JANICZEK® WEALTH MANAGEMENT

Portfolio Matters
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A TALE OF TWO HALVES
Volatility Underscores Our 2016 Outlook

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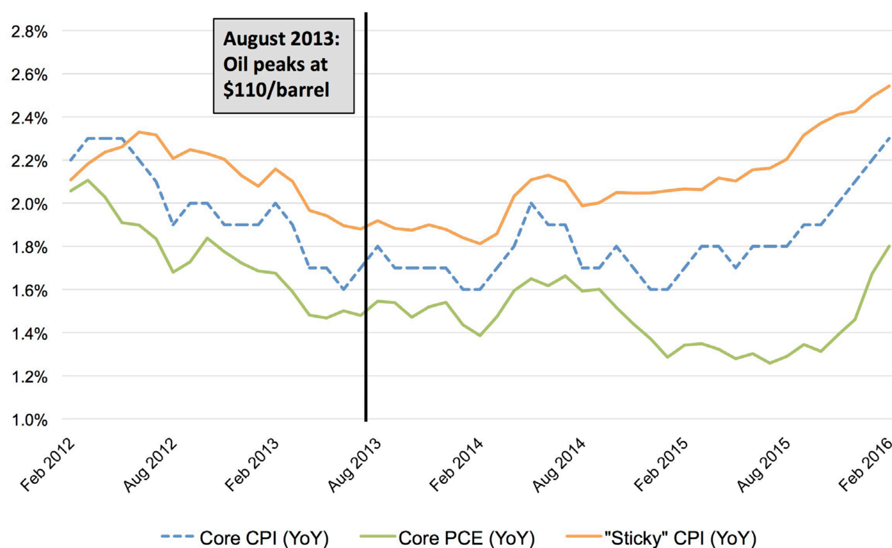
The month of April brings one of the year's more popular days (baseball's opening day) as well as one of its least popular days (tax day). But swinging between good days and bad days is something that investors have gotten used to in recent quarters, and so far 2016 is no exception.

After its worst calendar year start on record, the global equity market rallied hard to post positive gains for the first quarter. Bonds beat stocks, but unlike historical periods of bond outperformance, we don't see signs of imminent recessionary risk. As we wrote in January, though, we do see a bumpy road ahead, and the first quarter surely delivered on that forecast.

Over the following pages, we translate these choppy markets into risks to monitor and opportunities to pursue.

Economy
At 81 months old, the U.S. economic expansion that began in July 2009 is now the longest on record. The bad news is that the 2.1% average growth generated during this expansion is also the weakest among all expansions dating back to 1948. This lackluster growth probably explains the seemingly permanent presence of pessimism in the markets.

The headline data suggest more of the same sluggish growth we've seen since the Great Recession ended over 6 years ago. The latest GDP growth number clocked in at 1.4% for the quarter ended December 31, better than the 1.0% the market was expecting. We won't get a read on the first quarter until the end of April, but we wouldn't be surprised to see a weak number, possibly even negative, based on some initial data points we follow.



BOTTOM LINE

- Equities had quite a ride in Q1, but our 2016 outlook remains unchanged
- We see some inflationary signs that would be a positive for economic growth
- Although bond yields could remain low for long, volatility is likely to rise
- MLPs operating results remain sound, toll road business model intact

Interestingly, while slow growth has sustained concerns about another recession and deflation, we see data that suggests a possible pickup in inflation. In a fascinating study done by the Federal Reserve Bank of Atlanta, economists took a different angle in analyzing the Consumer Price Index ("CPI"), categorizing its underlying components based on how often price changes occur. For example, prices at the gas station or a restaurant may change more frequently than, say, services such as medical care, education, and personal care. The "sticky" CPI includes about 70% of the overall CPI, and given its forward looking characteristics, it's a good indicator for future readings for the overall CPI. The latest "sticky" CPI is running at 2.5%, up from 1.9% in August 2013.

The CPI shows current inflation of 1.0%, but stripping out the volatile food and energy sectors, the so-called "Core CPI" shows inflation running at 2.3%, up from 1.8% in August 2013. Another inflation measure that's followed more closely

by the Fed, the Personal Consumption Expenditures ("PCE"), shows inflation at 1.8%, higher than its August 2013 reading of 1.5%.

