Financial Insights:

Q1 2016 Capital Market Review & Outlook

MCF ADVISORS

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Capital Market Review & Outlook

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OVERVIEW

U.S. equities fell quickly and deeply into the red to start 2016, producing the worst opening 10-days of the year in history. International equities also had a poor start to the year as another plunge in oil prices, continued concerns over slowing global growth, and lingering effects of the Fed's interest rate increase in December all contributed to the selloff in risk assets. Oil and equities showed more correlation than ever before. Predictions of a recession, an equity market collapse, and the end of the 7-year bull market permeated the media and investment flows quickly turned away from equities. Investors had 40 days of panic and uncertainty as the S&P 500 started the year at 2,044 and dropped to 1,829 on February 11, down -10.3% (including dividends) since the start of the year.

Just as quickly as markets fell in the first half of the quarter, equities bounced back in the second half of the quarter. Economic data releases were mostly positive, including better-than expected Q4 2015 GDP growth and increasing consumer spending. A mid-quarter rebound in oil prices and hawkish-turned-dovish commentary from several Fed chairs helped turn stocks around to finish the quarter with a very strong run that mostly offset the early quarter correction.

Oil and Equity Markets: Q1 2016

frame that delineates "long term" (it is more specific to each investor's goals), one quarter is certainly short term. Periods such as the first quarter, when U.S. stocks fell more than -10% then rose by nearly 13% (all within a period of 3 months!), are the reason it is not prudent to focus on short-term results. Speculators betting on short-term sentiment and emotionally-driven investors would have sold in early February as the market tanked, sitting idly by as markets recovered. Investors basing decisions on long-term fundamentals and their appropriate asset allocation would have rebalanced during this market turmoil, adding to equities and benefitting greatly on the upswing.

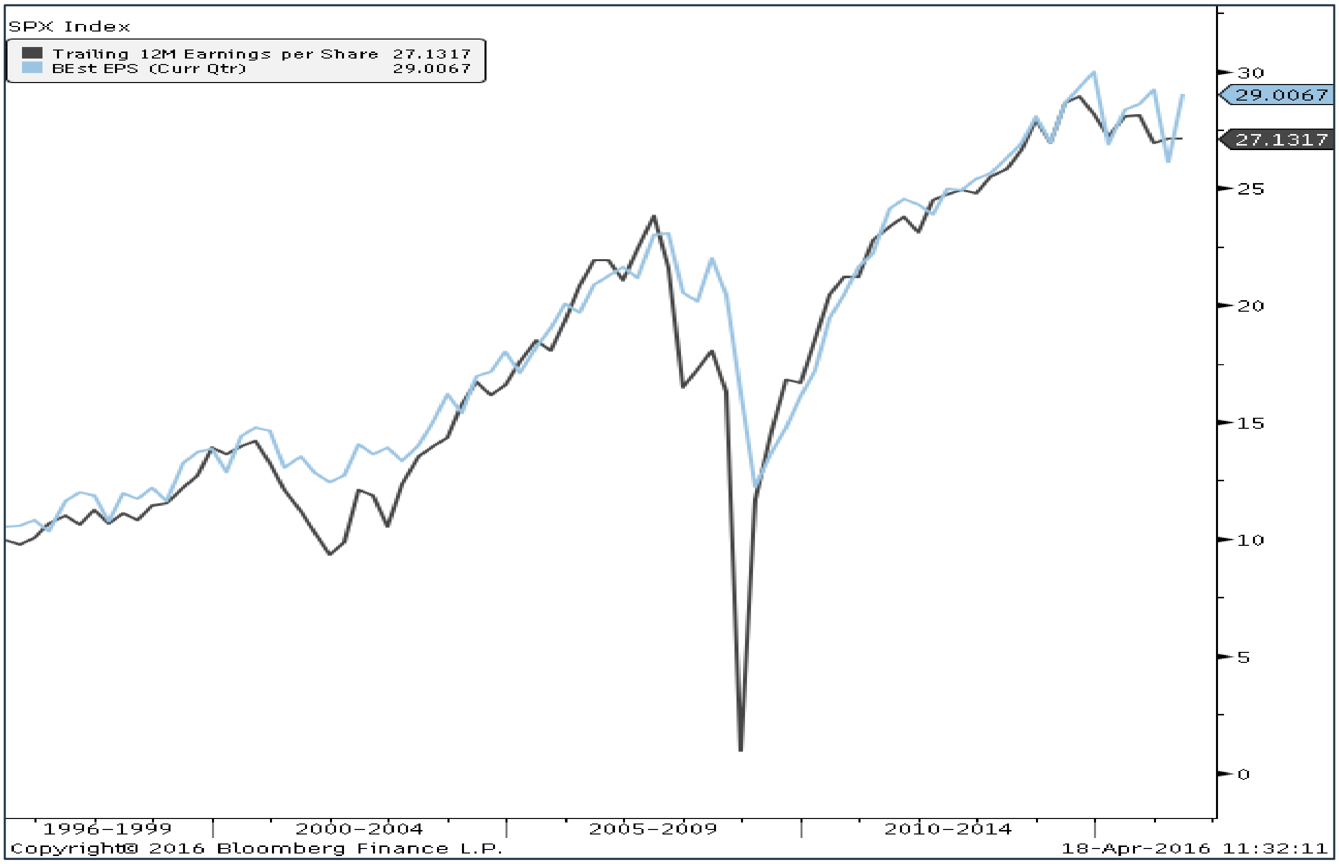
Even though yields remain near historical lows, bonds had another strong quarter – first boosted by the equity selloff, then by Fed commentary stating that interest rates in 2016 likely will stay lower than originally projected. Central banks around the world echoed the Fed by reinforcing easy monetary policies, including the controversial use of negative interest rates in an attempt to stimulate lending and growth. Foreign bonds generally performed better than U.S. bonds as rates globally continued to decline, driving the price of bonds higher.

