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ECONOMY: Is the U.S. Headed for Recession?

January's stock market plunge has raised the questions about whether the U.S. is headed for a recession. While the first estimate of 4th quarter GDP came in weaker than expected at 0.7%, overall U.S. GDP grew 2.4% in 2015.

STOCK MARKET

The S&P 500 is certainly in an earnings recession. However, this is primarily attributable to the Energy and Materials sectors. It is unlikely that these two sectors, which make up less than 10% of the index, would be able to cause a U.S. recession. Moreover, the stock market has been an unreliable indicator in predicting previous recessions.

INTEREST RATES

One fairly reliable predictor of recessionary periods is the slope of the yield curve - the difference between short term interest rates (3 mo. U.S. T-Bills) and longer term interest rates (10 yr. U.S. Treasury Bonds). When this relationship inverts, short term rates higher than long term rates, this is a recessionary indicator. Despite an increase in short term rates in December and a decrease in longer term rates which has caused the yield curve to flatten, it remains positively sloped.

EMPLOYMENT

The unemployment rate fell to 4.9%, while 151,000 jobs were added in January. Perhaps more importantly, the leading indicator of initial jobless claims fell after a few slightly elevated readings, indicating at least for now that companies are not panicking and laying off workers. Average hourly earnings also rose 2.5% year-over-year in January, up from 2.2% in December. Strong employment and wage data is not very supportive of a recessionary environment.

LEADING ECONOMIC INDEX

The Conference Board computes a composite of 10 key economic variables known as the Leading Economic Index (LEI). *"The U.S. LEI fell slightly in December, led by a drop in housing permits and weak new orders in manufacturing. However, the index continues to suggest moderate growth in the near-term despite the economy losing some momentum at the end of 2015. While the LEI's growth rate has been on the decline, it's too early to interpret this as a substantial rise in the risk of recession."*

ISM DATA

The ISM Manufacturing index is in contraction territory, while the ISM Non Manufacturing Index remains in expansion territory. The good news is the service sector represents approximately 88% of the economy. The bad news is that manufacturing has tended to be a leading indicator, and the services index has weakened a bit recently.

CREDIT SPREADS

Credit spreads - the yield difference between corporate bonds and government bonds –are widening. This spread represents the premium demanded to take on the higher risk over benchmark U.S. Treasuries. While high yield spreads have increased significantly, investment grade spreads are also widening. Tightening credit does not always lead to a recession, but recessions generally start with a tightening of credit.

