CAPSTONE
Investment Group

2016 Economic Forecast

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2016 Economic Forecast

"Have no fear of perfection – you'll never reach it."

– Dali

Having laid down the fear of perfection in the writing that follows we again venture into the unknown that is the coming year. Every attempt has been made to ensure this report is both accurate and timely but we fully acknowledge our own limitations in offering predictions and keeping pace with events as they evolve on a daily basis.

As in years past, this is meant primarily to be an internal document that serves as a basis for conviction in the management of client assets and dispensation of advice. We first review our 2015 Forecast to see how we did and then move on to the prognostications for 2016. We recognize that some terms contained herein may be unfamiliar to the reader and as such we've included a technical glossary of terms at the end of the documents. There are so many facets to examine in the financial markets - we focus here on some of the more salient topics that will likely impact our economic future in the year to come. First, we begin with a look back at our 2015 Forecast to see how we fared.

Prior Year Hits

World GDP growth was constrained as predicted coming in at 2.7% annualized. The IMF in its estimates continues to be overly sanguine as to the prospects for global growth.

The ECB did engage significant QE as predicted.

Japan maintained its easy monetary stance and their equity market benefited as a result in 2015.

Japan did not experience meaningful economic growth in the prior year.

Brazil's fate was indeed tied to the fate of commodity prices in 2015 and as such Brazilian equities fared quite poorly as oil prices moved even lower.

Russia's equity market fared poorly in 2015 driven largely by continued weakness in oil prices.

Chinese GDP growth was indeed within our anticipated range of 6.4%-6.7%

China continued devaluing the Yuan in an attempt to loosen its peg to the Dollar and allow the currency to float more freely.

The US Economy grew within our target of 2.4%-2.8%.

US rates did indeed rise in line with our forecast albeit later in the year than we anticipated.

<u>Prior Year Misses</u>

The QE provided by the ECB did not provide the tailwind to European equities that we anticipated.

We failed to anticipate the continued weakness in crude oil prices.

Falling crude oil prices brought more weakness to S&P 500 earnings than we otherwise forecast.

While we anticipated a weaker Yuan, we did not believe that would lead to the equity market gyrations that it ultimately led to.

Our takeaway from 2015 is that our data feeds are sound but we were early in anticipating a recovery in European equities, and we underestimated the US market impact of China. That topic will be discussed in more detail, but our overall lesson from 2015 is that just because an event has been communicated to the markets, such as a weakening Yuan, doesn't mean that markets still can't respond negatively. While we take heart in a number of items that we feel we have a clear grasp on, as evidenced by the data, we are reminded of the humility required in approaching any forecast and ultimately our willingness to learn from our short-comings. Having said that, let's turn our attention to 2016 and our thoughts regarding the year ahead for investors.

Overall Climate: An Inflection Point

As the finishing touches are put on this document the US equity market is off to one of its worst starts in history. **We believe that we are at a critical inflection point in equity markets in which it is increasingly possible to see more near term weakness in stocks before seeing them turn meaningfully higher.** The fear that this can produce tends to quickly recall the ghosts of 2008-2009 and concerns that we will find ourselves in a similar market begin to emerge. While the short term prognosis for stocks is not good it is important to remember that this is no 2008-2009. We do not have systemic failure in our banking sector nor do we have the leverage in the financial system that we had during that timeframe. This is not stated to obscure or dismiss the very real issues that we face, but rather to attempt to ground us in the reality of our present circumstances, both good and bad.

This inflection point is intensified by the fact that a great deal of our market strength from 2009-2014 was driven by unprecedented money printing from the Fed in the form of "Quantitative Easing." That program has ended in some respects and rates have begun rising, albeit modestly. In order for the market to continue making gains in an environment in which the Fed is less engaged there has to be underlying strength in corporate earnings. Essentially, the patient that is the economy has hitherto been on monetary life support and needs to begin functioning on its own. Many sectors in the economy such as health care, bio tech and technology are doing just fine, but 2015 earnings for the US market have been dramatically impacted by one single factor: the price of oil.

Oil

The decline in the price of oil is having a significant impact on both the bond and equity markets. Therefore, in understanding how this present reality will transform into our future it is critical for us to examine the dynamics present in the oil market and how we should respond to those factors. Forecasting where oil prices are heading is a pervasive topic of discussion within the investment community.

Many energy cycles have occurred where higher prices led to more conservation (lower demand) and higher profits led to greater supply from increased exploration and production. That ultimately drove prices lower leading to less exploration and production and greater consumption, which then drove energy prices higher again. And the cycle repeats… This is basic economics where price, demand, and supply interact. However, there are variables at play in this cycle that make shorter-term forecasts a bit more challenging. First, understand that existing wells produce the most oil immediately after they are drilled and production declines over a period of years until the well is no longer economic. The natural depletion rate globally is estimated to be 3 – 6%. So energy supply would be decreasing 3 – 6% each year in the absence of new wells being brought online. In recent years, oil in excess of $100/barrel incentivized additional production, which along with a technological revolution in the US energy industry, has resulted in the United States becoming the world's leading oil producer; exceeding the production of Saudi Arabia. By the end of 2014, the world found itself oversupplied with oil to the tune of roughly 1 mm barrels a day. The day after Thanksgiving in 2014 the Saudis shocked the markets by not cutting their production and instead electing to essentially drive higher cost producers out of the market by lowering the price with excess supply. **The current imbalance is estimated to be approximately 1.5% more supply than global demand.** That does not seem to be a huge gap, but oil is priced at the margins and there is a cost (as well as limited capacity) to store excess production. US production has indeed already responded to lower prices and started into a significant decline, however, prices are at the same time being pressured lower by the expectation that Iran could add 600,000 barrels per day back to supply, although many analysts argue that Iran's deteriorating energy infrastructure makes a much lower volume more likely. Iran also has a stockpile of oil in floating storage estimated to be as much as 30 million barrels, which they could keep in storage awaiting higher prices, or bring to market at any time. While the Saudis were deliberately acting in order to lower prices, it seems they grossly miscalculated the extent to which crude oil would continue to plummet. Over the course of 2015, Brent crude dropped 25% and is showing continual weakness in 2016. Below is a chart for crude to illustrate the dramatic decline:

Oil's Impact on bonds

Through most of the high yield sector's history; energy companies comprised between 5 – 15% of that market. Energy companies are currently at historically high levels, now representing over 15% of the high yield ETF, JNK. Many of these energy companies borrowed with the assumption that high energy prices would persist far into the future. We believe that many of these leveraged energy companies will go bankrupt as much of their debt comes due in 2016 and 2017. There are also banks in the energy regions of the country that have over-extended lending with higher energy price assumptions. The impact of lower oil on energy company debt in the high yield index has driven high yield bonds persistently lower over the last year. **That has created nervousness about the entire high yield sector and is broadly reducing the availability of credit and/or increasing rates for below investment grade borrowers.** We believe that the economics of high yield borrowers outside of the energy space is vastly different and provides some opportunities in issuers with solid economic fundamentals that have been tainted by the energy component's contribution to the sector.

