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2Q 2016 INVESTMENT LETTER:
Globally Coordinated "Jawboning"

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Globally coordinated "jawboning" – the issuance of communiqués by governments and central banks to influence markets – seems to have successfully dampened the recent market volatility. The year began with turmoil and worsened in February as oil prices dropped sharply, yet by the end of March a sense of normalcy returned to the markets. In the U.S., the Fed helped to moderate interest rate expectations and perhaps allayed some of the fear that an overzealous FOMC may overshoot in its attempt to stave off the threat of inflation. Economic statistics have shown timid growth, and there are indications that market volatility may be affecting that growth through two avenues: first, by slowing business investment, and second by stifling consumer spending, which has been one of the few highlights in an otherwise tepid recovery underway in the U.S. since the end of the Great Recession.

The Fed's dovish signaling has been important to this stabilization. Chairman Yellen highlighted the benefits of effective communication to the markets regarding the trajectory of future Fed interest rate hikes in a recent speech: “Financial market participants appear to recognize the FOMC’s data-dependent approach because incoming data surprises typically induce changes in market expectations about the likely future path of policy, resulting in movements in bond yields that act to buffer the economy from shocks. This mechanism serves as an important ‘automatic stabilizer’ for the economy.”

Certainly, factors beyond jawboning have had an influence on the market recovery, such as a brief interruption in oil supplies in Iraq and Nigeria that offered a tailwind to oil prices. Still, a pledge of fiscal stimulus in China and statements of clear monetary accommodation in the U.S. and Europe served to fill the sails of the global markets. Accommodative deeds followed words, with no rate hike in the U.S. in March and heightened asset purchases announced in Europe.

Our view, on balance, is that the global economy is headed toward yet another year of subdued economic growth across most regions. We see attendant risks for most asset classes, as uncertainty toward the financial health of private corporations comes under scrutiny and the effects of slowing global trade persist. Against this backdrop, the Investment Committee advocates: 1) remaining fully invested, 2) opting for balance between equities and fixed income in mid-risk portfolios, and 3) setting an allocation to alternatives in balanced to more aggressive portfolios. Within the major asset classes, the Committee believes that large cap equities provide advantageous dividend yield and security relative to small caps. We also favor non-energy high yield, on a relative basis, for its potential appreciation and adequate compensation for the risk taken. We believe that Emerging Markets (EM) assets present a still uncertain outlook as commodities prices remain depressed, and so recommend lighter EM allocations across related asset classes.

1. Market Volatility: A Bumpy First Quarter Settles Down – For Now

The reprieve from low oil prices that dipped into the $20s during the first quarter has injected some life into the equity markets. In the U.S., most of the initial equity market losses experienced during one of the worst starts to a year ever have now recovered. West Texas Intermediate (WTI) oil prices reached the low $40s

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by late March after dipping as low as $26/bbl. The S&P 500 rebounded to 2,060 (near its December level) by the end of the first quarter, after dipping as low as 1,829 on February 11th. European stocks remain 8% lower than year end, while the Nikkei was down 12% in the first quarter (see Key Market Performance Indicators – Equities, below). The stock market in China, a source of much of the volatility since last year, ended the quarter down 15%. The Chinese government offered its own jawboning to those willing to listen as Chinese Prime Minister Li Keqiang promised more government support to the domestic economy through its long successful gambit of fiscal deficits and relaxed credit standards (readily supported by the country's large net export balance). The Prime Minister announced a target growth rate of 6.5%-7.0% for 2016, and the speech led to the highest single-day gain in iron ore prices ever: 18.6% on March 7th.

Key Market Performance Indicators – Equities

(in % except stock indices)

	Total Returns in USD				
	2014	2015	**1Q16**	12/31/2015	**3/31/2016**
Stock Index Levels:					
S&P500	13.65%	1.37%	**0.77%**	2,044	**2,060**
Eurostoxx	-8.00%	-3.60%	**-8.05%**	3,268	**3,005**
Nikkei	-4.16%	9.90%	**-11.95%**	19,034	**16,759**
Brazil Bovespa	-13.44%	-41.97%	**15.47%**	43,350	**50,055**
China (Shanghai Composite)	53.85%	6.36%	**-15.12%**	3,539	**3,004**

