Rocaton

INSIGHTS

2016 Capital Market Outlook

December 2015

203.621.1700 | **rocaton.com**

Executive Summary

As 2015 draws to a close, investors are starting to turn their attention to 2016. We thought it would be useful to describe some themes which may be important topics for investors in the coming year. The table below has a broad overview of these themes which we then explore in more detail in the pages that follow. The impact of these issues will vary by portfolio, but investors of all types should have some takeaways.

Theme	Key Takeaway
Global Growth	Global growth will be supportive of or undermine asset class returns in 2016
Europe	Political risk is rising in Europe due to a lack of action and reform
Fed Rate Hike(s)	Expect continued pressure on the long-end of the yield curve in 2016
Search for Return	Asset class valuations are still elevated and there are few markets that appear attractive
Energy Market Uncertainty	The fundamental backdrop for energy prices remains challenging as global supply remains robust
Bond Market Liquidity	Bond market liquidity continues to be an important issue for investors

Global Growth May Disappoint

Economic growth, broadly speaking, disappointed during 2015 as many emerging market economies, including China, continued to slow and developed market growth was average (U.K., Germany) or even poor (Japan). The U.S. remained the one relative bright spot, although growth remained below historical standards. As a result of disappointing growth in 2015, expectations have been reduced for 2016 globally. The International Monetary Fund recently reduced its prediction for global growth in 2016 to 3.6%, down from 3.9% earlier in the year. The Organization for Economic Co-operation and Development followed suit just a few weeks later, lowering global growth expectations in 2016 to 3.3%. Much of the uncertainty comes from emerging markets, where there continues to be a large divergence among growth expectations.

Key Takeaways: Global growth will be supportive of or undermine asset class returns in 2016, not so much depending on the absolute level of growth, but more in how that varies from investors' expectations.

Portfolio Impact: A surprise to the upside in global economic growth in 2016 would likely be supportive for equity prices and potentially cause interest rates to rise. Slowing or disappointing growth may result in poor returns from risk assets and reduces the likelihood of rates rising quickly as the Federal Reserve and other central banks will likely keep rates low in an effort to stimulate economic growth.

Global Growth May Disappoint - continued

Portfolio Strategy: Remain diversified and don't stretch for yield or return in ways inconsistent with long-term objectives or risk tolerance. However tempting it may be, reaching for additional yield in unconventional ways in a low-yield environment has often resulted in disappointing outcomes for investors.

The European Backdrop May Again Drive Markets

Europe's economy in 2016 may be heavily influenced by the result of several elections which market participants will have to digest alongside an influx of refugees. Early next year, national elections will be held in Ireland, Spain, Austria and Portugal. In the latter half of the year, the focus could shift to the 2017 elections for France and Germany. Finally, in 2016, the United Kingdom is slated to renegotiate their position in the European Union and will hold a referendum on a possible EU exit before the end of 2017. While the political situation is far from certain, current European fiscal policy should continue its trajectory from austerity to stimulus and we expect that monetary policy could become even more expansionary. In 2016, European consumers will need to remain a key driver of a continued economic recovery amid a backdrop of policy uncertainty, refugee absorption and concerns about the stability of a single currency.

Key Takeaways: Political risk is rising in Europe due to a lack of reforms and the influx of refugees.

Portfolio Impact: There is the potential for further euro weakness which could soften equity market returns for unhedged U.S. investors. A fragile European economy may also keep European interest rates low which, in turn, will put pressure on U.S. interest rates.

Portfolio Strategy: Despite the potential for further euro weakness, we believe most investors should remain unhedged in their international equity portfolios. For investors with sufficient scale and meaningful foreign currency exposure, a hedging program may be worth considering.

Despite The Fed Rate Hike, Do Not Expect Much Change Further Out On The Yield Curve

Predictions of rising interest rates have likely been on most pundits' annual outlooks for many years. While the Federal Reserve recently raised the Federal Funds rate for the first time in almost a decade, not much else has changed with global interest rates. In fact, there are a number of reasons why we believe U.S. interest rates could stay low in 2016, including low inflation and lackluster growth. Further, U.S. rates remain much higher than rates in almost all other developed countries and well above those in Germany and Japan. As a result, global investors who are searching for yield may continue to buy U.S. Treasuries, resulting in continued pressure on interest rates. Naturally, expectations for investment grade fixed income returns continue to be modest with the threat of either a rising rate or "low for longer" scenario.

Despite The Fed Rate Hike, Do Not Expect Much Change Further Out On The Yield Curve - continued

Key Takeaways: Expect continued downward pressure on the long-end of the yield curve in 2016.

Portfolio Impact: Rising interest rates are a positive in the long run for fixed income investors as higher rates are needed to generate more attractive long-term returns. In our opinion, the bigger risk to investors is that interest rates do not increase, ensuring that fixed income returns will be low for years to come.

