AEQUITAS INVESTMENT ADVISORS

INVESTMENT REPORT - FIRST QUARTER 2016

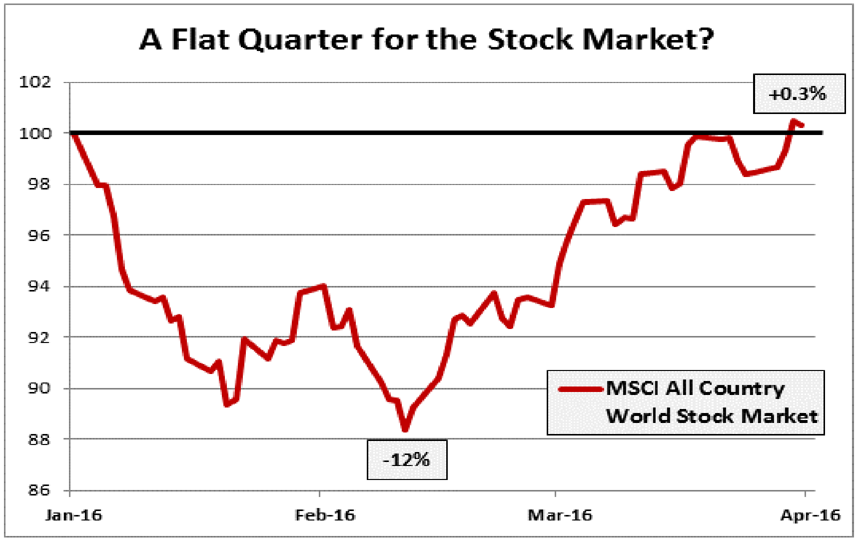
To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Has the Global Economy Become Mired in the *New Mediocre*?

Dear Client,

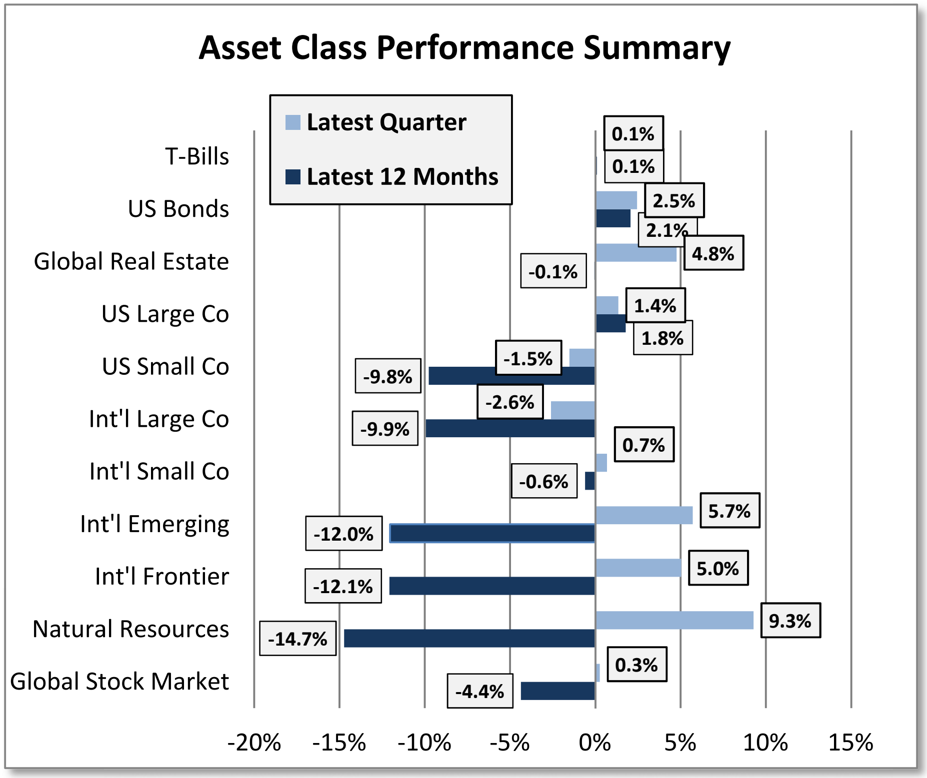
In a recent speech, the Managing Director of the International Monetary Fund, Christine Lagarde, summarized some of the highlights (and lowlights) of the IMF's semi-annual *World Economic Outlook Report*. Ms. Lagarde reviewed the serious risks and challenges facing the global economy including China's economic slowdown, depressed oil prices, potential missteps by central bankers (e.g., raising interest rates too soon) and rising geopolitical tensions, including the impact of terrorism, global epidemics and the refugee crisis. Not a particularly rosy picture, to say the least. While she is cautiously optimistic about the state of the global economy ("…the recovery continues; we have growth…"), she's concerned the recovery remains too slow and fragile with too many people still suffering the ill effects of the Great Recession. Particularly concerning to Lagarde is that persistent slow growth could become "self-reinforcing" and we could become trapped in what she calls the "new mediocre", i.e., an economy which underperforms its full potential. One result of disappointing economic progress has led some to question established institutions and international cooperation. Lagarde bemoans, "To some, the answer is to look inward,….to close borders and retreat into protectionism" (sound familiar?). Rather than retreating into isolationism, Lagarde calls on policymakers across the globe to move forward in cooperative efforts to (1) implement structural reforms (e.g., deregulating product and services markets and reforming labor markets), (2) create pro-growth fiscal policies (e.g., reducing outlays on costly subsidies and investing more in social and physical infrastructure) and (3) continue implementing appropriate monetary policies, including taking measures to strengthen the banking system and lessen the systemic risks to the financial system. Lagarde's three-pronged set of recommendations will clearly be difficult to implement from a political perspective, but unless our political leaders and policymakers rise to the occasion, she fears we may be stuck in the "new mediocre" for many years to come (we'll address some of the potential implications for investors later in this report).



