CAPITAL PLANNING ADVISORS™

Q1 ECONOMIC AND INVESTMENT OUTLOOK

Family, Business & Legacy Wealth Advisors

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Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

CAPITAL INSIGHTS

Q1 Economic & Investment Outlook
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THE U.S. ECONOMY BABY, IT'S COLD OUTSIDE

For anyone who has seen the recent holiday television commercial featuring Lady Gaga and Tony Bennett, you are most likely now familiar with the song, "Baby, It's Cold Outside." This tune was written by Frank Loesser in 1944 and has been recorded many times over through the years by the likes of Dean Martin, Louis Armstrong, Pearl Bailey, Sammy Davis, Jr., Ray Charles, Bette Midler, James Taylor, Liza Minelli and Sheryl Crowe, just to name a few. The song has very much become a part of the cultural seasonal "language" of the modern era.

It just so happens that the title of this song characterizes perhaps the key issue facing the US economy in 2016. Over the last few years specifically, increasingly the global economy is becoming "colder" outside of the US. A key question for the New Year being, what are the implications for the domestic US economy of a lowering of the global economic temperature?

Let's set the stage for what is now occurring by joining with "Father Time" in a very quick journey through the holiday's past. One of the key drivers of global economic growth over the last few decades has been the buildout of productive capacity in the emerging economies. The historically unprecedented magnitude of Chinese manufacturing capacity and infrastructure build out alone helped to create a once in a multigenerational boom for the global industrial sector and commodity producers specifically, the emerging market countries being key beneficiaries. For now, that boom is over. In a currently demand growth challenged global environment, excess manufacturing capacity is all too apparent and commodity price deflation a stark reality.

To suggest global economic conditions are pressuring emerging market economies is an understatement. Simultaneously, we also find developed economies with important export components like Japan, in recession. Just what does this mean for the US economy looking into 2016?

As we look back across decades of economic history, it has been a truism in the modern era that the US has led the global economy into recession, but never the other way around. As such, you'll find few who would suggest this may occur. Our thinking looking into 2016 is that we need to keep in mind how interconnected the global economy has become over the last few decades, and what this means for the US economy singularly. The IMF tells us that the emerging market economies accounted for just over 50% of global GDP in 2013, up from 31% in 1980. Importantly, PWC (the old Price Waterhouse Coopers) estimated China, India and Brazil alone accounted for 50% of global GDP "growth" in 2013. During a talk in mid-2014, Bill Gates noted that "in the prior three years alone, China has used more cement than the US used in the entire 20th century." We have the feeling very few understand the size of the prior period emerging market boom and how that contributed to global economic growth. Nominal economic magnitude and potential growth impact of the emerging markets on global GDP are what is certainly different in the current cycle relative to historical context.

The important question for the New Year becomes, could ours be the economic cycle where weakness outside of the US ultimately impacts domestic activity in a meaningful manner? Will the rhythm of decades of the US economy determining the direction of the global economy be broken? We suggest emerging market economic weakness is one of the key risks to US economic outcomes in the year ahead.

So just how do economies of emerging markets impact the US? In December, Caterpillar reported its 36th consecutive month of decreasing world sales. In its third quarter earnings report it announced the elimination of 10,000 jobs over the coming three years. As few as 18 months ago, the US domestic energy sector accounted for some of the greatest job growth rates and highest paying new jobs being created stateside since 2009. Headcount reductions are now a reality and this will

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continue into 2016 as oil prices have continued to slide. Joy Global, the largest underground mining equipment manufacturer in the US, has watched its stock price plummet over 90% since 2011, due to the toll global demand contraction has taken on its bottom line. As you'd guess, manufacturing sector employment gains in the prior year suffered. It's simply common sense that the key transmission linkage of emerging economies to the US is via employment.

