January 4th, 2016

Forewarned is forearmed…

It was a somber 2015 for investors as most of the major asset classes that diversified investors allocate capital to finished the year near the flat line or handsomely in the red:

- Dow Jones Industrial Average lost 2.2%
- S&P 500 declined 0.7%
- Nasdaq Composite rose 5.7% (the sole bright spot among major US equity indices)
- Euro Stoxx 600 declined 4.1% (in dollars)

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- Japan's Nikkei 225 Index finished near the flat-line with a modest decline of 0.4% (in dollars)
- China's Shanghai Composite contracted 4.4% (in dollars)
- Emerging Markets (EEM) cratered 18%
- The 10-year Treasury bond managed a slight gain of 0.1% despite its yield increasing by 10 bps from the beginning of 2015 (10-year yield ended 2015 at 2.27%)
- Junk Bonds experienced their worst year since 2008 losing 12%
- The U.S. Dollar Index rose 9.3%
- CRB Commodity Index plunged 14.6%
- WTI Crude Oil cratered 30.5% in 2015 after a 50% decline in 2014

In a word, 2015 was challenging for investors with risk assets limping to the finish line as the S&P 500 capped off the last week of the

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year by losing 0.83% and closing out the month of December with a 1.75% loss. What's more, the technical setup for stocks continues to be feeble with market breadth barely showing a pulse. While the S&P 500 ended the year a modest 4% below its May 2015 all-time high of 2,131 the internals of the index are looking much weaker with more than 30% of its components in a bear market.

Technical weakness stems beyond just the large-cap dominated S&P 500 with the median stock in the Russell 3000 (a benchmark index that comprises 98% of U.S. traded stocks) down over 20% from its 52-week high, 37% of the stocks in the S&P MidCap 400 index down 20% or more, and 46% of the stocks that make up the S&P 600 SmallCap index down more than 20%. I don't mean to pour cold water over all the optimism that comes with ushering in a new year, but a

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similar breadth setup occurred before the bear markets in 2007, 2000, and 1987.

Unfortunately the handoff from 2015 to 2016 is off to a rough start with China's Shanghai Index plummeting 6.9% overnight as circuit breakers were triggered to halt trading given the severity of the one-day decline. The sell-off was fueled in part by continued weakness in China's manufacturing sector with the Caixin PMI index falling to 48.2 in December from 48.9 in November (this marks the 10th straight month of sub-50 readings for this index). This of course renews the calls that China is destined for a hard landing and that a smooth transition to a service and consumption based economy is a foolhardy notion.

Time will tell how this ultimately unfolds, but ignore at your own peril the growth slowing

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and deflation signals that are emanating from this transformation in what is the second largest economy in the world. For instance, copper is down almost 3% to kick off 2016 and this follows a nearly 25% decline last year – this is a metal that is known for its well-earned PhD in economics when it comes to gauging economic strength (or lack thereof) in the global economy.

Beyond China we have a blossoming rift between Saudi Arabia and Iran following the kingdom's execution of dissident cleric Nemer al-Nemer which inflamed sectarian tensions. This is causing oil prices to spike in the wee hours of the morning, but I suspect this will be a fleeting knee-jerk reaction as investors take note of comments from Seyyid Mohsen Ghamsari, Head of International Affairs at National Iranian Oil Co., that they intend to boost oil production by 500k barrels a day

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within a week of sanctions being lifted, and by 1 million barrels per day shortly thereafter.

Inevitably, the supply/demand backdrop in the oil market will find equilibrium as all the participants find their place at the table, but it is very difficult to put a date and price level on when this will occur. The U.S. rig count has been slashed by almost 70%, yet production in the states is still running above 9 million barrels per day from a peak of 9.6 million bpd. The latest data out of Russia indicates that its production increased to a record high 10.825 million bpd last month. OPEC continues to pump crude as if prices were north of $100/barrel in large part as a result of Saudi Arabia's unwillingness to relinquish market share to any of its competitors.

