

# ONE LOOK BACK AND TWO LOOKS FORWARD

Presented to the Central Arizona  
Estate Planning Council  
January 4, 2016  
by Thomas J. Connelly



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1

## LOOKING BACK ON THE 2015 ECONOMY

Economic growth in 2015 was driven by consumer spending, primarily on services.

Credit growth is picking up across the board, except for the mortgage sector.

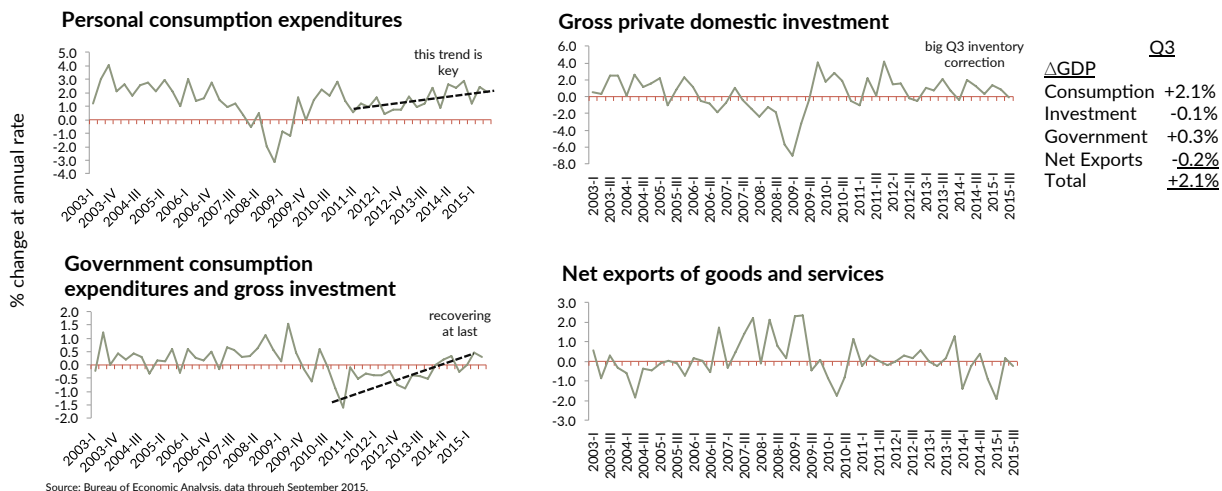
Global government spending will be positive for the first time since 2009.



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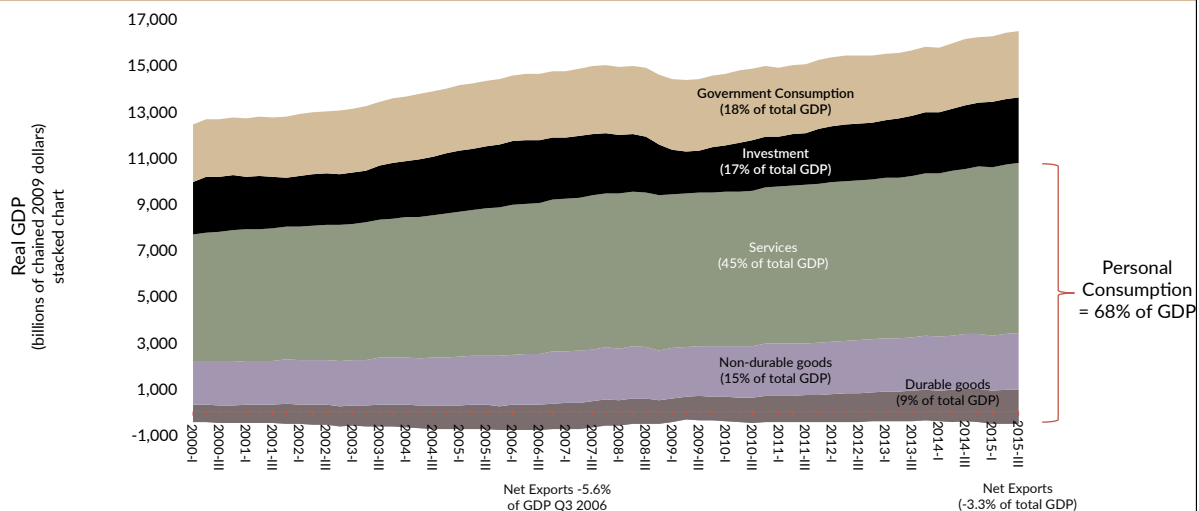
# Looking Back GDP Contributors: C + I + G + Net Exports



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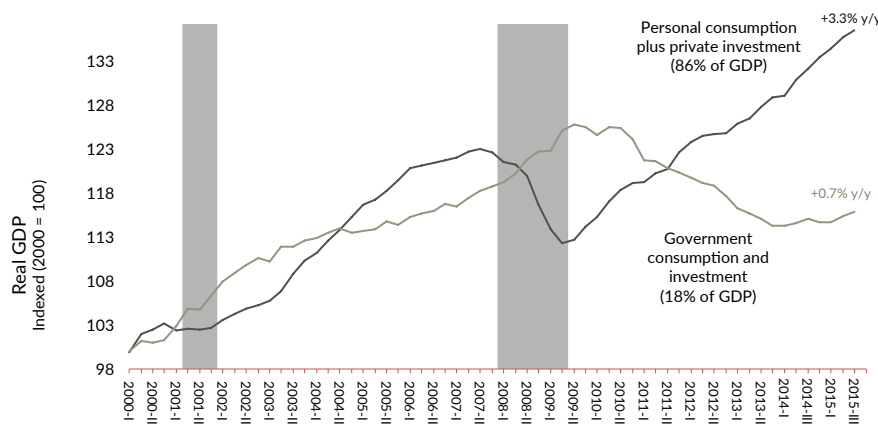
# Looking Back Components of GDP



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# Looking Back GDP Contributors: C + I + G



86% of the economy – the private sector – has been growing at +3.3% y/y.

Government sector has been a drag on growth, but will be a net positive for the first time since the GFC. This is true across the developed world, especially in Europe.

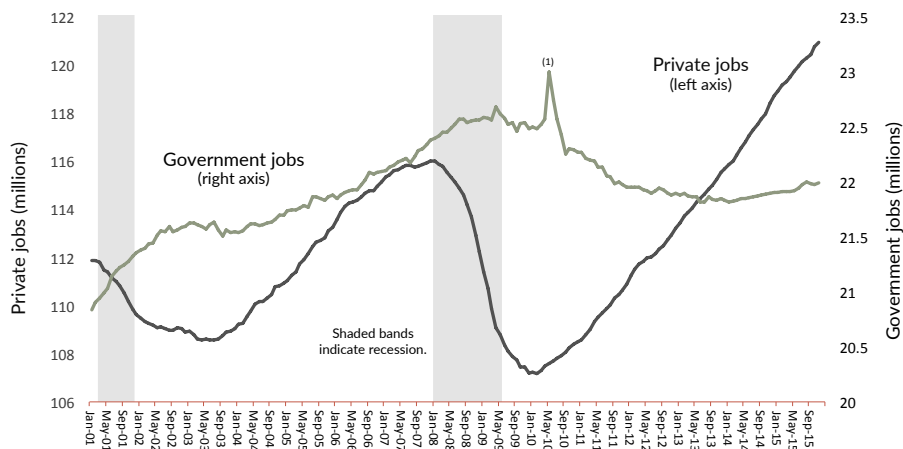
*Personal Consumption is driven by changes in income and changes in credit.*

Source: Bureau of Economic Analysis, data through September 2015.



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# Looking Back Private Jobs Rose, Government Jobs Stagnant



Private sector jobs recovery looking good.

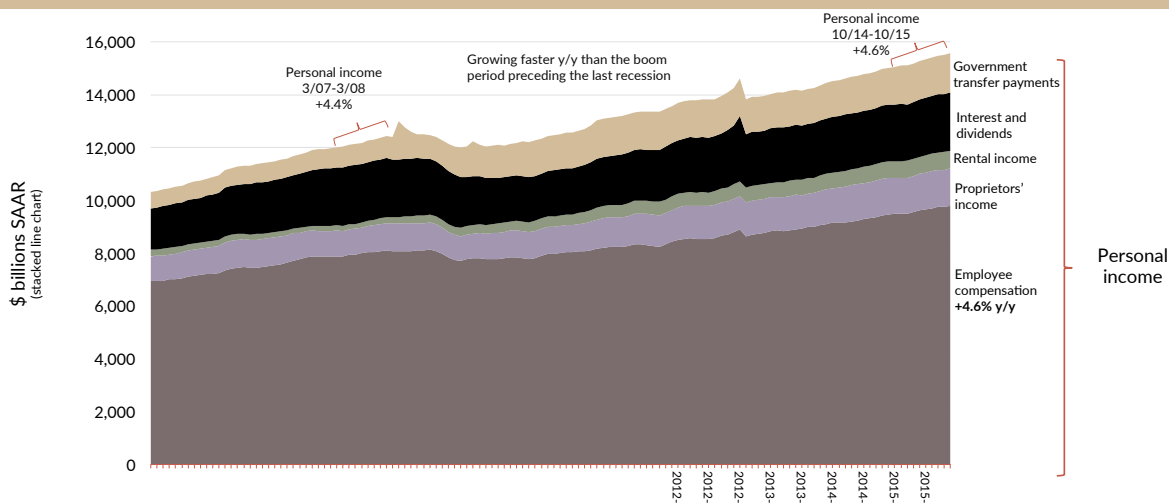
Government jobs halting recovery.

Source: Bureau of Labor Statistics; data through November 2015.  
 1 2010 census hiring spike.



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# Looking Back Consumer Income By Source



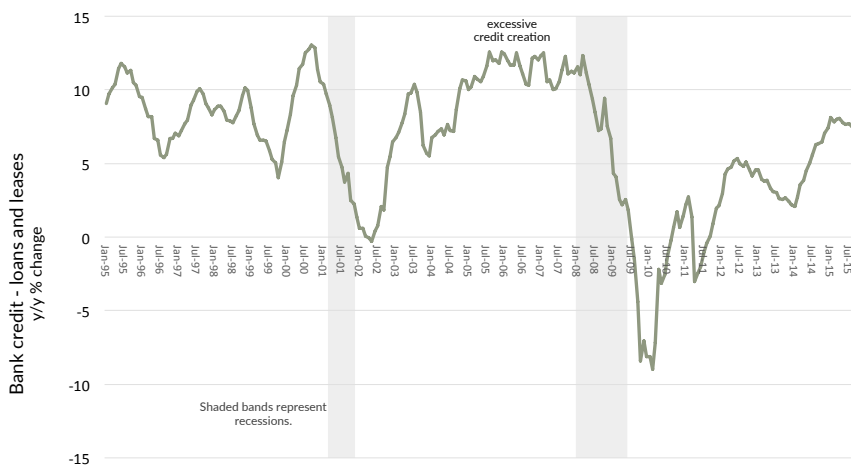
Source: Bureau of Economic Analysis, monthly data through October 2015. Includes wages, salaries, benefits and employer contributions for social security and Medicare.



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# Looking Back Bank Credit – Recovery in a Key Economic Driver



Bank credit is the lifeblood of economic expansion.

The rate of bank credit creation is finally looking robust.

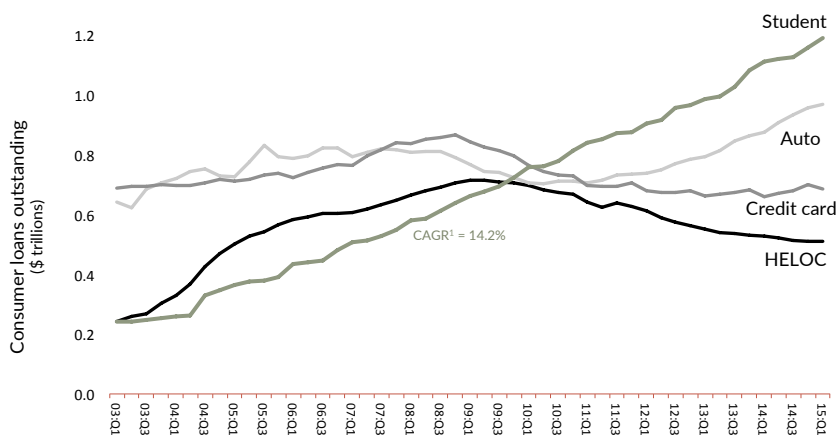
Source: Federal Reserve, schedule H8. Data through October 2015, released December 4, 2015.



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# Looking Back Runaway Growth in Student Loans



Student loans \$1.2 trillion and growing 3X faster<sup>2</sup> than total household debt.

The high growth rate of student debt was a conscious policy decision to expand one credit conduit when virtually all others were not functioning after the GFC.

Income-oriented and service-related government relief programs have been started to alleviate debt burdens. Initial price tag: \$38b.

Source: Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, May 2015.  
<sup>1</sup> CAGR = compound annual growth rate. <sup>2</sup> 14.2% CAGR compared to 4.2% CAGR for total household debt, including mortgages.