Asset Class Performance Review

Over the past three months, investors have been busy reacting to conflicting news about the economy as well as troubling and heartbreaking geopolitical events. In the graph above, note how investors were particularly bearish in the first six weeks of the year leading to a 12% stock market plunge; the *worst start to a calendar year on record*. The tide turned sharply positive, however, as investors cheered healthy US employment reports and reassurance from both Janet Yellen and Mario Draghi (President of the European Central Bank) that interest rates would likely remain low for longer (while lower rates in the short-run may be stimulative, low rates are particularly problematic for bond investors).

The latest quarterly performance was positive for all but two of the major asset classes with the biggest gains coming from three of the worst performers in 2015; Natural Resources (+9.3%), Emerging Markets (+5.7%) and Frontier Markets (+5.0%). Natural Resource stocks received a nice boost in March as the price of oil began to rebound. Stocks in the Emerging and Frontier Markets also benefited from rising oil prices as well as bargain hunting by investors. Global Real Estate (+4.8%) continued to attract capital flows from investors in search of higher yields. Next in line were US Bonds (+2.5%) and US Large Cap stocks (+1.4%); Int'l Small Co's (+0.7%) and Treasury Bills (+0.1%) produced miniscule gains. The two losing asset classes were US Small Co's (-1.5%) and Int'l Large Co's (-2.6%). The MSCI All Country World Stock index gained a paltry 0.3% (i.e., the *flat* return on stocks for the quarter).



Performance over the latest 12-Months was mostly negative with the sharpest declines coming from the three winners of the latest quarter; Natural Resources (-14.7%), Frontier Markets (-12.1%) and Emerging Markets (-12.0%). International Large Co's (-9.9%) and US Small Co's (-9.8%) also landed in negative territory. Int'l Small Co's (-0.6%) and Global Real Estate (-0.1%) were about flat for the year while US Large Co's (+1.8%) and US Bonds (+2.1%) eked out small gains. US T-Bills "gained" 0.1%. The MSCI All Country World Index lost 4.4% for the trailing twelve months.

The Impact of Lower Investment Returns

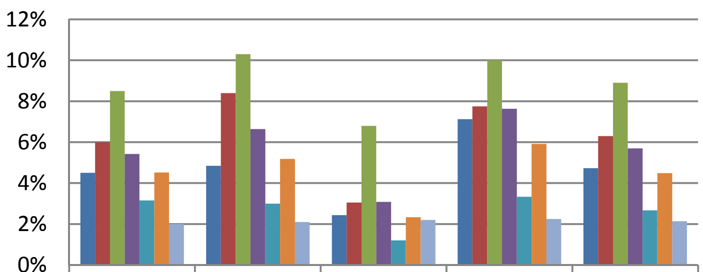
An article appeared in the *Financial Times* this month reporting findings from a Stanford Graduate School of Business study which claimed the US public pension system is potentially facing a "disastrous" funding gap due to low interest rates and potentially lower returns on investments in the future (due to a slower growing economy). According to the study, many public pension funds (primarily cities and states) have been calculating their funding liabilities under the assumption they could achieve investment returns of 7% to 8% annually. While public pension funds may have realized returns in excess of 7% in the past, achieving such returns in the future is problematic given low interest rates and the prospect of lower than historic returns for equities. The study identified the states of Illinois, Arizona, Ohio and Nevada and the cities of Chicago, Dallas, Houston and El Paso as having the largest pension funding gaps. To deal with the shortfalls, according to the study, contributions to the pension funds will need to be increased significantly "either by raising taxes or cutting spending on vital services." Of course, as in the case of Detroit's bankruptcy, another unfortunate alternative may be a reduction in retiree's pension benefits.

