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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

For the past six years, the Federal Reserve Bank (Fed) has pursued a policy of aggressive monetary stimulus. This policy ended in December. In theory, this historically unprecedented strategy should have produced a booming economic recovery. Instead, the economy continues to struggle to post even modest growth. There are many reasons for the failure of monetary policy; restrictive regulatory and fiscal policies and the lack of coordination with other central banks are the primary reasons cited. For monetary stimulus to work, the liquidity created by the central bank needs to circulate, i.e. to be invested to create profits which are invested again. In such a theoretical cycle, jobs are created and the economy grows.

During the past six years, even as the Fed produced abundant liquidity, that liquidity was constrained by headwinds. Instead of investing in new production, banks, corporations and individuals either hoarded or purchased existing assets. Companies acquired other companies, asset prices were bid higher, and capital sought opportunities abroad.

Now the Fed has raised rates. Historically, the beginning of a Fed tightening cycle has served to confirm economic progress. Over the previous 12 tightening cycles, the Fed implemented the initial rate hike, as well as the majority of its tightening, while the economy was in the mid-cycle phase. In other words, the Fed is expressing confidence that the economic expansion is sustainable. However, if one looks only at export-oriented sectors such as manufacturing and crude oil production, which are experiencing a decline in earnings due to weaker global conditions, a stronger dollar and low oil prices, there is a warranted fear that the Fed's action will be a disaster. **While we are concerned by the recent impact of a strong dollar and weak global demand on corporate profits, albeit distorted by a 60% decline in the energy sector, low inflation and the expectation for greater monetary accommodation in the developed economies provide an opportunity for improvement in manufacturing and energy in the coming year.**

But, to just focus on manufacturing and energy is to ignore the accelerating growth in the much larger domestic sector. This growth is driven by the positive real income outlook for U.S. households. Labor market improvement and a strong dollar support purchasing power, while the outlook for housing is a solid beneficiary of demographics, constrained supply, wage growth and a gradual easing of lending conditions.

Since monetary policy works partly as a signaling mechanism, we view the Fed tightening as generally constructive, in so far as policy ambiguity is removed. For the last six months of 2015, the question of when the Fed was going to raise rates dominated the financial news, the uncertainty casting a pall over markets and economic activity. With the announcement, it was a non-event. So much liquidity has been created that a 25 basis point increase in short rates will not make much difference.

According to a recent article, quoting a study by Jack Bogle, founder and former CEO of the Vanguard Group, there are three sources of return from equities. First is the dividend yield, currently about 2%; second is real earnings growth, which has averaged about 5%; third are changes in "animal spirits," human psychology which determines the price investors are willing to pay to own a stock. With the Fed agenda to raise rates throughout 2016, a case can be made for buying dividend growth over dividend yield. Already a simple formula grows more complicated. **Also, since 2015 produced such anemic profit growth, earnings comparisons, even in a slow growth economy, could surprise on the upside.**

The last piece in the returns puzzle is the most elusive. A forecast of market psychology is never obvious. A year-end research report, "Geopolitical Strategy," by BCA Research, proposes that multi-polarity will be the central theme for 2016. BCA describes multi-polarity, "As more states become capable of pursuing their interests independently, a stable geopolitical equilibrium becomes more difficult to achieve; geopolitical crises will, in turn, keep animal spirits in check, creating a bearish feedback loop in 2016." **But, in the ensuing instability, BCA distinguishes between "'red herrings' – distractions with little market impact – from 'black swans' – low probability, high impact events."**

We had our share of "red herrings" last year. For the most part they were distractions, adding to market volatility, but having little economic impact. With our expectation for another sluggish year in the global economy, we can only hope for positive surprises.

Fixed Income Market

Houston, we have liftoff. The amount of attention paid by the media and the markets to the Fed's so called "liftoff," its first interest rate hike in years, was truly amusing. **Even though the expectation has been for a modest 25 basis point increase in the Fed's target rate, a move that would barely impact broad economic activity, the stock and bond markets teetered for months on every economic data point and every word choice made by members of the Federal Reserve.**

As the fourth quarter progressed, it became increasingly clear that the Fed was headed for a rate hike at their December meeting based on Fed comments and strong employment numbers. By the day of the meeting, those who expected the Fed to hold rates steady were heavily outnumbered. **Short-term bond yields moved up accordingly in anticipation of the Fed's announcement.**

Because the Fed met expectations with a 25 basis point increase, the markets made no sustained reaction to the Fed's announcement. Now, thankfully, this liftoff rhetoric is behind us, and we can look forward to the next chapter in financial history.