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# LOOKING AHEAD IN 2016 AND BEYOND

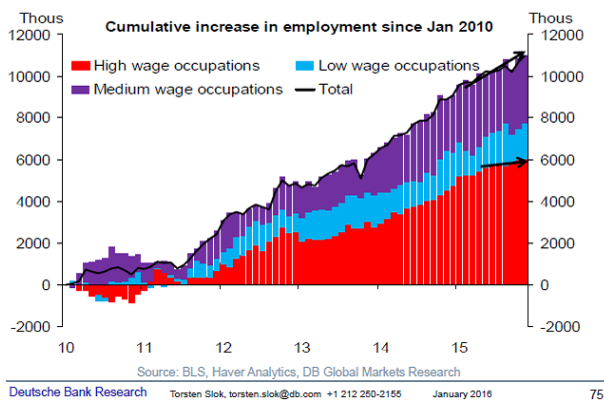


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# Looking Ahead

## Why Consumer Income Growth is Strong

Most of the jobs created during this recovery are high-wage jobs but recently more medium and low-wage jobs have been created 

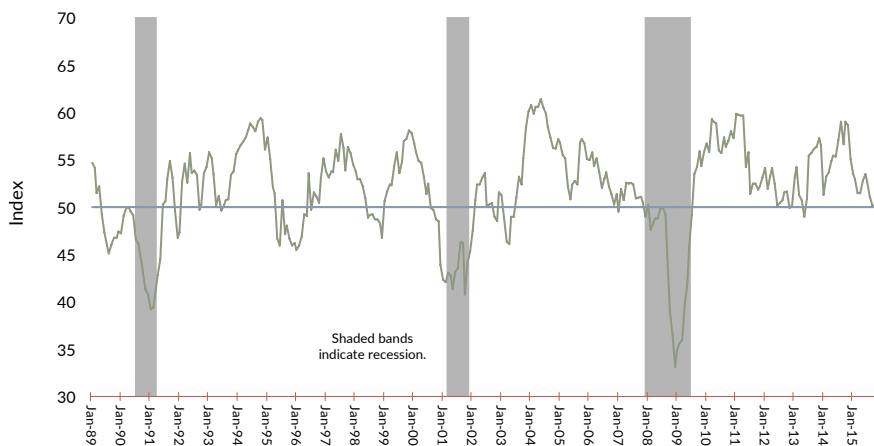


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# Looking Ahead

## ISM Manufacturing Purchasing Managers Index



November ticked down to 48.6 from 50.1 in October.  
New export orders at 47.5 are a drag.  
Note the historic volatility in the manufacturing PMI.  
Note how this indicator has slumped well below 50 even during periods of strong economic expansion, eg. 1995, 1999, 2003, 2013.

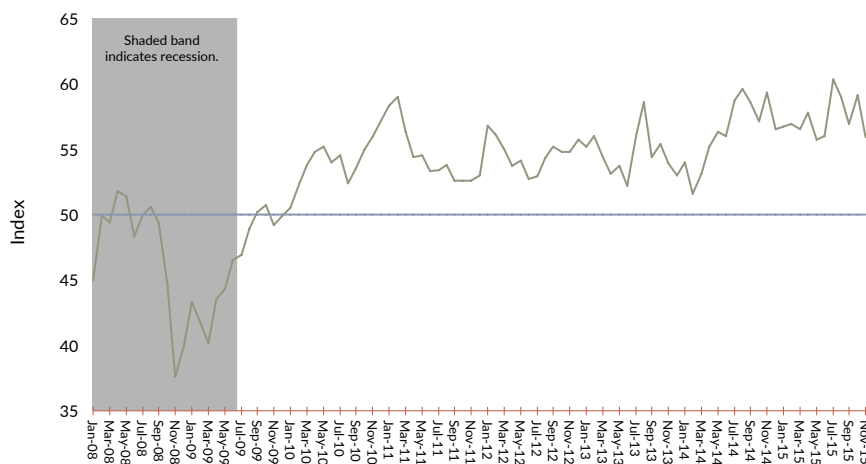
Source: Copyright 2015, Institute for Supply Management; data through November 2015. ISM: "A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. A PMI in excess of 43.1 percent, over a period of time, generally indicates an expansion of the overall economy."



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# Looking Ahead ISM Non-Manufacturing Purchasing Managers Index



Non-manufacturing captures the vast majority of the U.S. economy.

November dropped to still-strong 55.9 from 59.1 in October.

New orders strong at 57.5. Export orders are hurting at 49.5.

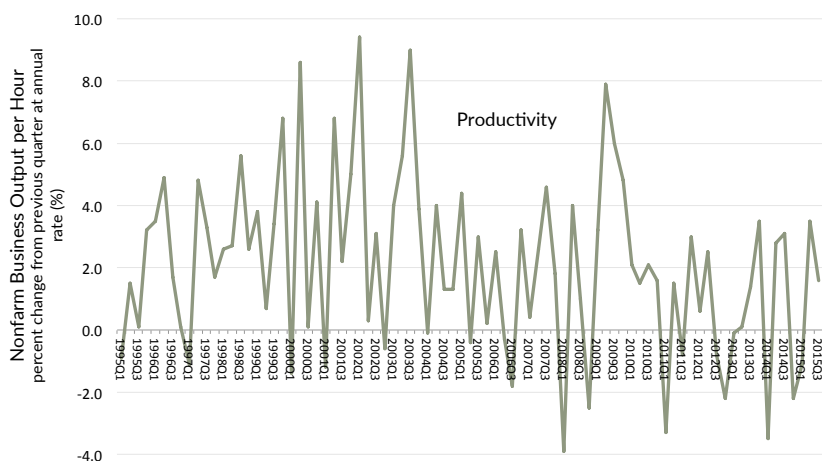
Source: Copyright 2015, Institute for Supply Management; data through November 2015. This data series was created in 2008. ISM: "A reading above 50 percent indicates that the non-manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting."



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# Looking Ahead Productivity - A Question Mark



1.6% in Q3.

Productivity gains have averaged only +0.6% per year for the last five years, not fully recovered from pre-recession. But, is the trend improving?

Productivity gains  
offset wage gains.

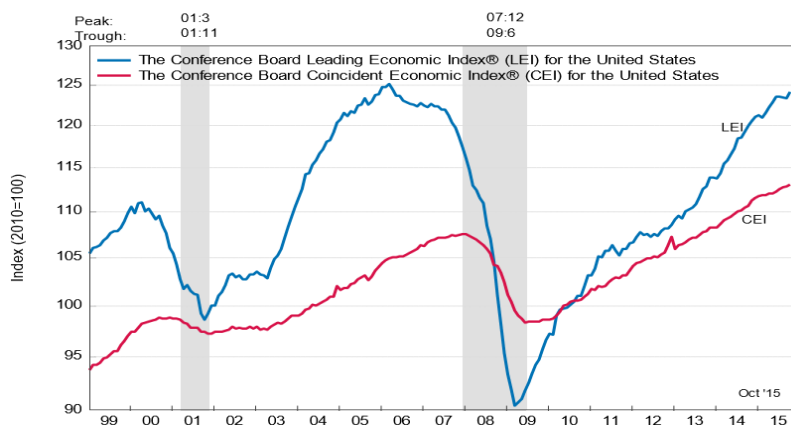
Source: Bureau of Labor Statistics, data through September 2015.



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# Looking Ahead U.S. Index of Leading Economic Indicators (monthly)



“The U.S. LEI rose sharply in October, with the yield spread, stock prices, and building permits driving the increase. Despite lackluster third quarter growth, the economic outlook now appears to be improving ... the U.S. economy remains on track for continued expansion heading into 2016.”

The Conference Board  
November 19, 2015

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders - consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits - new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.

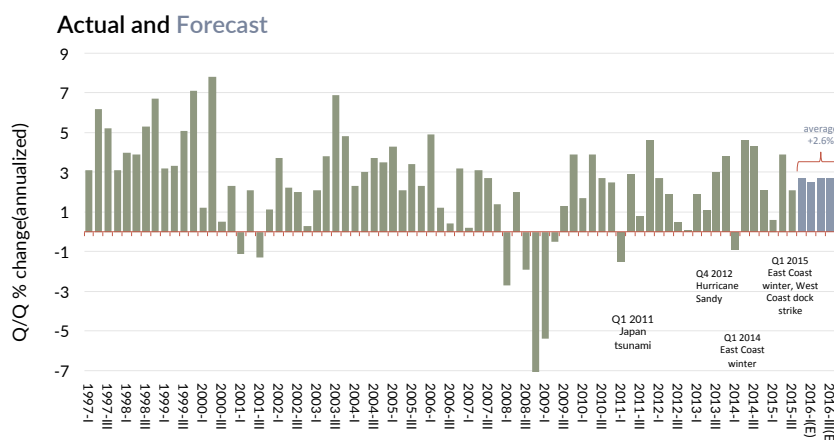
Source: ©The Conference Board. Data through October 2015, released November 19, 2015.



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# Looking Ahead Consensus U.S. Economic Forecast



The 70 economists surveyed in early November see an average +2.6% rate of quarterly GDP growth ahead

It's a Goldilocks forecast ... healthy economic growth with benign inflation.

Unfortunately no post-war recession has been forecasted successfully by the Fed, or any administration or survey.

Sources: Bureau of Economic Analysis, actual data through September 2015; The Wall Street Journal survey taken November 2015.

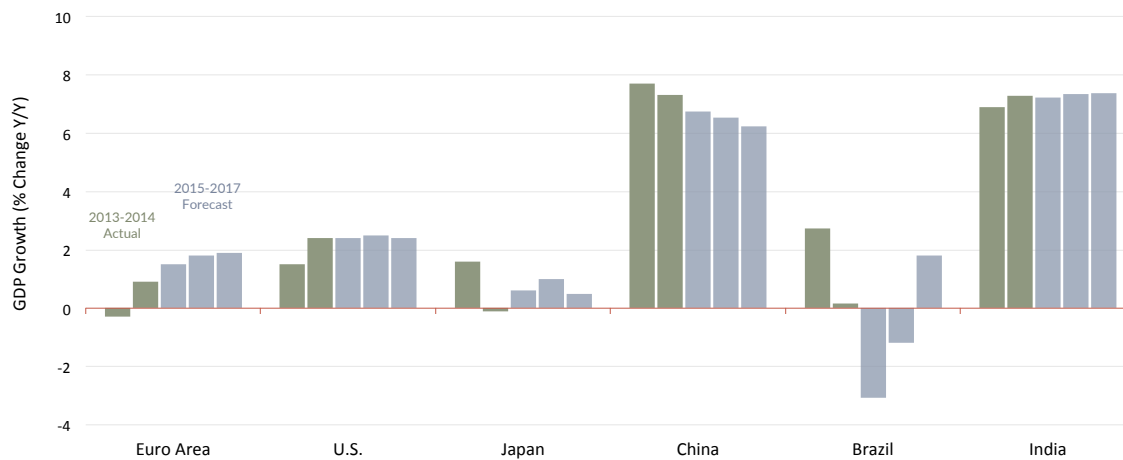


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# Looking Ahead World GDP Growth Forecasts - Acceleration



Source: OECD Economic Outlook, November 9, 2015.



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# SPECIAL TOPICS



“Daddy’s mad at interest rates.”

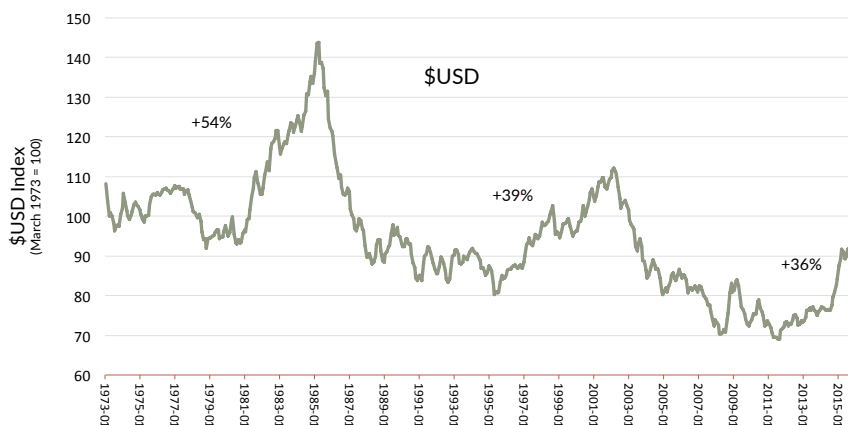


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18

# Special Topics - The Dollar

## U.S. Dollar Index



Despite its dramatic surge, the dollar could go higher.

"... no model projecting directional movements in exchange rates is significantly superior to tossing a coin."

-- Alan Greenspan<sup>1</sup>

Source: Federal Reserve major currencies index. Data through November 2015. Federal Reserve, Remarks by Chairman Alan Greenspan before the Economic Club of New York, March 2, 2004.

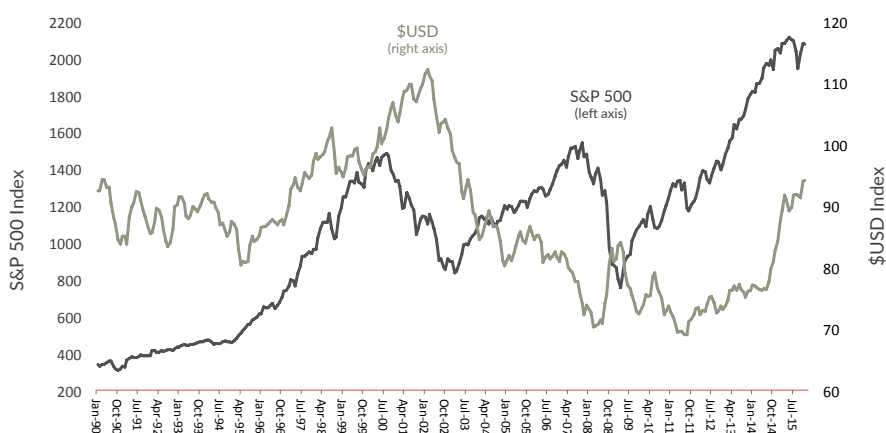


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19

# Special Topics - The Dollar

## S&P 500 vs. \$USD



Is a strong dollar bad for stocks?

The argument is often made that a stronger dollar makes it tougher for exporters and foreign currency translation, hurting earnings and, thus, stock prices. Around 40% of S&P earnings are foreign sourced.

The record illustrates bull markets in periods of both rising and falling \$USD.

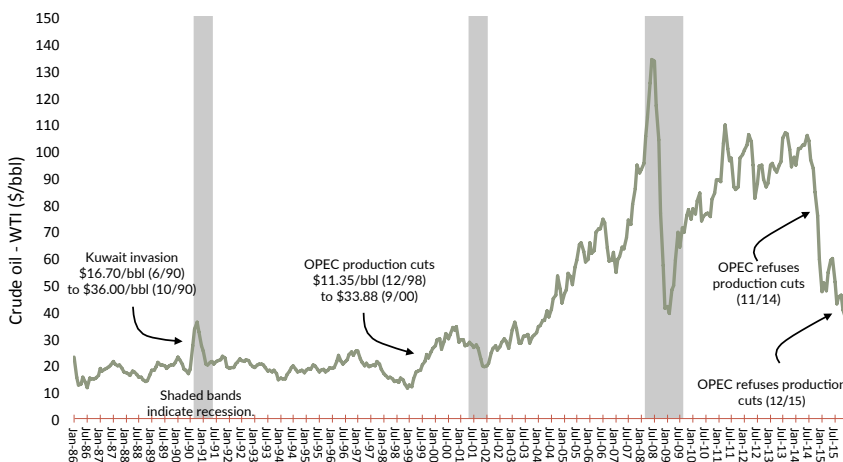
Source: Standard and Poor's, Federal Reserve. Monthly data through December 7, 2015.



