Stembrook Asset Management

Stembrook Market Review — First Quarter 2016

The first quarter of 2016 can be told as a tale of two dramatic parts of a decidedly unremarkable whole. From the end of 2015 through February 11th, global equities were down -11.3%,[1] and oil prices fell -29.2%.[2] From February 11th through the end of the first quarter, global equities were up 13.2% and oil prices soared, rising 46.3%. Each ended the quarter up 0.4% and 3.5%, respectively. This volatility was primarily influenced by two factors, fear of continued economic slowdown in China and earnings weakness in the U.S. The precipitous fall in oil prices was driven by increased output from OPEC countries and abundant shale oil supply in the U.S. The market was able to regain its footing in the second half of the quarter as oil prices stabilized and China continued its efforts to bolster its economy.

These can be challenging times for investors, but such times can also provide opportunities for long term investors to purchase fundamentally strong assets at a discount. The type of volatility experienced in the early stage of the first quarter is not uncommon (see the center chart on the bottom of this page). Amid this volatility, stock prices remain reasonably priced, relative to their earnings. The price-to-earnings ratio is one of our most reliable metrics for forecasting long-term returns. Our proprietary models forecast returns ranging from 1% - 5% for fixed income and 4% - 12% for equities (see table to the right). We continue to favor equity over fixed income and have identified areas where prospects look most attractive. These views are outlined on the following page.

Economic Backdrop

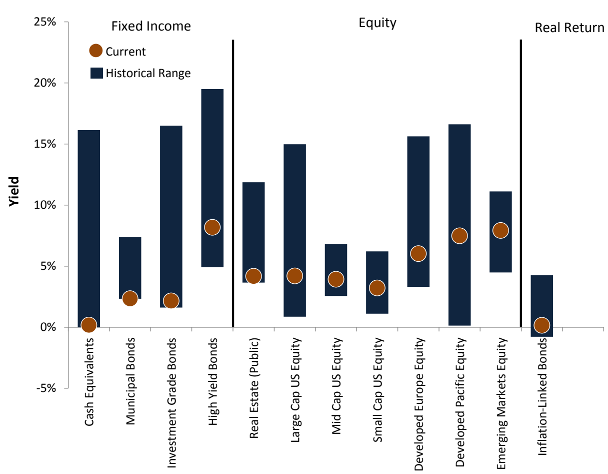
- Global GDP ticked up 1/10% to 2% for G-20 countries, still low on a historical basis.[3] Inflation slowed to 1.7% amongst the same group of nations.[4]
- U.S. GDP growth continues to plod along and is expected to expand by 1.2% in the first quarter.[3] The unemployment rate, at 5.0%, remains below its post-World War II average of 5.8%, after dropping as low as 4.9% in the first two

Expected Market Returns and Risks
7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
Inflation	1.6%	1.6%	3.1%
Cash Equivalents	0.5%	0.3%	3.3%
Municipal Bonds	2.2%	2.2%	4.4%
Inflation-Linked Bonds	1.6%	0.9%	4.7%
Investment Grade Bonds	1.9%	1.0%	6.7%
High Yield Bonds	4.6%	2.2%	13.7%
Real Estate (Public)	4.3%	2.1%	18.3%
Broad Market US Equity	9.8%	7.7%	17.5%
Developed Non-US Equity	8.9%	6.8%	22.4%
Emerging Markets Equity	11.8%	7.7%	30.6%

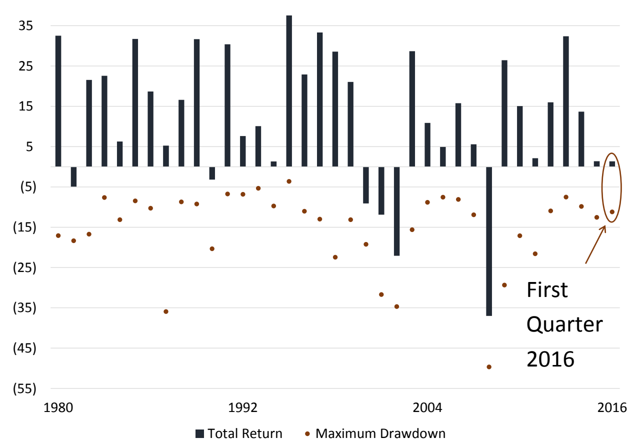
A sampling of return expectations produced by our models. These expected returns are projections and are not guaranteed.

