Uncertain Times Require a Long-Term Perspective, Clearly Defined Goals and Discipline

TRUXTON TRUST
A PRIVATE BANK

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Executive Summary

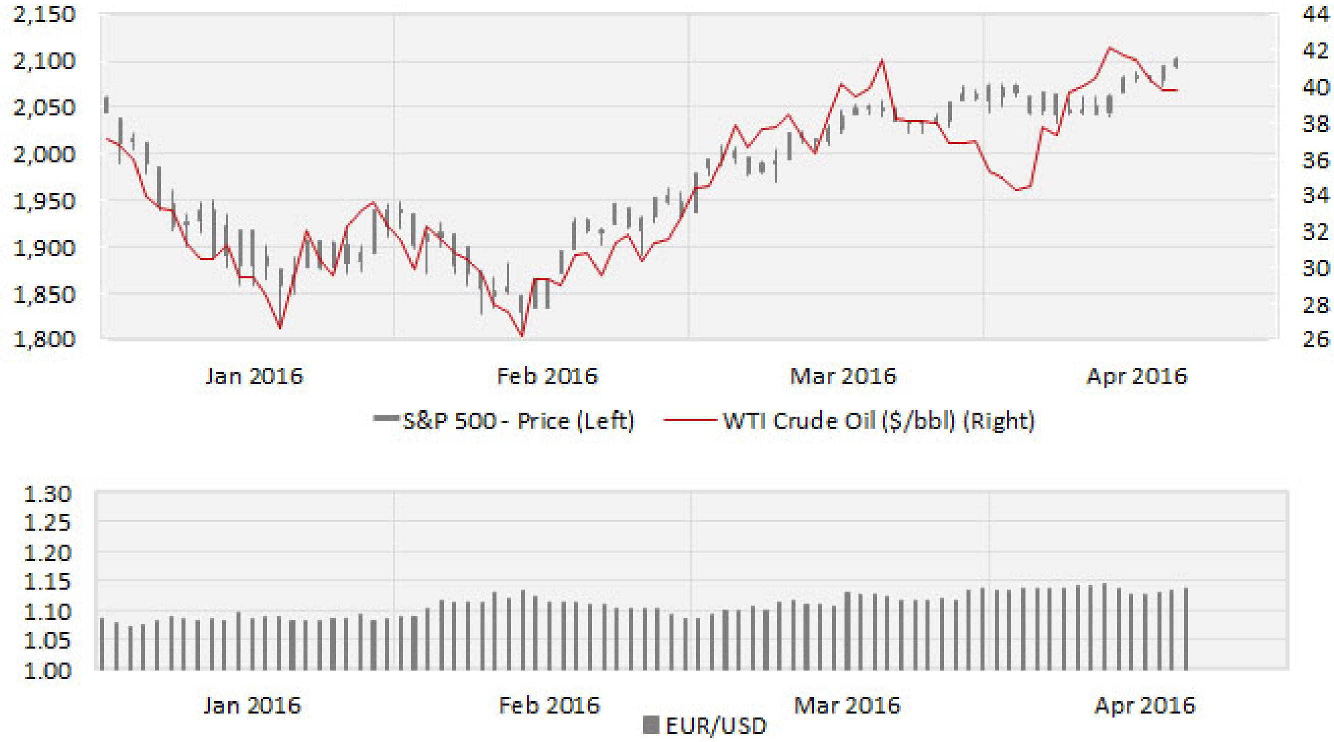
- *Unlike the last 30 or so years, oil and stocks are showing a very strong and positive relationship thus far in 2016.*
- *U.S. economic data remains mixed. Most importantly, however, employment remains strong as we believe employment is the primary driver of GDP growth over time.*
- *From Europe to China, we believe there are more bright spots for international markets than there were three months ago; however, there are several challenges that could derail (or improve) the outlook for the global economy.*

Oil and Stocks Move in Sync – A Rare Occurrence

The first quarter of 2016 has confirmed that oil and the dollar are driving global equity indices for the time being. This phenomenon is somewhat counterintuitive because cheap gas and a strong dollar are beneficial to U.S. consumers, which account for nearly 70% of our economy as measured by GDP. Nearly everyone uses gasoline each day and the strong dollar reduces the price for many consumer goods imported from abroad. Historically, the S&P 500 actually has shown a negative or insignificant relationship to oil and foreign currencies. This time, the relationship has been positive and very strong. Crude oil and the S&P 500 both hit lows on or about February 11 and both have performed well since that date. The dollar started weakening versus the euro; however, the relationship is still strong.