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## Special Topics - Oil WTI Spot Crude Oil Prices



In November 2014, in the midst of increasing over-supply, OPEC refused to cut production while non-OPEC is boosting production.  
Ditto in December 2015.

According to Deutsche Bank, oil shorts are at all-time highs.

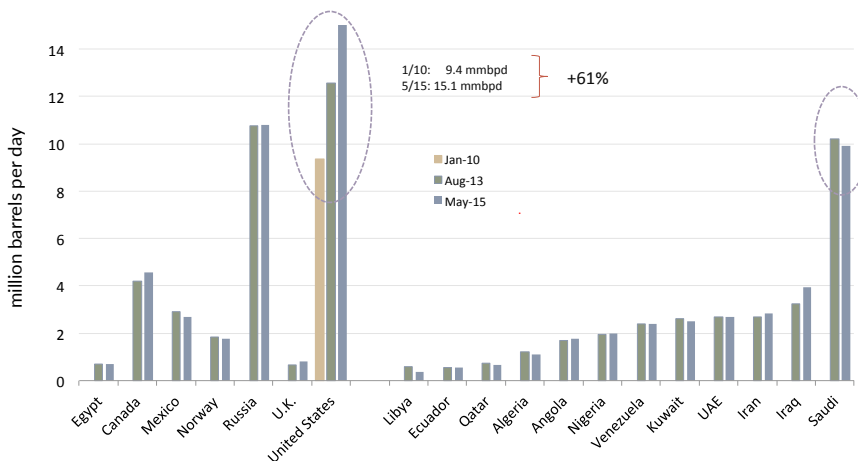
Source: U.S. Energy Information Agency, Data through December 7, 2015.



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## Special Topics - Oil World Crude Oil Production – U.S. Shale Explosion



U.S. shale production has upset the global supply/demand equilibrium.

Saudi Arabia has borne the brunt of the production cuts while others in OPEC have increased.

Saudis decided not to take it any more!

But their target is not shale oil, it is other high-cost marginal producers.

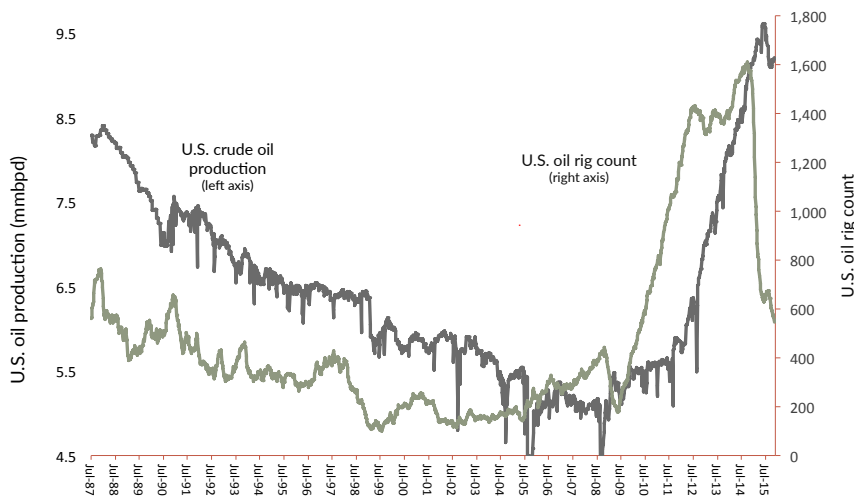
Source: U.S. Energy Information Agency, Short-Term Energy Outlook, June 2015. For non-OPEC producers the figures include crude oil plus liquids production. For OPEC producers the figures include crude oil but exclude liquids.



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## Special Topics - Oil U.S. Drilling Plunge



9.2 mmbpd production. Peaked at 9.6 mmbpd in June 2015.

545 rig count. Peaked at 1,609 in October 2014.

What is priced in today: approximately \$44/bbl for the end of 2016.

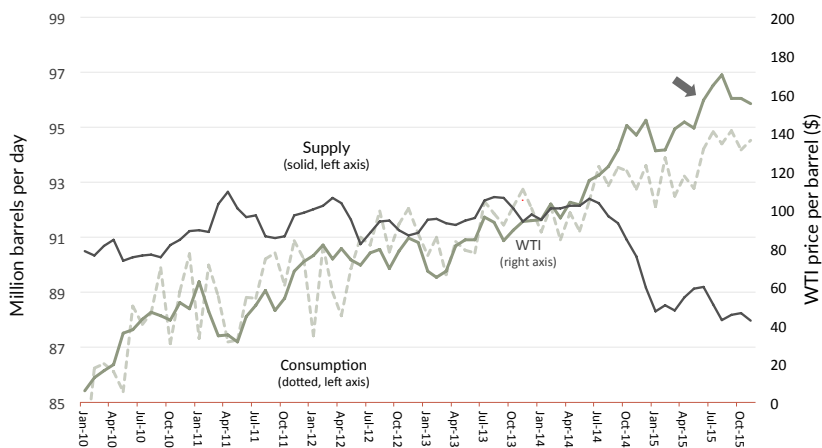
Source: U.S. Energy Information Agency, Baker Hughes. Rig count through December 4, 2015. Crude oil production through November 27, 2015.



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## Special Topics - Oil World Crude Oil Supply vs. Consumption



In 2014 and so far in 2015, global supply surged, outstripping demand growth, driving prices down.

Supply has now outstripped demand for 16 consecutive months.

1.3 to 600 mmbpd oversupply.

**IEA sees oil rebalance in 2020**  
The Int'l Energy Agency said **crude prices should rebound to \$80 a barrel by 2020, a longer timeline than some oil companies have predicted**, though a more bearish scenario from the oil watchdog puts oil prices in the \$50 range until 2020. The IEA predicted OPEC will boost its market share at the expense of non-cartel members like Russia and the U.S. shale industry. But oil demand from America, Europe and Japan will drop on increased use of cleaner fuel.

Source: U.S. Energy Information Agency, Short-Term Energy Outlook, December 2015, data through November 2015. Includes condensate and natural gas liquids. Investor's Business Daily, November 11, 2015.



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# Special Topics - Interest Rates Much Lower Than Expected Bond Yields



Lower than expected bond yields have been the big surprise for the last four years.

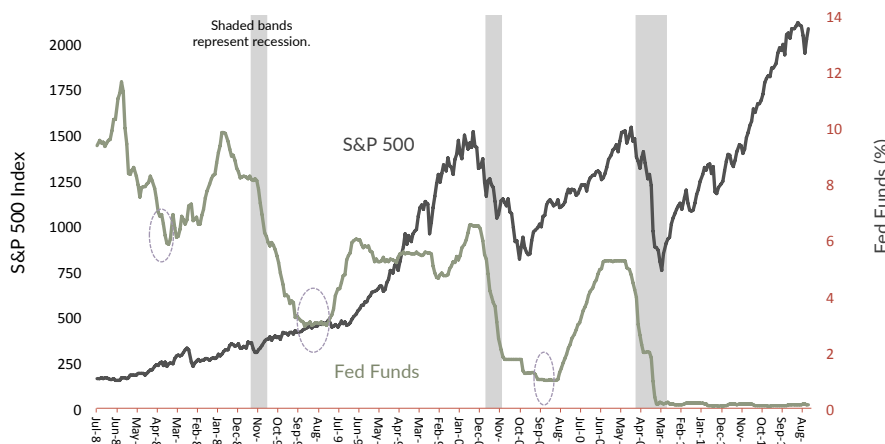
The CME Group's FedWatch computes an 88.1% implied probability of a 0.50% fed funds rate hike at the 1/27 FOMC Meeting, and a 50% chance of a hike to 0.75% at the 3/16 meeting as of 1/1/2016.

Source: Federal Reserve, Data through December 4, 2015.  
<sup>1</sup> Average of economists' forecasts from *The Wall Street Journal's* monthly surveys taken November 2011, January 2014, September 2014 and April 2015.



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# Special Topics - Interest Rates Fed Policy... it's the *last* rate hike that matters



Initial fed funds rate hikes have caused the stock market to stutter.

But, following the initial stutter stocks have continued higher even as the Fed has repeatedly hiked rates... until fed funds have approximated bond yields.

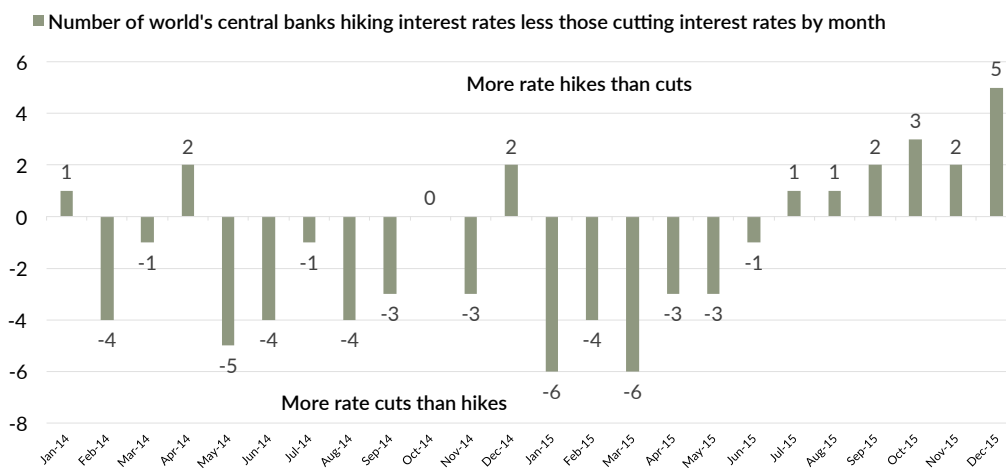
Sources: NBER, Federal Reserve and Standard & Poor's. Data through November 2019.



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## Special Topics - Interest Rates

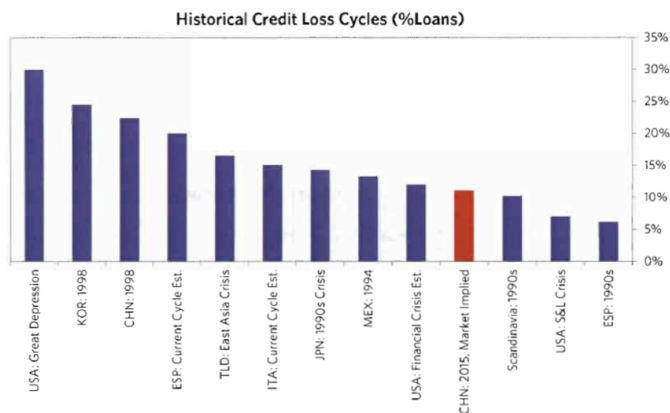
### Central Banks Shift to Rate Hikes From Cuts



## Special Topics - China

- China is Trying to Re-engineer Its Economy From an Industrial Exporter to a Consumption-Based Economy Revolving Around Services.
- China is in a period of credit adjustment resulting from a period of hyperinvestment. It is in the early stages of passing through credit losses (Bridgewater Daily Observations, 11/29/2015):
  - Debt service burdens reduced through interest rate cuts.
  - Restructurings and forbearances have been selectively mandated.
  - Defaults are allowed to flow through at a reasonable pace.
  - Targeted fiscal stimulation.
  - Government has propped up asset prices and exchange rates to allow troubled debtors time to unwind.
- The Banking System is Well Capitalized and May be Able to Handle the Problem if Given Time.
- Chinese Government Reserves are Extensive and Available.
- But the pace of Credit Creation is Still Too High – Painful But Manageable Adjustment Ahead.
- Undertaking steps to float the currency and rise to reserve currency status.
- The government has committed to full interest rate liberalization.

# Special Topics - China



Source: Bridgewater Associates



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29

# REVIEW OF GLOBAL INVESTMENT MARKET RETURNS



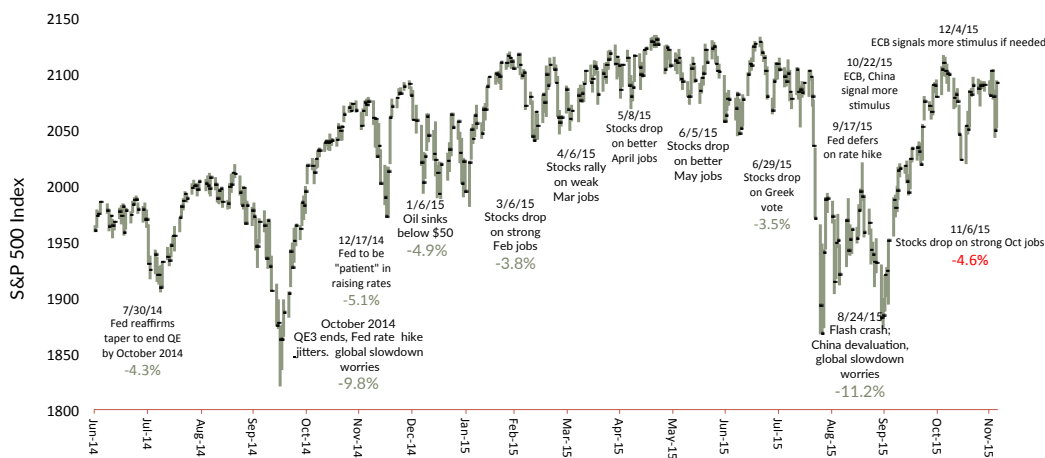
*"But Daddy, you were so smart yesterday."*



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30

# Review of Global Investment Market Returns S&P 500 – Flat for the Year Amidst Drama



Source: Standard & Poor's, data through December 4, 2015.