Portfolio Strategy: We continue to encourage investors to maintain an allocation to investment grade bonds as this allocation can act as a store of wealth and a source of portfolio diversification. It is entirely possible that, even in the face of a Fed rate hike, the long end of the yield curve does not move or even comes down on expectations that the Fed will exercise caution regarding additional moves.

The Search For Return And Yield Continues

With most major asset classes on track for flat or negative returns in 2015, many investors are likely left wondering where returns will come from in 2016. Although short-term interest rates are now slightly higher than they were in the beginning of this year, yields on cash and other fixed income instruments are still near historically low levels. Fixed income assets that do possess moderately attractive yields, such as high yield and emerging market debt, are faced with a number of challenges and have the potential for increased volatility. Within global equity markets, U.S. valuations remain at elevated levels and non-U.S. equity markets, both developed and emerging, face a number of fundamental challenges.

Key Takeaways: Asset class valuations are still elevated and the few markets that appear attractive have challenges to overcome. For example, the high yield markets is currently offering yields above 8%. However, this assumes the full return of principal on bonds, some of which have challenging fundamentals, including those in the energy sector.

Portfolio Impact: Investors should continue to expect modest returns and position their portfolios accordingly.

Portfolio Strategy: Given the high level of uncertainty and elevated valuations in the U.S. equity market, investors may want to position their portfolios more defensively by holding high quality fixed income which can preserve investor capital and dampen downside outcomes. Taxable fixed income investors could explore high yield municipal bonds which appear attractive relative to corporate high yield. Investors who can accept some illiquidity may want to allocate to private assets, such as private energy investments or real estate lending, which continue to offer attractive risk premiums.

Uncertainty In The Oil / Energy Market Continues

We have no ability to predict oil prices, but we feel that the oil price in 2016 may once again be driven by the response or lack of response of producers to the low oil price environment. As we enter 2016, the oil market remains oversupplied, U.S. production growth remains positive on a year-over-year basis and the North American energy industry has once again proved that some of its key strengths are innovation and adaptability. New production from Iran is likely to materialize in 2016, Saudi Arabia seems focused on protecting market share by maintaining current supply output and other national producers have budget holes to fill. On the demand side, softer global growth may offset any eventual drop in supply, although it is worth noting that current demand remains robust, particularly as U.S. drivers take advantage of cheap gas prices. Taken together, we believe oil prices will not recover until there are greater signs of demand and supply balance.

Key Takeaways: The fundamental backdrop for energy prices remains challenging as global supply remains robust.

Portfolio Impact: Performance of high yield and public equity portfolios with exposure to the energy sector will be driven by the direction of oil prices. Currently, markets are pricing in a sustained low oil price environment; any surprise to the upside could positively impact energy exposures. Returns for commodity futures portfolios broadly may also remain modest as there are imbalances in supply and demand across industrial metals and energy markets beyond oil.

Portfolio Strategy: We continue to believe that the best way to take advantage in the energy sector is via private capital vehicles with long time horizons. Distressed debt and equity-oriented funds should have terrific opportunities over the next several years to capitalize on broken capital structures and low-priced assets. We continue to recommend divesting commodity futures allocations.

Bond Market Liquidity Remains An Important Issue

The topic of bond market liquidity, or the lack thereof, has been discussed at length, but remains an important issue for investors with fixed income allocations. Dealer balance sheets continue to shrink, largely a function of new capital and leverage rules that have made it more costly for dealers to hold corporate bonds. This lack of liquidity has caused bond prices to "gap" lower (i.e., fall significantly in price in a short period of time) in response to negative events in 2015. The recent downgrade of Brazil's state-run oil firm Petroleo Brasileiro SA ("Petrobras") represents a recent example. Petrobras, which represented ~0.7% (on a par weighted basis) of the Barclays Long Credit Index prior to the downgrade, was subsequently excluded from the long credit index and also omitted from broadly followed high yield benchmarks. In the twelve trading days following the downgrade, most Petrobras issues fell nearly 20%. Although this example represents an outlier event, investors should be aware of the current dynamics in fixed income markets.

Bond Market Liquidity Remains An Important Issue - continued

Key Takeaways: Bond market liquidity continues to be an important issue for investors.

Portfolio Impact: A lack of liquidity augments the potential for fixed income portfolios to have higher ex-post tracking error and investors should be aware of the potential for disappointing relative performance. Investors, when faced with underperforming bond managers, need to determine whether the nature of the underperformance is a fundamental error by the investment manager or merely volatility driven market dynamics.

Portfolio Strategy: Investors should consider utilizing managers who can exploit price dislocations resulting from the illiquidity in the bond market. In an uncertain macro environment, these might provide some of the greatest opportunities for bond market investors in the years to come. Investors should also examine liquidity needs and, if necessary, consider making adjustments to their fixed income portfolios while market volatility remains relatively low.

Rocaton

2016 Capital Market Outlook

Performance Information and Return Expectations

203.621.1700 | **rocaton.com**