Uncommonly Tight Correlation Between Stocks and Oil

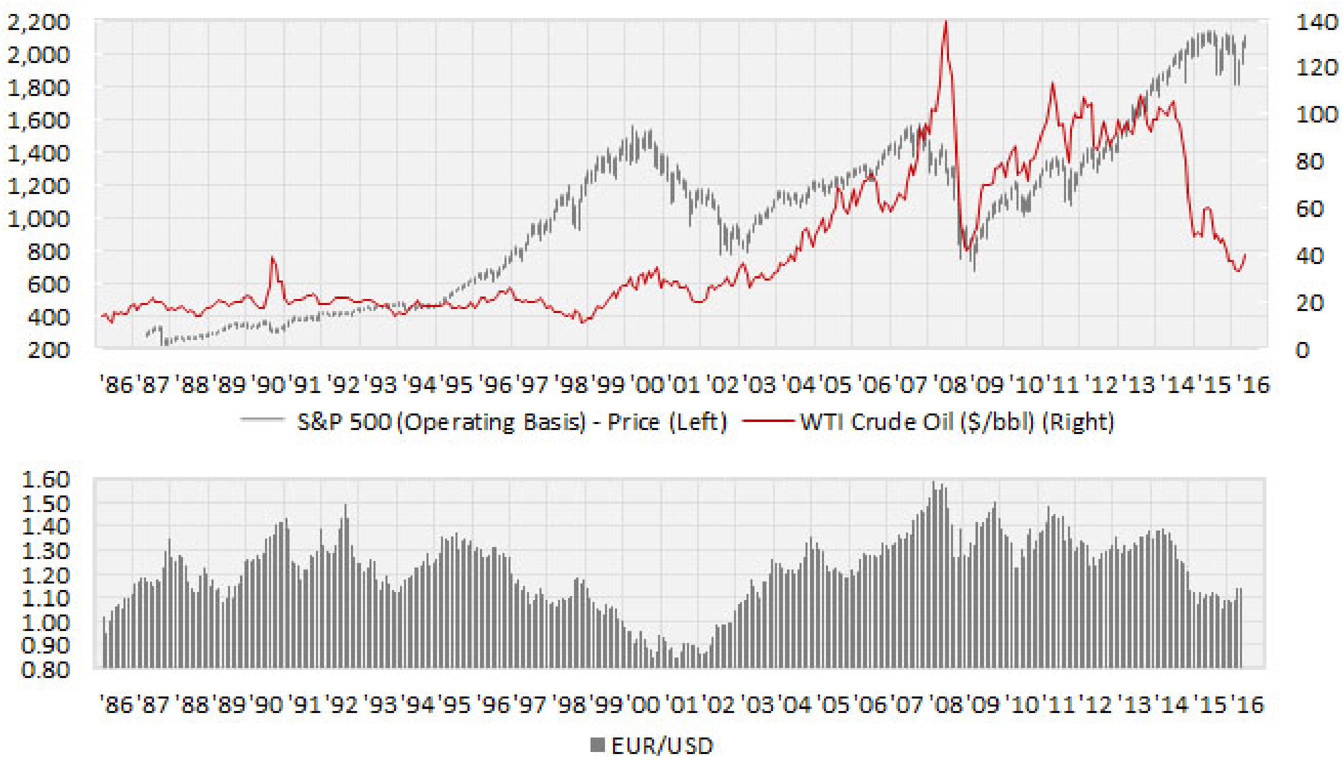
Year-to-date Prices for the S&P 500 and Brent Crude Oil/EUR/$ Exchange Rate