Does all of this spell death and destruction for the US economy? Of course not. Through this point in the current cycle, the service side of the US economy (by far the largest percentage component) continues to move forward. What current emerging market circumstances and trends mean for the US economy in 2016 is the potential for further drag in what is already a historically slow growth cycle. 2016 will be further discriminating in its domestic economic sector beneficiaries. Ours isn't the business of an economy, but alternatively an economy of individual businesses. Some will be dressed warmly, others, not so much, but all will know is that "baby, it's cold outside."

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Lawrence A. Hansen Partner & Founder
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & CEO
Michael Sollazzo, Esq., CPA INACTIVE, Partner & Wealth Management Counsel

Roseville
(916) 286-7650

Walnut Creek
(925) 524-2800

INTEREST RATES THE "OTHER" MAJOR FED DECISION FOR 2016

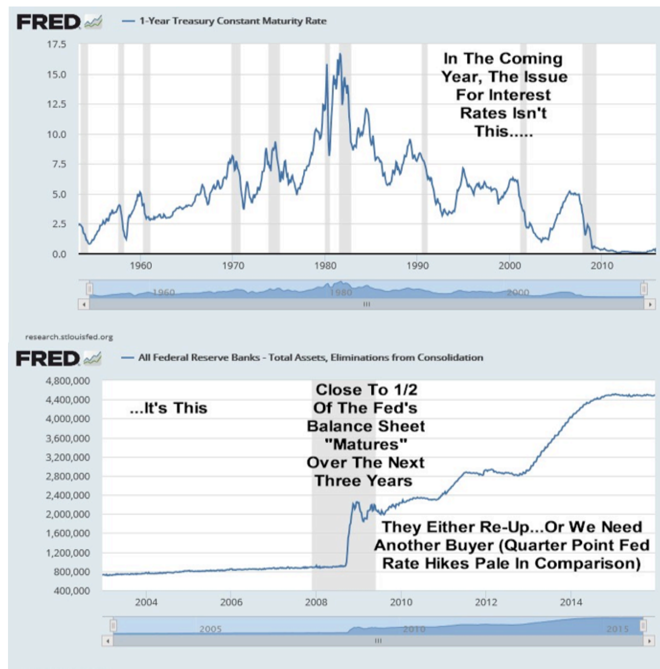
"With unceasing anticipation all through the year, the financial market Who's down in financial market Whoville knew it finally was here. No need for fanfare, not a sound in the joint. Ms. Yellen raised rates a mere quarter point. But looking ahead, rates aren't the issue. It's the Fed balance sheet that may cause bond investors to grab for a tissue."

In all sincerity, we are so very glad to have the first Fed interest rate increase out of the way. The amount of time and energy wasted on anticipation and timing commentary as well as digital/print coverage was simply getting ridiculous. We've been as guilty as anyone. The fact is that there is not one sitting Fed member today that was a part of the Fed the last time the Fed Funds rate was increased. There is no magic formula. As former Chinese leader Deng Xiaoping once remarked, the Fed is "crossing the river by feeling the stones."

Undoubtedly, we will be entertained by all of the guessing games that will occur in the financial media in 2016 regarding future Fed rate increases to come. We suggest to you that this will be a sideshow compared to the most meaningful, and least talked about, Fed decision slated for 2016 – whether to reinvest bond maturities on the Fed balance sheet. Our conclusion is this. If financial markets remain rocky, they will reinvest every nickel of bond maturities. Alternatively, in the face of calmer markets, they may indeed choose to shrink their balance sheet, which is essentially quantitative easing in reverse. Let's look at why this decision is important.

What does this balance sheet decision process mean "in English" and how will it impact bond investors? Let's roll the clock back to when the Fed first decided to embark on Quantitative Easing. At that time, the Fed had a balance sheet valued at approximately $800 billion. Today that number stands at roughly $4.4 trillion, an increase of over $3.5 trillion. The balance sheet growth came from Quantitative Easing, the "printing of money" as it has been characterized. This printed money was used by the Fed to purchase bonds on the open market, helping to insure interest rates across many maturities remained low.

