FIRST QUARTER 2016
INVESTMENT COMMENTARY

ANOTHER YEAR OF SLOW GROWTH AND LOW INFLATION LOOMS, LEAVING THE ECONOMY VULNERABLE TO SHOCKS AND THROTTLING BACK OF THE FED'S RATE-HIKING PLANS

In this Issue:

- **No Lift From Capital Spending**
- **Low Inflation Here to Stay**
- **It May Be One and Done for Data Dependent Fed**

Heading into the home stretch, it looks like the economy's engine is cruising at a so-so pace, implying a lukewarm end to the year. To be sure, a spike in last minute Christmas shopping could have altered the picture, facilitating a more respectable exit to 2015. Odds are, however, the fourth quarter will shape up to be much like the third, posting about a 2 percent growth rate. If so, that would punctuate another year of lackluster growth, falling well short of the 3.3 percent average pace registered over the postwar period. Indeed, it will mark the tenth consecutive year that the economy has failed to deliver a full-year growth rate of 3 percent, the longest such stretch since the end of World War 11.

As the calendar page turns to 2016, the year ahead is fraught with a number of uncertainties. That's nothing new; the start of a new year always comes with some trepidation, particularly in a global environment wherein volatile geopolitical developments are being heightened by the pernicious threat of terrorism. Nor are all things calm on the domestic front as the nation girds itself for a presidential election year. It's a safe bet Congress will not upset voters by enacting controversial legislation that might disrupt the economy. But as the campaign season heats up, households and businesses will be bombarded with partisan rhetoric and some unsettling policy proposals. That tends to create doubt about the future, which could well have an effect on spending and investment decisions.

On average, postwar expansions lasted just under five years. This one is moving into its seventh and, while there are no imminent recession threats, they are rarely identified before a downturn occurs. Bubbles, for example, do not appear on the radar screen until they burst. Yet there are ominous warning signs that make you sit up and take notice. One such is the record mergers and acquisition activity in 2015, which smashed previous annual records by December 21, totaling $3.8 trillion. The previous peak occurred in 2007 ($3.4 trillion), which exceeded the 2000 record. Each of those two previous highs occurred in the final expansion year. The causal relationship may not seem obvious on the surface, but a common underlying catalyst that spurs heightened takeover activity is that companies fail to see organic growth in sales and, hence, strive to broaden their revenue base by acquiring other companies. Large-scale acquisitions, in turn, always result in layoffs, an ominous portent of an expiring expansion. With multinational companies facing sputtering demand outside of the U.S. and lackluster demand within, it's fair to wonder how much time is left before the next recession sets in.

No Lift From Capital Spending

Aside from the political uncertainties, the year ahead faces a number of headwinds that could well impede growth. Chief among them is the persistent weakness in business capital spending, something that shows no sign of turning around. Clearly, the lag in spending has little to do with corporate cash flow or profits, which posted decent gains outside of the energy and export-sensitive sectors. But instead of plowing the profits into new equipment or structures, corporations opted to use a good fraction of the funds to repurchase shares, increase dividends or, as noted above, acquire other companies. Hence, following a middling 6.3 percent increase in 2014, nonresidential investment spending slowed to a tepid 2.7 percent average annual rate over the first three quarters of 2015. This is not the time-honored cyclical pattern. Historically, business investment

Smith Affiliated Capital • Wall Street Plaza, 88 Pine Street • New York, NY 10005 • (212) 644-9440 • www.smithcapital.com

gains strength during the more mature stage of a recovery, as excess capacity is used up and businesses strive to offset rising labor costs with more efficient capital equipment.

There are a number of compelling reasons why investment spending has deviated from this normal cyclical pattern. For one, due to the lackluster growth rate over the course of the six-and-a-half year old recovery, the huge capacity gap that opened up during the Great Recession has been slow to close. Normally recessions are followed by muscular rebounds in activity that pushes up capacity utilization rates much more quickly. Not so this time. Indeed, as of November, industrial companies still had more unused capacity than they did on average over the past thirty five years. For another, the usual acceleration in labor costs failed to materialize this time. With labor remaining cheap, companies lacked the incentive to replace workers with more productive equipment.