Source: Bloomberg, LISI

In the fixed income markets, US 10-yr Treasury Notes fell to 1.63% on Feb. 11th in concert with the market volatility that hit at that time. They settled at 1.78% on March 31st, and averaged 1.91% for the quarter (see Key Market Performance Indicators – Fixed Income, below). Mixed economic signals led economists (and this committee) to vacillate on their expectations regarding the speed and magnitude of coming rate hikes. The Fed now gives strong indications of at most two 25 basis point increases this year. It is important to note that while this economic recovery is one of the longest in the postwar period, its shallow nature – with low wage growth in the U.S. and meager business investment despite negative interest rates in Europe and Japan – offers little in the way of resistance to some exogenous shock that could then lead to a new recession (though we do not predict one soon).

Key Market Performance Indicators – Fixed Income

	Average Yield (%)			
	2014	2015	**1Q16**	3/31/2016
Yields:				
US Treasury 10-year Bond	2.54	2.14	**1.91**	1.78
German Bund 10-year	1.22	0.51	**0.27**	0.12
Japanese Government 10-year Bond	0.55	0.36	**0.12**	0.00
Bloomberg Emerging Markets Composite Bond	5.03	5.52	**6.12**	5.61
Brazilian Government 10-year Bond	12.24	13.86	**15.20**	13.90
Chinese Government 10-year Bond	4.23	3.38	**2.88**	2.88

Source: Bloomberg, LISI

Regarding valuations, the Price-to-Earnings (P/E) ratios of the major markets continue to be range-bound and within long-term averages. At 17.7x as of March 31st (see chart below), the S&P 500 has held up reasonably well in the face of pressure on particular sectors such as energy and manufacturing, reflecting the predominance of the services sector in the US economy. Still, the prospect of spillover effects from energy and energy-related sectors could affect the real economy through a variety of mechanisms that include tightened lending standards and downward pressure on consumer confidence. P/E ratios across markets remain low relative to previous late expansion phases, with the S&P 500 hovering about 18x and Eurostoxx still in the 20x-21x range.

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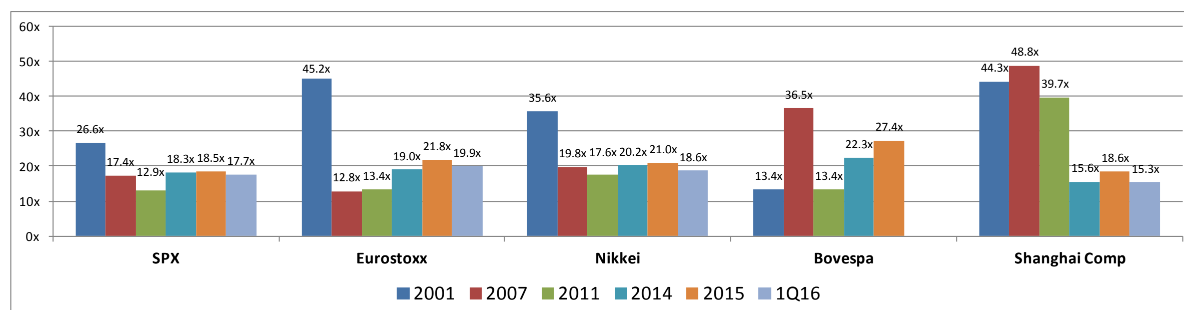
Major Market Price/Earnings Ratios in Late Cycle (2001-1Q16)



Source: Bloomberg, LISI

Risk premia, as illustrated by fixed income market spreads, tightened slightly from year-end 2015. This reflects the market recovery and signals a general risk-on trade that caused a considerable amount of short-covering, which added further support to the market and a contraction in bond spreads. Energy sector spreads remain elevated at above 1300 basis points over comparable Treasurys, while EM high yield tightened by about a half percent to about 866 basis points, down from over 900 basis points at the end of December (see table below). Global high yield corporate spreads remain elevated at levels that we believe to be attractive in non-energy sectors.