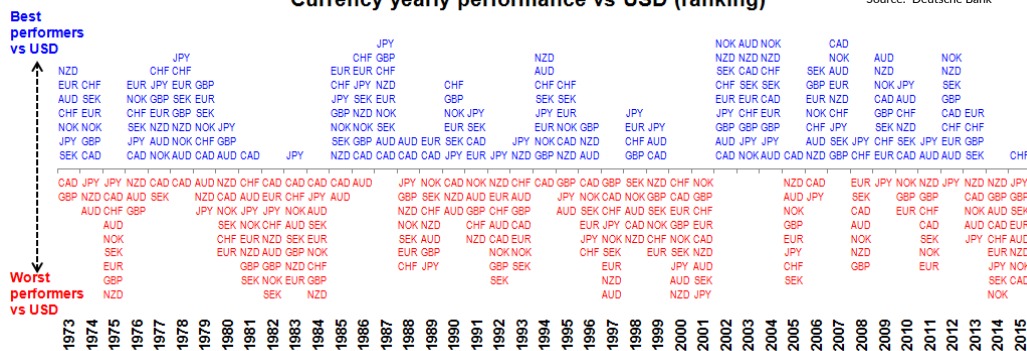
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31

# Review of 2015 Investment Market Returns Developed Market Freely Floating FX

Currency yearly performance vs USD (ranking)

Source: Deutsche Bank



No currency has rallied as strongly as the dollar into its third year.

Being long the U.S. dollar was described by DB as the year's most crowded trade.

Economic strength in the US, rising interest rates, and the rest of the world conducting monetary policy via currency depreciation suggests the dollar's strength may be resilient for the time being.

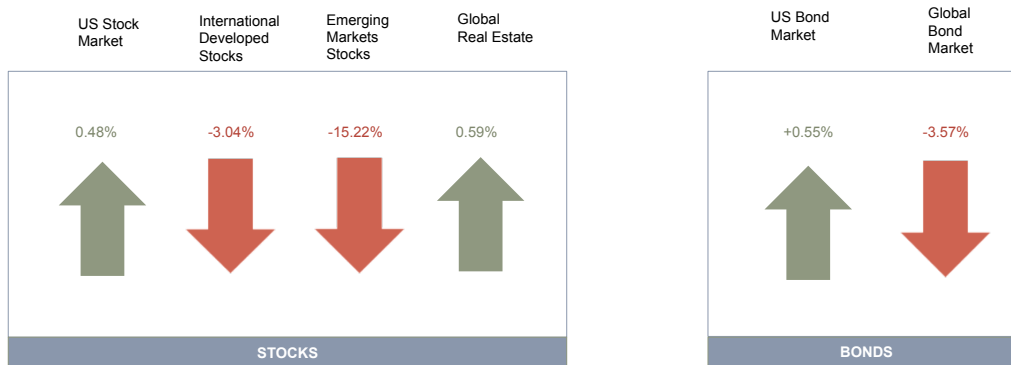


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32



# Review of 2015 Investment Market Returns Market Summary



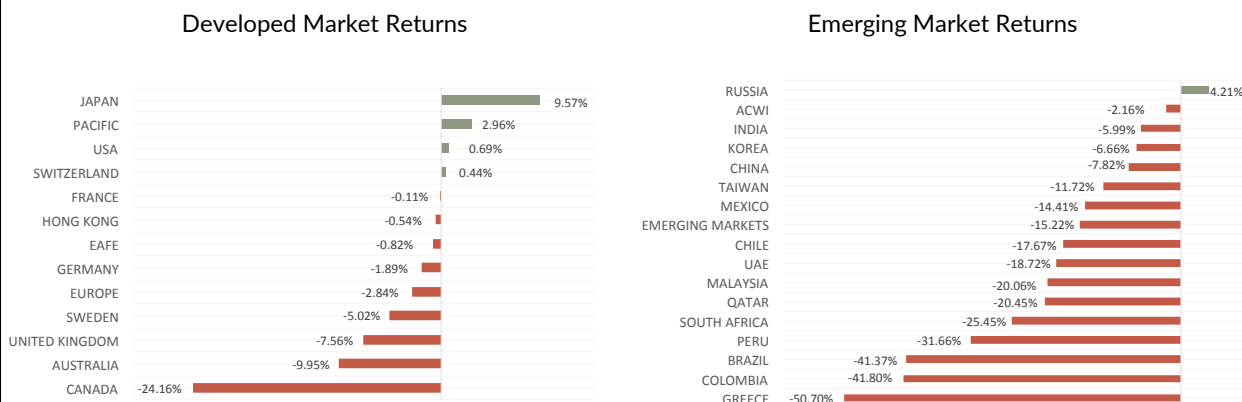
Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index), Emerging Markets (FTSE Emerging Markets Index), Global Real Estate (S&P Global REIT Index), US Bond Market (Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citigroup WGBI). The S&P data are provided by Standard & Poor's Index Services Group. Russell data © Russell Investment Group 1995-2015, all rights reserved. MSCI data © MSCI 2015, all rights reserved. Barclays data provided by Barclays Bank PLC. Citigroup bond indices © 2014 by Citigroup.



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33

# Review of 2015 Investment Market Returns Select Country Stock Market Performance



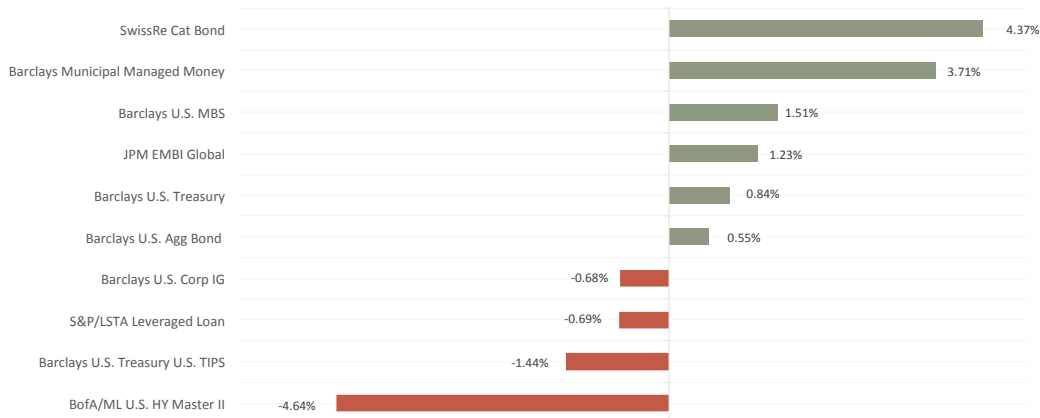
Source: Morningstar. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Country returns from MSCI 'country' NR USD index data.



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34

## Review of 2015 Investment Market Returns Fixed Income



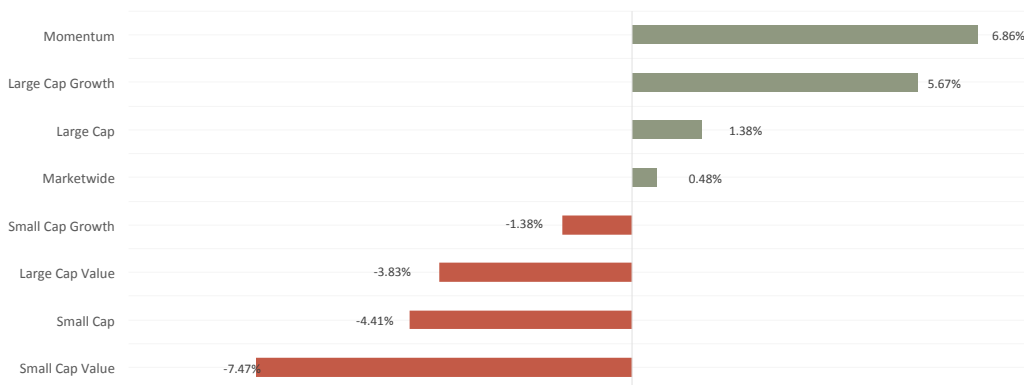
Source: Morningstar



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35

## Review of 2015 Investment Market Returns U.S. Stocks by Style



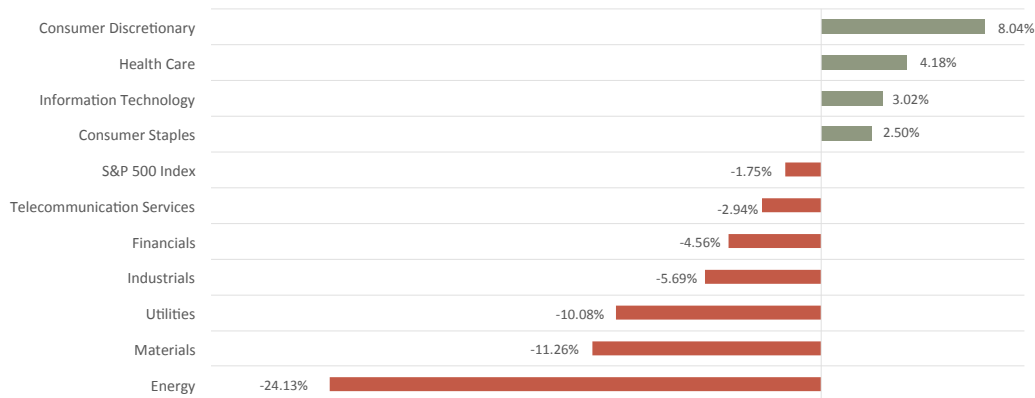
Source: Morningstar. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: Marketwide (Russell 3000 Index), Large Cap (S&P 500 Index), Large Cap Value (Russell 1000 Value Index), Large Cap Growth (Russell 1000 Growth Index), Small Cap (Russell 2000 Index), Small Cap Value (Russell 2000 Value Index), Momentum (MSCI USA Barra Momentum and Small Cap Growth (Russell 2000 Growth Index).



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36

## Review of 2015 Investment Market Returns U.S. Stock Market Sectors



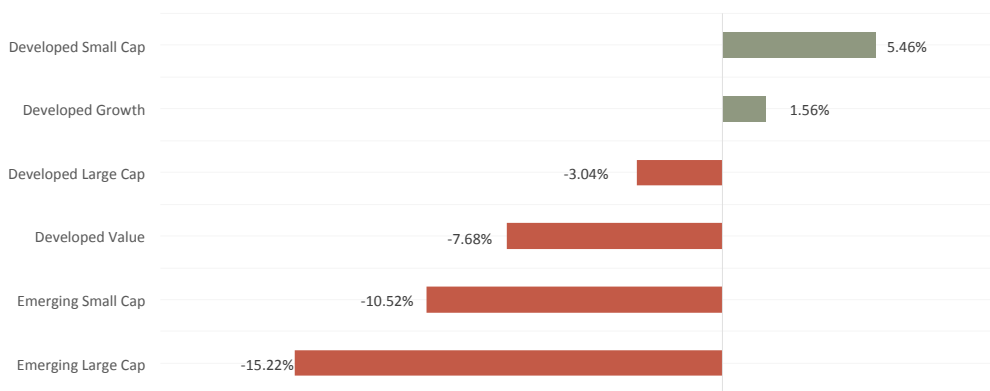
Source: Fidelity Research



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37

## Review of 2015 Investment Market Returns International Stock by Style



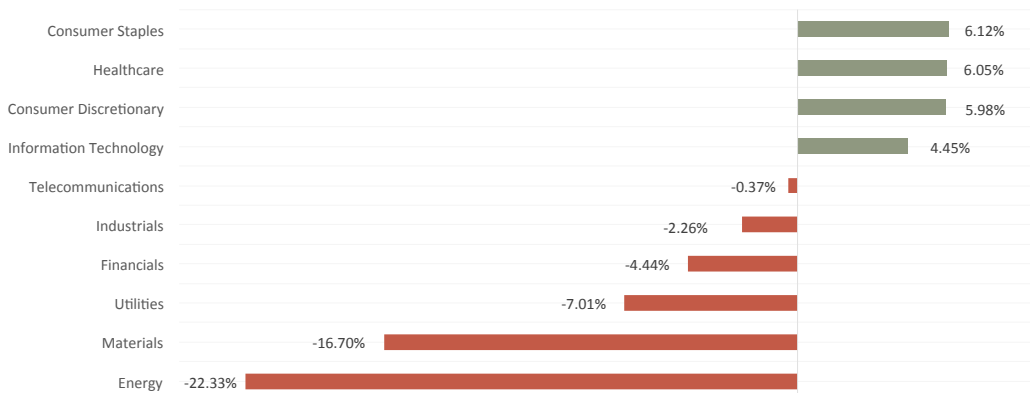
Source: Morningstar. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: Large Cap (MSCI World ex USA Index), Small Cap (MSCI World ex USA Small Cap Index), Value (MSCI World ex USA Value Index), and Growth (MSCI World ex USA Growth), Large Cap (MSCI Emerging Markets Index), Small Cap (MSCI Emerging Markets Small Cap Index).



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38

## Review of 2015 Investment Market Returns Global Stock Market Sectors



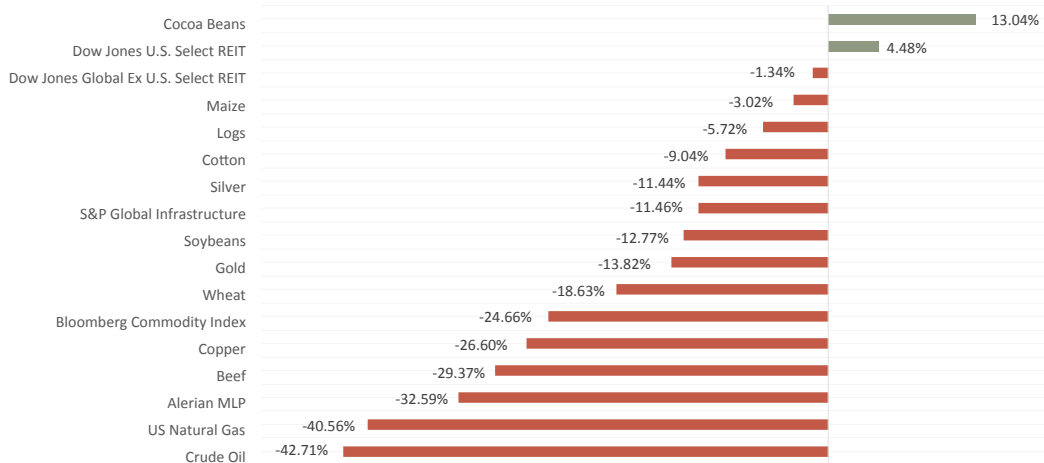
Source: Morningstar. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Sector returns are from S&P 1200 Global Index sector returns.