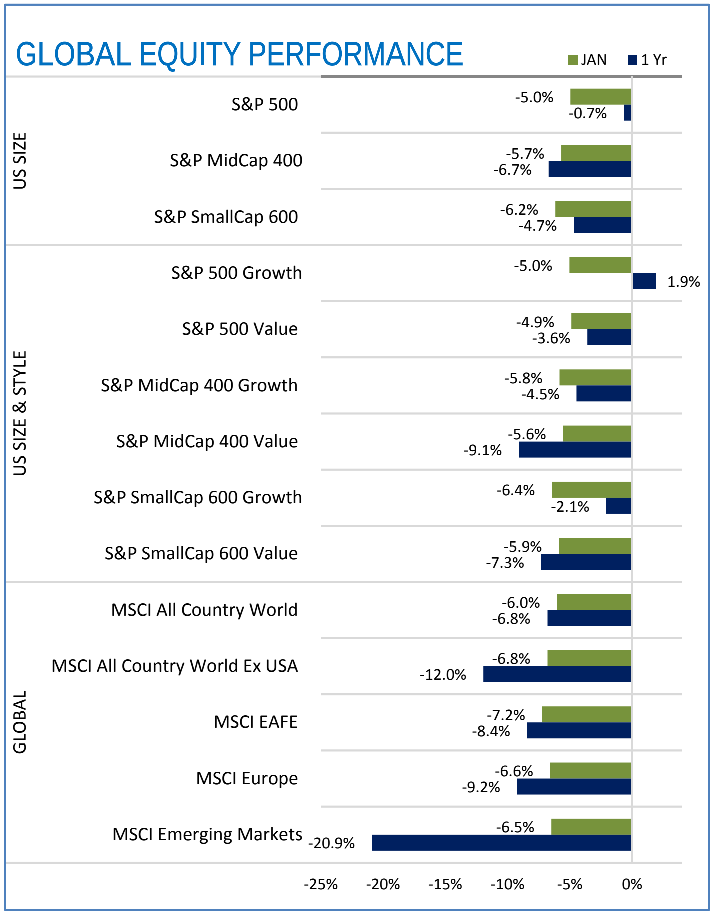
OIL PRICES

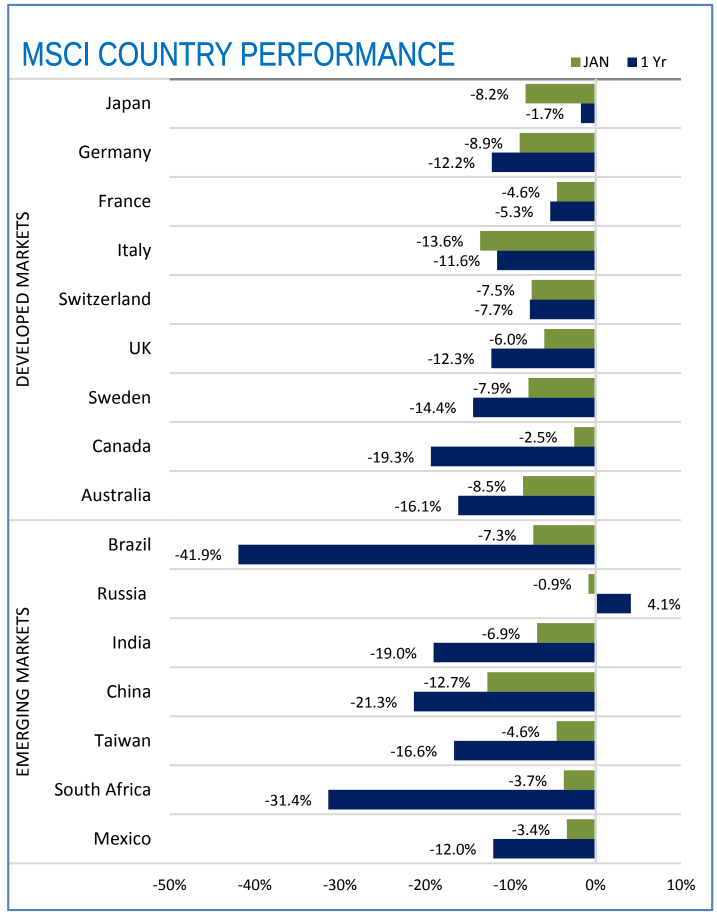
Historically, recessions have only been associated with a spike in oil prices, not a crash. Spiking oil prices in 1973, 1980, 1991, 2001 and 2007 contributed to the economic recessions of 1973-4, 1980-81, 1991-92, 2001-2003 and 2007-08.

CONCLUSION:

While there is always the possibility of a U.S. recession, it does not appear highly likely from the current data. The U.S. economy has slowed, but remains in a much stronger position than most other global economies. Investor sentiment will likely remain negative until we see better economic data from both the U.S. and China, as well as a stabilization in oil prices. We would anticipate these developments will occur over the coming months, but the timing is unclear. Nonetheless, we also acknowledge that volatility will likely remain high, and there may additional downward pressure on risk assets in the near term.

GLOBAL EQUITIES: China Focus Continues





U.S. Equities Off To A Rough Start

U.S. equities recorded their worst monthly performance since August 2015 as investors continued to worry about falling oil prices and slowing global growth. The S&P 500 finished the month down 5%, while mid and small cap stocks were down 5.7% and 6.2% respectively.

