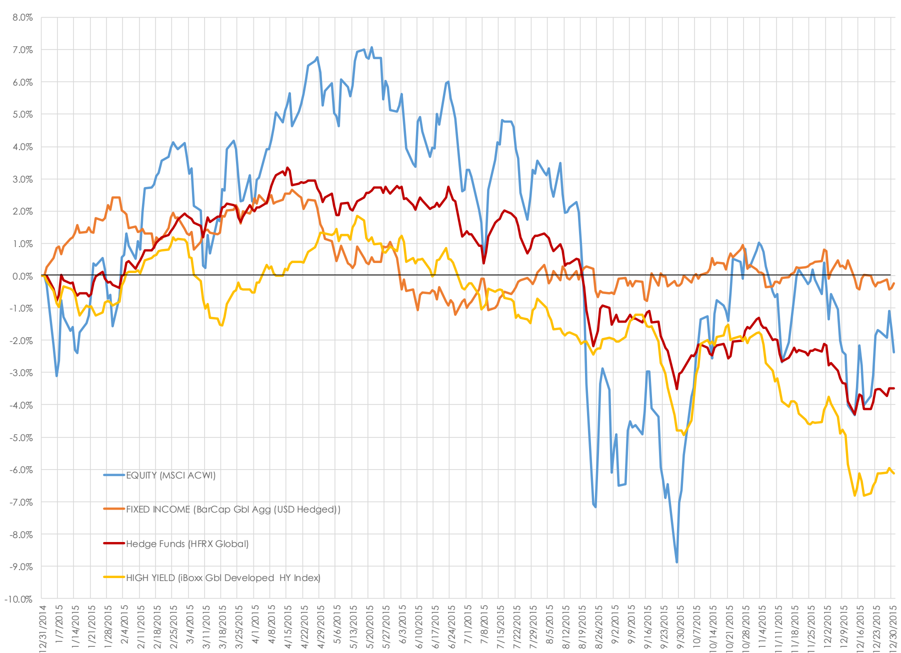
What Lies Ahead for 2016?

2015: Few places to hide

2015 was a year when, very unusually, the main asset classes of stocks, bonds and even hedge funds had almost identical returns. One did not have to worry about allocating between them; the results would have been similar. The way to make money was to try to profit from the rise of the dollar and the fall of commodity prices, or to invest in real assets such as property. It's important to understand that a flat portfolio in 2015 measured in USD means a portfolio up at least +10% measured in "purchasing power" given the strong appreciation of the US Dollar last year.

Graph 1. 2015 was a Year of Negative to Flat Returns



1. Source: Bloomberg

Market Forecasts for 2016

At last 2016 is here. As such, our BSP Investment Committee is expected to suggest what investors should do to position themselves for the 12 months ahead of us. There are two problems with this task.

The Thinking Man's Approach

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Investment Committee
BigSur Wealth Management LLC

At the outset of every year we engage in the task of analyzing the views of many of investment banks and independent buy-side research shops to gauge their sentiment. But more importantly to share our views and investment strategy for 2016.

On the traditional/ liquid side of the portfolio we favor high quality mega capitalization stocks over high grade bonds and recommend a higher than average cash position for tactical trading. Investors need to be ready to execute a planned trade under a certain circumstance (like a market correction or a VIX spike).

We continue to recommend investors to increase the "illiquid" allocation of their portfolio, focusing on revenue producing assets like commercial real estate and private debt.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

ideas@bigsurpartners.com

First and foremost, we do not know what will happen in the next 12 months, and neither does anyone else. The best we can manage to do is some scenario analysis. We need to balance our views for the short-term (i.e. for 2016) with our clients' long-term objectives. Clearly, a 12-month calendar year is arbitrary and we should be planning much longer term, positioning portfolios for the next 5 to 10 years.

In the following table, we show some of the main investment banks, as well as BSP's, outlooks for the main asset classes: The table tries to summarize the views in terms of their positioning for 2016; their favorites and their underdogs.