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## Review of 2015 Investment Market Returns Inflation-Sensitive Investments



Source: Morningstar and the IMF. Prices as of December 10, 2015



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40

# MARKET RISK INDICATORS

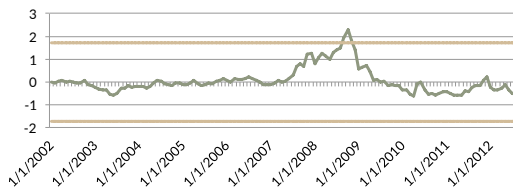


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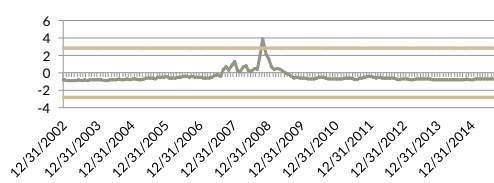
41

# Market Risk Indicators Risk Metrics

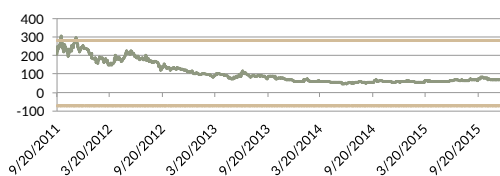
**2-Year Swap Spread**



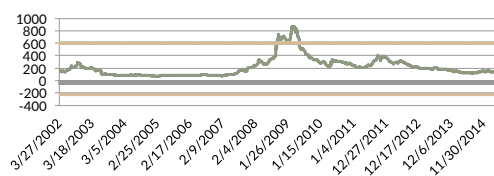
**TED Spread**



**Credit Default Swap Select 10 (bps)**



**5 to 10 Year Financial OAS**

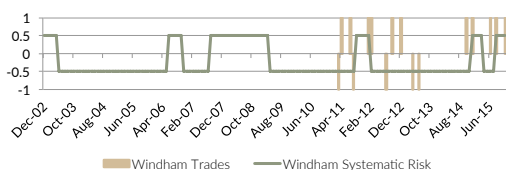


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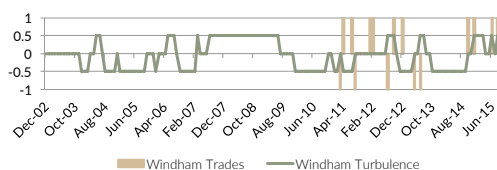
42

# Market Risk Indicators Risk Metrics (Cont.)

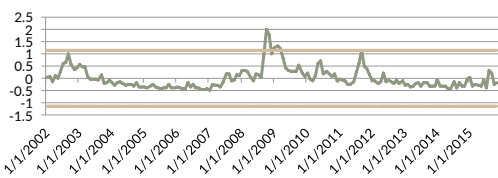
Windham Systemic Risk



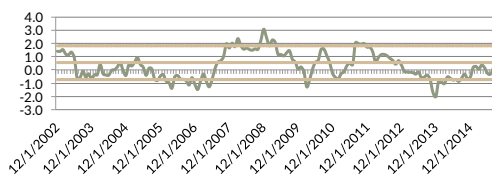
Windham Turbulence



CBOE VIX Index



Cleveland Fed Financial Stress Index



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# GLOBAL INVESTMENT MARKET EXPECTATIONS

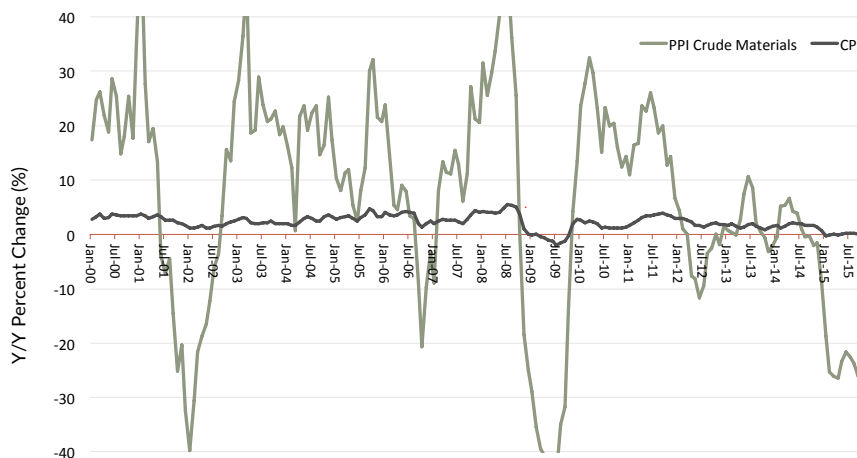


*"Daddy! Daddy! Red's my favorite color!"*



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# Global Market Expectations Commodity Contribution to Inflation



PPI Crude Materials captures commodity price inflation. This measure is comprised roughly 60% of crude foodstuffs, feedstuffs and crude oil; and roughly 40% of all other commodities used in manufacturing, including metals.

The plunge in commodity inflation has pushed the v/v ΔCPI practically to zero.

Source: Bureau of Labor Statistics, data through October 2015.

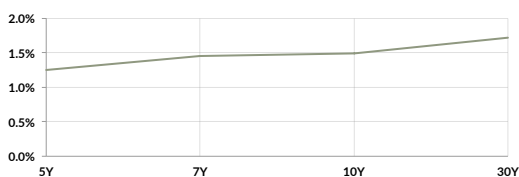


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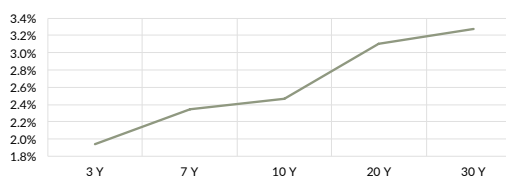
45

# Global Market Expectations Expected Inflation

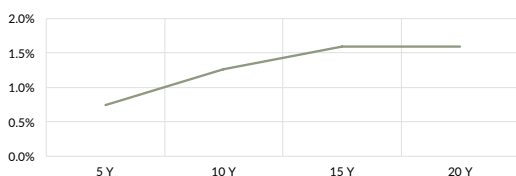
US Treasuries vs Inflation Indexed



UK Gov. Bonds vs Inflation Indexed



Canada Gov. Bonds vs Inflation Indexed



- Discounted breakeven rates were generally down worldwide in 2015.
- 5y/5y rates are 2% in the US and developed Europe. Five year forward rates are much lower in Europe.
- 5y/5y rates are less than 1%, well below the BOJ target.
- Surveys of inflation forecasts and swap markets agree with the bond markets.

Source: Investing.com, Globinvestor.com, and U.K. Debt Management Office. Data as of 12/31/2015.

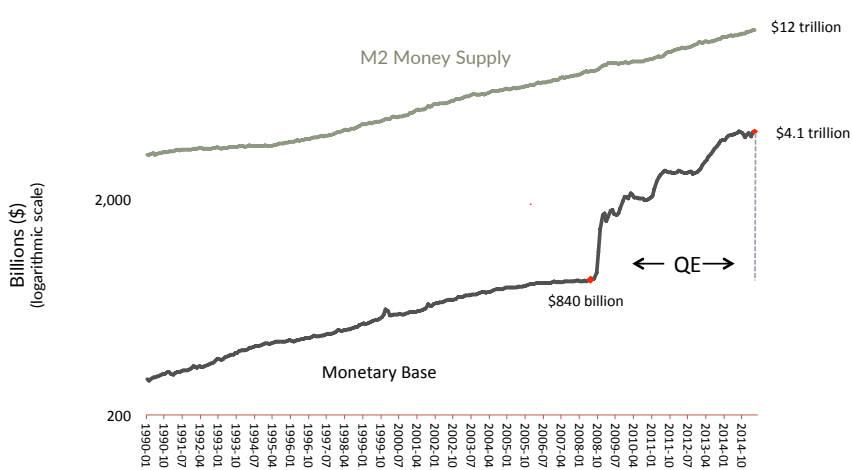


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# Global Market Expectations

## The Fed is "Printing Money." Why *Hasn't* Inflation Surged?



Key distinction between monetary base and money supply.

The Federal Reserve engineered an explosion in the monetary base – reserves that commercial banks keep on deposit at the Fed – in an effort to restore confidence in banks and stimulate the economy.

M2 – cash, checking and savings accounts held by households and businesses – is a function of both supply *and* demand for funds – is responding sluggishly.

For inflation to pick up, M2 has to pick up ... more money chasing the supply of goods and services.

Source: Federal Reserve. Data through April 2015, released June 4, 2015.

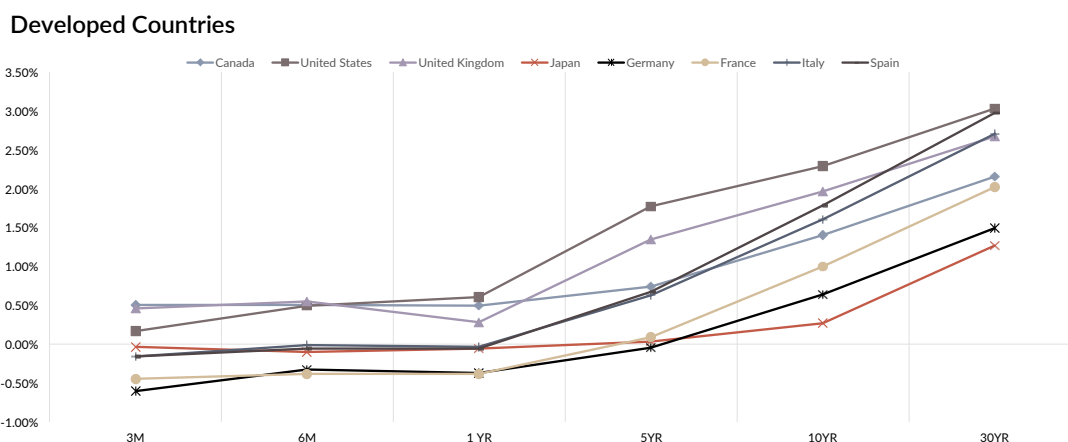


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# Global Market Expectations

## Sovereign Yield Curves – Developed Markets



Source: Investing.com. Data as of 12/31/2015.



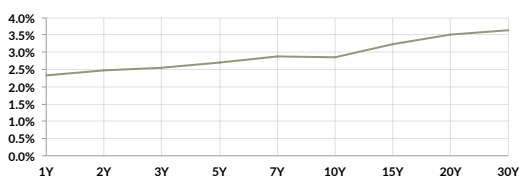
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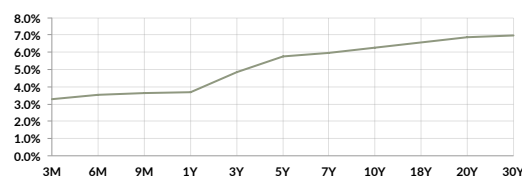


# Global Market Expectations Sovereign Yield Curves – Emerging Markets

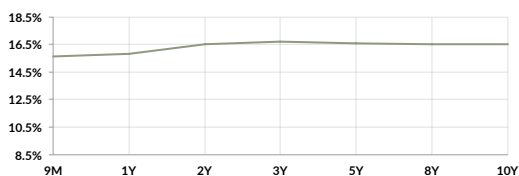
**China Government Bonds**



**Mexico Government Bonds**



**Brazil Government Bonds**



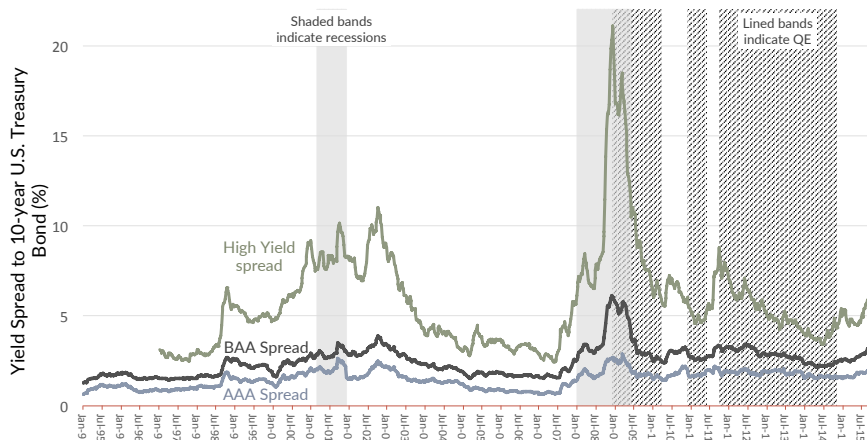
Source: Investing.com. Data as of 12/31/2015.



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# Global Market Expectations Corporate Bond Spreads



Source: Federal Reserve, Federal Reserve Bank of St. Louis, Data through December 4, 2015.



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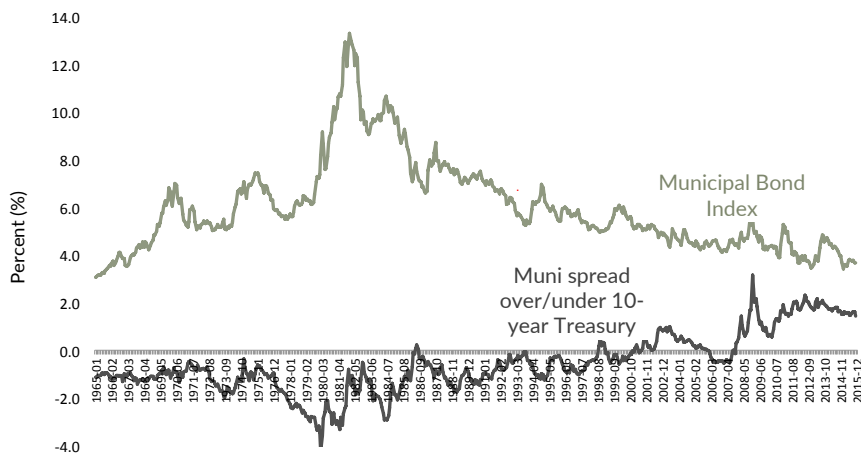
Have spreads widened enough to get concerned about the economy?