<u>Oil's Impact on stocks</u>

The energy sector is one of the single biggest factors impacting earnings for the S&P 500 as a whole and a significant contributor to the volatility in stocks that began in the summer of 2015. This volatility was in large part driven by concerns of overvaluation for the S&P driven by declining earnings estimates. These declining earnings estimates were highly concentrated in the troubled energy sector. This is illustrated by the chart below which shows year over year growth earnings & revenue for the S&P as a whole in the left columns, growth (or rather steep declines) from the energy sector in the middle columns, and finally what S&P results would look like if you didn't include the Energy sector. What this tells us is that a great deal of the decline in the S&P Earnings & Revenue picture can be tied largely to the flagging prospects for the energy sector. This is good because it underscores the fact that slower growth had been driven in large measure by tremendous difficulty in 1 of the 10 major sectors and not by a wholesale slowdown in economic activity. While not necessarily cheap, **we believe that S&P earnings will find reasonable footing once oil finds a bottom.** This belief is strengthened by the fact that the US is still a net consumer of petroleum which means price declines, net to net, benefit consumers more than they hurt. Therefore, **comparatively lower oil prices should be a help to the US consumer and a support to S&P Earnings & Revenue in 2016.**

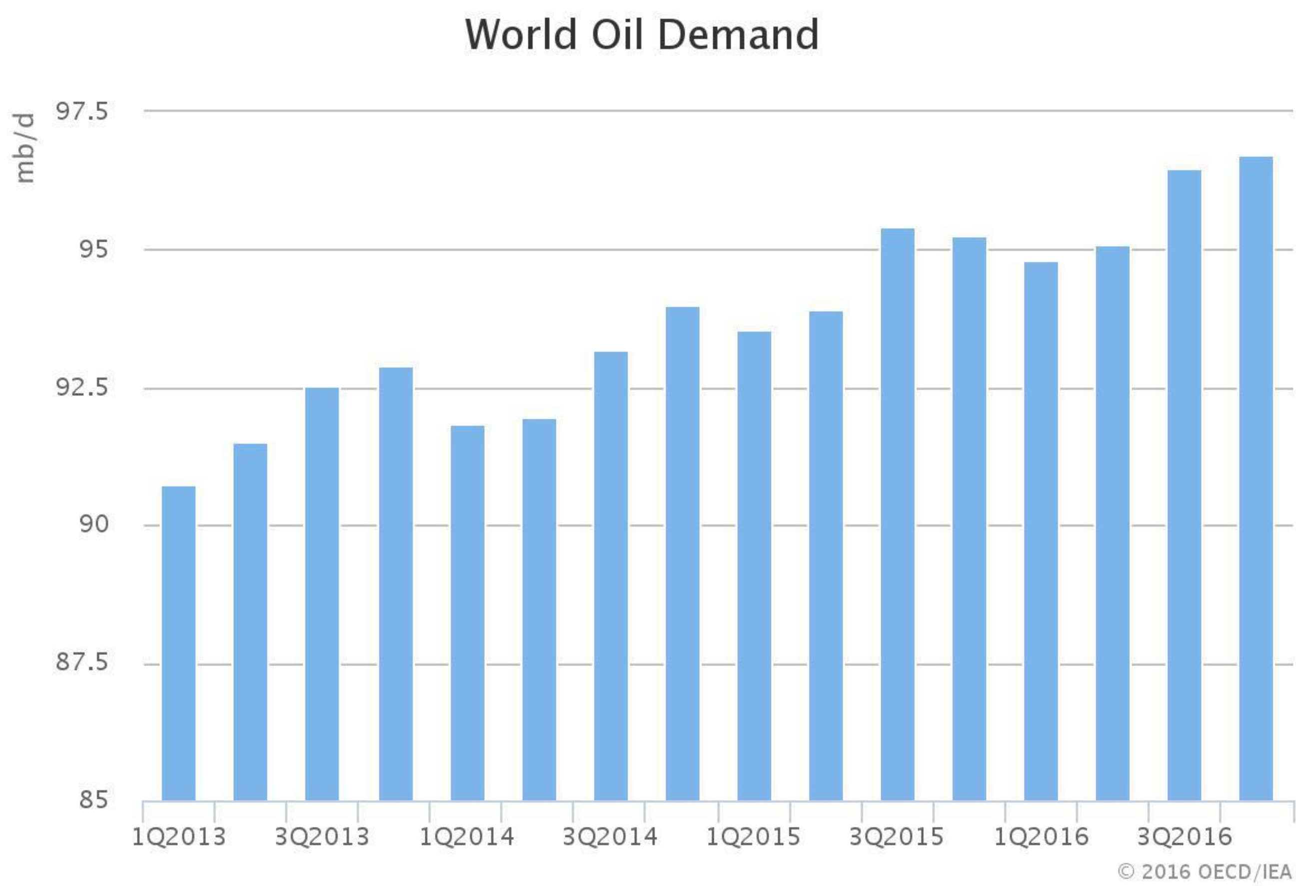
S&P 500 Year over Year Earnings Growth				**S&P 500 Year over Year Revenue Growth**			
		Energy	**S&P 500**			**Energy**	**S&P 500**
Period	**S&P 500**	**Sector**	**Ex-Energy**		**S&P 500**	**Sector**	**Ex-Energy**
1Q16E	.7%	-30.5%	4.1%		1.8%	-11.8%	3.5%
4Q15E	-4.7%	-57.0%	1.2%		-3.3%	-34.8%	1.2%
3Q15E	-0.9%	-59.3%	6.5%		-3.6%	-35.8%	1.9%
2Q15	1.3%	-56.4%	8.9%		-3.5%	-31.7%	1.5%
1Q15	2.2%	-57.9%	10.3%		-3.1%	-34.7%	2.4%
4Q14	7.0%	-21.8%	10.5%		2.1%	-13.5%	4.8%
3Q14	10.3%	10.3%	10.3%		4.1%	-2.6%	5.3%
2Q14	8.6%	17.0%	7.5%		4.7%	3.3%	4.9%