Risk Premium Required Above US Treasury (%)				Change in Bps	
	Mar. 31, 2015	Dec. 31, 2015	Mar. 31, 2016	2015	1Q16
Bloomberg High Yield Corporate Bond Index	5.24%	7.33%	7.21%	184	-12
Bloomberg High Yield Energy Corporate Bond Index	9.39%	13.76%	13.12%	369	-64
Bloomberg EM High Yield Corporate Bond Index	8.61%	9.21%	8.66%	-27	-54
Bloomberg Investment Grade Corporate Bond Index	1.40%	1.72%	1.73%	35	1
Bloomberg Investment Grade EM Corporate Bond Index	2.77%	2.89%	2.71%	-25	-17

Source: Bloomberg and LISI

2. Fed Accommodation Redux

Fears of an unfettered path of Fed rate hikes have dissipated with straightforward declarations of data-driven market support from Chairman Yellen, despite the occasional objection voiced by one or another of the Fed governors. In her recent remarks to the Economic Club of New York (ECNY), Chairman Yellen tellingly marked ground on a more extended accommodative stance: “…the Committee anticipates that only gradual increases in the federal funds rate are likely to be warranted in the coming years, emphasizing that this guidance should be understood as a forecast for the trajectory of policy rates that the Committee anticipates will prove to be appropriate to achieve its objectives.” She stated further that, “… developments abroad imply that meeting our objectives for employment and inflation will likely require a somewhat lower path for the federal funds rate than was anticipated in December.” With that and the FOMC's average projection of a 0.9% target Fed Funds rate for end-2016, the market has confidence that low rates will prevail for some time.

Quantitative Easing – an International Phenomenon

We pointed out in 2015 the introduction of asset purchases as an effective tool in the Fed’s arsenal to help counter the economic downturn created by the excesses that led to the Great Recession. We mapped out, as seen in the chart below, the corresponding trends in unemployment and inflation. In her recent ECNY speech, Chairman Yellen provided a frank acknowledgment of the Fed’s proclivity toward using quantitative easing (QE) to guide the economy toward the FOMC's employment and inflation objectives: "While these tools may entail some risks and cost that do not apply to the federal funds rate, we used them effectively to strengthen the recovery from the Great Recession, and we would do so again if needed.” The level of asset purchases has tapered off slightly in recent quarters, yet remains above the $4 trillion level first established in late 2013. While the Fed may see QE as a necessary complement to low Fed target rates, these ongoing stimuli to the economy have not been felt widely, e.g., consumers continue to bank the “fuel subsidy”

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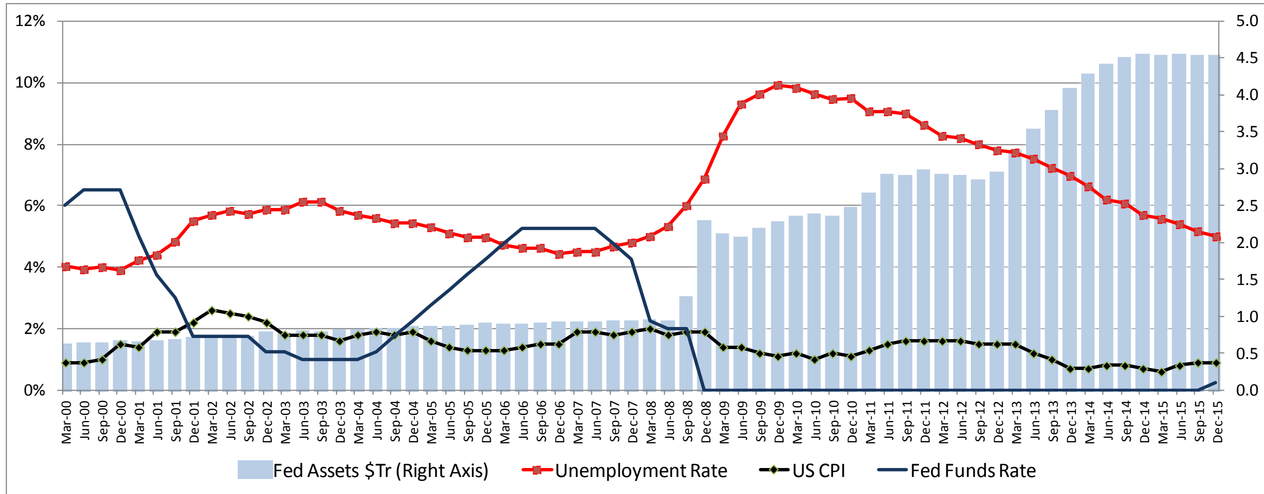
provided by lower gas prices instead of spending most of it. This, in part, is why we maintain cautious optimism on the U.S. economy.