Investment-grade spreads have only just normalized following the termination of QE.

Wider junk spreads are due, specifically, to energy and materials. Contagion in HY from energy but not in HG bonds.

Too late in the cycle to stretch for yield?

# Global Market Expectations Municipal Bonds



Municipals' spread-to-Treasuries is attractive.

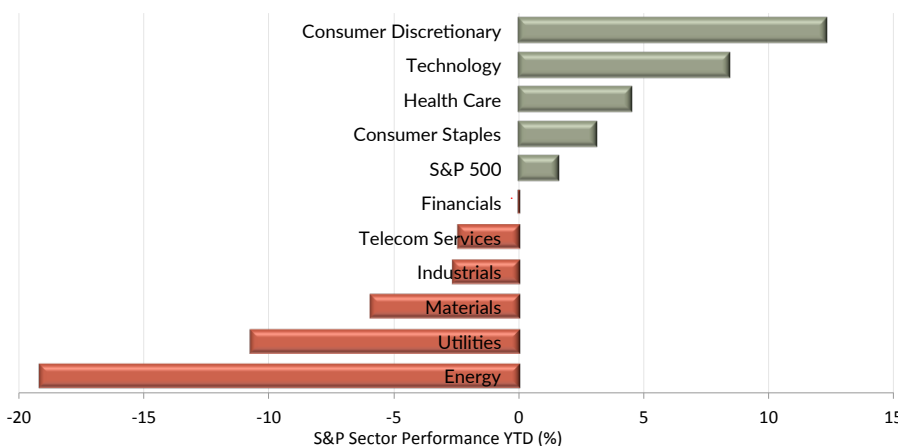
Source: Federal Reserve, bond buyer GO 20-bond municipal bond index. Data through November 2015.



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# Global Market Expectations S&P 2015 YTD Sector Returns – Not What the Strategists<sup>1</sup> Expected



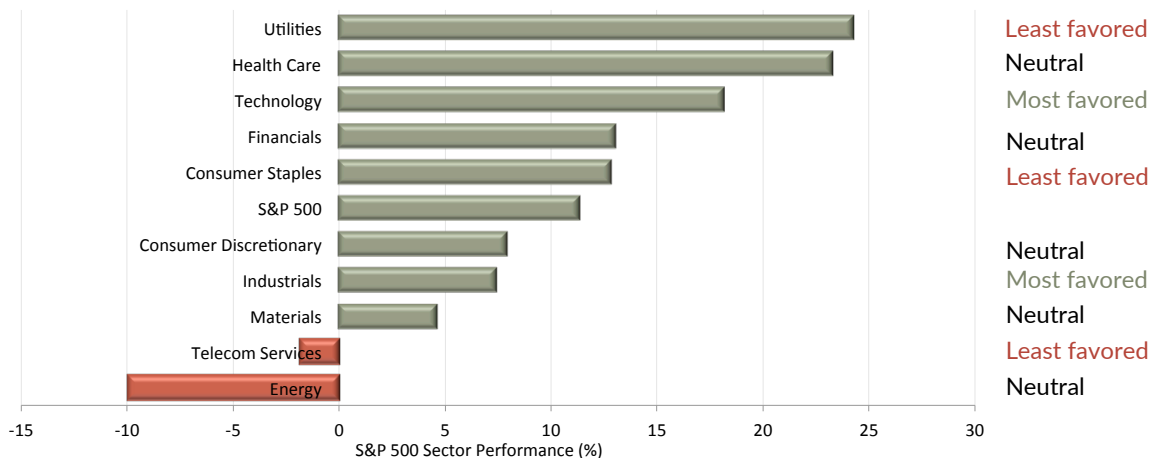
Source: Standard and Poor's. Data through December 4, 2015.  
<sup>1</sup> From Barron's survey of 12 Wall Street strategists, published December 15, 2014.



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## Global Market Expectations S&P 2014 YTD Sector Returns – Not What the Strategists<sup>1</sup> Expected



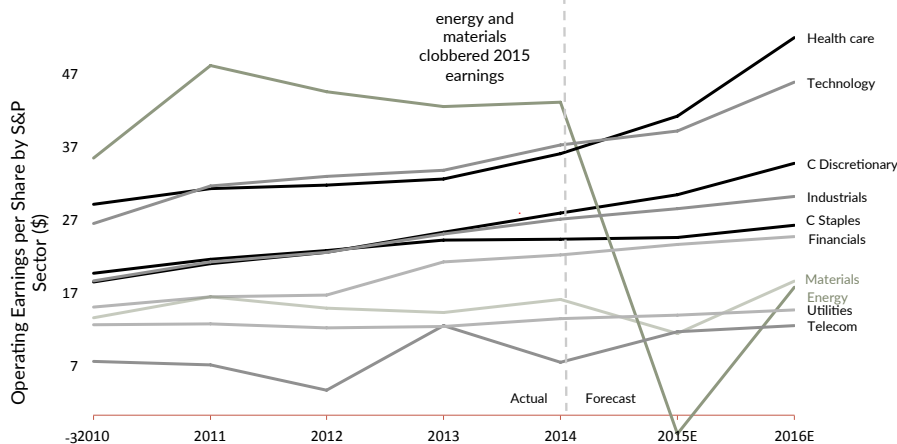
Source: Standard and Poor's. Data through December 31, 2014.  
<sup>1</sup> From Barron's survey of 12 Wall Street strategists, published December 16, 2013.



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## Global Market Expectations S&P 500 Sector Earnings Forecasts – Most Headed Higher



Energy and materials clobbered 2015 earnings. The other eight sectors have posted good gains to date.

Accelerating earnings growth forecast for most sectors in 2016, with 14% growth in the S&P 500 for 2016 forecasted.

2015 earnings for the energy sector were down 14.4%, the rest of the S&P grew 6%.

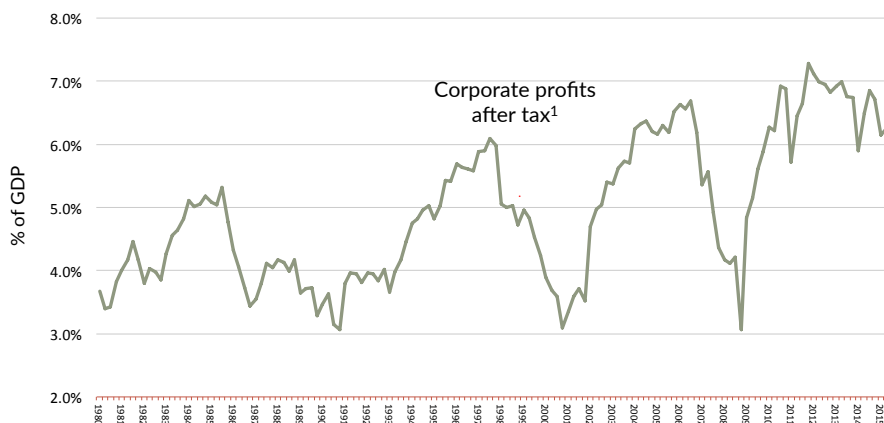
Source: Standard & Poor's. Earnings estimates are based on the Capital IQ consensus forecast. Data as of November 30, 2015.



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# Global Market Expectations Corporate Profit Margins



Corporate profit margins are running strong, although down from recent record highs.

Source: U.S. Department of Commerce, Bureau of Economic Analysis. Quarterly data through September 2015.  
<sup>1</sup> With inventory valuation and capital consumption adjustments.



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# Global Market Expectations US Stock Market Returns

S&P 500	1920s	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s	2015	1926-2015
Dividend Yield	4.82%	5.38%	5.91%	5.28%	3.28%	4.17%	4.61%	2.68%	1.77%	2.14%	2.06%	4.03%
Earnings Growth	9.09%	-4.09%	8.15%	3.87%	5.48%	9.90%	4.42%	7.72%	0.51%	4.30%	-6.52%	5.00%
Multiple Expansion	7.62%	-1.17%	-5.16%	9.72%	-1.09%	-8.30%	8.17%	7.59%	-3.23%	5.90%	5.79%	0.80%
Total Return	21.54%	0.12%	8.90%	18.87%	7.68%	5.77%	17.20%	18.00%	-0.95%	12.43%	1.34%	9.83%
Inflation	-1.30%	-2.00%	5.42%	2.20%	2.52%	7.37%	5.10%	2.95%	2.52%	1.52%	0.50%	2.96%
Real Return	22.71%	2.21%	3.30%	16.31%	5.03%	-1.49%	11.52%	14.61%	-3.39%	10.75%	0.83%	6.67%
Real Earnings Growth	10.14%	-2.09%	2.59%	1.63%	2.88%	2.36%	-0.65%	4.63%	-1.96%	2.73%	-6.99%	1.98%
Real GDP Growth	2.70%	1.80%	5.40%	4.00%	4.30%	3.30%	3.10%	3.20%	1.80%	2.4%	2.5% est	3.02%

RETURNS										
Stocks	17%	-2%	10%	18%	8%	7%	17%	18%	-2%	
Bonds	22%	15%	8%	-1%	4%	10%	14%	10%	12%	
Gold	0%	5%	1%	-1%	0%	31%	-3%	-4%	11%	
Commodities	-5%	-4%	6%	0%	2%	10%	-2%	-1%	9%	

	1920	1930	1940	1950	1960	1970	1980	1990	2000	2010	2015
Expected Inflation	5.10%	-1.00%	-1.60%	0.80%	0.50%	4.20%	8.10%	4.40%	2.20%	1.60%	1.60%
Total Debt/GDP	127%	166%	164%	145%	140%	143%	155%	224%	256%	355%	334%
Money/GDP	8%	7%	21%	16%	10%	8%	6%	5%	6%	14%	23%

Source: Standard & Poors, BEA, BLS, Versant Capital Management, Bridgewater Associates



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56

# Global Market Expectations World CAPE Ratios

Country/Region	CAPE	CAPE Earnings Yield	TTM P/E	TTM Earnings Yield	P/B	Dividend Yield
GREECE	0.90	110.84%	N/A	N/A	0.49	1.20%
RUSSIA	3.55	28.14%	7.83	12.77%	0.62	4.85%
BRAZIL	4.69	21.30%	17.05	5.87%	1.13	4.58%
PORTUGAL	6.20	16.12%	15.40	6.49%	1.48	3.78%
POLAND	6.48	15.43%	11.11	9.00%	1.09	3.72%
CZECH REPUBLIC	6.53	15.32%	13.50	7.41%	1.33	7.04%
HUNGARY	6.63	15.07%	10.62	9.42%	1.25	2.10%
TURKEY	6.94	14.40%	9.60	10.42%	1.21	3.53%
AUSTRIA	7.16	13.98%	13.24	7.55%	1.06	1.86%
NORWAY	7.29	13.72%	12.57	7.95%	1.49	4.20%
SPAIN	8.59	11.65%	15.97	6.26%	1.28	5.19%
ITALY	8.71	11.48%	29.78	3.36%	1.05	3.02%
EM (EMERGING MARKETS)	10.51	9.52%	11.76	8.51%	1.22	2.81%
CHINA	12.45	8.03%	10.95	9.13%	1.42	2.76%
EUROPE	12.64	7.91%	18.09	5.53%	1.78	3.42%
EAFE	14.04	7.12%	16.99	5.88%	1.63	3.17%
BELGIUM	16.53	6.05%	19.26	5.19%	2.47	3.00%
MEXICO	16.68	5.99%	27.56	3.63%	2.61	1.46%
ACWI	17.23	5.80%	17.95	5.57%	2.00	2.60%
HONG KONG	17.35	5.76%	11.49	8.70%	1.18	3.00%
PACIFIC	17.81	5.61%	15.24	6.56%	1.40	2.73%
INDIA	19.07	5.24%	22.67	4.41%	3.22	1.42%
JAPAN	20.60	4.85%	16.02	6.24%	1.37	1.91%
SWITZERLAND	20.85	4.80%	18.38	5.44%	2.58	3.09%
USA	23.18	4.31%	20.54	4.87%	2.77	2.15%
PHILIPPINES	24.95	4.01%	20.19	4.95%	2.73	1.79%
DENMARK	30.55	3.27%	25.86	3.87%	4.06	1.59%

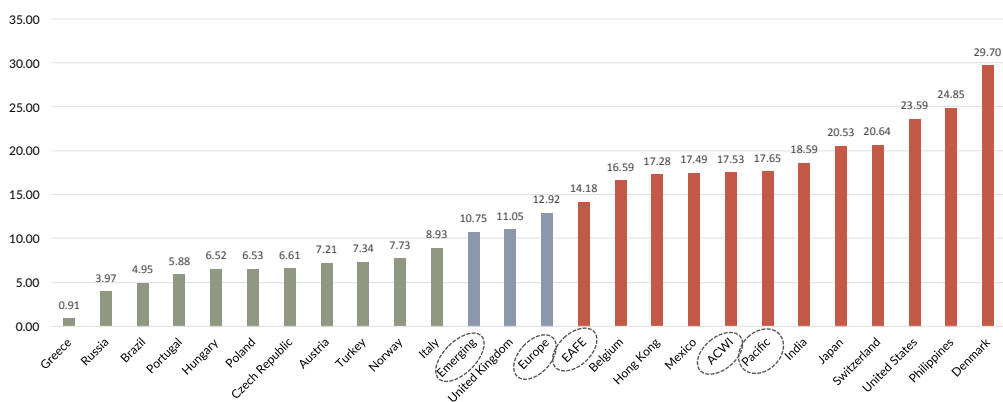
Source: MSCI, Robert Shiller. Data as of 12/31/2015



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# Global Market Expectations World CAPE Ratios



Sources: MSCI, Robert Shiller. Data as of 11/30/2015

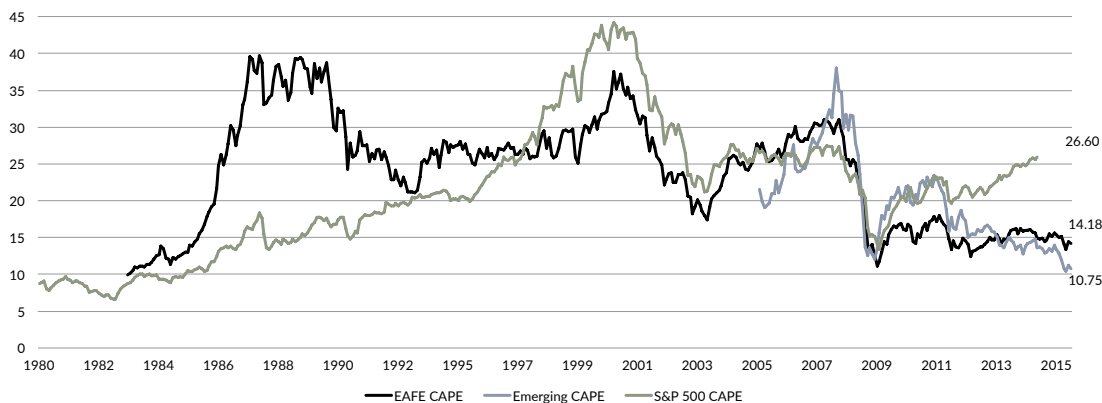


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# Global Market Expectations World CAPE Ratios Comparison

CAPE Comparisons



Source: MSCI, Robert Shiller. Data as of 11/30/2015.