Table 1. 2016 Outlook Summary

	BigSur	BCA	Citi	CS	DB	GS	HSBC	JPM	ML	MS	UBS
Cash	Neutral	NA	Neutral	Neutral	More negative outlook	Neutral	Positive outlook	Neutral	Neutral	Positive outlook	Neutral
Government Bonds	Neutral	Positive outlook	Neutral	Negative outlook	More negative outlook	More negative outlook	More positive outlook	More negative outlook	Neutral	Positive outlook	More negative outlook
Credit	Neutral	Neutral	Neutral	Neutral	Positive outlook	More positive outlook	More positive outlook	More positive outlook	Negative outlook	Positive outlook	Positive outlook
Equities	Positive outlook	Neutral	More positive outlook	Positive outlook	More positive outlook	More positive outlook	Neutral	More positive outlook	Positive outlook	Neutral	More positive outlook
Forex	Positive outlook	Positive outlook	More positive outlook	More positive outlook	Positive outlook	Positive outlook	Negative outlook	More positive outlook	Positive outlook	Positive outlook	Neutral
Commodities	Negative outlook	More negative outlook	Neutral	Negative outlook	More negative outlook	More negative outlook	More negative outlook	Negative outlook	Neutral	Neutral	Positive outlook

Keys:

- More positive outlook
- Positive outlook
- Neutral
- Negative oultook
- More negative outlook

Source: Banks & independent research published reports.
[BCA= BCA Research; Citi = Citibank; CS = Credit Suisse; DB = Deutsche Bank; GS = Goldman Sachs; JPM = JP Morgan; ML = Merrill Lynch; MS = Morgan Stanley]

Equities

Based on the data set of the table above developed by BSP, the investment views are more fertile or "greener" on the Equities asset class (no orange or red colors show up; it's mostly green).

Valuations are not cheap but fairly valued, with the S&P500 trading at 16x 2016 earnings per share of $123. This means that the market offers a 6% earnings yield – comfortably above bond yields and inflation. Stocks still look good relative to Treasuries, high-grade bonds and cash (as the dividend yield is 2.2% better than almost any G-7 government bond yield).

2016 earnings are expected to grow between 5-8% based on much better comparable for the oil and commodities sectors (that compose 18% of the market combined). However, the volatility in these earnings expectations is high based on 3 factors: the US Dollar strength, oil prices and the China stabilization (or lack of). Given this volatile earnings environment, BigSur favors high-quality megacap stocks, with good dividend growth.

What are the likeliest scenarios for 2016? A stock is worth its future stream of earnings, discounted by a suitable long-term interest rate. So let us break this down to the two issues of earnings and rates.

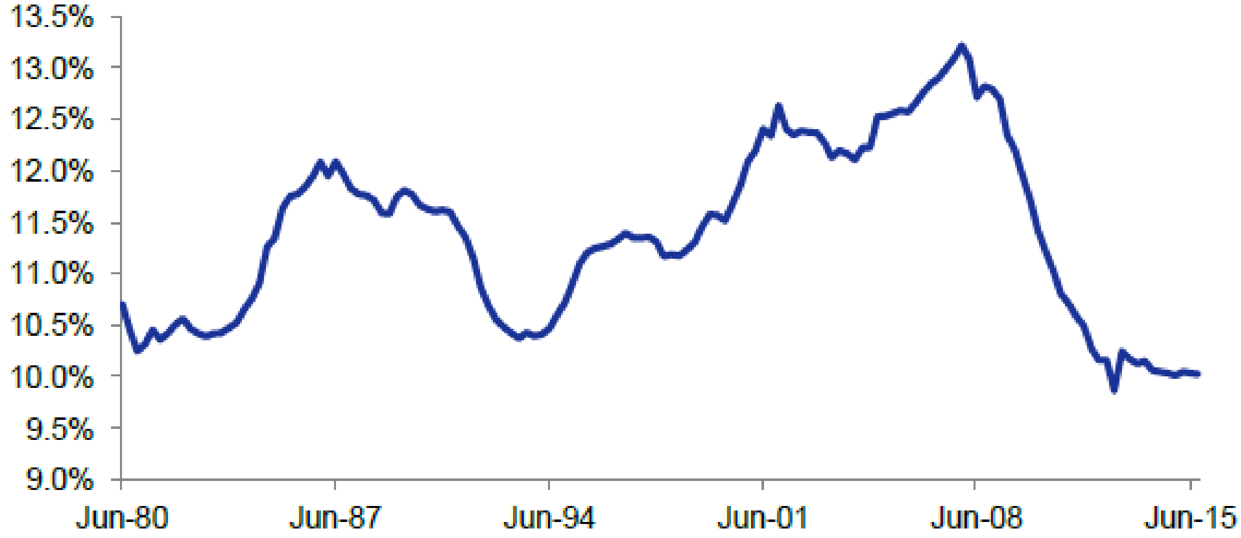
Earnings for the US S&P 500 fell slightly last year. In the third quarter, S&P 500 earnings dropped by -0.8% YoY, and the consensus expectation is that they will be down -3.5% in 4Q15, mostly thanks to energy. Brokers' analysts, as polled by Thomson Reuters, expect a +8% growth this year, although most top-down analysts expect the outcome to be +6%. European earnings, coming off a very bad year, are expected to rebound somewhat more. But 2016 will show again positive USD earnings growth vs. the negative USD earnings growth registered in 2015.