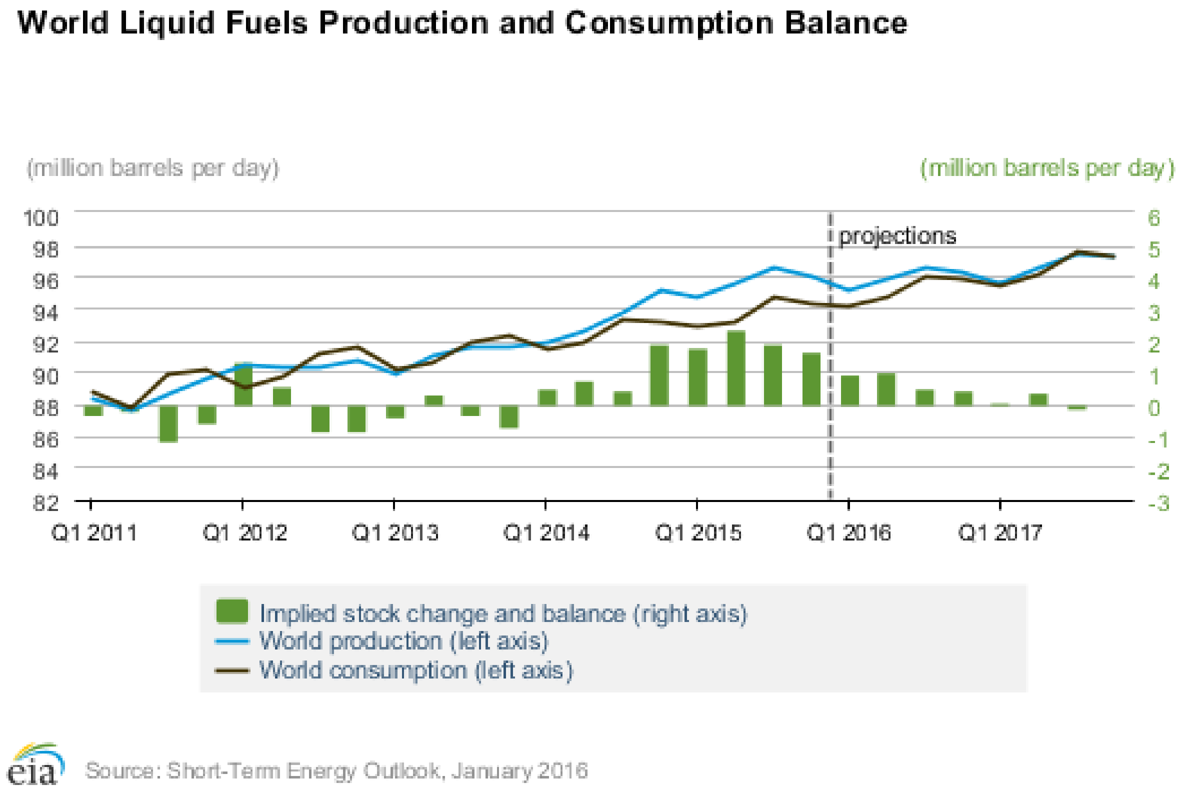
4Q15E and 1Q16E are estimates

Source: Thompson Reuters I/B/E/S as of 1/15/2016

If the energy sector has had such a dramatic impact on the valuation and subsequent level of the US market it begs the question with respect to crude oil: "where is the bottom?" To answer this question as it relates to 2016 we have to look at the two components in any market that determine price: supply and demand.

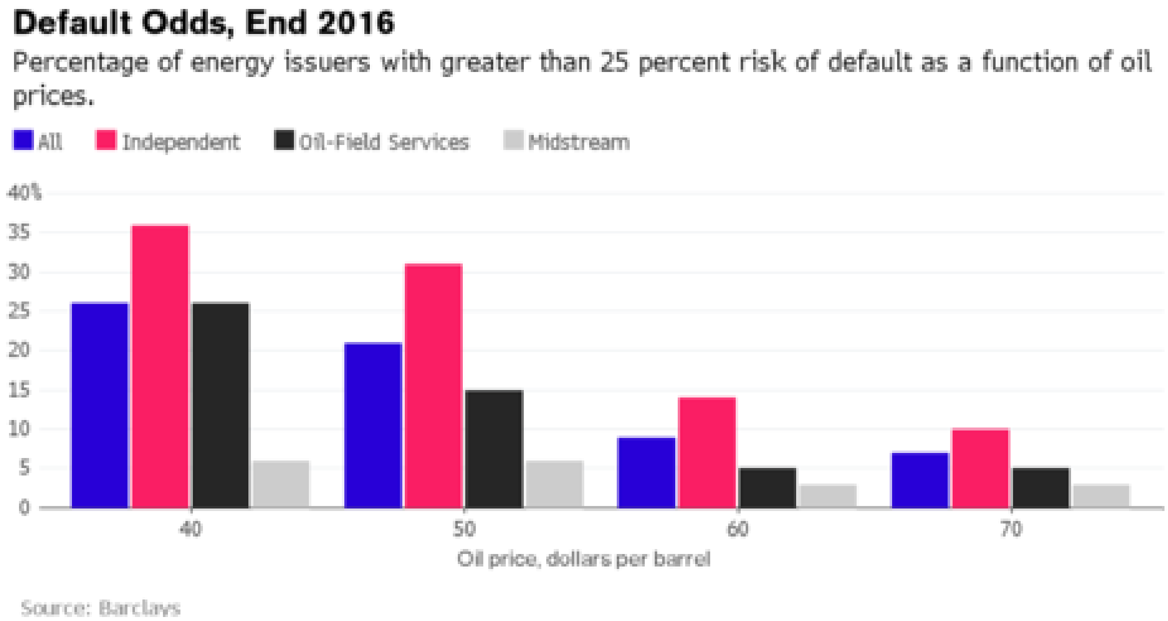
Beginning with the demand side of the ledger we see that global demand for oil is actually stable and rising modestly. Below is the data from the International Energy Agency indicating recent past and forecasted demand for crude oil expressed in "millions of barrels per day." Clearly the issue is not one of a vast reduction in demand and we cannot reasonably believe that demand will pick up enough in 2016 to bring higher pricing. Therefore, the only hope for stable and rising oil prices is a reduction in supply.





What the above indicates as we move into the 1st Quarter (Q1) of 2016 is that we're about 1 million barrels a day oversupplied as illustrated by the blue line(production) being higher than the black line (consumption). Production has therefore declined; but not enough to balance out the demand and until that happens prices will not find footing. **We believe there are two major catalysts that can provide a reduction in global oil supply in 2016: A production cut by Saudi Arabia (possibly in coordination with other OPEC and non-OPEC countries), and a substantial reduction in the number of new wells developed.**

We have already begun to see the effects of the oil crisis in the US oil patch as 23 energy companies in the United States defaulted on their debt in 2015. Given the fact that pricing has only weakened we believe that such defaults will continue in 2016 and will be helpful in eliminating the new exploration and production of higher cost wells. **A continued decline in the rig count is a critical indicator of reducing new production and providing meaningful support and upward trajectory to oil prices.** By the end of 2015, the rig count was approximately 1/3 of what it was at the peak of the energy boom.