Source: Factset as of April 19, 2016

Historically Low Correlation Between Stocks and Oil

30-Year Prices for the S&P 500 and Brent Crude Oil/ EUR/$ Exchange Rate



Source: Factset as of April 19, 2016

So, why is the current relationship both strong and inconsistent with history? And will it stay that way? Our best guess for the second question is "no" because we believe oil and foreign exchange are serving temporary roles for capital markets. We believe oil prices have become a proxy for the strength of global economic growth in a world filled with uncertainty. The greatest uncertainty comes from China where the economy is threatened by excessive debt. China's government reporting of economic statistics is generally believed to be highly managed and often unreliable. Because GDP reports, unemployment reports and industrial surveys cannot be trusted, analysts have started examining all kinds of alternative, publicly available information that are less susceptible to distortions and manipulations, such as utility consumption. As the fastest growing oil consumer, Chinese demand does impact the price of oil. The Chinese economy also has grown to the point at which it affects the growth trajectory in many other economies. Therefore, it makes sense that investors are using oil prices as a simple proxy for global growth.

The United States also has become a more significant energy producer since the advent of shale drilling, so there are greater employment and capital spending repercussions on our own soil. As OPEC members probably anticipated, our capitalist system has quickly reduced the capital allocated to drilling until the returns are back to acceptable levels.

U.S. Economic Outlook is Positive, but Uncertainty Remains

The dollar strengthened because the U.S. had the strongest economic fundamentals in the world offering the Federal Reserve the opportunity to end its zero interest rate policy that began during the 2008 recession. A strong economic position seems like it would be a good thing, but a stronger U.S. dollar puts a tremendous amount of pressure on U.S. exporters, which comprise the majority of S&P 500 companies. First, U.S. goods are expensive to foreign consumers when the dollar is strong, reducing demand. Second, sales and profits for companies with global operations take a hit as they collect less dollar revenue in depreciated foreign currency, but still have many of the same expenses in dollars.

More than anything, we believe U.S. investors are looking for earnings growth. S&P 500 earnings were basically flat in 2015 and the current 2016 expectation is for flat earnings again. The strong dollar and energy producing S&P 500 constituents explain much of the 2015 flattening versus the 7% to 8% trend we saw 2012 through 2014. While the annual forecast is for flat S&P 500 earnings in 2016, the trajectory is forecasted to improve throughout the year. Estimate revisions could hurt equity performance, so confirmation of growth in the global economy and an abatement of the prevailing energy and currency headwinds will be closely watched.

The U.S. economic tea leaves are definitely still mixed. Most importantly, employment remains strong. March unemployment remained flat despite the addition of 215,000 employees to the estimate of non-farm payrolls. Average hourly earnings are increasing, but the pace is relatively slow. The trouble spot over the past six months has been manufacturing activity and this is the most notable point of improvement. While the sector is still seeing job losses, the forward-looking U.S. Institute of Supply Management (ISM) Purchasing Managers

Index survey rose to 51.8 as of March 31, 2016 from 49.5 end of February. A reading above 50 indicates growth, while a reading below 50 indicates contraction. Manufacturing is a volatile sector with greater exposure to the troubled energy and mining sectors than the economy at large. We find the turn encouraging, but the surveys can be volatile and we will need more months above 50 to confirm a better trend. March retail sales declined 0.3% with a notable decline in auto sales. Economists reduced estimates for first quarter GDP growth in response; however, we believe employment is the primary driver of consumption over time and expect recovery as the year progresses.

Shimmers of Hope Emerge for Global Economies, but Stay Tuned...

Internationally, we believe there are more bright spots than there were three months ago. Europe continues to grow at a slow pace; however, quantitative easing and Italian progress toward a "bad bank" solution to stifling credit issues are encouraging. We believe Europe will continue to "muddle through," dealing with banking concerns and country-specific fiscal issues in an orderly fashion. Equity valuations, dividend yields and forward earnings trends for European equities appear attractive on a relative basis. China recently has shown better economic statistics, whether we believe them or not. For many emerging markets, falling commodity prices have been an extreme headwind. While we do not see dramatic improvement, there is some evidence of stability.