Why are we referencing August of 2013? Because oil peaked at $110 a barrel that month and has fallen 65% to $37 a barrel. Our point here is that continued declines in commodity prices have offered consumers a nice economic boost. But looking beyond the food and energy components, we see the potential for higher inflation in coming quarters. This is good news for the economy, at least, until wage inflation becomes problematic for employers. Currently, wage growth has some room to run.

This brings us to the Federal Reserve's monetary policy. During the quarter, the Fed signaled a slower pace of interest rate hikes in 2016. This is good news for investors as it brought the Fed's forecasts down to an expectation that's in line with the market. Further, past interest rate hikes done at a slow pace produced greater equity market returns than cycles in which interest rate increases were done faster.

We reiterate that we view the current economic environment in the U.S. as a healthy one, and it's increasingly difficult to justify near-zero interest rate policy. We expect short term rates to normalize around 2.5% to 3.0%, but timing will depend upon the economy's (and inflation's) path.

In assessing the U.S. economy, we also look at aggregate economic data at the state level. In fact, aggregating state economic figures into a model has done a nice job of signaling turning points in the national economy. Currently, this model points to a low level of recession in the near future, giving us further confidence in our domestic outlook.

During the quarter, the U.S. dollar index (the U.S. dollar measured against a basket of foreign currencies, weighted by trade volume) fell 4.8%. This decline follows a 10.9% gain in 2015 and a 28.6% rise since 2012. Changes in the values of the U.S. dollar (or any foreign currency, for that matter) impact short term results, but studies show that longer term currency movements tend to have little impact on investment returns.

Our economic research suggests that the U.S. dollar's rise may be challenged by inflation differences across borders. While higher U.S. rates should theoretically attract investors, pushing the dollar higher, "real" interest rates (interest rates after accounting for inflation) are already lower in the U.S. than abroad, which will discourage investment. Our point here is that the strong gains in the U.S, dollar seen since 2012 are not expected to persist, and the 2016 decline supports that thesis.

Our global economic data shows some risks to growth, but the data fall short of calling for a global recession. With U.S. strength, we believe the overall economic backdrop is supportive for investors.

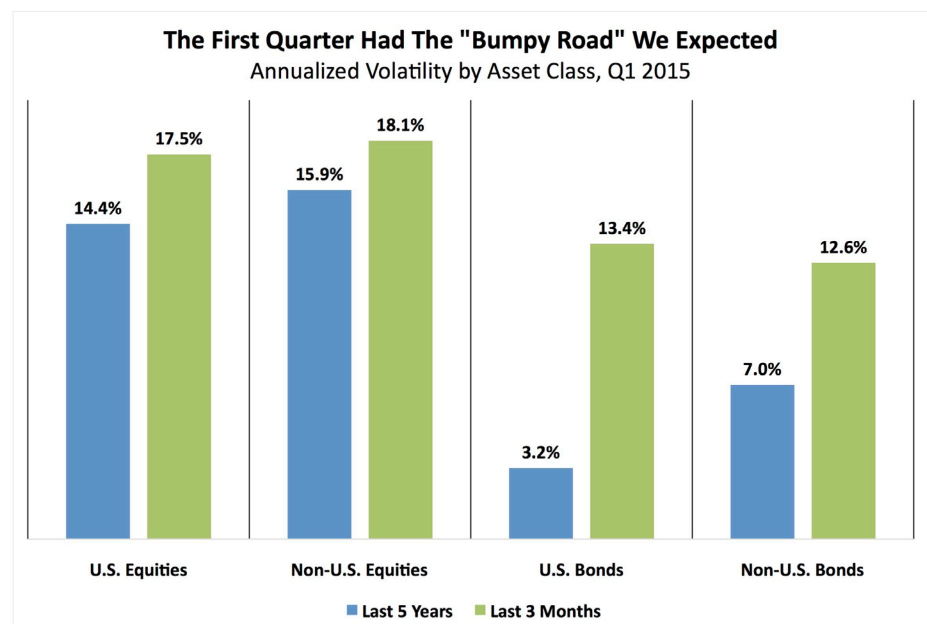
Asset Allocation

A quick glance at first quarter returns suggests a fairly normal market, but the results mask the roller coaster ride investors endured.