So the base case scenario is a positive, albeit not great, recovery for US earnings. This largely thanks to the low base of comparison for energy companies, with a more robust recovery in Europe. We recommend clients to overweight European stocks vs. US stocks and given our outlook of a slightly softer EUR, clients should consider at least partially hedging their EUR exposure (partially as European large cap companies export around 40% to the USD market).

An alternative scenario is that US earnings continue to fall because higher wages and higher interest rates eat into margins, while commodity prices stay low, impacting corporate pricing power. China, in this scenario, probably drags into further difficulties, which means European earnings - rather more dependent on exports to China - also suffer, and the European economy fails to achieve any lift-off.

For profits to recover more strongly, we require a more genuine, full-blooded economic recovery, probably because the US consumer starts buying more, using the savings that cheaper oil has generated, making revenues increase. Despite the obvious anxiety in the US, as reflected in the presidential campaigns so far, higher wages, higher house prices and a cleaner household balance sheet all suggest that this scenario is not far-fetched, though it is unlikely. This is the upside scenario for 2016.

Graph 2. Cleaner US Consumer Balance Sheet



Source: Deutsche Bank

Our conclusion of the scenario analysis is that the upside/downside risk for stocks is not that great when we consider a high volatility environment. BSP Investment Committee sees a 3-5% index return for stocks on top of the dividend yield, for a total return of 5-7%. We will likely see further increases in volatility (as shown by the trajectory of VIX in 2015) and most probably more number of volatility spikes in 2016 than in 2015 (i.e. a larger number of "ugly" days).

Graph 3. Volatility Spikes to Increase

Spikes in equity volatility have corresponded with major global shocks.

Source: Goldman Sachs

If 2015 was a "violently flat" in the US equity market, 2016 will show to be more violent. We think that there will be many days of PANIC SELLING that will be opportunities. Technically there's one plus and one minus:

1. Plus: It's important to note the BEARISH sentiment in the US Equity market, as shown by the Association of Individual Investors, which BSP finds to be a plus for the market support.
2. Minus: Narrow participation: as the Financial Times points out according to Peter Atwater, who analyses market psychology, narrow participation is a symptom of extreme nerves and the top 10 stocks in the S&P 500 are up +13.9%while the other 490 are down -5.8%: The largest spread since the late 1990s! Facebook, Amazon, Netflix and Google, known as the FANGS (for their initials) together with Ebay, Priceline, Salesforce, Microsoft and Starbucks, to create a "Nifty Nine" and they beat the rest of the US market by more than 60%.