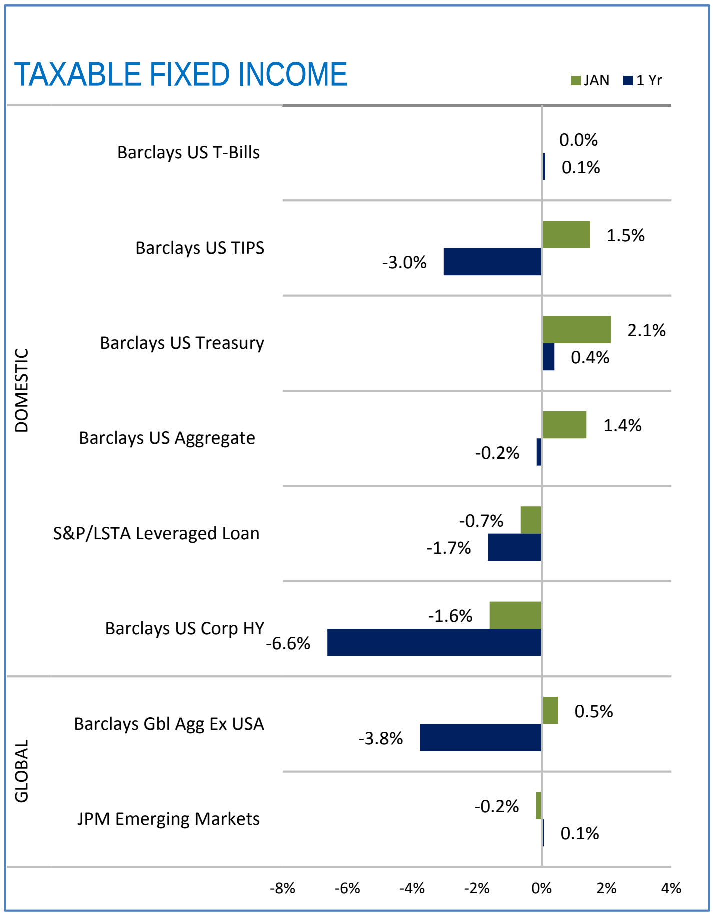
Global Markets Follow Suit

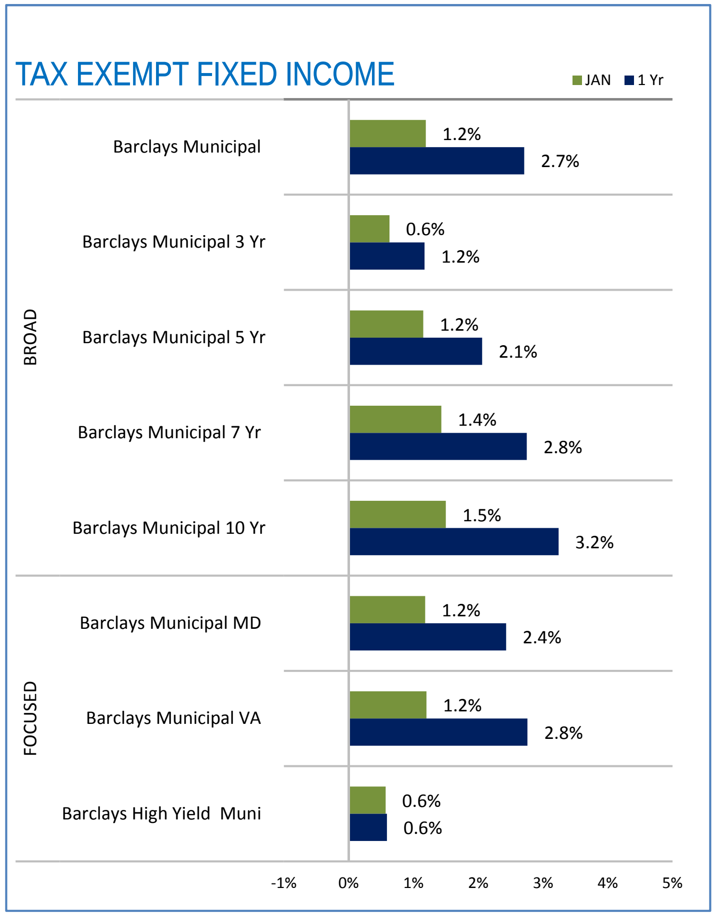
The MSCI EAFE (Europe, Asia, Far East) Index fell 7.2% in January. European stocks fell 6.6% in January amidst capital concerns amongst European banks. Nonetheless, the ECB remained supportive of future intervention as deflationary concerns remained.