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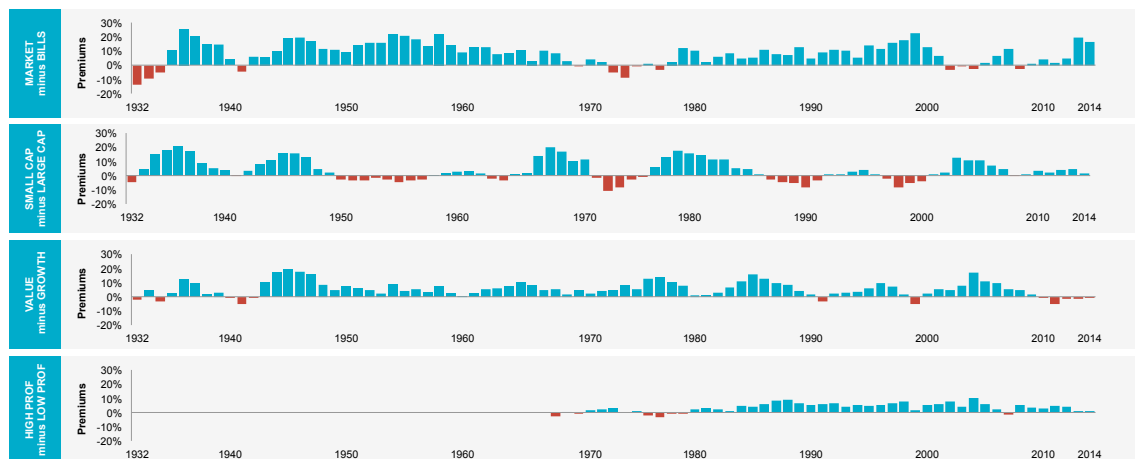
# Capital Markets Assumptions\*

Category	Asset Class	BNYM	JPM	Northern Trust	NEPC	GMO	WBlair	RA
		10 Years 1/1/2015	10-15 Years 9/30/2015	5 Years 7/31/2015	5-7 Years 12/15/2015	7 Years 11/30/2015	8 Years 11/30/2015	10 Years 9/30/2015
US Equities	US Large	7.20 %	7.00 %		6.00 %	0.10 %	4.70 %	3.60 %
	US Small	8.40 %	7.25 %		6.00 %	1.40 %	3.90 %	2.85 %
	US High Quality			5.60 %				
	US Broad Equity	7.30 %		8.60 %	8.50 %			
International Equities	Private Equity	10.70 %	8.50 %	8.60 %	8.50 %			
	Global Equity	7.40 %	7.50 %	6.50 %			6.80 %	
	Ex-US Developed Equity	7.00 %	7.75 %	6.10 %	7.25 %		8.80 %	7.77 %
	International Large					2.20 %		
Real Estate	International Small	7.50 %				0.90 %		
	Emerging	9.80 %	10.00 %	7.80 %	9.75 %	6.30 %	15.70 %	10.38 %
	US REIT	8.00 %	6.00 %					4.98 %
Fixed Income	Global REIT	7.70 %		6.90 %				
	Direct Real Estate	5.60 %	5.50 %		6.50 %			
	US Aggregate	2.70 %	3.75 %	3.00 %	3.75 %	1.30 %		3.59 %
	Municipal Bonds	3.10 %	3.25 %	3.30 %				
	US Treasury Bonds	2.10 %	3.00 %	2.50 %	1.75 %		1.60 %	3.26 %
	US High Yield	4.80 %	6.75 %	5.80 %	5.25 %		5.60 %	5.31 %
	International Bonds (Hedged)		2.50 %		1.09 %	-0.40 %		
	Global Aggregate	2.20 %	2.50 %	2.50 %			2.30 %	3.77 %
Inflation Protection/ Hedging	Ex-US Developed Fixed Income						2.50 %	
	Emerging Debt	4.90 %	6.50 %	7.80 %	4.50 %	4.40 %	4.90 %	5.11 %
	US TIPS	2.30 %	2.75 %	1.70 %	2.50 %			3.65 %
	Gold		3.50 %					1.40 %
	Diversified Hedge Funds	4.90 %	4.25 %	4.40 %	5.75 %			
	Event Driven Hedge Funds	5.10 %	6.00 %	5.00 %				
	Cash			1.50 %	1.50 %	2.10 %		
	Infrastructure	7.30 %	6.50 %	6.20 %				
Commodities	2.30 %	3.00 %		4.50 %			4.75 %	
Inflation					2.20 %		2.50 %	

\*Returns are geometric and stated in nominal terms. Real return estimates are adjusted to nominal returns by adding back expected inflation as estimated by that source.



# Capital Market Expectations 2008-2015 Five-Year Moving Average of Premia



Information provided by Dimensional Fund Advisors LP.  
 Five-year rolling equity premium is the five-year arithmetic average return of the Fama/French Total US Market Research Index minus the five-year arithmetic average return of the one-month US Treasury Bill. Five-year rolling size premium is the five-year arithmetic average return of the Fama/French SMB factor: (Fama/French US Small Value, US Small Neutral, and US Small Growth Research Indices) minus (Fama/French US Large Value, US Large Neutral, and US Large Growth Research Indices). Five-year rolling value premium is the five-year arithmetic average return of the Fama/French HML factor: (Fama/French US Small Value and US Large Value Research Indices) minus (Fama/French US Small Growth and US Large Growth Research Indices). Five-year rolling profitability premium is the five-year arithmetic average return of the Fama/French RPPW factor: (Fama/French US Small Robust and US Large Robust Profitability Research Indices) minus (Fama/French US Small Weak and US Large Weak Profitability Research Indices). Profitability is measured as operating income before depreciation and amortization plus financial income, net of taxes.  
 Fama/French indices provided by Ken French. Index descriptions available upon request. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP.

## WHAT IS DIFFERENT TODAY

The Good

The Bad, and

The Ugly

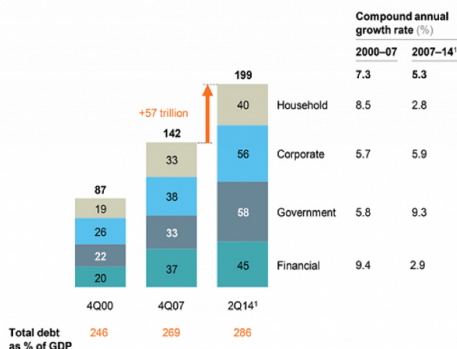


Dr. Hamilton makes a breakthrough in his quest to convert pessimists to optimists.

# What is Different Today - The Ugly Deleveraging, What Deleveraging?

Global debt has increased by \$57 trillion since 2007, outpacing world GDP growth

Global stock of debt outstanding by type<sup>1</sup>  
\$ trillion, constant 2013 exchange rates



<sup>1</sup> 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.  
NOTE: Numbers may not sum due to rounding.

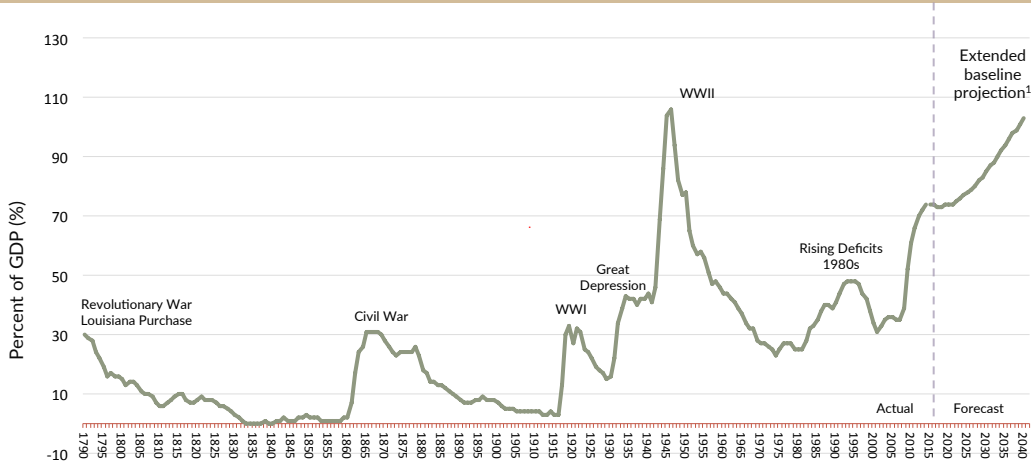
SOURCE: Haver Analytics; national sources; World economic outlook, IMF; BIS; McKinsey Global Institute analysis



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63

# What is Different Today - The Ugly Federal Debt % of GDP Through 2040



Source: Congressional Budget Office (CBO), *The 2015 Long-Term Budget Outlook*, June 2015. <sup>1</sup>CBO's 10-year and extended baselines are meant to serve as benchmarks for measuring the budgetary effects of proposed changes in federal revenues or spending. They are not meant to be predictions of future budgetary outcomes; rather, they represent CBO's best assessment of how the economy and other factors would affect revenues and spending if current law generally remained unchanged.

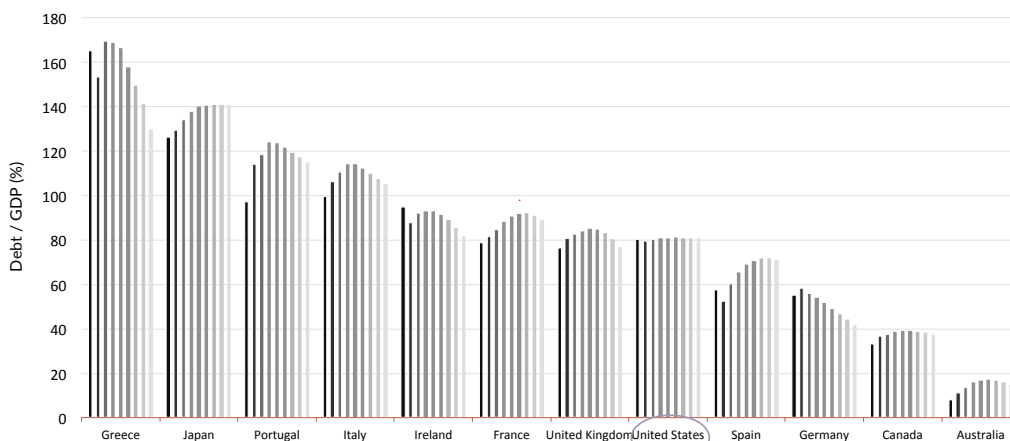


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# What is Different Today - The Ugly Government Debt-to-GDP Ratios (2011-2019)



Source: IMF, World Economic Outlook Database, October 2014. Data for years (from left to right) 2011-2019. For all countries except the U.S.: actual data for 2011-2013, estimates for 2014-2019. For the U.S.: actual data for 2011-2012, estimates for 2013-2019



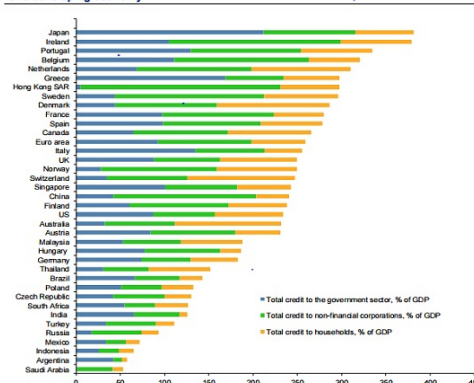
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# What is Different Today - The Ugly Country Debt-to-GDP Ratios

- The debt problem is endemic in developed market economies.
- Current real yields on sovereign debt are barely positive in some countries; negative in others.
- The debt problem will be worked through with some combination of restructuring government benefits and transfers, continued repression of interest rates, restructuring of debt commitments, and induced inflation.
- There are few positive outcomes for holders of long-term sovereign debt.

The big, overriding balance sheet theme. Too much DEBT. China is too high on this chart for a developing economy



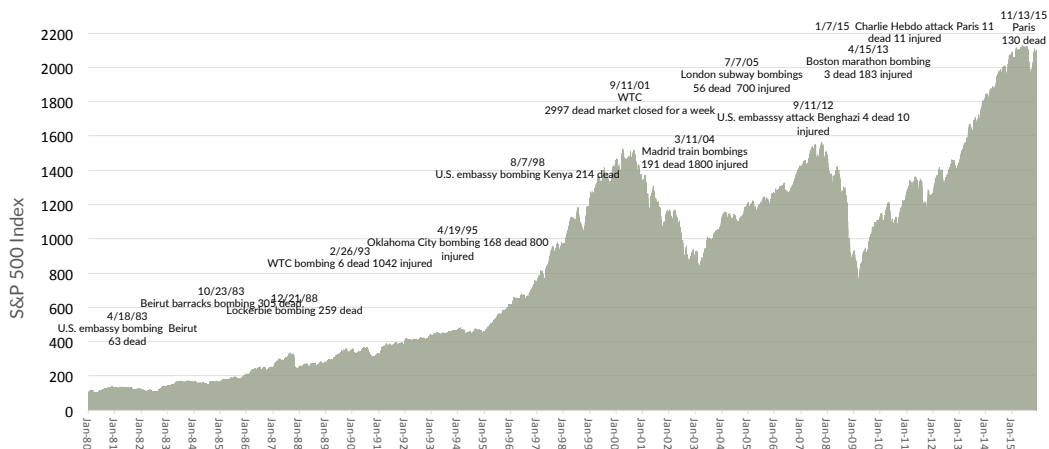
Source: RBS, BIS data as of Q1 2015



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# What is Different Today – The Bad S&P 500 and Terrorist Attacks



Source: Standard & Poor's, data through December 1, 2015.