Global equities posted an 11.4% drop during the first 6 weeks of the quarter, the worst start to a calendar year ever by some measures. But equities rallied over 13% to finish the quarter up a mere 0.2%. Global bonds saw no such roller coaster and, with a boost from a lower U.S. dollar, posted a 5.9% gain.

We made a few moves in our portfolios, given the volatile quarter. We entered the year in an overweight equity position, a tactical view we reinstated after last fall's equity market correction. The decline in the beginning of the quarter challenged our tactical position, and although we saw several signs that the selloff was in its final stages, we followed our disciplined process and raised cash from some bond alternatives to further buffer against our volatile equity exposure. By mid-February, additional risk metrics led us to trim back a bit but still maintaining an overweight equity position which we held through quarter end.

Our cash position provides us several benefits, but we're not interested in maintaining the position for long. When we trimmed our equities in February, we observed Treasury yields that had sunk as low as 1.5%. Investors were piling into bonds as a shelter from falling equities, but we viewed cash as a safer option to a short term bond position in which one needed to exit before those low yields reversed. Sure enough, as



equities rallied off their February 11 lows, yields rose and bonds declined.

Holding cash also allows us to maintain our overweight equity position. Although we believe the evidence supports the equity exposure, our cash holding provides some temporary insurance against the "what if we're wrong" outcome, which was a valid possibility in mid-February.

We plan on re-deploying cash in the near term, likely into a more diversified bond allocation. For the past couple of years, our research has favored credit risk (i.e., lower quality bonds) over interest rate risk (i.e., long-term Treasuries). But recently, the data has shifted to a more neutral bond exposure, albeit still underweight overall versus equities. This exposure includes a little credit risk and a little interest rate risk. Our liquid cash position allows us to build out that new bond allocation which will be a better diversifier against our equities.

Finally, a word on volatility. Since equities last peaked almost a year ago (April 2015), we've seen four separate instances of selloffs in equity markets. They ranged from 7% to 15% over periods of 4 months to 10 days. During those periods, simply put, those selloffs felt awful. They came with dramatic headlines and dire warnings from all the talking heads on TV. In fact, the only thing that declined more than the equity prices was investor confidence … and that's exactly the point.

Markets are a collection of participants, and those participants are humans capable of a range of emotions that can turn in an instant. Those same selloffs were followed by rallies of 7% to 13% over 2 to 7 weeks. When we look back on the last year, the roller coaster ride equities experienced resulted in a 6% decline. Historically, equity volatility is 16% to 20% in a 12 month period, so why would we fret over 6%?

As our clients know, we follow a disciplined process that provides us hard evidence during emotional times to decisively act upon. Recently, our tactical moves within this whipsaw market have not added value, but we fully understand that our process can be somewhat challenged in markets such as these. No investment approach works all the time. But we know that our process will help avoid those deep declines (i.e. 2008) while participating in long upcycles (i.e., 2009 to date).

Fixed Income

In general, bonds bested stocks during the quarter, but only if you owned the right bonds.

As equities dropped and investors sought safety in bonds, the 10-year Treasury yield touched 1.53% by February before closing the quarter at 1.77%. As such, owners of 10-year Treasuries gained 3.2% during the quarter. The benchmark Barclays U.S. Aggregate Index returned 3.0%, as investment grade corporate bonds gained 4.0%.