Beyond offering a measure of hope in terms of removing supply via the elimination of adding new wells from high cost producers, the above chart also offers clues as to investment opportunities within the oil patch. You'll notice that the least impacted segment of the US energy sector, in terms of increasing defaults as a result of lower prices, is the Midstream segment. These are companies that are in the business of transporting oil and natural gas and generally have limited exposure to the price of the commodity itself; they get paid to move the product regardless of the price. As excess production comes offline there will undoubtedly be Midstream players that are hurt; but **we believe there is opportunity both for growth and income oriented investors in the Midstream space in 2016.**

The other catalyst for higher prices is a cut in Saudi production. It is impossible to forecast with any accuracy when such an event could occur but we believe the Saudis will be forced to reduce production at some point in the latter half of 2016. This is largely driven by the reliance the Saudis have on oil revenue as indicated in the following chart:

COUNTRY	ESTIMATED OIL PRICE REQUIRED TO BALANCE 2015 BUDGET
Norway	$40
Kuwait	$54
Abu Dhabi	$55
Russia	$105
Saudi Arabia	$106
Nigeria	$122
Iran	$131
Algeria	$131
Venezuela	$160

Sources: International Monetary Fund (2014b), except for Nigeria, Russia and Venezuela (Deutsche Bank, 2014) and Norway (Fitch Ratings, 2014).

This suggests that in order for Saudi Arabia to break even on its budget, oil need would need to be at $106. Every day it is below that is a day that the Saudis are dipping into reserves or cutting government services in order to compensate. The following chart indicates how much the Saudi's have had to dip into the piggy bank in order to cover the shortfall brought on by lower oil prices. Essentially, they've spent $86bn or 12% of their reserves to compensate for lower oil prices through Aug of 2015. This number is only going up with each passing day and it is simply a question of when for the Saudi government to act to slow the bleeding.

The math for the Saudis, who still control 39% of the world's daily oil production, is more complicated than a balanced budget and halting development of many U.S. shale wells. There is also the geopolitical calculus of how much they can hurt petrodollar rivals such as Iran and Russia. **We cannot say when the breaking point will be for Saudi policy but we do believe it will happen out of necessity, and it will be positive for oil prices when it does.**

Net Takeaway: Oil prices will settle into a "new normal" of $25-50 per barrel. We expect prices to bottom at very low levels in the first half of 2016 and rebound sometime in the latter half as supply is reduced.

Key Opportunities: Midstream Energy companies with minimum exposure to oil price and Junk Bonds oversold in the midst of the energy sector rout. Many areas of the US economy will begin to benefit from the new lower range for energy costs and US Stocks will benefit subsequent to the final lows from stable to moderately rising oil prices.

China

This brings us to the broader conversation about commodities demand, which also brings us squarely to the question of China. While a collapse in the oil market has done damage to global markets, fears surrounding a Chinese slowdown have certainly helped fan the flames of a potential crisis. Let us discus a couple salient topics with respect to the Chinese economy and draw some conclusions about what that means for investors in 2016.

The first and most pressing issue as it relates to China and the commodities market is that a slowdown in China means less demand for commodities such as iron ore and copper. We believe that, while China will certainly continue to build and expand infrastructure, the near future will represent a slowdown in demand for raw materials. There are many pieces of evidence we could cite to support this claim, but perhaps the most compelling is in the pictures of Shanghai below:

What this tells us, in two simple pictures, is that urban China has largely been built and that demand for the raw materials that took cities like Shanghai from where it was in 1987 to where it is in the present day will almost certainly be lower going forward. This is however not an indication that all is lost for China. Far from it. China is navigating the waters of moving from a production-based economy to one in which economic growth is increasingly driven by the service sector. This requires increased urbanization and education for its people. This transition will not happen overnight nor will it be without challenges but it portends good things for the Chinese economy over time.

One simple anecdote that we can perhaps appreciate which underscores the transition of their society and the opportunity that represents can be found in a recent press release of our beloved Starbucks. Starbucks just announced their plan to open 5,000 stores in China every year for the next 5 years.

That's 25,000 new Starbucks in mainland China in half a decade. Presently, Starbucks operates 2,000 stores in China so this represents a dramatic growth trajectory for the company and doesn't even touch the level of market penetration Starbucks enjoys in North America. It is most certainly not valid to zoom in on one company's policy and extrapolate a direction of an entire country's economy. However, it is telling to see China at a transition point and to see other companies identifying that as well and seeking to build their businesses in what they must believe to be a profitable enterprise. **China's economy will continue to grow, albeit at a slower pace, and in different ways than it has in the past.**

The second topic of focus as it relates to China is that of its currency, the Yuan or as Renminbi as it is sometimes referred. Part of the volatility in 2015 and even some thus far in the very new year of 2016 has been as a result of China weakening its currency. Why does that matter? In simple terms, if their currency gets cheaper, then their exports also become cheaper. This can cause consternation for other competitors in the US whose products become less attractive simply through the mechanism of currency fluctuation. Below we see the depreciation of the Yen versus the dollar with the first major move down in Aug of 2015:

What China is doing in depreciating the Yuan is not manipulation of its currency but actually the cessation of manipulation that has hitherto kept the Yuan artificially over-valued. China is working to have the Yuan accepted as one of the major reserve currencies of the world joining the likes of the Dollar, Yen, Euro and Pound. The goal is to have the greater Asiatic region dominated in trade terms by the Yuan. In order for that to happen the Yuan has to be allowed to “float” freely on the market absent an artificial floor which means that some level of Yuan depreciation is necessary. While all of this may sound reasonable, the timing of China’s depreciation couldn’t be worse because it comes at a point when the world is concerned about China’s growth prospects and therefore it is easy to assume China is using its currency in a move of desperation to prop up weakening exports. **We believe that the Yuan’s volatility will subside in 2016 and that the damage on US multinationals will be limited meaning investors should not avoid US stocks simply because of Chinese currency devaluation.**

The final component of the Chinese question which garners media attention in the US is the direction and volatility of its stock market as measured by the Shanghai index. The chart below indicates the value of the index via the white line showing the massive bubble that formed and ultimately popped in June of last year. The blue line indicates stocks that are “oversold;” the higher the blue line the more likely there is for a short term rebound. Absent the run-up and bursting of the bubble last year, the Chinese market has offered reasonable returns to investors and remains in positive territory over the past five years.