Yields Across Asset Classes



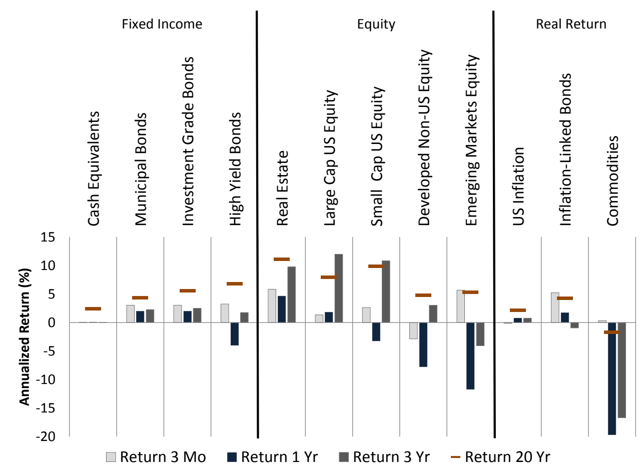
Yields are an indicator of future returns. Orange dots show current yields. Blue bars show historical ranges. Yields are generally low versus their historical range.

S&P 500 Total Returns and Drawdowns



Since 1980, the average drawdown (fall from peak to trough) for the S&P 500 has been -15.4% per calendar year, while the average total return has been +12.9%.

Historical Market Returns



Historical market returns as of March 31st, 2016. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

months of this year and is at its lowest level since April 2008.[5] The civilian labor force participation rate, a measure of the share of the working age population seeking employment, rose to 63%. Slightly above its post-World War II average of 62.9%.[6]

- Much like other global economies, the Eurozone's growth slowed to 1.4%, down -2/10% of from the fourth quarter of 2015.[3]
- Japan's economy, growing at a disappointing pace of 0.7% in the first quarter, works to shake off a weak fourth quarter, when real GDP contracted -1.1%.[3]
- The emerging market economies continue to slow, with GDP growth of 3.3%. Notable weakness was apparent in Brazil, Argentina, Russia and Taiwan; all of which contracted in the first quarter.[3] Concerns of growing weakness in the Chinese economy and its impact on its trading partners continue to loom over emerging markets.
- Consumer confidence in the U.S. was down just -0.1% over the first three months of the year, after rising by 3.5% in 2015.[7] The ISM Purchasing Managers Index rose through 51.8 in March after ending the year at 48.[8] A reading of greater than 50 represents expansion, while a reading of less than 50 indicates contraction.

Currencies

- After appreciating by 9.3% in 2015, the U.S. Dollar fell by -4.1% versus other major currencies in the first quarter of 2016.[9]

Equities

- The U.S. equity market continued to outperform developed non-U.S. markets, with the broad U.S. stock market up 1.6%,[10] versus a fall in developed non-U.S. markets of -2.9%.[11] The implementation of a negative interest rate policy and doubts about the effectiveness of Abenomics hung over the Japanese equity market which was down by 6.3% in the first quarter.[12]
- Reversing a trend of the past few years, emerging markets outperformed developed markets with returns of 5.7%, in Dollar terms, over the quarter.[13]
- The CBOE Volatility Index (VIX), a measure of fear versus complacency, ended the first quarter at a level of 14.0, just above its low, after peaking at 28.1 on February 11th.[14]

Fixed Income

- Higher bond prices caused yields across the maturity spectrum to fall, with the exception of shorter-term Treasuries.
- Credit spreads, an indicator of bond market risk perceptions, tightened. Though, concerns remain in the high yield market that energy-related issuers could have trouble meeting future debt obligations.

Commodities

- From June 2014 through the end of 2015, WTI crude oil prices fell by -64.9%. Prices rebounded by 3.5% in the first quarter, after a tumultuous start to the year.[15]
- As rig counts continue to fall, supply will decrease and prices will rise to equilibrium. Although, the timing of such a rise is highly unpredictable.