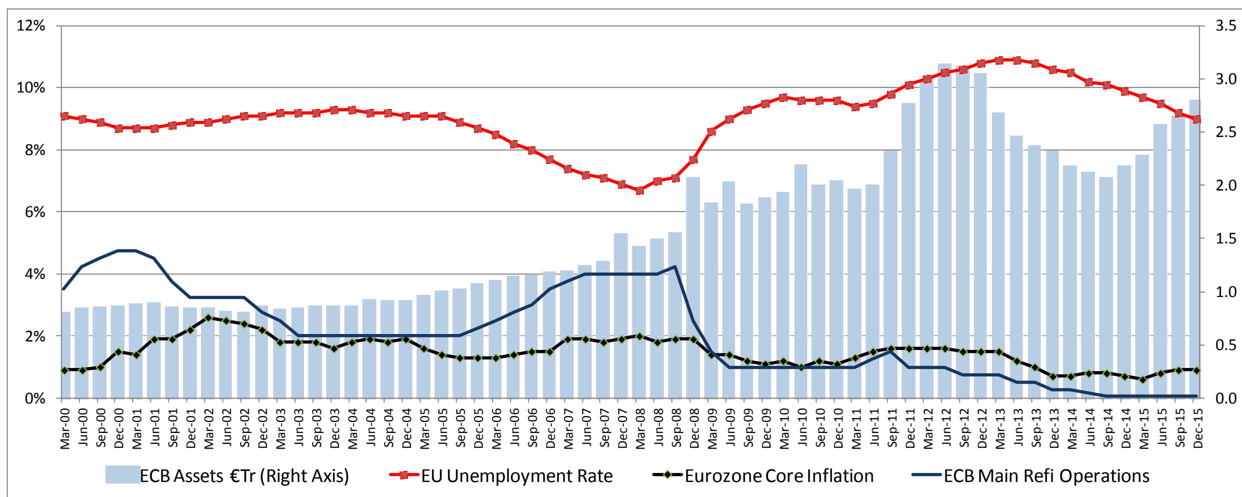
Federal Reserve Board Tools and Key Decision Inputs



Source: Bloomberg and LISI

We think it is instructive to observe similar official accommodation in Europe, where QE began earlier than in the U.S. and first exceeded €1.5 trillion in 2007 (see chart below). While rates headed down toward zero, it was not until the Greek crisis in 2011 that the European Central Bank (ECB) began to take stronger measures and boosted its asset holdings above the €3.0 trillion level. Once the crisis was over, it reduced its level of holdings to about €2.0 trillion by late 2014. However, these have crept up toward €3.0 trillion again, in response perhaps to the new challenges facing the continent, including 1.2 million new immigrant arrivals in 2015. Perhaps it is most important to note how the Europeans have used QE in a more tactical manner than the Fed, whose first attempt to slow asset purchases in May 2013 led to the infamous “Taper Tantrum” in which markets sold off on the mere suggestion that the Fed might weaken its support. Still, despite the variability in purchases, European unemployment in general has remained stubbornly high. Perhaps recognizing this, the ECB in March increased asset purchases further, from €60 billion to €80 billion per month.

European Central Bank Tools and Key Decision Inputs



Source: Bloomberg and LISI

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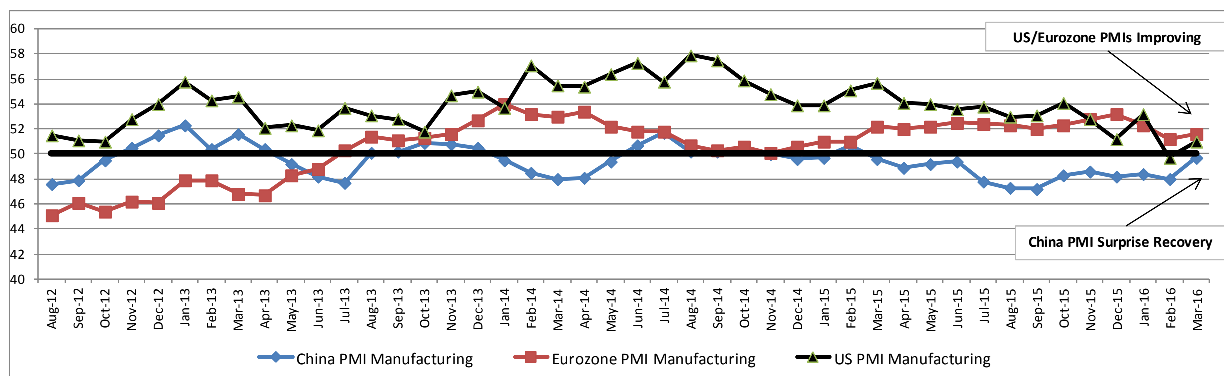
Global Growth and Major Market PMIs