Tactical Trades for 2016

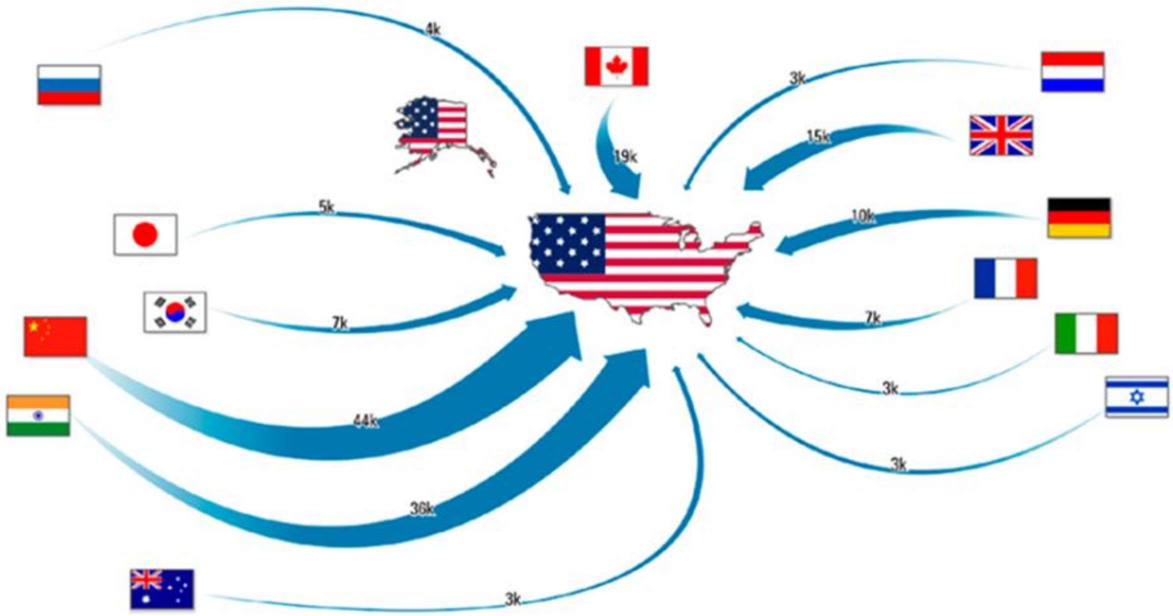
1. Taking Advantage of Volatility

One of the trades that seems reasonable is to buy the market in strong pull-backs when VIX overshoots. We have been able to execute *BUY-WRITE strategies* (or selling at-the-money puts) in those moments, and we think it will be a very tactical equity market. We do think that Europe and mainly EM equities offer long-term value and a better risk return profile. A gentle shift towards cheap stocks in emerging markets may have a better chance of working in 2016.

2. Information Technology (IT)

IT has been and continues to be one of our favorite sectors due to average valuations being attractive (PE ratios below the S&P500 PE ratio) and for fundamental reasons. From the earnings point of view, IT companies have a great pricing power and as such have much better earnings visibility than the rest of the market. Pricing power is derived from intellectual capital that continues to favor the USA. Based on the latest Population Census in the USA, the migration of inventors still strongly favor the USA. Anecdotal information provides us comfort this continues to be the trend. The World Intellectual Property Organization also released a report in 2014 that notes immigrants to the US are key to innovation and entrepreneurship in Science, Technology, Engineering & Mathematics (STEM) fields. Immigrants not only provide a substantial portion of the highly skilled employees in these fields, but they also represent the leaders in these fields – as they constitute a disproportionate share of U.S. Nobel Prize winners in the STEM fields, which are arguably the most important areas of the economy to achieve growth.