What is becoming increasingly worrisome is the duration of time at which oil prices have

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stayed at these low levels. Keep in mind that the finances of numerous economies are predicated upon the profits derived from their oil production, where we are starting to see the financial pain impact the fiscal standing of these nations with deficits to GDP escalating rapidly. Moreover, default rates for over-indebted energy companies are also on the rise which spells trouble for stability in the capital markets.

Shifting the attention back to the economy and by extension the capital markets, coming into 2015 our view could best be described as cautiously optimistic with a touch of skepticism. It was my belief that we were somewhere in the mature stage of the business cycle and I was on the lookout for signs of a transition into the late stage of the cycle. It is difficult to discern how long this transition could take – could be months, could be years

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– either way it was a distinction that I knew would have to be made in real time as the data was reported throughout the year.

As the year unfolded and data from corporate profits, employment, and confidence to gauges on manufacturing and non-manufacturing activity, imports and exports, capital market activity, and investor positioning got reported, my cautious optimism and skepticism evolved into outright caution and it now stands at concern.

I am currently of the belief that investors need to acknowledge and position themselves accordingly based upon the escalating probability that a recession materializing in the next 12 – 18 months has increased significantly. This isn't to say that it is a foregone conclusion or a definite outcome. Those of you who have read these musings

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know that I like to think in terms of probabilistic outcomes – not in terms of black or white. With that said, our research as well as the work we follow leads us to conclude that the probability of a recession is elevated to a point where we think it is prudent for this outcome to be reflected in how we are allocating our client's capital.

Furthermore, I am of the opinion that the consensus view within the capital markets is that we are in the midst of a mid-cycle slowdown or a pause that refreshes. If this 'pause that refreshes' view proves to hold true, and my recessionary view is wrong, I don't think the upside payoff on the consensus view is very lucrative. Reason being is that I think this outcome is already priced into a stock market that is trading at an above average 16.5x forward earnings (near peak levels for this cycle), where stock ownership

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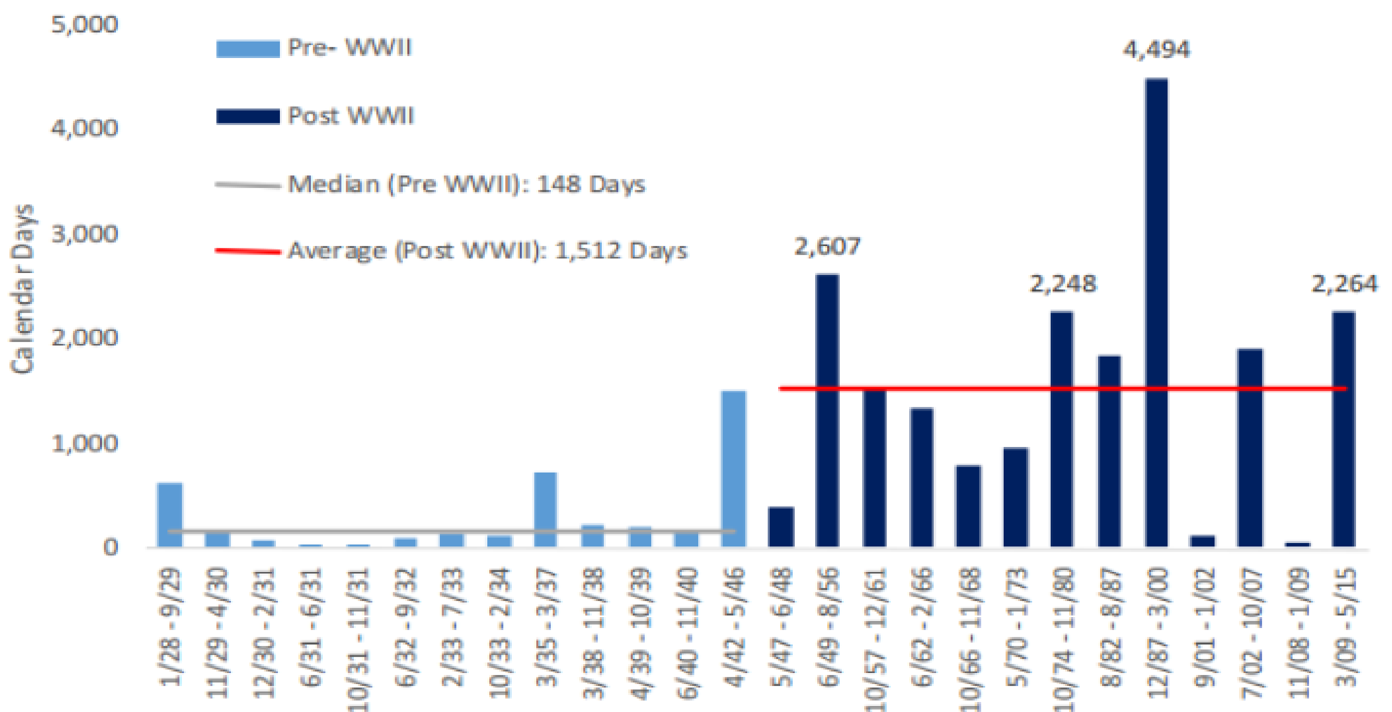
as a percent of household assets at 37% is at its second highest level in the history of the data going back to 1951 (compared to readings at prior bull market peaks of 35% in 1968, 47% in 2000, 36% in 2007 – contrast this with bear market levels of 15% in 1982 or 29% in 2003), and investor complacency is widespread as a result of the fourth longest and fourth strongest bull market in history (see chart’s below).