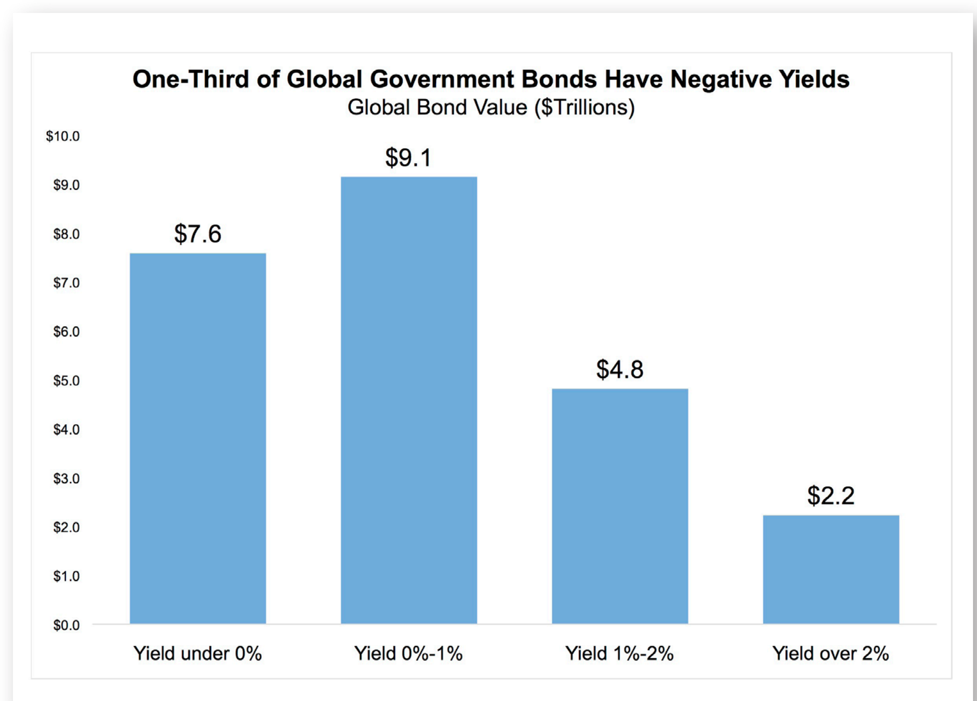
As investor emotions swung back to "risk-on" optimism in the last 7 weeks of the quarter, lower quality bonds saw bigger gains. High yield corporates returned 3.4% for the quarter, including a 9.0% rally from the equity market low on February 11.

With a decline in the U.S. dollar, non-U.S. bonds received an additional boost of about 4%, allowing non-U.S. debt in developed markets to gain 8.3% while emerging market debt jumped 9.1% for the quarter.

We readily admit that the low yield environment has been going on longer than most, including us, have expected. The 10-year Treasury yield fell to levels not seen since 2012. And it's not just the U.S. When we look at government debt from out across the globe, we find over $7 trillion (about one third of all global government debt tracked by Bloomberg) is currently yielding less than 0%.

We continue to believe the market may be underappreciating the risk of unwinding such a low yield environment. But it's important to note that we don't expect yields to steadily climb in the near term. We observe steady demand from foreign investors buying U.S. investment grade government and corporate debt. As foreign central banks continue to stimulate their economies with negative interest rates, this source of demand for U.S. debt will likely keep yields on investment grade bonds low.

But with low interest rates, full bond valuations, and reduced liquidity in the bond market across various sectors, it's likely that bond investors underappreciate the



risk of greater volatility, at least, relative to what they've become accustomed to since the early 1980s. Bond yields continue to imply low inflation for years to come: The 10-year implied inflation rate is 1.6% while explicit inflation expectations are over 2.0%.

Our research indicates that the 10-year Treasury yield should be almost half a percentage point higher, and the success of the Fed's quantitative easing (QE) campaign explains the gap. Further, hedge fund ownership in Treasuries recently hit all-time highs, likely due to skittishness in the markets. But when they move out, yields could move rapidly from their artificially low levels. Our concern is a repeat of the 2013 "taper tantrum", a period in which bonds lost 5% in 4 months (or over 13% annualized).

Although the laggards among bonds in the first quarter, municipal bonds still delivered a 1.9% return and we continue to like this sector going forward. Municipal bonds offer attractive tax-exempt income, especially when compared with historical levels.

Since 1990, the average municipal bond yield was about 80% of the 10-year U.S. Treasury yield. This made sense, as the muni yield was free of income taxes while the Treasury yield still delivered taxable income.

Today, municipal bonds trade evenly with Treasuries, implying that the tax benefit available to investors is essentially free at a time when income taxes have only gone up (and may continue to rise). With finances among municipals continuing to grow, we see value here for high tax bracket investors.

We remain steadfast in our opinion of the ongoing secular bull in equities, but we're revising how this opinion is expressed within the bond section of our portfolios. Part of this change is driven by our current research, and part is driven by some portfolio remodeling.