Graph 4. Migration Flow of Inventors to the US

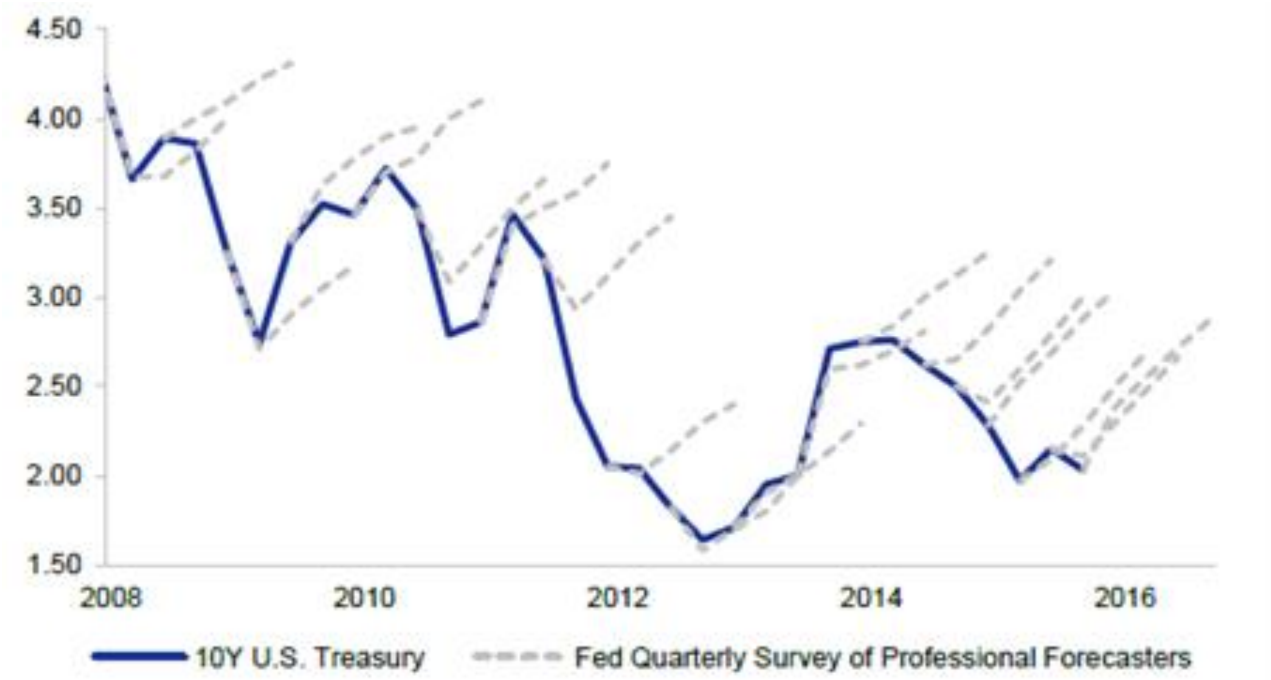


Data through 2010.
Note: Showing the number of inventors migrating to the United States between 2001 and 2010.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, World Intellectual Property Organization.

IG Bonds

It's hard to be excited with government bonds, but they still are one of the only "hedges in town". BSP Investment Committee thinks safe-haven bond yields will remain depressed throughout 2016. Government bonds are a market distorted by QE. European negative yields are a poster child of this distortion. The US is still a high yielder when compared to Europe, England and Japan. Inklings of inflation in the rich world are outweighed by downward pressure on prices elsewhere.

Graph 5. US Treasury Expectations: The Market Has Been Wrong



Source: Deutsche Bank

The expectation projected by bond markets is that LOWFLATION will persist, and we generally agree. Where inflation can be found in the world, it is not obviously a function of capacity constraints. Economies like Brazil, in which core inflation is above the central bank's target, tend to be commodity exporters that have suffered big falls in their currencies.

The Fed's "Dovish rate hike" is an oxymoron: Rich-world policymakers will find that they have to keep their domestic economies primed with low interest rates to offset disinflation from abroad. We think the 4 rate hikes for 2016 embedded in the market curve, are over exaggerated. We see good opportunities in the lower quality IG corporates in the BBB sector. For US investors: Within IG bonds we still think Municipal Bonds will continue to outperform as they offer attractive after-tax yields.

Credit

Regulatory pressure on big banks to reduce risk has left markets more vulnerable to price swings fueled by emotions and the movements of small investors, forcing Wall Street firms to cut inventories of the assets they help customers to trade. This has engendered a substantial and growing void in liquidity ("too much water in the pool with very thin pipes"). Market makers have pulled back on every credit asset type from high-yield bonds, European sovereign debt, bank loans and distressed securities. Incredibly low inventories are being taxed with extreme volatility and the challenges of a market that is often driven by emotions, rather than by fundamentals.

For this reason, during 2016 we recommend being very selective and defensive in "spread products", focusing on high liquidity, high quality issues. We are concerned by this deterioration of credit fundamentals (due to rising leverage) and lack of liquidity in the markets. On the other hand, we see the opening of some interesting opportunities, but one needs to be selective regarding:

a) Liquidity: it is very important to get exposure to High Yield and Emerging Markets bonds through the appropriate investment vehicles. We recommend reducing exposure to mutual funds with daily liquidity (manager is forced to sell assets on daily basis when they face redemptions) and to increase exposure to either individual bonds and/or funds with monthly liquidity. This will provide managers more flexibility in case of redemptions. This is particularly relevant for lower quality High Yield investments.
b) Duration: Investing in the short end of the curve, and/or long-end (barbell approach) in low price, high return securities;
c) Sector: In the immediate future, avoid commodity related sectors due to the strong deterioration in credit fundamentals;
d) Country risk/Region Exposure: Europe should benefit more due to continuing BCE support and an improving corporate financial health.