The "long term" is often cited in the investment world, and for good reason. Although there is not a definitive time

U.S. EQUITIES

Domestic large-cap stocks, as measured by the S&P 500 Index, fell by as much as -10.3% during the quarter before bouncing back to finish the quarter up 1.4% (including dividends). Mid-cap stocks (S&P 400 Index) also bounced back during the quarter, finishing up 3.8%. Small-cap stocks, as measured by the S&P 600 Index, finished the quarter up 2.7% (however, other small-cap indexes remained in negative territory, such as the -1.5% return of the Russell 2000 for the first quarter). In a reversal from recent years, value-oriented stocks outperformed their growth-oriented counterparts in the first quarter of 2016.

S&P 500 Quarterly Earnings Per Share (EPS) vs. Bloomberg EPS Estimates



Although U.S. stocks ended the quarter on a strong note, weaker earnings expectations (Q1 2016 S&P 500 earnings are estimated to decline -8.7% year-over-year according to FactSet) and arguably high P/E valuations continue to drag on the U.S. equity outlook. Investors also are worried over the Energy sector's ability to cover its large debt balance amid lower oil prices and expect an increase in the default rate within the sector, which also pressures bank stocks. Over previous quarters, the strength of the dollar also has been a factor in reduced earnings growth, but the recent reversal in the dollar may provide some relief going forward. The Fed comforted investors with recent statements that emphasized a more dovish outlook on interest rates, which should provide a soft floor for equities over the next several quarters. Uncertainties around oil prices, default rates, economic growth, and interest rate movements limit the upside of markets in the near term. U.S. equities likely will remain in a tighter trading range until investors get more clarity, but even the long-term outlook is modest at best.

Within our U.S. equity allocation, we are overweight mid-cap equities. Mid-cap equities currently have a nice balance of growth potential tied heavily towards the U.S. economy (as opposed to large-cap equities, which tend to depend more on global growth) with lower risk than small-cap equities. We also trimmed our growth-oriented tilt, which performed well over the past few years, and may continue to move towards a value-tilt if valuation levels continue to become relatively more attractive. We are slightly underweight U.S. equities in favor of more attractive opportunities in international equities.

INTERNATIONAL EQUITIES

International stocks had mixed results for the quarter. International developed markets, as measured by the MSCI World ex-USA Index, fell -3.0% for the quarter. Emerging markets (MSCI Emerging Markets Index) provided the strongest equity performance with a 5.7% return for the quarter. The commodity recovery combined with strengthening currencies boosted emerging markets while concerns over slower global growth and a potential "Brexit" (British exit from the European Union) weighed on international developed stocks.