The key point looking ahead is that these bonds on the Fed balance sheet will be maturing in the years directly ahead. Over the next three years, approximately $2 trillion in bond maturities will occur on the Fed Balance Sheet ($1.1 trillion in US Treasury bonds and $900 billion in mortgage backed securities). Key question being, will the Fed reinvest the proceeds of these bond maturities, again helping keep Treasury and mortgage backed bond rates low? Or will they forgo reinvestment and shrink their balance sheet back toward historical norms?



If the Fed reinvests the bond maturities, it limits its own future decision making flexibility in times of potential economic recession (assuming its ability to print money is not limitless). If a US recession were to arrive, the Fed would have less flexibility in stimulus tools (dropping rates and/or printing additional money). Conversely, if the Fed declines to reinvest these bond proceeds, and acts to return its balance sheet to more historic levels, then these bonds will need to be financed by the markets broadly who are not as price insensitive as the Fed. The open market may indeed demand a higher rate of return (higher interest rate) than would the Fed.

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Walnut Creek
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This bond reinvestment decision by the Fed will be made in 2016, and specifically in the first or early second quarter. From our perspective, this will be the Fed's most important decision in 2016. We do expect the Fed to continue raising the short term Fed Funds rate, but they will be in no hurry to do so, and may slow for extended periods of time, especially if financial markets are volatile. The key decision for bond investors will be the balance sheet reinvestment decision. Again, very near term we expect them to reinvest bond proceeds if they deem financial markets to be unsettled, but this will not continue forever.

Late last year, we experienced meaningful deterioration in the high yield portion of the US bond market. Energy related debt has hurt the high yield market in general, but it's not energy alone. A slowing economy is not bond market friendly (pressure on cash flows), especially in lower quality credit. We also saw a touch of weakness in investment grade corporate debt. The Fed owns very high quality debt, a portion of the market that held up in 2015. Will it be so again in 2016? In very large part the answer to that question depends on the Fed answer as to whether the reinvestment of bond maturities on its balance sheet will continue in 2016 and beyond.

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THE U.S. STOCK MARKET IF SANTA CLAUS SHOULD FAIL TO CALL, BEARS MAY COME TO BROAD AND WALL

There is an old saying on Wall Street that tells us, "if Santa Claus should fail to call, bears may come to Broad and Wall." Old sayings are humorous and fun, but in no way are they guaranteed determinants of forward outcomes. Nonetheless, we did not see a stock market "Santa Claus rally" in late 2015 and are indeed experiencing a bit of heightened early year volatility in the US and global stock markets. Just where do we find ourselves as we enter 2016?

STOCK MARKET VALUATION

We've discussed this many a time over the last few years. From the context of historical perspective, the stock market is not cheap based on overall valuations, but in like manner, it is not in outright bubble territory either. As such, we can't count on expanding valuations to propel prices higher. Earnings growth is important. Although the US and global economies are growing very slowly, they are growing. It is very rare we find the US stock market down two years in a row, unless recession becomes reality. In 2016, watching the ongoing character of the economy will be very important. Again, we believe our thinking regarding how the global economy impacts the domestic will be a key to economic and financial market outcomes stateside.

CHINA

China ushered in the New Year with a day one 7% stock market decline. Happy New Year for investors in Chinese equities? Not so much, at least not for now. Global investors took this as a sign that the Chinese economy is growing more slowly than official numbers indicate. Accompanying the market decline was further measured devaluation of the Chinese currency. As we wrote about last fall, China is just beginning its currency devaluation process. Further currency decline should be no surprise at all, but China's currency devaluation is academically deflationary for the global economy.

What this suggests to us is that investment selectivity will continue to be very important, as it was in 2015. Looking into 2016, sector and specific investment avoidance will be equally, if not more important, than sector/asset class participation. Will a slowing in China, and potentially the global economy, be more impactful for an essential purpose consumer products and health care company like Johnson and Johnson, or an earth moving equipment manufacturer such as Caterpillar? Which company's earnings are at greater risk in the current environment?