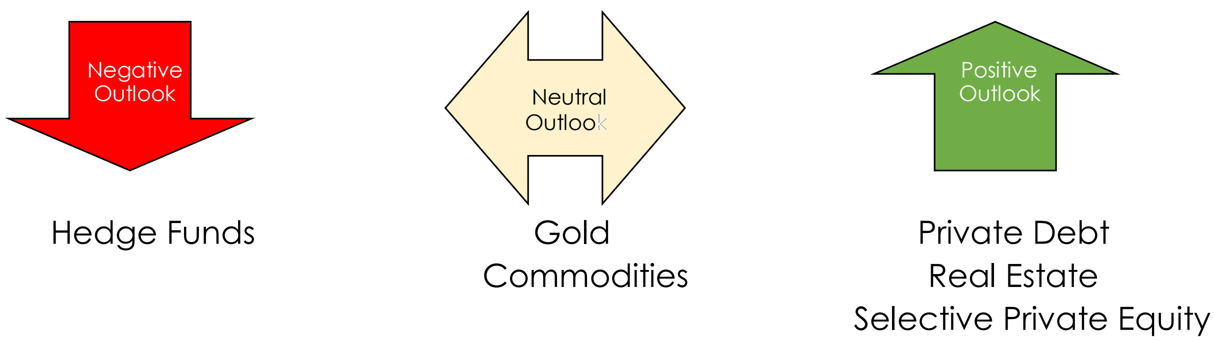
Alternative Investments

This year could look like 2015, when alternative assets proved "a place to hide". We reiterate our views, which highly paid off in 2015, to overweight "income producing" alternative investments in niche markets like Private Debt, Commercial Real Estate and Mezzanine Debt in less liquid markets that offer great risk-return profiles. We at BSP have been and continue to be quite negative on hedge funds, which continued to underperform in 2015 (-3.5% in 2015). As we have written about many times last year, we believe that it will be difficult to detect clear value in traditional asset classes (cash, equities, fixed income) going forward, especially as extraordinary money creation of the last few years has inflated financial assets, particularly in the most liquid and mature markets. Thus, we are focused on finding alternative or "non-traditional" income producing assets, which offer intrinsic value, and with time will also benefit from capital flows as investors recognize these opportunities. These alternative income producing assets constitute an opportunity for investors to position their portfolios for multigenerational wealth.

When it comes to private debt, we like the attractiveness of its yields and risk profile. Private debt is a highly specialized market. Thus, it requires managers with a strong track records as well as a solid network to gain access to deals. We believe the best way for our clients to invest in private debt is through high quality third party managers. In real estate, we are focused on income producing core commercial properties, which has been our focus since we started investing in real estate in 2009. We continue to look for trophy assets in secondary markets, which have more attractive opportunities than top tier cities. There are also opportunities in niche asset types. These opportunities are spread across a wide variety of industries, but the investment criteria remains the same: income producing high quality assets and/or investments with intrinsic value over comparable risk assets which offer higher liquidity.

One such example is investing in debt securities that are collateralized with royalty streams from leading pharmaceutical products. We have also invested in secondary interests in private equity funds, which offer investors the opportunity to buy discounted shares with lower terms, increasing the potential for return.

Graph 6. Illiquid Alternative Investments BigSur's Outlook: Income producing vs. non-income producing



Commodities (and the China "effect")

2016 could be a year where there will be an entry point to go LONG Commodities, but it's still not now. There are 2 commodities that directly or indirectly affect our clients' portfolios: Oil and Gold.

