have fallen short of theory. In an exercise of unintended consequences, maintaining low and negative rates for too long has proven counterproductive over the last seven years in the US and Europe and for nearly twenty years in Japan.

Exhibit 3: Highly Illogical

Theoretical versus Actual Effect of Negative Real Interest Rates

	Consumers	Corporations
Theoretical Effect	Savings to fund future expenses yield less. Borrowing is cheaper at lower rates. More spending and borrowing rather than saving. A faster growing economy.	Borrowing is cheaper at lower rates. More borrowing supports increased investment. Investment drives demand and productivity. A faster growing economy.
Actual Effect	Lower yields make savings less productive. Savings are less able to fund future expenses. Consumers need to accumulate more savings. Personal savings rate rises. No contribution to economic growth.	Borrowing is cheaper at lower rates. More borrowing to fund dividends and buybacks. Financial engineering for EPS growth. Higher debt levels on corporate balance sheets. No contribution to economic growth.

After seven years of policies that have inflated asset prices without helping the economy, policy makers and investors face a Catch-22 scenario. If the Fed and their counterparts continue on their present course, further misallocation of capital may limit growth in the economy and earnings, while a reversal of policy in favor of higher rates may spur higher volatility and lower financial asset prices. We see the Fed's "tighten ever so slowly" approach as deferring action as long as possible. Yet, we also believe the status quo to be unsustainable. In the past quarter, corporations such as BP, BMW, Sanofi, and Henkel have joined governments in issuing debt at a negative yield where investors pay interest to rather than receive interest from the borrowers. No, that's not a typo. We've crossed a frontier past which financial and capital theory has no working knowledge.

Outlook & Strategy

Economic growth has continued along the slow but positive trend witnessed in recent years. Consensus expectations for real GDP growth have been revised down to 1.5% in the US and 2.9% globally, and we continue to expect a "lower for longer" pace of economic expansion. Importantly, we don't consider a recession to be an immediate threat to capital markets, but will be mindful of any developments that would alter that view. Corporate earnings remain challenged, and the next round of quarterly results will likely be the sixth consecutive to show a decline. The tenor of earnings may improve modestly in 2017 as cyclical sectors recover from the worst effects of the recent oil price shock.

With a modest outlook for earnings, high historical valuations for both stocks and bonds, and unknown consequences from central bank policies, we recognize the need to be selective in how we invest client capital. Rather than blanket exposure to the market, we believe a focused portfolio can deliver attractive risk-adjusted returns.

Large cap stocks appear more attractive than the mid or small cap variety. Their valuations are not as stretched versus history, and they present attractive qualities of balance sheet strength, lower volatility, and higher yield. Large cap technology in particular fits this description, and it represents the largest sector position in client portfolios. We also see attractive relative value among international stocks and include such exposure.

Meanwhile, we will take central bankers at their word when they unanimously discuss holding rates low while letting inflation rise above their official targets. As such, we've increased client positions in gold, which we anticipate will perform well in a more volatile and inflationary environment.

Finally, we recognize that politics may have a more prominent effect on capital markets both in the fourth quarter and going forward. The current backlash against global trade ideally proves to be temporary, since it's been an important driver for long-term economic and capital markets growth.

We hope this review of the economy, capital markets, and investment strategy helps inform you on how we're investing your assets to achieve prudent risk-adjusted returns. Please contact us if you would like to discuss the outlook for capital markets and the investments of your portfolio. We would welcome your call.

Live long and prosper!

Jeff Neil Fred Austen Milena

Jeffrey E. Bernardo Neil J. Sullivan Frederick M. Blum Austen P. Cornell Milena D. Spasova