Another old saying in the markets is "it's not a stock market, it's a market of stocks." We need to keep this clearly in mind as we move into 2016. The character of the domestic and global economy will impact individual companies quite differently. Selectivity and active avoidance of some areas of the market will be key.

OIL

To suggest the domestic and global energy sector is under pressure is an understatement. Bordering on depression conditions is more like it, at least if you are involved in the sector. Oil prices have modestly broken 2009 lows and are at a level last seen in 2004. We know the Saudi's are continuing production to protect their market share (attempting to cause US producers to fold). Russia has also quietly increased production simply to maintain revenues in what is a struggling macro Russian economy. The chances are we will not see any meaningful production cutbacks globally, inclusive of the US, until there is more pain. Having said this, we need to realize that markets have already meaningfully priced this scenario into many an energy stock.

Declines in stocks that represent the many sectors of the energy industry have already gone well beyond what the damage of a normal bear market would inflict. Point being, we are approaching a once in a decade investment opportunity in the energy sector. Are we there yet? In our estimation no, but latter 2016 may be that time. The best investment opportunities are borne of prior period price

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destruction in industries that fulfill essential purposes. Macro global demand for energy has not dropped at all and will not unless there is a major global recession. We simply need to remember that the seeds of a few of tomorrow's investment opportunities are being planted as we speak. Everything runs in cycles.

GLOBAL CAPITAL FLOWS

We've mentioned many a time in these reports the importance of global capital flows and relative global currency movements to specific investment outcomes. This theme will continue to be important in 2016. For now, the US Dollar reigns supreme and is the only major global currency not being actively debased, hence it retains a high level of attractiveness as a destination for global capital. This is a positive for US assets.

Accompanying this theme is the fact that looking longer term taxes are destined to go higher in global developed economies, including our own, due to the fact that government balance sheets are under the increasing stress of decades of unfunded liabilities. Europe has passed legislation that allows for "bail ins" of bank depositors if Euro area banks get into real trouble (by the way, a "bail in" means confiscation of a portion of depositor assets to "pay" for a bank bailout). This "hunt for taxes" suggests we need to closely analyze asset class character on an ongoing basis.

To avoid potential "bail in" circumstances in the Euro banking sector, does capital depart and look for a new home? Bank assets are no longer the absolutely safe investment vehicle they have been for decades. We've written about the financial troubles of Chicago in the past. Higher real estate taxes have already been enacted in Chicago and increases in other taxes are likely on the horizon to help fund their pension obligation difficulties. The non-movable nature of real estate makes it an easy target to raise taxes in what will be an increasingly higher taxation environment ahead. Key lesson? When investing in real estate it will be important to understand the balance sheets of the local and state governments who have the power to enact real estate taxes since real estate is not "portable."

We know the Fed in the US has begun to raise interest rates. Academically, the price of existing bonds declines when interest rates rise. Are bond investors looking at a wipe out ahead? No, but rates of forward return will look nothing like they have in the greatest bond bull market of our lifetimes that was the last 35 years. What lays ahead is something completely different and there will be periods of meaningful loss. They last time that occurred was the 1970's.

Although there are plenty of risks ahead, as we look at the character of the asset class of stocks from a global capital flow perspective, stocks offer global portability. Stocks are not beholden to the tax jurisdiction of individual geographies, they represent an investment in real assets, there is no "bail in" mechanism for stocks as there exists in some banking systems, and for US stocks specifically, they are "priced" in one of the strongest of global currencies – the US Dollar.

Is this an exhaustive review of the issues surrounding the US stock market looking into 2016? Of course not, but we believe these are some of the major near term drivers. We expect price volatility will continue to be an important theme this year and as such, we will attempt to use that volatility to our greatest advantage in investing. Price discipline and an ongoing risk management overlay will be very important. Amidst this volatility, and this is very tough to do, we need to remember that in many investment sectors right now, "tomorrow's" opportunities are being created before our eyes. As easy as this is to say, controlling our emotions in investment decision making will be key in 2016.

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