Focus on China Continues

Chinese stocks continued to fall in January. The MSCI China index fell nearly 13% and the Shenzhen A share market fell nearly 28%. The Chinese A share market correction that began in June 2015 is firmly into bear market territory (generally referred to as a drop of more than 20%). The yuan came under renewed pressure after China's central bank fixed its exchange rate at a lower-than-expected level for several consecutive days in early January, renewing concerns that the economy was weaker than expected.

FIXED INCOME: Treasuries Rally As Safe Haven





Treasuries Rally As Safe Haven

Risk aversion and volatility in global financial markets dominated January, benefiting safe-haven assets such as U.S. Treasuries. U.S. Treasuries rallied, pushing the yield on the 10-year Treasury note below 2.0% at the end of the month. This marked the first time since October 2015 that the 10-year Treasury yield fell below 2%.

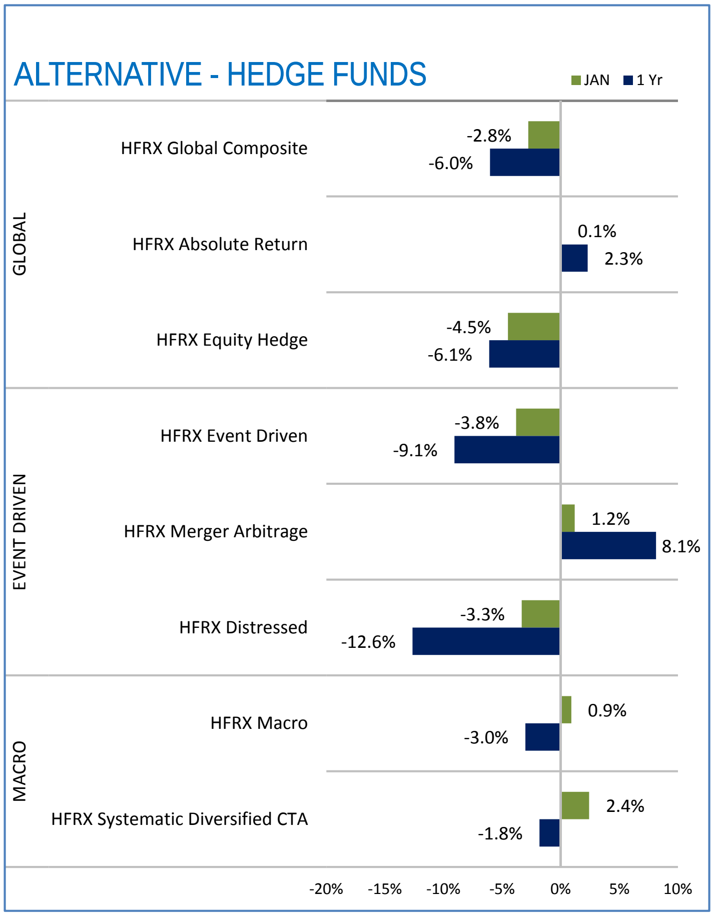
Japan Surprises With Negative Rates

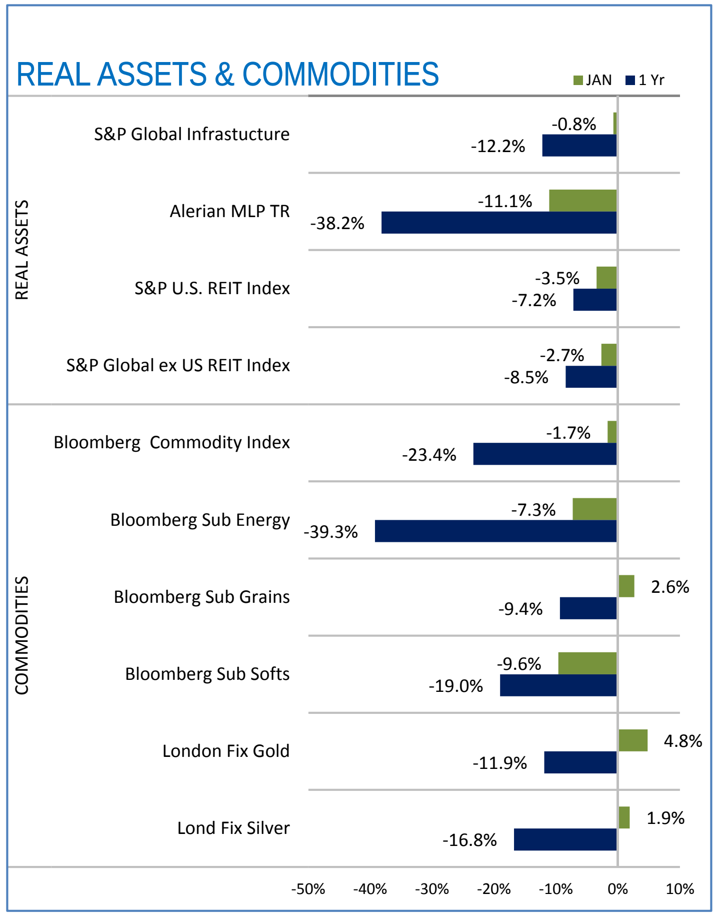
The Bank of Japan, concerned about the impact of a slowing Chinese economy, reduced its interest rate for some bank reserves to -0.10% on the last trading day of January. The aggressive move surprised the markets, and the yield on the 10-year Japanese government note decreased to a record low following the announcement.

Commodities Weigh on Credit