Then, of course, there is the huge drag from the cutbacks in the energy sector, which vaporized demand for oil drilling equipment, pipelines and the like. Keep in mind that energy-related spending, fueled by innovative hydraulic fracturing techniques, played a big growth-boosting role during the earlier stage of the recovery, amplified by the knock-on effects it had on a large supporting cast of industries. With the plunge in oil prices since mid-2014, that thrust has all but disappeared and the aftershocks of downsizing are still rippling through the economy. It's unclear which direction oil prices will head in 2016, but the market remains oversupplied, thanks to OPEC's unwillingness to cut output and the still-high level of production by the more efficient U.S. producers. What's more, the market is bracing for an increased supply coming from Iran, reflecting the lifting of sanctions as part of the recent nuclear pact.

Finally, there is the matter of the strong dollar, which has increased by nearly 20 percent against our major trading partners over the past 18 months. This, of course, makes U.S. produced goods more expensive in the global marketplace, even as it reduces the cost of imports. Needless to say, goods manufacturers are most directly affected by this negative shift in the terms of trade, which undercuts any incentive to expand capacity. Putting all these headwinds together, it comes as no surprise that capital spending remains in the doldrums, and is likely to remain there over the immediate future. That prospect was confirmed by the latest government report on durable goods transactions. New orders for nondefense capital goods in November, a proxy for capital spending plans, fell 0.4 percent in November, and the original 1.6 percent increase reported for October was revised down to 0.6 percent. Worse, shipments fell in both October and November, which suggest that capital spending may actually be a drag on growth in the fourth quarter.

Low Inflation Here To Stay

In early 2012, the Fed explicitly set a 2 percent target for inflation to go along with its dual mandate of achieving maximum employment, then deemed consistent with a 5.5 percent unemployment rate. While the employment target, which has since been revised down by about a half-percent, has been met, inflation has been a stubborn underachiever. Indeed, not since the 1960's has inflation, as measured by the Fed's preferred gauge, remained below 2 percent for as long as it has. The last time the personal consumption deflator and its core component that excludes volatile food and energy prices simultaneously hit a 2 percent annual rate was in April 2012, the longest stretch of below-2 percent inflation since the 1960-1966 period.

The longest previous such episode was in the late 1990's, lasting from 1997 to 1999, even as the unemployment rate tumbled to a postwar low of 3.8 percent. But that two-year period of exceptionally low inflation and unemployment was an artifact of a productivity surge associated with a high-tech revolution that was powered by the Internet and a capital-spending boom. That surge offset the inflationary impact of rapidly rising wages and facilitated a happy confluence of strong growth, rising living standards, robust profits and tame inflation.

But the Goldilocks scenario that unfolded in the late 1990's is hardly present today. The current episode of exceptionally low inflation is characterized by weak productivity and stagnant wage growth amidst a lackluster recovery. In addition to these cyclical forces, the pricing power of domestic companies has been weakened by increased competition from abroad, as globalization has become ever more prevalent, and by the expansion of Internet shopping, which has broadened the choices of price-conscious consumers. The aging population may also be restraining inflation, as older consumers tend to purchase fewer material goods than do younger ones.

Not surprisingly, given these cyclical and longer-term influences, many believe that low inflation is here to stay. Indeed, the Federal Reserve itself does not expect its 2 percent inflation target to be hit at least until 2018, a target that has repeatedly been pushed back. To be sure, the long lag did not deter the central bank from lifting the funds rate on December 16th, perhaps the most telegraphed initial hike in modern banking history. But the liftoff was taken grudgingly, as the Fed needed to retain credibility after repeatedly failing to follow through on previous rate-increase promises, as well as to establish a cushion to lower rates if the economy suddenly weakens again. Rather than dwell on the initial increase, Fed Chair Yellen strove mightily to deflect attention towards the entire rate trajectory, which she asserts will be gradual and end at a lower level than in past tightening cycles.

It May Be One and Done for Data Dependent Fed

According to the latest FOMC projections, released at the December policy meeting, the funds rate is expected to top out at 1.4 percent at the end of 2016, implying a quarter point hike in every other meeting during the year. From our lens, and those of most financial market participants, even that cautious approach appears to be too ambitious. Indeed, many believe that the Fed is more likely to rescind the initial rate increase than engineer another one, and the fed funds futures market is pricing in a rate of 1 percent or less at year's end. We suspect that the first hike will be kept intact, but the next one will not take place at least until mid-year, if then.

Our view is predicated on the assumption that the Fed will respond to the data, as Chair Yellen has promised, rather than move in the mechanistic fashion seen in past tightening cycles. Clearly, there is a strong desire to normalize policy after seven years of keeping short-term rates at the zero bound. But the current and prospective environment is far from normal, and certainly not strong enough to withstand much higher rates. The global economy continues to be buffeted by rotating recessions, currently paced by emerging market economies, including Russia, Brazil and several other Latin American countries, even as China continues to weaken, Japan remains in a deflationary stagnant state and Europe is just barely staying above water.