After a couple of years favoring high yield bonds, our indicators switch to a more neutral position during the quarter. While we've seen high yield rally, we won't re-establish a credit-heavy tilt in our bonds until other indicators support such a move. For example, if we saw weaker credits sustain some outperformance, if we saw a bottom in commodities, and/or if we saw less sentiment among bond managers normalize, then a move would be justified. Until then, we'll manage our bond portfolios to a neutral position in credit.

Even when our research gives high yield the green light, we'll likely right-size our position to serve the overall portfolio better. The change here is minor, but as we believe volatility in both stocks and bonds is here to stay, we're improving the durability of our bond allocation to weather such periods of panic. The result is a more diversified portfolio for the long haul.

Equities

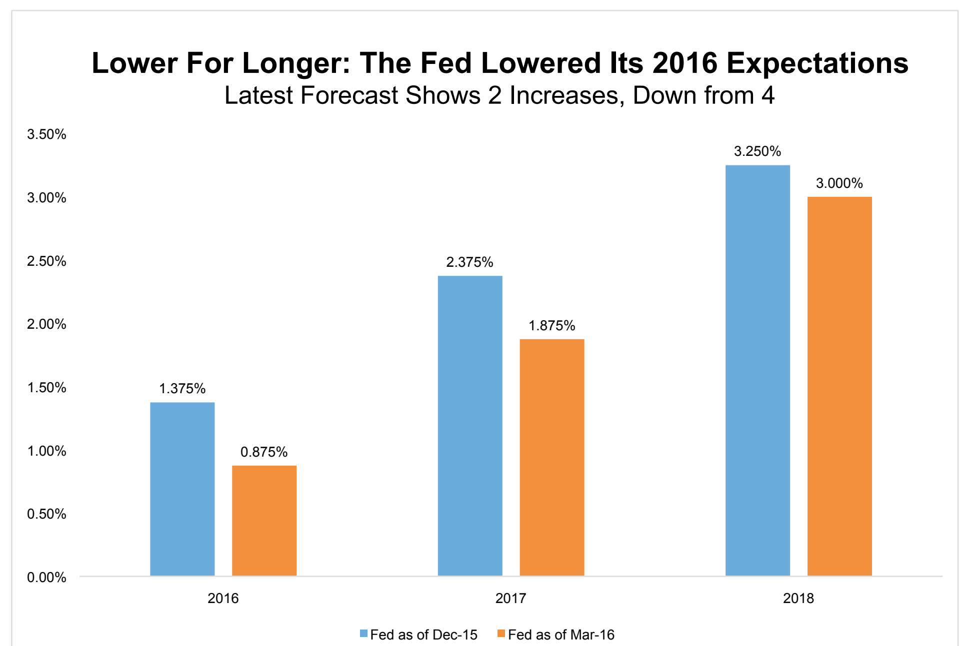
With a second significant downturn since last summer, global equity performance was "déjà vu all over again" during the quarter.

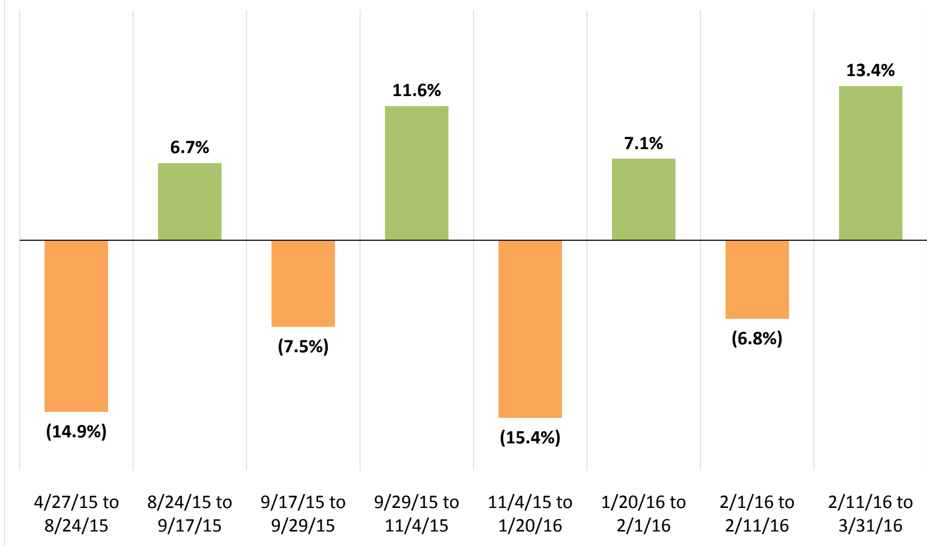
In the U.S., large cap stocks rose 1.3%, better than U.S. small caps' 1.5% decline. Outside the U.S., emerging market equities jumped 5.8% and non-U.S. developed markets gained 2.8%. But had the quarter ended on February 11, returns across all of these global regions would have been negative by double digits.