Moody's also put nearly the entire exploration & production (oil) and metals space on negative watch as it lowered its commodity outlook. Moody's noted that multi-notch downgrades could occur in some cases and that the reviews should conclude by the end of the quarter. The downgrade/upgrade ratio, which measures the amount of debt that has been downgraded versus upgraded, has climbed to 2x for investment grade and 4x for high yield corporates.

ALTERNATIVES: Gold Finally Shines





Hedge Fund Hodge Podge

Hedge funds posted mixed performance in January. Managed futures rallied 2.4% on the back of falling commodities and U.S. dollar strength. Event Driven strategies fell 3.8% as credit spreads widened and equity prices declined. Falling equity prices also contributed to a 4.5% decline for the HRFX Equity Hedge (long/short) index as well.

REITs Provide Some Relief

The S&P U.S. REIT Index fell only 3.5% in January, outperforming nearly all equity risk assets for the month. Relative to other risk assets, REITS have benefitted from a limited exposure to oil and commodities, primarily domestic operations, and stable incomes tied to long term leases.

Gold Finally Shines

The Bloomberg Commodity Index (BCOM) fell for a seventh straight month, the longest stretch in a year, and touched the lowest level since at least 1991. For the first time in 12 years, oil fell below $30 a barrel. However, gold finally found its luster. After dropping for three straight years, gold reestablished itself as a safe haven asset, rallying 4.8% in January.