Projecting Future Investment Returns

While it is impossible to predict the future, in order to create long-term investment plans for our clients it is necessary to make assumptions about prospective rates of returns and to consider a wide range of possible economic scenarios. Given the possibility of a slowly growing global economy (the "new mediocre"?), we need to make certain our assumptions about future investment returns are realistic and achievable. We also need to carefully consider our assumptions about future inflation rates. History has taught us a great deal about how various investments have performed in a variety of economic conditions, including periods of low and high inflation as well as periods of slow economic growth, including recessions, and periods of faster growth. We also review a great deal of current macroeconomic data in constructing future return expectations, including where economists see interest rates heading and which regions of the world are likely to exhibit faster economic growth. Current stock market valuations and future corporate earnings estimates also provide clues as to future relative stock market performance. Much of the data we evaluate is provided by highly regarded *independent* macroeconomic research firms; including BCA Research and Capital Economics which employ teams of economists and have extensive research capabilities around the globe in both the Developed and Emerging Markets.

We also consider the forecasts of other respected investment firms in order to evaluate alternative points of view about future returns. In the chart below, we've compared the recent long-term forecasts of four firms: BCA Research and the investment firms of Research Affiliates, GMO and J.P. Morgan. (Keep in mind these are "expected" future return estimates based upon different assessments of current and future economic conditions as well as different mathematical models. The forecasts are updated periodically as economic conditions evolve.) The range of expected returns is quite wide with the most pessimistic being GMO (unsurprisingly) and the most optimistic being Research Affiliates and J.P. Morgan. In the red box, we've created a Balanced Portfolio utilizing the individual asset class returns as a point of comparison (40% in Bonds and 60% Global Equities). The Balanced Portfolio's range of returns over the next 7-10 years is from a low of 2.3% to a high of 5.9% with an average of 4.5%. In comparison, over the past ten years (which includes the Great Recession), the annual return on a similarly constructed 40-60 Balanced Portfolio was 5.5%. In sharp contrast, the historic average annual return from 1926 to 2015 for a 40% Bond and 60% US Stock portfolio was close to 7.5% (perhaps that's what the US public pension funds are hanging their hats on?).

"Expected" 10 Year Future Annual Returns



	BCA (10 Yrs)	Research Affil. (10 Yrs)	GMO (7 Yrs)	JPM (10+ Yrs)	Average
US Equities	4.5%	4.9%	2.4%	7.1%	4.7%
Non-US Dev. Mkts	6.0%	8.4%	3.1%	7.8%	6.3%
Emerg. Mkts Equities	8.5%	10.3%	6.8%	10.0%	8.9%
Global Equities Mix	5.4%	6.6%	3.1%	7.6%	5.7%
Fixed Inc Mix	3.2%	3.0%	1.2%	3.3%	2.7%
40% Bond-60% Stock Balanced Portfolio	4.5%	5.2%	2.3%	5.9%	4.5%
Inflation	2.0%	2.1%	2.2%	2.3%	2.1%

What other observations can we glean from the four forecasts of expected future returns? All four firms project the highest returns will come from Emerging Markets stocks and Non-US stocks generally (US stocks are considered over-valued relative to non-US stocks). Three out of four expect bonds to beat inflation; however, the average of 2.7% for bonds is far lower than their historic average of 4% to 5%. On a more positive note, all four forecasts expect inflation to average a little over 2% which is about 1% lower than the historic average (a lower rate of inflation will help partially offset the impact of lower investment returns).

How Might We Potentially Improve Future Portfolio Returns?

There are other important factors to consider in constructing future return expectations, including the allocation to Small Cap versus Large Cap stocks and the allocation to Value versus Growth stocks. Historically, Small Cap stocks have outperformed Large Caps by about 1% per year on average and Value stocks have outperformed Growth stocks by about 3% per year. By "tilting" our recommended portfolio structures toward smaller companies and lower priced Value stocks, we believe the potential exists to significantly improve future investment returns.

Must We Accept the "New Mediocre"?

Christine Lagarde paints a rather discouraging picture of future economic growth unless certain actions are taken by our policymakers and political leaders. On the policymaker front, we're somewhat optimistic that central bankers around the world will continue their efforts to stimulate economic growth through supportive monetary policies. In our view, Janet Yellen and the Fed are doing a good job to foster growth in the US. On the political leadership front, at least in the US, we probably won't have clarity on future fiscal stimulus possibilities until after the election in November. We hope the next president recognizes the need for pro-growth fiscal stimulus in order to address our nation's physical and social infrastructure needs.

From an investment planning standpoint, we need to incorporate the impact of potentially lower returns when we review and revise our long-term financial projections. However, we're optimistic we can structure portfolios to take advantage of important factors which have the potential to improve future returns (emphasizing undervalued asset classes, for example). So while the global economy may end up mired in the "new mediocre", we don't believe our portfolios need suffer the same fate.