We view the Purchasing Managers Index (PMI) for Manufacturing in different regions as a key leading indicator of economic health. A reading under 50 signals weakness and we have noted that China has been weak and both the US and Europe remained strong throughout 2015 (see chart below). In the first months of 2016, it appears that the U.S. has begun to slow, while China experienced a spike in the month of March to just under 50. The Eurozone remains steady at just above the 50 mark.

Key Market Purchasing Manager Indices (PMIs)



Source: Bloomberg and LISI

In our 1Q16 Investment Letter we highlighted rapidly falling Chinese international reserves and questioned whether the People's Bank of China (PBOC) would have adequate reserves to counter sustained pressure on the yuan in the wake of further stimulative monetary intervention. It appears that the PBOC has been able to arrest capital outflows and avoid the need to support the yuan (perhaps through capital controls). The PBOC reported that reserves only fell by $29 billion in February, and thus maintained a level of $3.2 trillion in reserves (as we noted last quarter, about $1.2 trillion above the minimum required to support the economy).

Still, the continued accommodation announced by Prime Minister Keqiang in early March may need to grow if the economy is to reach the government's targeted 6.5%-7.0% GDP growth for 2016 (see Key Economic Indicators below). The Baltic Dry Index remains at 20-yr. lows, and *The Economist* reports that Chinese imports have fallen by nearly 19% over the past year. An example of the pressures China faces can be seen in steel industry statistics. Chinese steel production doubled from 2000 to 2014, to 1.6 billion tons per year; with a slowdown in the domestic construction sector Chinese steel companies have flooded the international market: steel exports doubled from 45 million tons in 2014 to 97 million tons in 2015. It is no wonder that the U.S. and other countries have begun to increase tariffs. Observers question the effectiveness of China's intervention. Regulatory reform is needed, and a nascent effort may be underway: the government will apparently not bail out the world's 14th largest steel company, Bohai Steel Group, which is now headed toward a restructuring.

Key Economic Indicators

	GDP Growth (%)			Current Account Surplus/GDP (%)		Public Debt to GDP (%)	
	2014	2015	2016p	2014	2015	2014	2015
United States	2.4	2.4	2.0	-2.21	-2.66	103	104.2
Eurozone	0.9	1.6	1.4	2.38	3.05	92.1	91.6
Latin America	1.3	0.1	-0.3				
Brazil	-0.7	-5.9		4.37	-3.21	58.9	67.3
Mexico	2.6	2.5		-1.94	-2.04	42.1	45.2
Argentina	0.5	0.9		-1.32	-1.67	42.7	45.8
Japan	-0.1	0.5	0.8	0.54	3.33	231.9	227.9
China	7.3	6.9	6.5	2.70	3.08	14.9	16.7