"We have a favorable outlook on international equities."

International equities, especially emerging markets, have a much more positive long-term outlook. Valuation levels are attractive and foreign central banks, including the European Central Bank (ECB), Bank of Japan (BOJ), and the People's Bank of China (PBOC), are determined to provide what they believe is the necessary boost to improve economic growth. According to Bloomberg, nearly 30% (over $7 trillion) of global developed government bonds had negative yields as of February 9th as central banks try to boost consumption with historically low interest rates. Low interest rates should aide economic and equity performance. The rally in the U.S. dollar since 2014 hindered international equity returns to U.S. investors (the value of foreign investments were worth less when converted back to a stronger U.S. dollar), but may not be as much of a drag going forward as the U.S. dollar may have plateaued. Although the long-term outlook for international equities is relatively attractive, the short-term gyrations in foreign markets will be more pronounced than in the U.S., so expect volatility to continue in the near term. These short-term swings can make it difficult to remain invested, but often times provide great opportunities for long-term outperformance to patient, disciplined investors.

We are overweight both international developed and emerging markets. Foreign central banks are taking extreme measures to stimulate growth, while the U.S. central bank (the Fed) raised interest rates in December for the first time since 2006. Although monetary policy is not the sole driver of equity returns, it certainly has an impact. Foreign central bank easing, combined with a potential boost from the waning strength of the U.S. dollar, could provide the optimal environment for strong international equity returns for the next several years. To control for the additional volatility, we limit our max exposure to international equities and will be opportunistic with our allocation to take advantage of sentiment-driven swings, both on the upside and downside.

REAL ASSESTS & DIVERSIFYING STRATEGIES

Real Assets had mixed results for the quarter, supported by an inflation uptick but held back by energy volatility. Real

Inflation Effect on Asset Class Performance

	Inflationary Environment			
Asset Class	Stable Inflation	Disinflation	Rising Inflation	Deflation
Traditional Equities	+	+ +	–	– –
Traditional Bonds	+	+ +	– –	+ +
Non-Traditional & Real Assets	+	+	+ +	– –

Inflationary Environment Explanation

Stable: Inflation is positive and rising steadily at a slow-to-moderate pace (example: 0-2.5% per year)
Disinflation: Inflation is positive, but rising at a decreasing rate (example: 3% in first period, 2.5% in second period, 2% in third period, etc.)
Rising: Inflation is positive and rising at an increasing rate (example: 2% in first period, 3.5% in second period, 5% in third period, etc.)
Deflation: Inflation is negative (example: -2.0% per year)

estate (FTSE NAREIT All Equity REIT Index) returned 5.4% for the quarter, boosted by the decline in interest rates. Master Limited Partnerships (MLPs) and Commodities struggled through a volatile quarter, finishing down -4.2% (Alerian MLP Index) and -2.5% (S&P Goldman Sachs Commodity Index), respectively. Diversifying Strategies provided some protection for portfolios during the market drawdown, but were not able to keep pace with equities during the second-half rebound. Insurance-linked bonds (SwissRe Global Cat Bond Index) steadily rose during the quarter and finished 1.2% higher.

For the past several years, Real Assets and Diversifying Strategies have detracted from portfolio performance as traditional stocks and bonds have performed well and inflation expectations were muted. In recent months, however, portfolios benefited from diversifying portfolio risks and should continue to benefit from exposure to non-traditional assets. Real Assets and Diversifying Strategies generally are a smaller allocation to portfolios, but will play an important role over the next several years to reduce volatility from short-term speculators bouncing back and forth from asset classes as they digest headlines from the changing economic and financial environment.

We are overweight Real Assets and Diversifying Strategies with the belief that these asset classes have better return potential relative to bonds. Allocations to Real Assets focus on hedging inflation risk while generating income, and Diversifying Strategies center around lowering portfolio volatility. We are researching ways to improve the diversification benefits of these allocations (not relying too heavily on one manager/strategy to produce our desired results), which may lead us to spread smaller allocations (3-5% each) across strategies as we increase these exposures.