There are several specific issues, which could derail (or improve) the outlook for the global economy. First, the British referendum on whether to remain in the European Union free trade zone on June 23 will be closely watched. Nobody really knows what the consequences of a "Brexit" (British exit) would be, but people will assume the worst until they know better. The process of European integration includes layers of intricate treaties and arrangements, for which dissolution could produce many unanticipated consequences. We are hoping the British vote to stay. Our own election has produced its own protectionist rhetoric on both sides and a contested convention would create the kind of uncertainty markets dislike. Second, the scope and severity of the Zika virus could hurt economic activity as epidemics have on several occasions in recent history. Finally, terrorism is a constant fear with tragic evidence recently confirming the determination and zeal of ISIS.

Stick to a Prudent Investment Plan

Investors must look forward in order to anticipate future earnings. The picture remains murky so investors are locking onto tangible evidence of global growth (oil prices) and earnings growth (dollar depreciation). We do not believe that the relationships of these two data points to market performance will hold over the long term. The recent decline in oil prices is really a supply driven problem. U.S production grew very fast with new drilling technologies, several former pariah nations have re-entered the global oil production ranks, and OPEC nations need oil income regardless of the return. Oil really has its own fundamentals. Demand is so large that even with a large, fast growing consumer like China, global demand remains pretty consistent. As for currency, relative value is determined by real interest rates in the short-term. Capital tends to flow to the strongest potential return. Over time, the relative strength of a currency is negatively impacted by higher inflation expectations and positively impacted by the strength of an economy. A strong dollar should be seen as a good thing.

Uncertainty is nothing new, so as always, we recommend disciplined adherence to a prudent investment plan centered on our clients' long-term goals. We firmly believe in calibrating equity exposure to reflect each client's unique willingness and ability to tolerate risk. Do not give up on bonds. Yields are low, but investment grade bonds are the most time-tested and cost effective risk management tool available to individual investors. We encourage investors to take advantage of equities' unique ability to outpace inflation over time due to earnings power and use bonds as a buffer for bouts of equity market volatility. We are optimistic about stock ownership, but we do not know what the next quarter or the next year will bring. Valuations are not demanding, but they are not cheap at the aggregate level. However, we do not have a difficult time finding reasonably priced investments for clients among large cap U.S. stocks, particularly large cap dividend payers. We see more general valuation opportunities for foreign stocks after a period of underperformance, but acknowledge that these stocks face significant risks that could drive greater volatility. ■

Returns

As of March 31, 2016

Asset Class	Index	1Q 2016 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	1.35	1.78	11.82	11.58	7.01
	Russell 1000 Large Growth Index	0.74	2.52	13.62	12.38	8.29
	Russell 1000 Large Value Index	1.63	-1.56	9.38	10.24	5.72
	DJ US Select Dividend	9.63	8.87	12.82	13.61	7.17
Mid Cap U.S.	S&P 400 Mid Cap Index	3.79	-3.60	9.46	9.53	7.79
Small Cap U.S.	S&P 600 Small Cap Index	2.66	-3.22	10.39	10.41	6.98
Developed International	MSCI EAFE Index	-3.00	-8.27	2.24	2.30	1.80
Emerging Markets	MSCI Emerging Market Index	5.71	-12.03	-4.51	-4.14	3.01
Commodities	Bloomberg Commodity Total Return Index	0.41	-19.56	-16.87	-14.15	-6.16
Real Estate	NAREIT Equity Index	6.00	4.44	10.47	11.88	6.55
Global Market Cap Weighted	MSCI World Index*	-0.34	-3.45	6.82	6.51	4.27

**The U.S. represents about 51% of the MSCI World Index.*

All returns greater than one year are annualized.

Source: Greenhill Market Index Review as of March 31, 2016