In response to weak global activity and strong deflationary forces, virtually every central bank is easing policy, pushing short-term rates in many cases into negative territory. This counter move to the Fed is putting more upward pressure on the dollar, something that will further dampen U.S. exports and result in more imported deflation. Chair Yellen still believes that U.S. inflation is being held back by transitory forces that are poised to fade. Hence, the rate hike in December was justified in part by expectations that domestic inflation will soon start to trend up towards the 2 percent target. More likely, policy officials are using that justification in an effort to lift inflationary expectations, which are on the verge of becoming unanchored due to the persistent absence of actual inflation.

Nothing scares the Fed more than a breakdown in inflation expectations, as that could well lead to a change in household and business behavior that would promote the very deflationary forces the Fed is desperately trying to prevent. But the financial market is already pricing in less inflation than the Fed expects (consistent with its lower fed funds forecast), and households are starting to follow suit. That was clearly evident in the latest surveys released by the Conference Board and University of Michigan. Both surveys revealed an uptick in household confidence in December, reflecting the improving labor market, but both also revealed a decline in the gauge of inflation expectations. Indeed, respondents in the University of Michigan survey explicitly noted that they were looking forward to large price discounts on big-ticket items.

No matter what the Fed does to short-term rates, long-term yields will be guided by the economy's performance, inflation expectations, global developments and investor appetite for risk. The general consensus is that the economy in 2016 will continue to advance at the lackluster pace just north of 2 percent seen over the past six-and-one-half years. There is no visible reason to believe otherwise. But if the new normal for growth is one-third below its long-run average, so too is the new normal for the equilibrium level of real bond yields. And with the economy cruising at a slower speed, it becomes ever more vulnerable to external shocks and bursting bubbles, which, as noted earlier, are never identified in advance.

Given the headlines, it would seem that any external shock would likely be an outgrowth of some geopolitical upheaval. But it could also come from a more mundane source, such as turmoil in the high-yield market, where trouble is already brewing. According to S&P Ratings Service, 50 percent of junk bonds issued by energy companies are at risk of default, and 72 percent of the bonds issued in the metals, mining and steel industry are equally distressed. Over 100 corporate bonds have already defaulted by early December, the highest volume since 2009, and with commodity prices still plunging more are on the way. Simply put, it may turn out to be another ho-hum year for growth in 2016, but the ingredients for a risk averse approach towards investing decisions are even more firmly in place now than they were at the start of last year.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.09	0.07	0.48	0.01	0.25
2-Yr. Note	0.68	0.63	1.05	-0.48	0.41
5-Yr. Note	1.66	1.36	1.76	-1.38	1.31
10-Yr. Note	2.17	2.04	2.27	-1.44	0.91
30-Yr. Note	2.75	2.85	3.02	-2.08	-3.17

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.11	3.12	2.85	2.55	4.81
ML G.O. 22+ Index	2.74	2.90	2.66	2.95	4.81

Equities	Levels			US $ Terms (%)	
	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
S&P 500	2,058.90	1,920.03	2,043.94	7.03	1.38
DJIA	17,823.07	16,284.70	17,425.00	7.70	0.23
NIKKEI (Tokyo)	17,450.77	17,388.15	19,034.00	9.59	10.97

Commodities	US $			Percent Change (%)	
	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,184.86	1,115.07	1,060.20	-4.92	-10.52
CRB Future Com. Pr. Index*	229.96	193.76	176.14	-9.09	-23.40
West Texas Intermediate Crude ($ per bbl)	53.27	45.09	37.04	-17.85	-30.47

Currencies	Levels			Percent Change (%)	
	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
Yen	119.78	119.88	120.22	-0.28	-0.37
Sterling	1.56	1.52	1.47	-2.59	-5.40
Euro	1.21	1.12	1.09	-2.82	-10.22

Foreign Bond Markets	Levels			US $ Total Return (%)	
	12/31/2014	9/30/2015	12/31/2015	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	0.02	-0.04	-0.09	N/A	N/A
ML German 10-Yr.+ Bond Index	1.12	1.07	1.20	-1.74	-0.10
3-Mo. LIBOR Yen Fixing (3)	0.11	0.08	0.08	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.82	0.90	0.78	2.53	2.53

Source: Bloomberg Financial Data

Notes: 1) 12/31/2014 thru 9/30/2015 2)12/31/2014 thru 12/31/2015

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index