2016 is likely to see some continued rise in short-term interest rates, particularly if inflation begins to tick upward after being very moderate for several quarters. While we cannot rule out a faster rise in rates, we think that continued strength in the U.S. dollar will prevent inflation from raising much above the Fed's 2% target rate anytime soon.

International Market

There was never a dull moment in 2015 as far as international investing was concerned. The showdown between the SYRIZA government, led by Greek's Prime Minister Alexis Tsipras, and the troika, formed by the European Central Bank, the International Monetary Fund and the European Union, dominated media coverage for the first half of the year. Countless mention of the word "Grexit" spread through news outlets. As investors were still digesting a temporary solution for the Greek debt issue, reached in early summer, the media's attention quickly switched to the extreme volatility of the Chinese stock market and the slowing of its economy. The "Global Recession" caused by the Chinese slowdown flooded major channels through the summer and beyond, probably triggering some panicked selling by novice investors.

Undoubtedly, these news headlines were scary at the time. However, subsequent developments and market recovery have once again taught global investors a very important lesson. No matter how scary the media has portrayed the situation, investors should not let their investment decisions be influenced by headlines without first analyzing the fundamental impact. **Most of the time, the impact is minimal to financial markets, and investors suffer dearly when they make decisions in panic.**

Looking forward to 2016, we continue to be more optimistic on developed markets compared to emerging markets. The median growth of the 152 emerging economies, tracked by the IMF, slipped to an estimated 3.2% in 2015. Except for 2009, this was the slowest growth since the Asian crisis of the late-1990's. The downturn in resource prices hit energy and commodity producers hard while the contraction in manufacturing hurt export-dependent countries. On top of these obstacles, weak exchange rates constrained policymakers from easing aggressively to boost their economies. This environment is likely to remain a difficult one for the majority of emerging economies going into the new year.

On the other hand, the situation in China is rather different because the country runs a current account surplus and is not overloaded with foreign currency debt, the two issues plaguing most emerging countries. While many people, ourselves included, question the official Gross Domestic Product (GDP) growth rate and suspect that growth is closer to 6% rather than 7%, the reality is that if growth was much weaker than announced, the authorities would have been much more aggressive with stimulus. Indeed, China has lots of room to pursue stimulus as monetary conditions are still very tight and gross general government debt is at only 43% of GDP. The fact that the moves to ease monetary and fiscal policy have been rather timid, until now, suggests that the government is not overly concerned.

Recently, the Chinese Communist Party announced their 13th five-year plan, which will run through 2020. Growth remains the top priority, but the new plan will try to strike a balance between the speed of growth and sustainability. By 2020, the party has pledged to comprehensively transform the country into a "xiao kang she hui (小康社會)" or a "moderately prosperous society." **This essentially means the middle-class will be the focus of the Chinese government and satisfying basic consumption needs of the middle-class could become the main driving force of China's growth in the coming years.**

The refugee crisis and Paris terrorist attack put Europe, especially the euro zone, on the front page again, exposing the deeply fractured state of the region's politics and the difficulty of dealing with common problems. The vision of deepening integration is becoming increasingly unpopular as nations attend to their own interests. **Since achieving the fiscal integration necessary to ensure a single currency structure becomes more difficult, the sustainability of the euro as the common currency will be re-examined.**

In the near term, the influx of refugees could have positive impact on the region's economy. Potential GDP growth rate is a function of productivity and labor force growth, and Europe suffers weaknesses in both cases, especially with regard to labor force growth. From a purely economic perspective, these migrants might provide the labor force growth that an aging Europe sorely needs. In addition, providing the basic necessities for these newcomers and enhancing counter-terrorism security could also provide fiscal stimulus, which has been sparse during the past few years.

Overall, global monetary conditions were generally accommodative in both developed and emerging countries in 2015, and this should continue to be the case in 2016. However, investors should not have unrealistic expectations on potential economic growth. **We continue to favor developed markets over emerging markets, and we especially like the euro zone in developed markets and China in emerging markets.**