Chart 1: S&P 500 Index

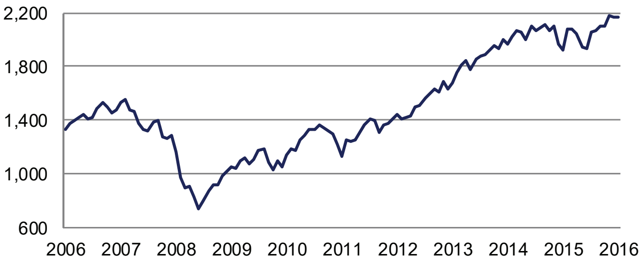


Chart 6: US Unemployment Rate %

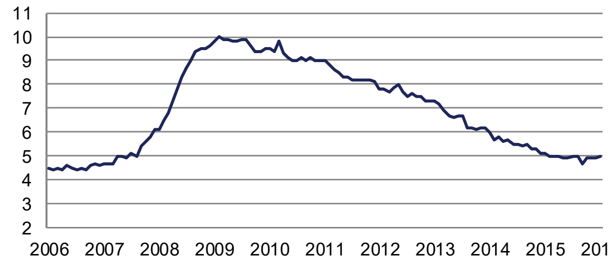


Chart 2: US Treasury 10 Year Yield %

Chart 7: US Consumer Confidence Index

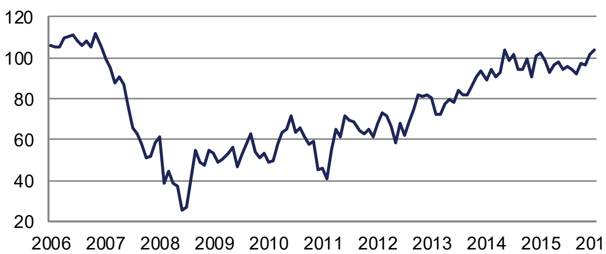


Chart 3: US Annualized GDP Growth %

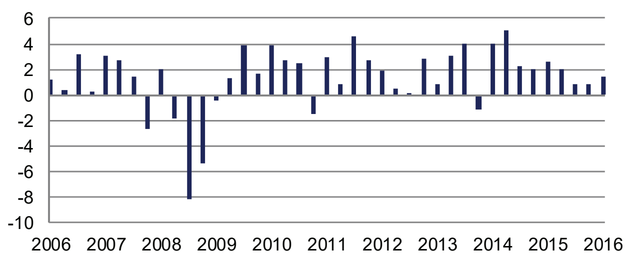


Chart 8: US Retail Sales Growth %

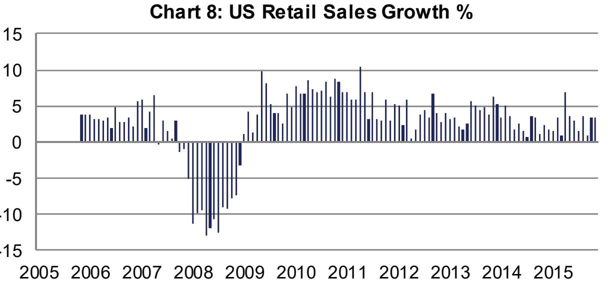


Chart 4: US Core Consumer Price Index %

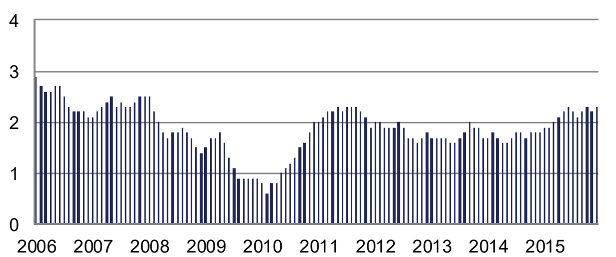


Chart 9: US ISM Manufacturing Index

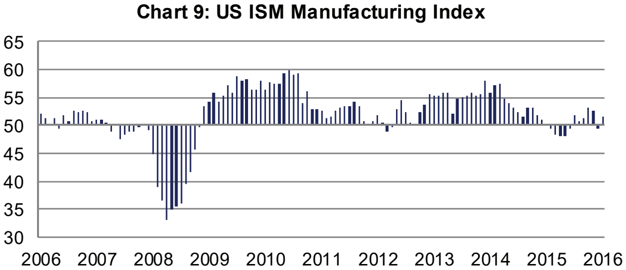


Chart 5: Trade-Weighted US Dollar Index

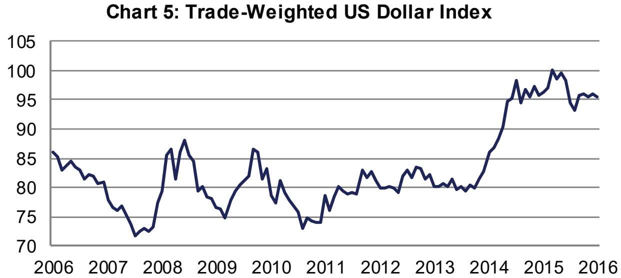


Chart 10: Conference Board Leading Index