While we do view Oil as recovering during the 2H2016 we still view Saudi Arabia's strategy as having more follow-through during the 1H2016. We strongly feel the oil shock is strictly a supply issue and not a demand issue, which plays well for a second half of the year recovery and decreases the probability of a the oil shock being a signal of a global economic recession. We have reiterated that the Chinese equity market is dominated by state owned enterprises and the authorities are struggling to achieve a liberalization of the FX and secondarily the Equity market. But all this is new and will show a "two step forward one step back" progress. More importantly, we do not view a Chinese equity market correction an indication of an economic recession in China. As the economic model shifts from an Investment/ Manufacturing/ Industrialization focus to a Consumption/ Services/ Technology focus, we see a natural economic deceleration from a 7-8% to a 4-5% GDP growth. Given these dynamics, we continue with our long-standing recommendation that clients gain exposure to China's growth markets from private equity, and not public equity.

China's equity markets continue to tumble, its currency is under unprecedented pressure and Chinese policy-makers' reputation for competence is looking ever more tarnished. Contrary to many of the headlines though, the economic data show no sign of major deterioration in recent months. There is little doubt that China's economy is growing at a slower rate now than in the recent past.

According to our China Activity Proxy, the economy grew by roughly 4.5% y/y last quarter, compared with 7% a little over two years before. On these grounds, investors have reason to be downbeat. But there is no sign of the more recent, deeper slowdown many argue must lie behind the stock market falls and capital outflows.

Regarding Gold, we have mixed feelings. This is because it's a questionable hedge asset in a soft market as the Fed hikes rates and dollar strength persists. In addition, we still see deflationary pressures (commodity prices, manufacturing overcapacity in China and natural deceleration and change of economic model in China) having a bigger impact than tepid inflationary pressures coming from tighter labor markets in USA, England and Germany.

Conclusion

2016 will show to be a much more volatile year than 2015, with a few more "places to hide" than last year. This is because of several factors like the aging bull market, ongoing multiple geo-political fronts like the Middle East and North Korea (where the US administration has created a power vacuum), the "China effect" and the commodities bear market cycle. China provides around 34% of global growth and thus the sensitivity in global markets to any change in the perception of growth of the second major economy in the world.

Nevertheless, we feel there's too much confusion while fundamental factors are acceptable. The oil market problems to us are a supply and not a demand issue, and it will eventually stabilize this year. Chinese economic growth seems to be naturally decelerating and while the equity market is not deep enough, it does not have strong transmission mechanisms into its real economy and thus the probability of a global recession are very low. For example, the US exports 13% of its GDP, 2% of which is to China.

While the new year has begun with a shock for investors — with equity markets around the world down 6-7% so far this year, investors may have overlooked strength in the markets' fundamentals, such as improving economic and survey data in Europe and signs of rising inflation (in the Services sector) and stronger consumer spending in the U.S. Also blurred among the negative headlines is a shift from fiscal drag to fiscal stimulus (as reflected in the spending bill passed by the U.S. Congress last month).

Stocks still look good relative to Treasuries, high-grade bonds and cash (as the dividend yield is 2.2% better than almost any G-7 government bond yield). 2016 earnings are expected to grow between 5-8% based on much better comparables for the oil and commodities sectors (that compose 18% of the market combined). However, the volatility in these earnings expectations is high based on 3 factors: the US Dollar strength, oil prices and the China stabilization (or lack of). Given this volatile earnings environment, Bigsur favors high-quality megacap stocks, with good dividend growth.

We advise investors to be patient and look for encouraging signs — like stabilizing Chinese growth, a stabilization in the PBOC loss of international reserves, a bottom in energy prices, and a calming of geopolitical risks — to add risk exposure throughout the year.

2016 is a year to use volatility in our advantage by doing "yield enhancement" strategies and hedging portfolios. Investors need to leave an above average cash levels for tactical trading and be ready to execute a planned trade when the circumstance arises. While many of our clients don't like to see high CASH allocations, let's remember never in the history did it have such a low opportunity cost. At least 10% cash allocation is recommended to provide flexibility to make tactical calls.

We still continue to recommend investors (with no large liquidity needs) to increase the "illiquid" revenue producing allocation of the portfolio, as we believe it provides an illiquidity premium of around 5% over comparable liquid securities. Clearly in 2015, this "illiquid" bucket provided one of the few "places to hide" in 2015. It may well do so this year.

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