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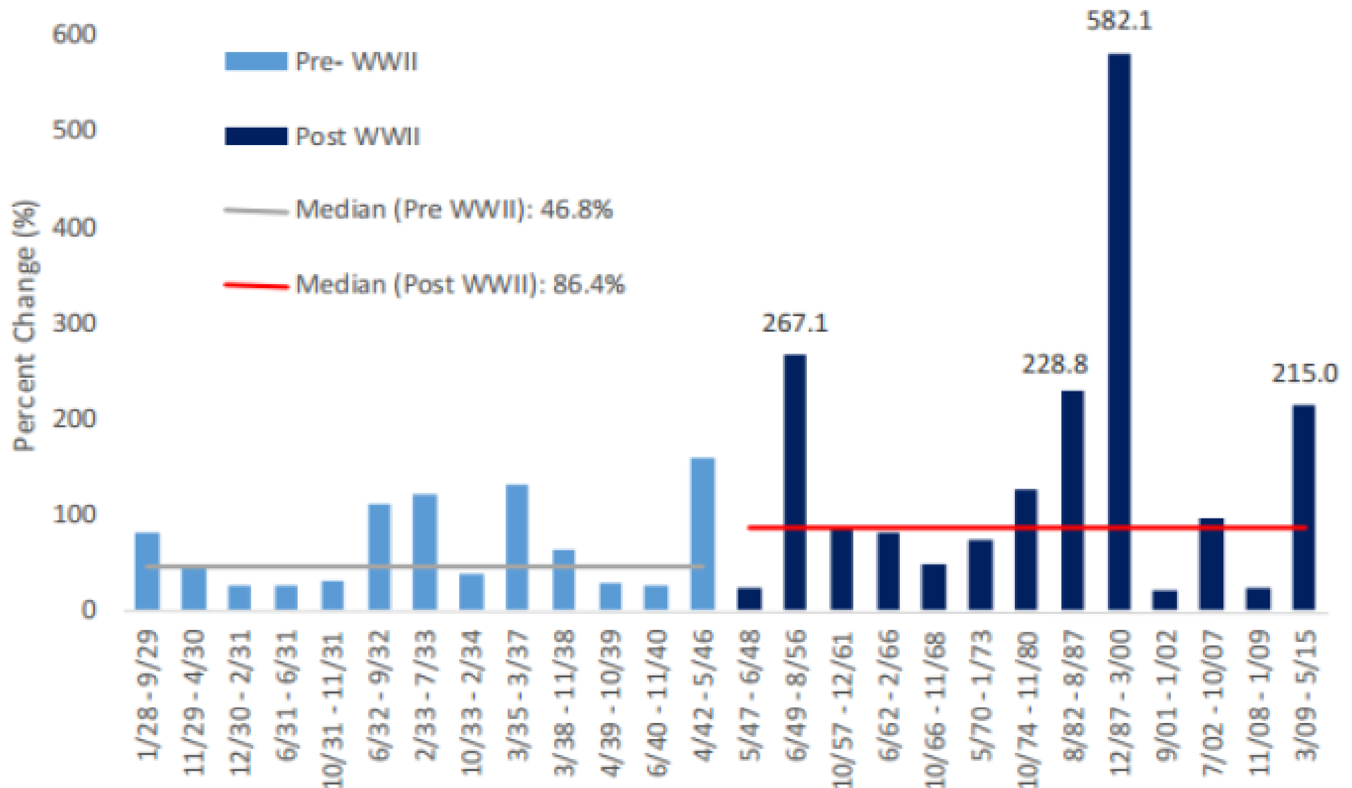