The violent move up and subsequent collapse to current levels do not portend a Chinese collapse. Rather, they are an indicator of hot money leaving real estate development and seeking returns elsewhere. This effect is magnified by the fact that the idea of Chinese stock market is itself a relatively new phenomenon and as such many Chinese investors are new to the paradigm of stock investing. The behavioral aspect of the Chinese investor cannot be overstated and will have a significant impact on how this market settles out. **We believe the Chinese market to be undervalued but that only the most risk tolerant investors should venture into these waters as volatility will persist.**

Interest Rates

Debt and Demographics have and will continue to serve as headwinds for growth as population growth slows and the developed world grapples with the accumulation of debt. Debt, in principle, is not necessarily bad but it always serves to pull future consumption to the present and in doing so reduce future consumption. A balanced debt load is therefore critical as too much debt can cause stagnation and even declines in the rate of growth.

Below is our estimate for interest rates in the key economic regions of the developed world:

Region	Current	Mid-2016	Dec-16	Dec-17	Dec-18
United States	0.50	0.75	1.0	1.5	2
UK	0.5	0.75	1.15	1.75	2.15
Europe	0.05	0.05	0.05	0.15	0.35
Japan	0.07	0.07	0.07	0.07	0.07

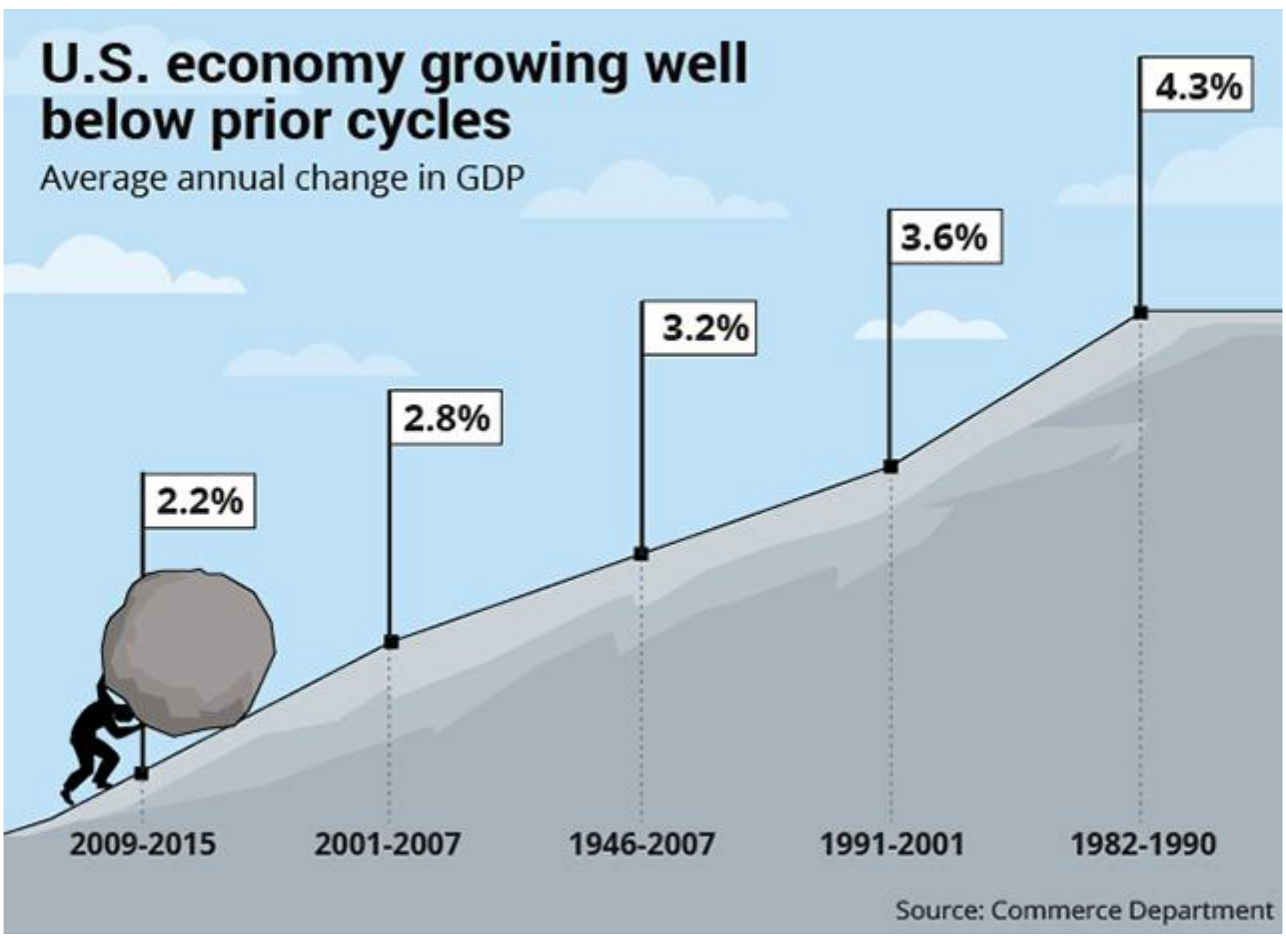
We believe that given benign inflation the US Fed will raise rates over the course of 2015 but more slowly then they initially indicated. Bonds can still be an effective tool for income and diversification but great care should be taken in the type and timing of those bond purchases.

Employment

The employment picture in the US will be little changed in 2016 having reached "full employment" as the headline, U3 figure dipped to 4.8%. The issue now, as it has been for the last number of years, is the quality of jobs not simply the quantity. We contend that the headline employment figure oversimplifies the employment picture in this country and that the labor market is far from robust in aggregate. Saying that, the employment levels of today bode well or at least better for consumption and they do not represent an economy that is over-heating by any degree.