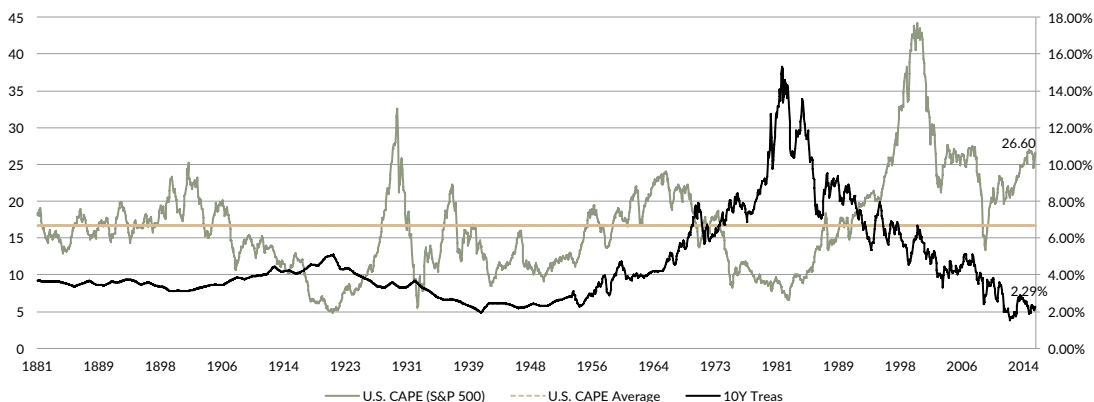


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# What is Different Today – The Bad Falling Rates – A Wind to Our Backs Since 1981

S&P 500 CAPE vs 10-Year Treasury Yield (rhs)



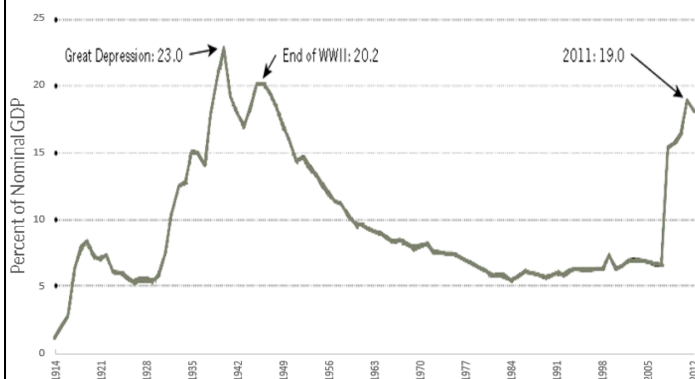
Sources: FRED, MSCI, Robert Shiller. Data as of 11/30/2015.



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68

## What is Different Today – The Bad Fed Options During the Next Downturn Limited



Expansion of the Fed's Balance Sheet has Happened Before.

We will Not Have a Demographic Wave and Women Entering the Workforce to Help Us.

The Most Consistent Worry Among Professionals is the Paucity of Remaining Options Available to the Fed For the Next Economic Downturn.

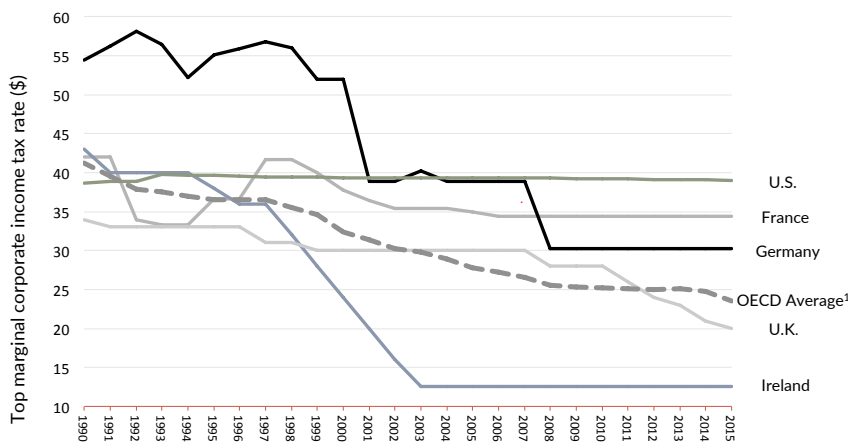
Interest Rates are Near Zero; The Fed has Already Aggressively Expanded Its Balance Sheet – Helicopter Money?



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## What is Different Today – The Good Corporate Tax Rates<sup>1</sup> – Comparison From 1990



Corporate income tax rates started moving lower in the mid-1990's but the U.S., alone, did not follow.

At 39% today, the U.S. is 15% higher than the OECD average.

*This is why the "inversions" are going to Ireland.*

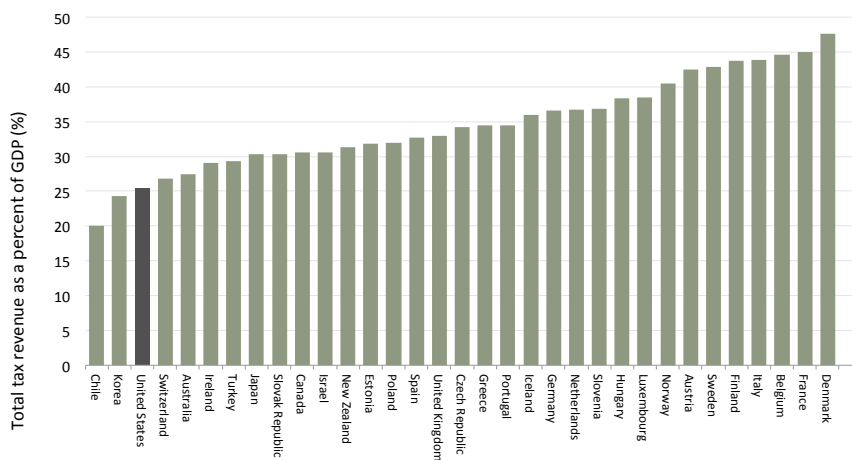
<sup>1</sup> Top marginal federal plus state and local corporate income tax rates. <sup>2</sup> Average of the 33 non-U.S. OECD countries. Source: OECD Tax Database, 2015, Table II.1. Does not include non-OECD countries such as China, Brazil, India and Russia.



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## What is Different Today – The Bad Taxes % of GDP - Comparison



While the U.S. has the highest corporate tax rate, the U.S. has one of the lowest total tax burdens among developed economies.

Small wonder U.S. companies are moving or opening foreign subsidiaries.

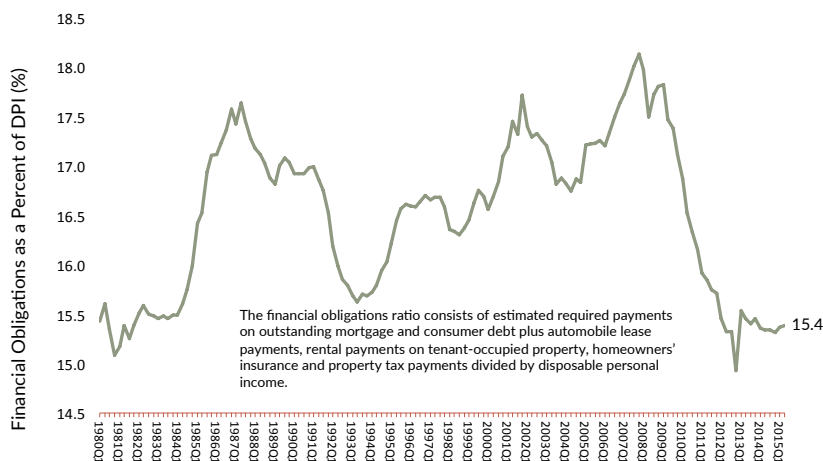
Source: OECD, Revenue Statistics, 2014 Edition. Data for 2013. Does not include non-OECD countries such as China, Brazil, India and Russia. Includes all forms of taxes: federal, state and local; income taxes, sales taxes, VAT taxes, estate taxes, property taxes, etc.



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## What is Different Today – The Good Consumer Financial Obligations Ratio Near a Low



Comparing consumers' monthly flow of income to their fixed recurring monthly expenses, including debt service, gives a more accurate measure of consumers' financial health.

Consumers' ability to cover the monthly "nut" has seldom been better as incomes have recovered, household debt has been reduced and interest rates remain low.

*Caveat: Refinancing risk.*

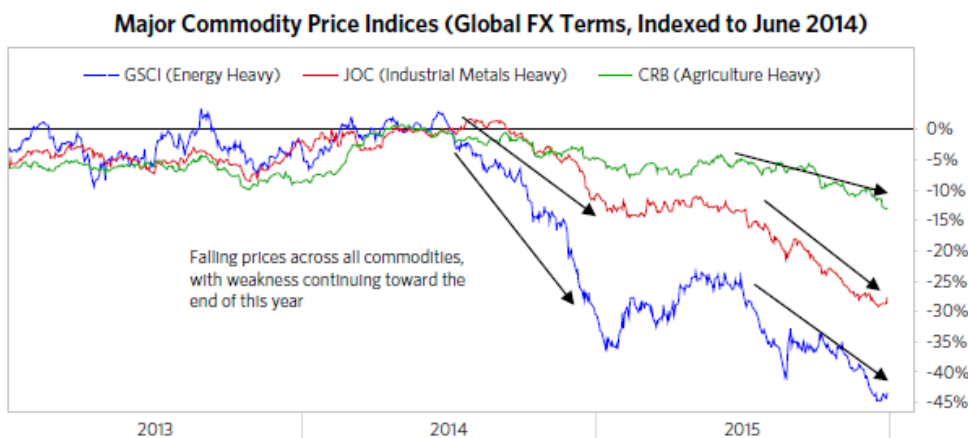
Source: Federal Reserve, data through June 2015; released October 5, 2015.



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72

# What is Different Today – The Good, the Bad, & the Ugly



Source: Bridgewater Associates

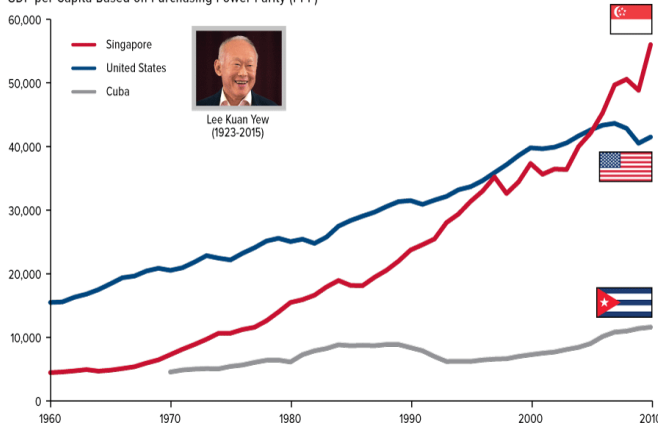


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# What is Different Today – The Good We Know How to Do This...Let's Go!

**Lee Kuan Yew's Singapore Flourished while Fidel Castro's Cuba Floundered**  
 GDP per Capita Based on Purchasing Power Parity (PPP)



Source: Penn World Table (Center for International Comparisons at the University of Pennsylvania), U.S. Global Investors



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74

## What is Different Today – The Good I'm With the Cornucopians

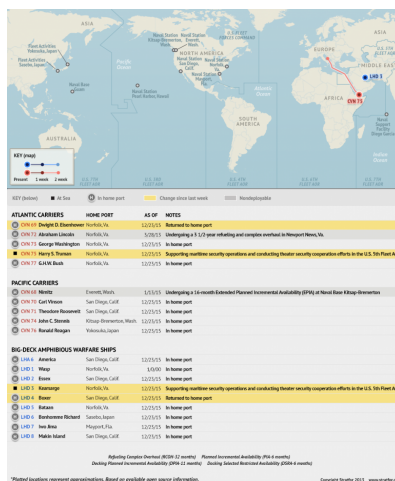
- Demographics, Debt, Interest Rates, Intergenerational Equity (who writes the check), and Malthusians are Headwinds.
- Positive Trends that Still Exist: The Improvement in the Lot of Most of the Planet's Inhabitants.
  - We know this can happen: Just look at Korea, Taiwan, Hong Kong, Singapore, and the former East Germany.
  - At around \$5,000 income per capita, big changes in diet and education.
  - Much investment in agriculture, energy, and materials will be needed.
  - The current market decline in these sectors may be teeing up quite an opportunity.
  - They also tend to be inflation sensitive sectors.
- The Cornucopians believe that technological progress will continue what was started in the late 1700s – more than a order of magnitude improvement in economic growth.
  - We believe even though we can't identify the future breakthroughs – like so much else an act of faith.
  - The Malthusians believe the future can't duplicate the advances of the past.

## What is Different Today – The Good Some Ideas

- Investment Strategies Focused on Forecasting are Dangerous – We Cannot Forecast Well Enough
  - Invest in market risk premiums inexpensively.
  - Tilt around the edges with favorable trends.
- Rebalance aggressively from the things that have done well (US growth stocks) into that which has not (emerging market stocks).
- The big decline in interest rates and run up in debt will not be duplicated over the next 30 years; consider some other asset classes in your investment strategy.
- Tend more toward global market capitalization than relying on U.S. stocks alone. There is still ample room for long-term earnings growth outside the U.S.
- Make sure your less liquid investments are held in kind or in the proper investment vehicle to preclude forced selling.
- The Issues of the Day, Debt, Demographics, Interest Rates, and Inflation are Difficult but Solvable if All Interests Contribute. There are Historical Precedents.

# THANK YOU FOR YOUR VALUABLE TIME

## Q&A



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# IMPORTANT DISCLOSURES

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