Current Positioning

- We added to our **commodity and equity positions** using accumulated cash, in mid-late January.
- We remain invested in **lower priced, value-oriented equities**, which tend to outperform the broad market over time.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Small Cap US Equity	Small Cap 6.6%	Real Estate 36.0%	EM Eq 39.8%	Inv Grd Bnd 5.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%
Large Cap US Equity	S&P 500 6.1%	EM Eq 32.6%	Commod 16.2%	CPI 0.1%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%
Real Estate (Public)	Real Estate 5.9%	Intl Eq 26.3%	Infl-Indx Bnd 11.6%	Infl-Indx Bnd -1.2%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%
High Yield Bonds	HY Bnd 5.6%	S&P 500 15.8%	Intl Eq 11.2%	HY Bnd -26.2%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%
Investment Grade Bonds	Inv Grd Bnd 3.7%	Small Cap 15.1%	Inv Grd Bnd 7.0%	Small Cap -31.1%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%
Inflation-Linked Bonds	Infl-Indx Bnd 3.3%	HY Bnd 11.6%	S&P 500 5.5%	Commod -35.6%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%
Emerging Markets Equity	EM Eq 3.2%	Inv Grd Bnd 4.3%	CPI 4.1%	S&P 500 -37.0%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%
Developed Non-US Equity	Intl Eq 2.6%	CPI 2.5%	HY Bnd 2.2%	Real Estate -39.2%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%
Inflation	CPI 1.6%	Commod 2.1%	Small Cap -0.3%	Intl Eq -43.4%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%
Commodities	Commod -5.4%	Infl-Indx Bnd 0.4%	Real Estate -17.6%	EM Eq -53.2%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

- We remain **overweight U.S. Equities.**
- We maintain our **overweight position in Non-U.S. Equities.**
- We maintain our **overweight allocation to Japanese Equities**, given continued monetary stimulus, ongoing structural reforms and attractive relative valuations.
- We remain **overweight Emerging Market Equities**, where valuations and long-term growth potential remain attractive, though near-term headwinds are all too clear.
- We remain **overweight Municipal Bonds** for taxable **and** tax-deferred investors, as prospective returns relative to other fixed income sectors remain attractive.
- Given our significant concerns regarding a longer-term, secular rise in interest rates, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries** and investing in **Corporate Bonds, High Yield Bonds and Floating Rate Bonds**.

We continue to focus our efforts on helping you meet your financial objectives. We accomplish this by following our disciplined investment approach, which incorporates fundamental valuations, time-tested return and risk models and tax-efficient strategies. This investment discipline is tailored to each client's individual situation in order to craft a customized solution.

As always, I thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA

Endnotes and Sources:

Text:

(1) Bloomberg: MSCI ACWI Total Return.
(2) Bloomberg: West Texas Intermediate Spot Prices.
(3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated in to USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 3/31/16.
(4) Bloomberg, Stembrook Research: Inflation data as of 3/31/16. Aggregate statistics are weighted by each country's GDP translated in to USD.
(5) Bureau of Labor Statistics: Total unemployed as a percentage of the civilian labor force (U3), as of 3/31/16.
(6) Bureau of Labor Statistics: Civilian Labor Force Participation Rate, as of 3/31/16.
(7) Bloomberg: Conference Board Consumer Confidence Index 12/31/14 - 12/31/15, 12/31/15 - 3/31/16.
(8) Bloomberg: Institute for Supply Management Manufacturing Purchasing Mangers Index, as of 3/31/16. A reading of greater than 50 represents expansion in positive sentiment amongst purchasing managers, while a reading of less than 50 indicates contraction.
(9) Bloomberg: Dollar Index 12/31/14 - 12/31/15, 12/31/15 - 3/31/16.
(10) Bloomberg: The S&P Composite 1500 combines three leading indices, the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600 to cover approximately 90% of the U.S. market capitalization.
(11) Bloomberg: MSCI Europe, Australia, Far East Total Return Index.
(12) Bloomberg: MSCI Japan Total Return Index.
(13) Bloomberg: MSCI Emerging Markets Total Return Index.
(14) Bloomberg: CBOE Volatility Index (VIX).
(15) Bloomberg: West Texas Intermediate Spot Prices 12/31/14 - 12/31/15, 12/31/15 - 3/31/16.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 3/31/16.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 3/31/16.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank.

S&P 500 Total Returns and Drawdowns: As of 3/31/16.
Source: Bloomberg. Standard and Poors 500. Drawdowns are measured the price change of the S&P 500 index from its highest point (peak) to its lowest point (trough) over each calendar year beginning in 1980. Total returns are calculated on a calendar year basis every year from 1980-2015.

Historical Market Returns:
Source: Bloomberg, Stembrook Research.
Indices: BofA Merrill Lynch 0 to 3 Month US Treasury Bill Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Consumer Price Index – US, S&P 10 Year US TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns:
Source: Bloomberg, Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index Barclays Capital Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.