What I believe to be the biggest risk facing investors over the balance of 2016 is that the escalating probability of a recession occurring starts to get priced in – this is not an outcome that is being reflected in the stock market currently (although, perhaps today's activity is a foray into what's to come on this possibility) . In the last three recessions we saw earnings decline on average by 33% (21% in '90-'91, 29% in '00-'02, and 49% in '07-'09) with

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corresponding peak to trough declines in the S&P 500 of 20%, 49%, and 57%, respectively. Consensus estimates are for the S&P 500 to earn $126/share in 2016, if a recession occurred and earnings were cut on average with the last three recessions we would see 2016 earnings cut to approximately $85/share. Put a recessionary multiple of 13x earnings on this figure and you could see the S&P 500 trading down to roughly 1,100 (46% below where it closed 2015).

There is a litany of data and market indicators that are driving my negative view. We are now entering the 80th month of this expansion which far outstrips the average length of 59 months for the previous fourteen expansions. The yield spread (steepness in the Treasury yield curve measured by the difference in yield between the 10-year and 2-year Treasury notes) ended 2015 at 123 basis points – its

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tightest spread of the year after starting the year at 146bps and reaching 177bps near the stock market highs in June. This spread was as wide as 258 basis points in December 2013 when the economy was rolling along and the stock market was putting the finishing touches on a +30% gain for the year. An inverted yield curve – interest rates on short-term Treasuries moving above interest rates on long-term Treasuries – occurred prior to each of the last seven recessions.

Employment growth is still expanding on an absolute basis as monthly average job creation eclipsed 200k for all of 2015, but the trend rate of growth in the monthly employment data peaked in Q1 and has been decelerating ever since. Furthermore, the following chart tracking initial jobless claims, which continue to hover near cycle lows and remain below the key 300k level (although starting to modestly