BONDS

U.S. intermediate bonds (Barclays Aggregate Bond Index) currently yield around 2.3%, which is generally viewed as the long-term expectation for future return potential. However, due to falling interest rates during the quarter, the Agg Bond Index returned a surprisingly strong 3.0% for the first quarter (as rates decrease, bond prices rise, boosting returns in the short run, but the opposite is also true – rising rates typically hurt bond returns in the short run). Intermediate-term municipal bonds also performed very well, returning 1.7% for the quarter based on the Barclays Municipal Bond Index. Short-term bonds also were mostly positive, but generally had lower returns. The 10-year U.S. Treasury yield finished the quarter at 1.79% (much lower than the 2.27% yield at the end of 2015) after Fed Chair Janet Yellen's dovish comments near the end of March.

We maintain an unfavorable outlook on bonds. Long-term returns, as based on current yields, are barely enough to cover expectations of inflation. Over the next several years, the potential for rising rates puts heavy downward pressure on bond returns. Expectations of an increase in default rates, especially in the energy and materials sectors, may drive high yield markets down, although spreads are currently above historical averages. Even though our long-term outlook on bonds is unfavorable (the same as at the beginning of the year), the first quarter showed how beneficial investment-grade bonds are as part of a well-diversified portfolio. When equities quickly fell in the first half of the quarter, bonds performed well as investors flocked to the safety of bonds. The bifurcation between stocks and bonds in the first half gave investors an opportunity to rebalance – "sell high" the winners (bonds) and "buy low" the losers (stocks) – and enjoy the strong equity rally in the second half of the quarter.

Our bond allocation is underweight and has an average duration shorter than the Barclays Aggregate Bond Index. We want to maintain exposure to bonds for portfolio stability, but see the risk-return relationship asymmetrically skewed towards higher risk and lower return. Bonds, especially those on the longer end of the yield curve, will have a much more difficult time consistently producing positive returns year after year if interest rates increase more rapidly than expected, and it is nearly impossible (mathematically speaking) for bonds to generate the same 6% long-term returns they have historically. For portfolios that are not all equity, we will always maintain some exposure to bonds even though our long-term outlook is negative – and it is periods like the first quarter, when risk assets (equities) go haywire, that make us glad we did.

ECONOMY

During the first half of the quarter, as equities could not find a bottom, headlines referencing only one or two weak data releases were rife with forecasts of a U.S. recession and ensuing bear market correction. As equities (following oil's lead) rebounded, the "gloom & doom" headlines quickly subsided and were replaced with brighter outlooks. According to the U.S. Bureau of Economic Analysis (BEA), the nation grew at a rate of 1.4% based on Gross Domestic Product (GDP) in the fourth quarter of 2015 and the Bloomberg consensus estimate for Q1 2016 stands at 0.7% growth. Auto sales topped 18 million year-over-year sales in the third quarter of 2015, but are closer to 16.5 million as of March 31 (the 5-year average is 15.5 million). Inflation, based on the Consumer Price Index (CPI), also has picked up, growing 0.9% over the past year but core Personal Consumption Expenditures (PCE), the Fed's measure for inflation for which it targets 2%, is closer to 1.7% for the 12 months ending February 29, 2016. Although high inflation can be harmful to the economy, controlled inflation is a sign of healthy economic growth as increasing demand tends to drive prices higher. Manufacturing improved and unemployment remains around 5.0% (bumped up slightly by an increase in the labor participation rate). Many economic releases show strength, but not every economic indicator points to a strong economy (rarely do all indicators align perfectly) and it is easy to make negative forecasts by selectively choosing data points. But with so many economic data points available, it is not appropriate to cherry-pick only those that agree with a certain agenda. When looking at the data in aggregate, the overall U.S. economy is in good shape.

> *"When looking at the data in aggregate, the overall U.S. economy is in good shape."*

Summary of Outlook & Positioning

Asset Class	Long-Term Outlook	Current Positioning
U.S. Equities	Unfavorable	Underweight
International Equities	Positive	Overweight
Real Assets	Positive	Overweight
Diversifying Strategies	Positive	Overweight
Bonds	Unfavorable	Underweight
Cash	Unfavorable	Underweight

INTEGRITY

We believe that you are served best when we share our expertise passionately and with transparency.

KNOWLEDGE

We must continually learn, building upon our intellectual capital and our technical ability in order to guide effectively.

SERVICE

When we continually strive to attain the highest standards, you experience superior service.

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