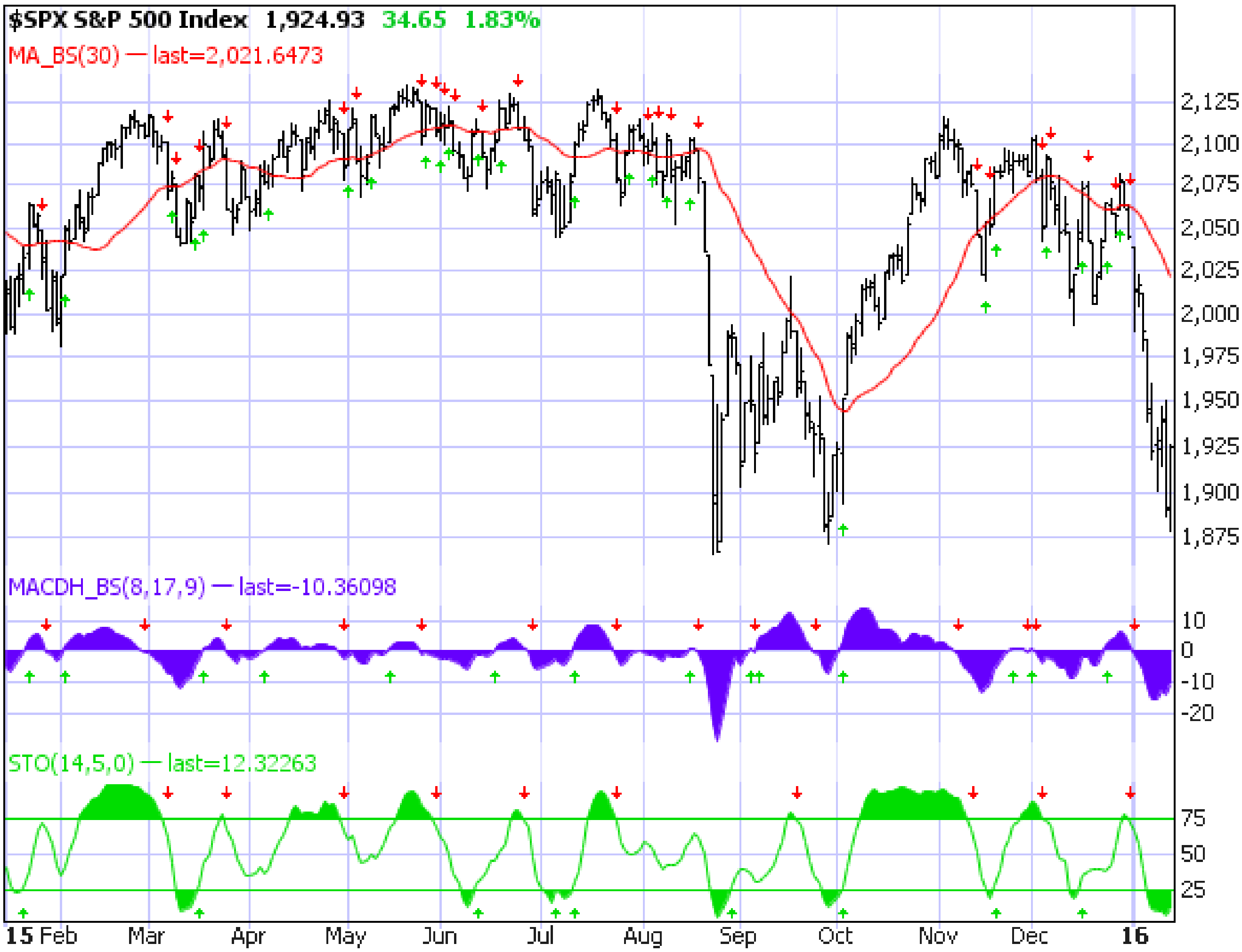
GDP Growth

The graphic below illustrates the sub-par performance of the recent recovery as compared with previous cycles. We believe the US economy will grow at a 2.25-2.5% annualized rate in 2016. **We believe stock market returns can be positive in this environment but expectations for future returns should be reduced.**

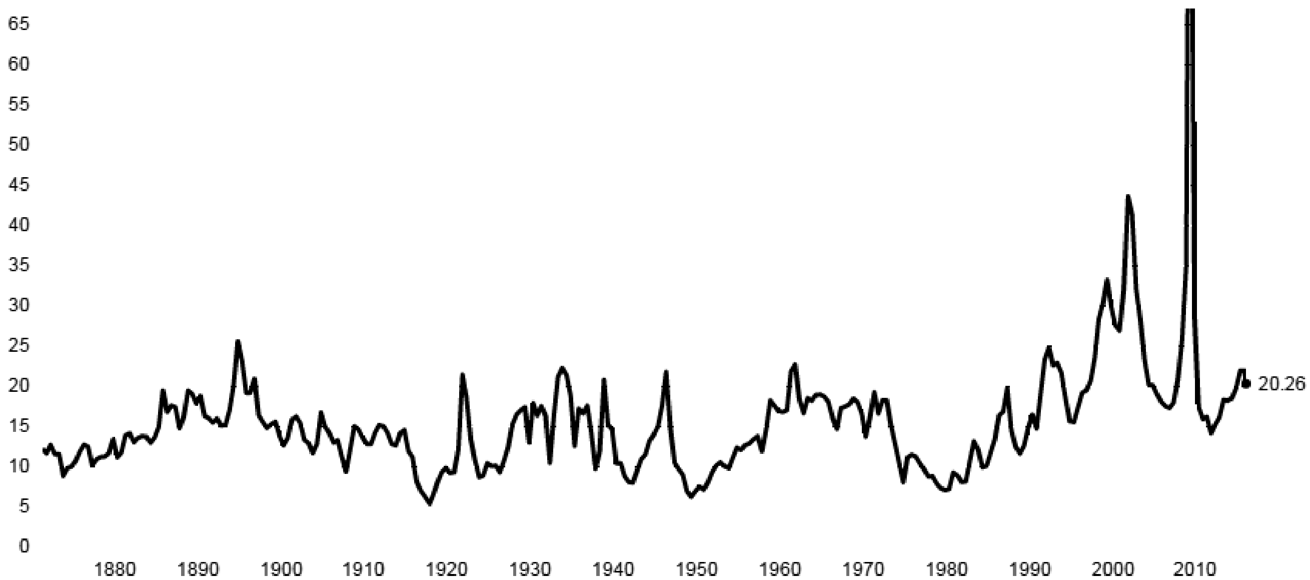


US Equity Market

The US markets as measured by the S&P are at a critical inflection point as illustrated by the trailing one-year chart below. 1875 is a critical level of support that as of today, is holding.



Fundamentally, we must look at the P/E ratio of the market to determine how cheap or expensive it is on a relative basis. A chart of the market P/E is on the following page:

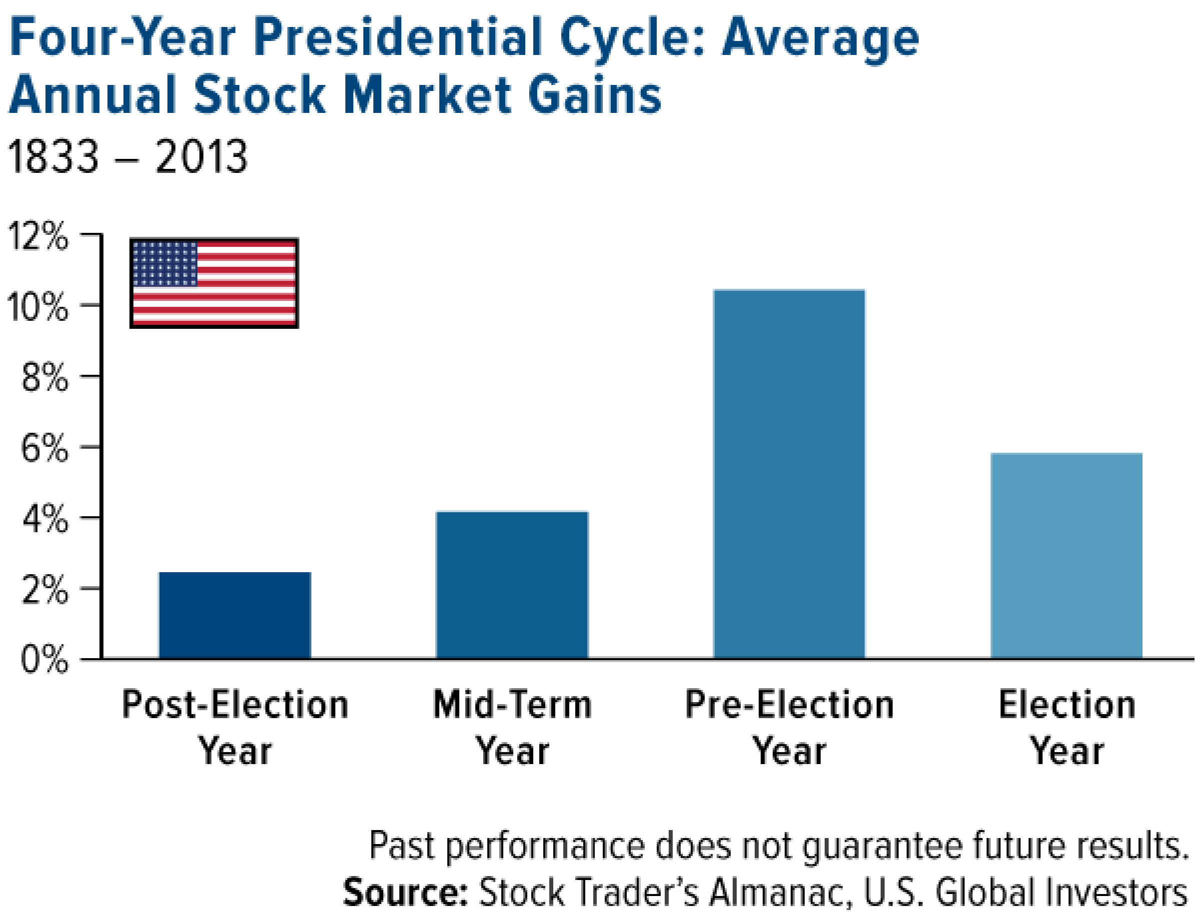


Currently the market is trading at a P/E of 20.26 based on an estimate of future earnings. The market has been dramatically more expensive for brief periods in 1897, 2001 and 2009. The P/E is in part elevated because the "E" portion of the equation has declined due to the crisis in the energy sector as we've discussed previously. **We believe that a stabilization and recovery in oil prices will have a positive impact on aggregate earnings and help current valuations. We also believe that the market is fully valued and absent above average earnings growth will be range bound in the near term.**

This is a time for investors to own high quality stocks, particularly those that pay dividends that can be reinvested while patiently waiting for opportunities to add to stocks if significant weakness should ensue. We want to emphasize that we still have a highly accommodative Fed and that markets are not in the position they were in going into 2008. We believe 2016 has the potential to be a positive year for stocks; but increased volatility will be the new normal at least until after the conclusion of the presidential election.

Elections

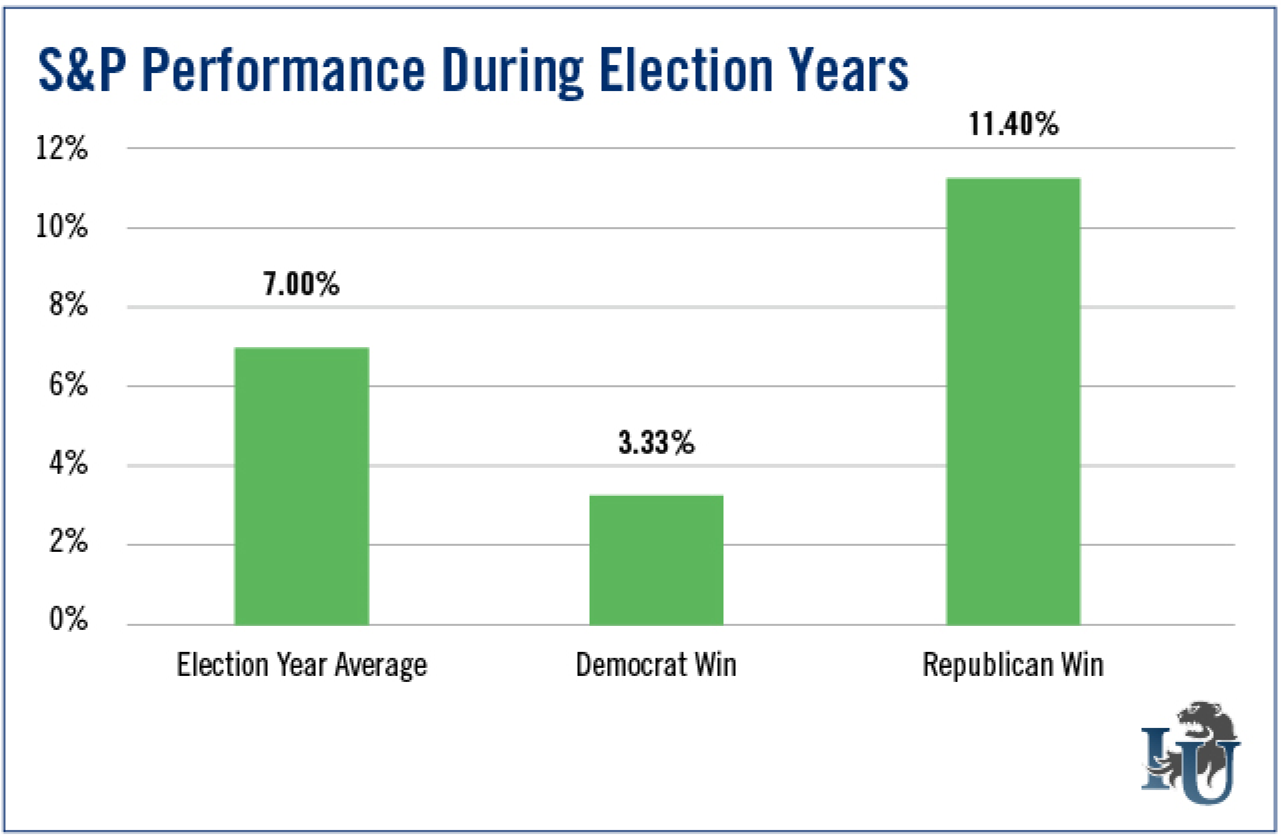
You don't need us to tell you that 2016 is a presidential election year and that politics can have something to do with the markets. If the election cycle already seems long and drawn-out, you're not alone and it will of course get worse before it gets better. We do not advocate attempting to build an investment strategy around Presidential cycles. It is dangerous to isolate one variable, such as an election, overlay a trend or market phenomenon and assume, that because they correlate, one has caused the other. Correlation is not causation so we must be careful, in examining the following charts to assume that there aren't other variables at play.