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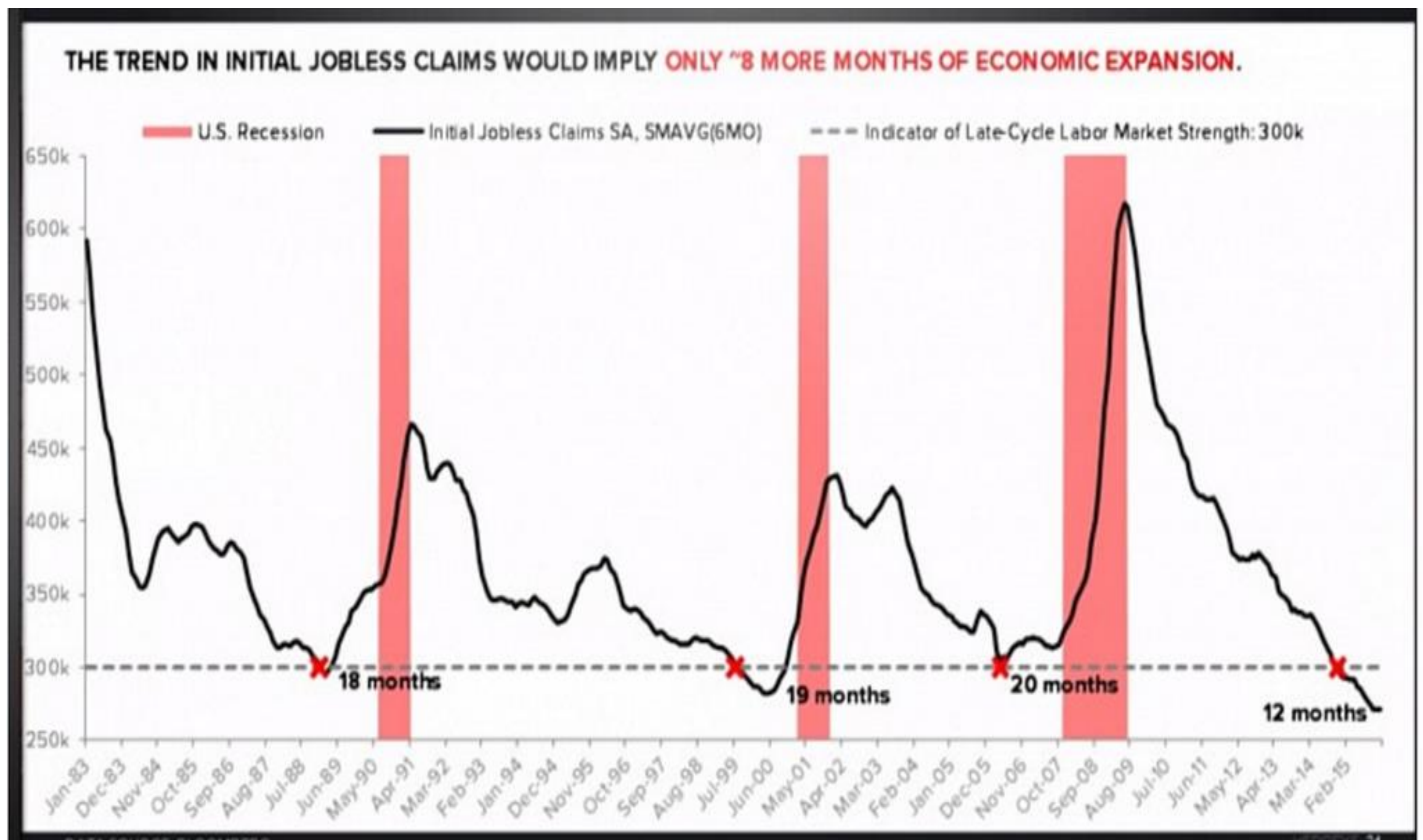
increase) are a notorious late cycle indicator and in the last three cycles we were in a recession within 20 months of the 300k level being breached on the downside.



Corporate profits are in an earnings recession with earnings growth in the second and third quarters contracting on a year-over-year basis – earnings estimates for Q4 indicate the S&P 500 is in store for a third consecutive