The rally from the intra-quarter lows was broad-based, a healthy sign that gains have some staying power. Our data show that 90% of equities were trading above their short-term trend, a positive sign that historically yields further upside. Specifically, this level of breadth has typically resulted in double digit gains over the ensuing 6 and 12 months.

Now that global equity indices are returning to their highs, we turn our attention to the tug-of-war between fundamental and technical signals. The focal points in the fundamental data are earnings growth and valuations. Interestingly, declining earnings doesn't necessarily lead to economic recession. Since 1947, there have been 19 instances of declines in corporate profits, but only 7 which coincided with recessions.

Uncertainty in this year's earnings growth has grown, adding to the bumpy road for equities. There are two culprits for last year's earnings decline that remain key players in this year's outcome: the





U.S. dollar and the energy sector. We've covered the U.S. earlier, but in short we expect lesser headwinds from a rising U.S. dollar, which would be supportive of better earnings growth this year.

Last year's earnings slide was also heavily impacted by energy sector earnings, and this year's expectations are a mile wide: Estimates range from 5% growth to upwards of 20%, and the price of oil seems to explain most of the gap. A stabilization in oil prices may be taking shape, and this bodes well for the bullish case of earnings growth in 2016.

Regarding valuation, current levels correspond with low single digit returns to come over time. Some argue that in the low interest rate environment, valuations are justified. (Indeed, finance textbooks teach that a lower interest rate will increase asset prices, which is exactly what central banks have been trying to do.)

But we're less concerned with valuation given equities track record of sustaining over- and undervalued levels for years. Witness the 1970s, when valuation levels were at their cheapest … for nearly a decade. Investors had to have been very patient to see returns (not that many investors were buying stocks back then). Then look at how many pundits recommended selling equities throughout the 1990s given high valuation levels. The point here is that valuation is a critical factor over time, but ignoring technical factors can also bring subpar results.

The U.S. offers a great example of this tug-of-war between valuation and momentum. Valuations (i.e., price to earnings) are borderline expensive, which would warrant a sell signal in the mind of the fundamental investor. But our process would go one step further and assess the technical case for owning U.S, equities. Momentum and relative strength warrant maintained exposure to U.S. equities versus other equity markets, including those which may have a lower valuation.

Non-U.S. equities offer up a different situation to wrangle. While valuations in the U.S. appear full, non-U.S equity market come with more attractive pricing. Put another way, earnings growth in non-U.S. equities has more room to run before valuation becomes a concern. However, the issue is more a fundamental one: What kinds of earnings growth can one expect given more challenging economic conditions?

That said, we find numerous reasons to be getting more positive about non-U.S. equities. Take Europe, for example. On the surface, this region has several positives such as a cheap currency, rock bottom interest rates, low oil, cheap valuations, and strong momentum off the February lows. These all support the growing thesis that, despite headline risk, European equities could climb back to their all-time highs of April 2015.

And emerging markets remain on our radar screen for increased exposure. The long term story still holds: faster economic growth driven by younger consumers with little debt. And since emerging markets have lagged developed markets for several years, valuations are attractive. Of course, we'll stay true to our process, especially given the inherent risks that come with emerging markets. For now, we maintain our neutral exposure.

Alternatives

As always, alternative investments can mean different things to different people. We'll focus on those alternative strategies relevant to our portfolio.

Equity-like alternative investments saw a higher than normal correlation to equities, given the volatility during the quarter. Real estate investment trusts mirrored equities closely, falling at the beginning of the year but rallying nicely to end up 5.2% for the quarter. MLPs (in our case, energy pipelines) followed suit as well, but their rally still left them down 4.2% through March 31.

Other alternative investments saw far less volatility but not necessarily better results. Hedged equity strategies, for example, returned anywhere from negative 2.6% to negative 0.6%.