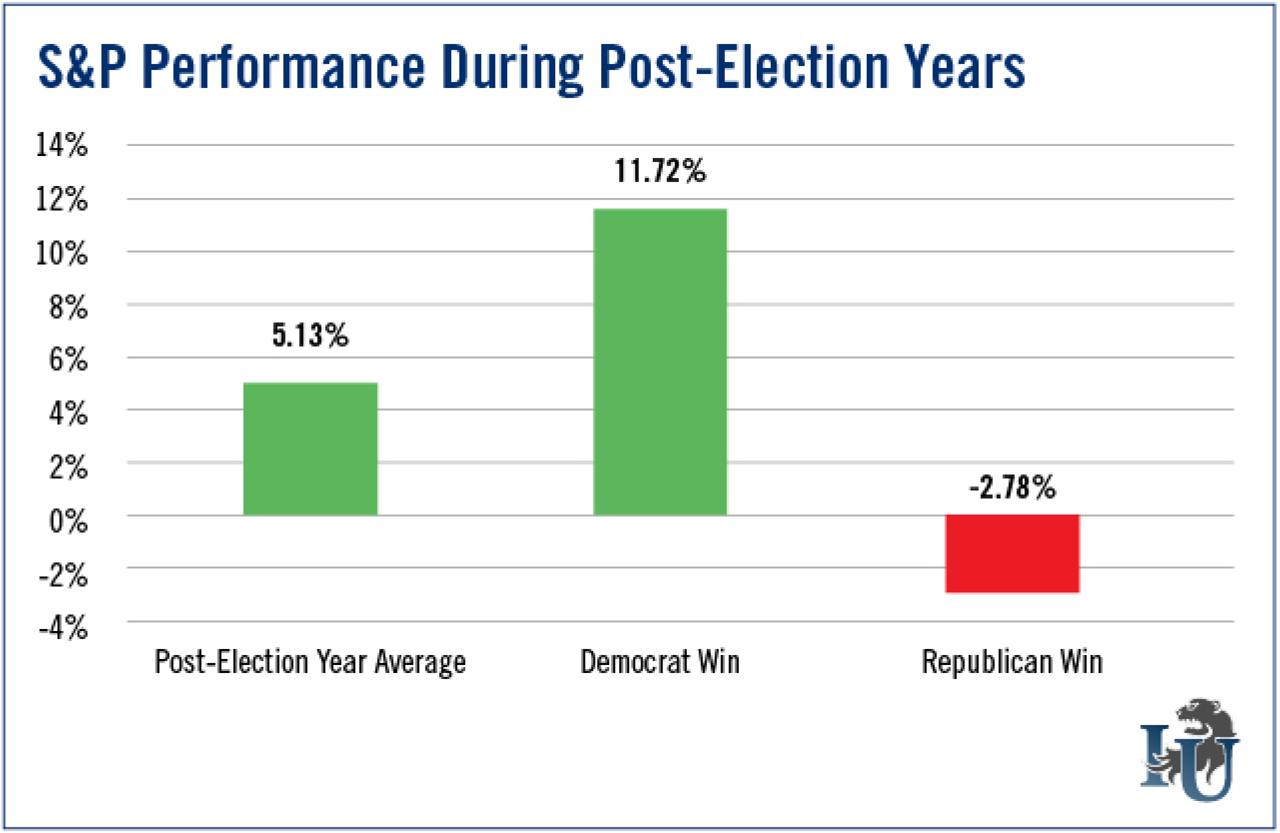


The above simply indicates that 4 year cycles tend to be best when measured at the end of a 3rd year in a presidential term and worst in the year after the election. There is generally some measure of relief once a candidate is elected and then increased volatility as the market seeks to grapple with what the new administration will mean to the economy. Just because it is an election year, however does not mean that stocks will necessarily do poorly. If they do poorly in 2016, it will be for reasons we've previously discussed and not simply because we're electing a new president.

The following two charts are not meant to illicit a partisan response one way or the other but simply to communicate the data. On average, we see that election years are positive regardless of who wins but that the market tends to do better in the election year when a Republican candidate wins the election.

The second chart indicates that even post-election years average out to be positive but that the market tends to do much more poorly when a Republican wins. We happily leave you to draw whatever conclusions you wish from that data.




S&P Performance During Post-Election Years
14%
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
5.13%
11.72%
-2.78%
Post-Election Year Average
Democrat Win
Republican Win

Concluding Thoughts

Understanding and grappling with data is important. As professionals, it's a task we're presented with each and every day. As important as good information is it cannot trump emotional discipline and sound investment process. It is our job to help our clients align their investment objectives with a portfolio of securities that offers them the best of chance of success in achieving those objectives. As we've said, we gave up the fear of perfection long ago but that does not keep us from striving to grow. We believe that success will come through the exercise of emotional discipline in the face of market turmoil. We further believe that emotional discipline can be grounded in sound investment process. We believe that success for any investor will come by consistent application of sound process and it is our job to implement and oversee such process each and every day.

The observations contained herein can in no ways fully plumb the depths of each of the subjects touched-upon so we encourage questions and feedback if there are additional items you'd like for us to address. Thank you for your time and consideration of our 2016 Annual Forecast.

Glossary of Key Terms

ECB – The European Central Bank is the central bank responsible for the monetary system of the European Union and the Euro as a currency. Unlike the Federal Reserve, the EU is not considered a lender of last resort and must thereby coordinate policy measures with individual member states.

GDP – Gross Domestic Product is the monetary value of all the finished goods and services produced within a country's borders.

IMF – The International Monetary Fund was founded in 1944 at the Bretton Woods Conference and formerly created in 1945 with 29 original member countries. The IMF seeks to promote global monetary exchange stability, facilitate the expansion of international trade and assist in the establishment of multilateral systems of payments for currency transactions.

PE Ratio – The Price to Earnings Ratio is the price paid for $1 of Earnings Per Share. The metric can be applied to individual stocks as well as indices and seeks to determine how cheap or expensive a security or index may be.

QE – Quantitative Easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

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