Source: Projections from Leumi Economics Dept.; Bloomberg, LISI

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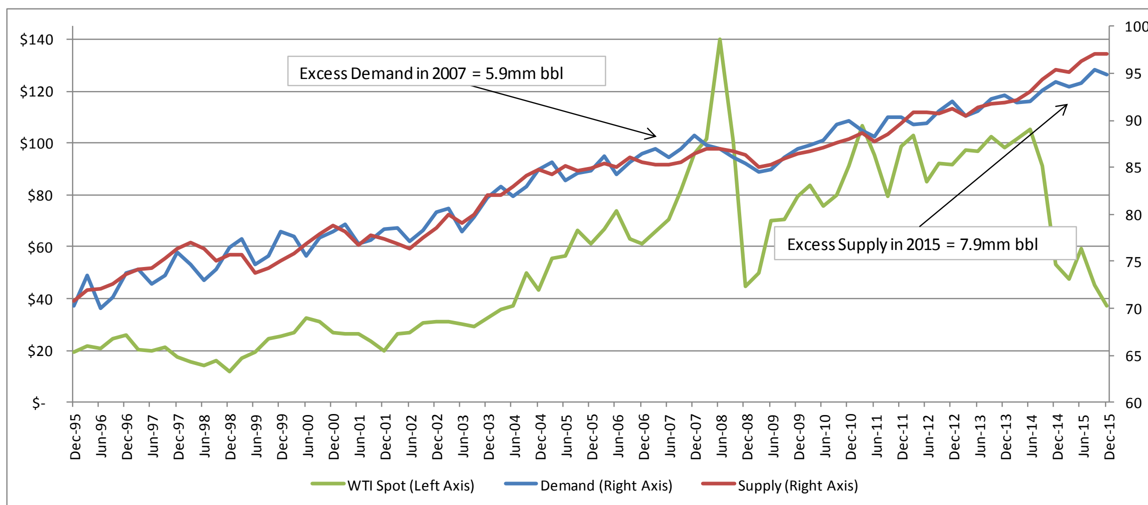
3. Oil May Resume Weakness

We think that oil prices are likely to come off their recent strength, barring geopolitical events that disrupt significant supply. A supply overhang that averaged some 1.2 million bpd during 2015 pushed prices down, but energy analysts observe that the long-term upward trend in energy consumption should continue with population growth and the gradual development of the middle classes in highly populated emerging markets countries. Eventually, demand should come into line with supply, particularly given cuts in high-cost fracking production and slowed or canceled exploration and production projects in the U.S. and other regions. We are not so sure.

World oil consumption did increase in the last few years, fueled by increasing growth in major economies like China and India. Still, relative calm in producing regions, a reluctance to cut oil production by OPEC members (principally Saudi Arabia), and growth in US fracking and traditional production in recent years meant that supply outpaced demand at a rate of 2 million bbl per year (see chart below). This imbalance is starting to right itself, but consumption depends on GDP growth, which is slow and may offset production cuts. In addition, stockpiling in recent years has added supply that needs to be worked out (Iran had an estimated 50 million bbl stored in tankers awaiting the lifting of sanctions to get released into the market). Despite the high stocks, a reported drop in U.S. production below 9 million bbl/day may provide support to prices. On balance, it is the Investment Committee's view that excess supply is here to stay for some time and that we are headed for another downturn in oil prices this year.

WTI and Global Oil Supply and Demand



Source: Bloomberg and LISI

4. Conclusion

The LISI Investment Committee has reviewed its policy with respect to asset allocation and is introducing a new structure with five general categories for investor risk tolerance: 1) Capital Preservation, 2) Conservative, 3) Balanced, 4) Moderate Aggressive, and 5) Aggressive. For each of these categories we recommend, on a quarterly basis, a Tactical Asset Allocation (TAA) across the general asset classes of Equities, Fixed Income, Alternatives and Cash. For example, our TAA for the Balanced portfolio includes 50% Equities, 45% Fixed Income and 5% Alternative Assets, favoring US and developed large caps for equities, and a balance including high yield for fixed income. Please see our separate asset allocations document. We again suggest deploying part of the cash that we favored setting aside in our Tactical Asset Allocations earlier this year. Our specific views include the following:

- Within the context of a well diversified portfolio the Committee advises clients to look at developed market large cap equities, particularly in the US and Europe, and selected high yield ex-energy to try to gain from oversold conditions among credits with good liquidity in more defensive sectors

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- Our view that low interest rates and QE are to continue in the US as well as in Europe and Japan leads us to choose duration over credit risk by favoring longer term credits in higher rated issuers

- Across asset classes we think that liquidity matters under a changing regulatory regime in which balance sheet commitment from large investment and money center banks has fallen. This relative illiquidity extends to small caps, some high yield and a large proportion of EM securities

- We believe that EM and specifically Latin American corporate bonds are likely to continue to be volatile in 2016 as downward pressure on oil prices and other major commodities persists and Brazil continues to work through its political troubles and the *Lava Jato* investigation

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