While we're pleased to see a rally in MLPs ("master limited partnerships", generally, energy pipelines), the disconnect between the market and the underlying fundamentals remains. The market continues to trade MLPs in line with commodities' prices, while MLPs' earnings continue to grow. The first 6 weeks of the quarter, MLP shares fell 29% … the exact decline in the price of oil. In the ensuing rise through March 31, MLPs

rose, less than oil's 46% gain but ahead of global equities' 13% return.

Meanwhile, MLPs' earnings and distribution growth continue to expand despite the market action. The latest data show earnings rising over 5% sequentially, continuing the steady record of earnings gains throughout this energy bear market. Further, 87% of the MLPs we follow announced distributions that met or exceeded the previous quarter's, continuing to defy the naysayers' prediction of massive distribution cuts. In the words of one of our MLP managers, "We believe these results continue to highlight the disconnect between the physical world (midstream throughput) and the financial world (commodity and equity prices)."

We've explored the bear case arguments, reviewed the analysis, and find continued misunderstanding in the MLP marketplace. The underlying businesses in which we're invested are far less risky than the extreme market swings would have you believe, and long term investors will be rewarded. As one manager put it, "you cannot make money on bad investments, but can make money on bad investors."

For example, one study looked at each pipeline company and every contract listed in their regulatory reports. These contracts name the oil or natural gas driller as well as the geography. With this data, the study assumed 50% of the weakest drillers go bankrupt to estimate the impact on the MLP pipeline universe. The result? Only about 5% of operating income across the top 50 MLPs was at risk.

This hypothetical aligns with actual experience from 2008: Oil fell 77%, "upstream" operators (i.e., drillers) fell 65%, MLPs (i.e. pipelines) fell 47%, drillers' bankruptcies spiked, but MLPs' operating results were little impacted. And through it all, MLPs continued to increase payouts to shareholders. Back then, oil rallied quickly, taking MLPs higher with it. Today, we expect the recovery to take longer.

While oil gets all the press, its natural gas that's more important to pipelines. We remind investors that the U.S. pipeline infrastructure is 70% natural gas and only 30% oil. While oil production in the U.S. peaked in 2015 and is expected to decline through 2017, natural gas production is growing. Using a 2016 estimate of 6% natural gas volume growth and 9% oil volume decline results in 1.5% total volume growth flowing through those pipelines. And it's the volume, not the price, of oil and gas that generates MLPs' revenue.

A quick note on real estate, specifically, the commercial properties underlying our real estate investment trust ("REIT") position. While there is increasing talk of overheated markets, we see plenty of positives to justify current valuations: Rents are rising, vacancy rates are the lowest in 14 years, little new supply is coming online, and the cost of financing remains attractive. This all leads to solid earnings growth and continued returns for our portfolios.

Conclusion

The subtitle for our 2016 Outlook published in January was "A Bumpy Road Ahead … But Worth The Ride." The first quarter surely delivered, but our outlook remains the same.

Looking into the second quarter, we see plenty of reasons to expect more volatility including Britain's national vote on exiting the European Union, the ongoing European refugee crisis, opaque Chinese economic policy, possible impeachment proceedings in Brazil, increased terrorist activity globally, growing oil patch bankruptcies, and of course, the U.S. presidential election.

One of the goals we have in delivering financial solutions is to put the investment markets into the right perspective for you, and we'd emphasis the "for you" part of that statement. Our clients range from 70-year old retirees living from their portfolios to 50-year old CEOs of publicly traded companies to 30-year old entrepreneurs with newfound wealth. As such, there's no magic wealth management formula to be applied globally, only a thorough bottom-up analysis of one's wealth, both quantitatively and qualitatively.

So communicating our opinions, our conclusions, our advice within what can be sometimes chaotic conditions is a key step in successfully managing our clients' wealth. In discussing his annual letter to shareholders, Warren Buffet stated, "I write for people like my sisters. They're smart, they read a lot. The have a lot invested in the company. They don't know all the financial jargon, but they don't want to be treated like five year olds. I try to let them know on paper what I'd tell them about the business if we sat down for the afternoon."

Hopefully this commentary has achieved the same. But if you're looking for some further guidance amidst a volatile world, come talk with us.

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