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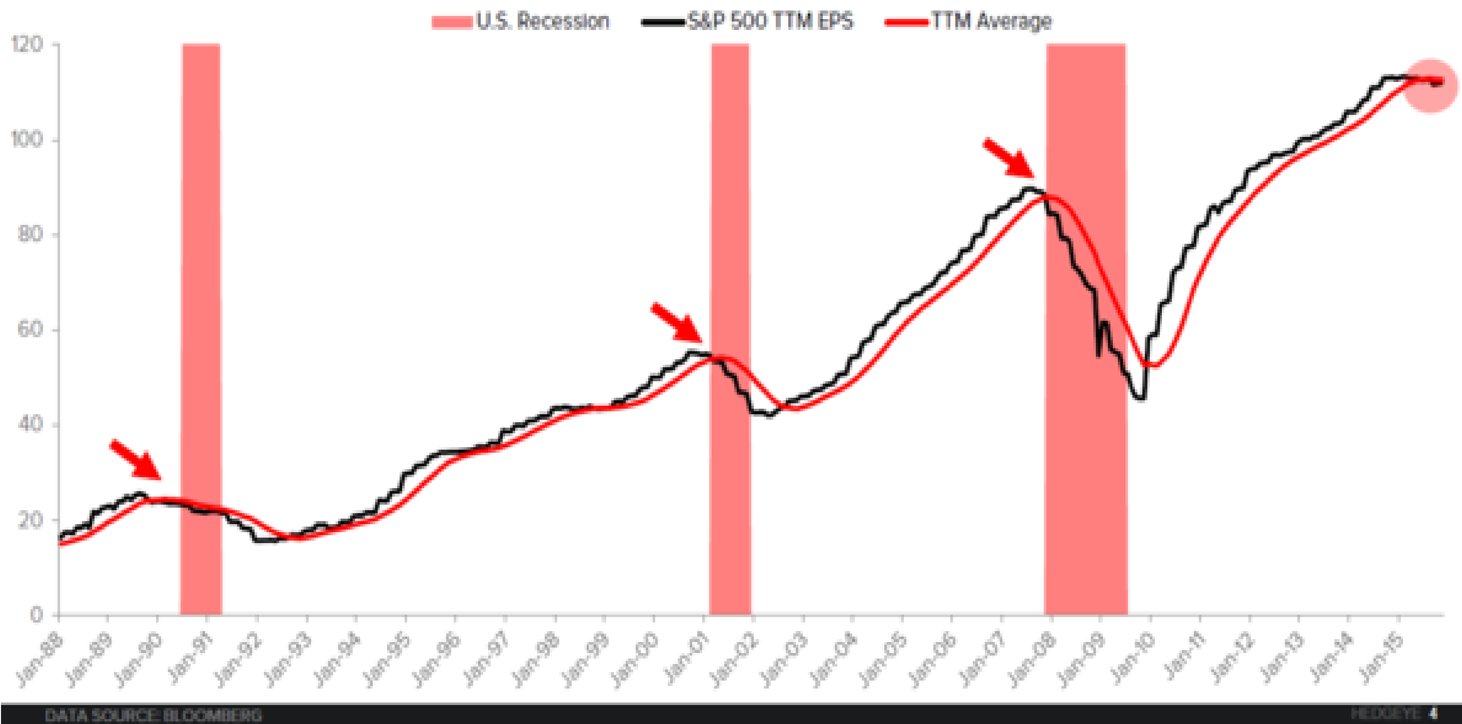
contraction. History shows that once EPS growth plateaus and begins to rollover it's not too long before a recession commences.



The industrial economy is already in a recession and this was highlighted by the putrid Chicago PMI index reading last week which fell to 42.9 in December from 48.7 in November. This was 16.5 points below the

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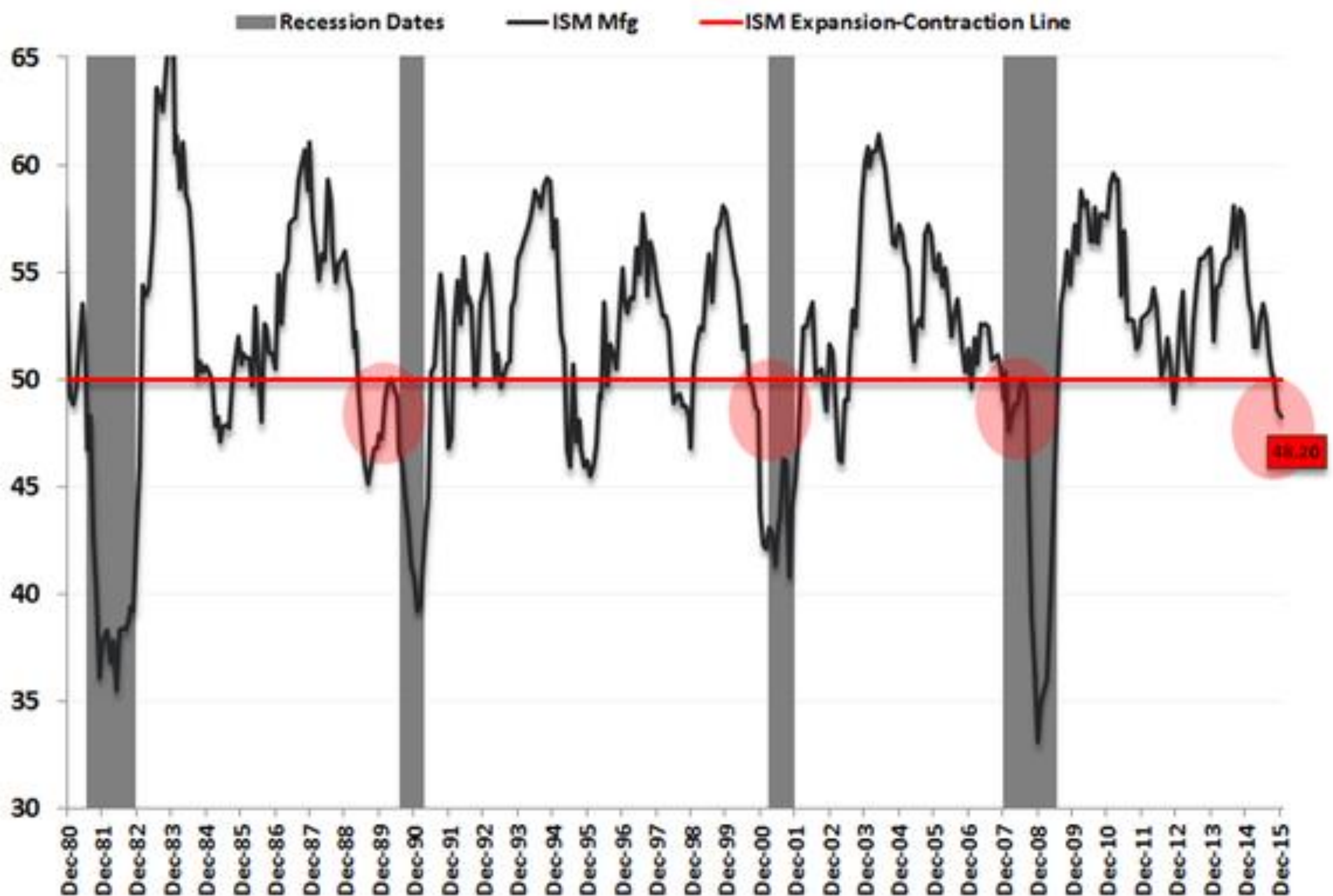
January high of 59.4 and foreshadowed the weakness in this morning's ISM Manufacturing Index falling to 48.2 in December from 48.6 in November. This is the second consecutive month of contractionary readings and history portends that this has not been a constructive omen for the economy or the equity markets.



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I could continue to litter this commentary with more charts showcasing the late cycle animal spirits of corporate America as M&A activity set new all-time highs in 2015 or consumer confidence peaking and rolling over in Q1… but I figure you more than likely get the point of what I'm getting at.

In a nutshell, my/our message is that the probability of a recession occurring in the next 12-18 months has increased to a level that I believe would be irresponsible for any investor to overlook or downright neglect if they chose to ignore it. This is a time that demands prudence, discipline, and patience, as the last stage of the business cycle is typically the trickiest and most difficult to navigate. It's chock-full of conflicting signals and head-fakes which will test your conviction and inherently create self-doubt. But rest assured, if this is where we are in the cycle, this is a

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time when you will be much better served being capital preservation oriented rather than focused on capital appreciation.

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