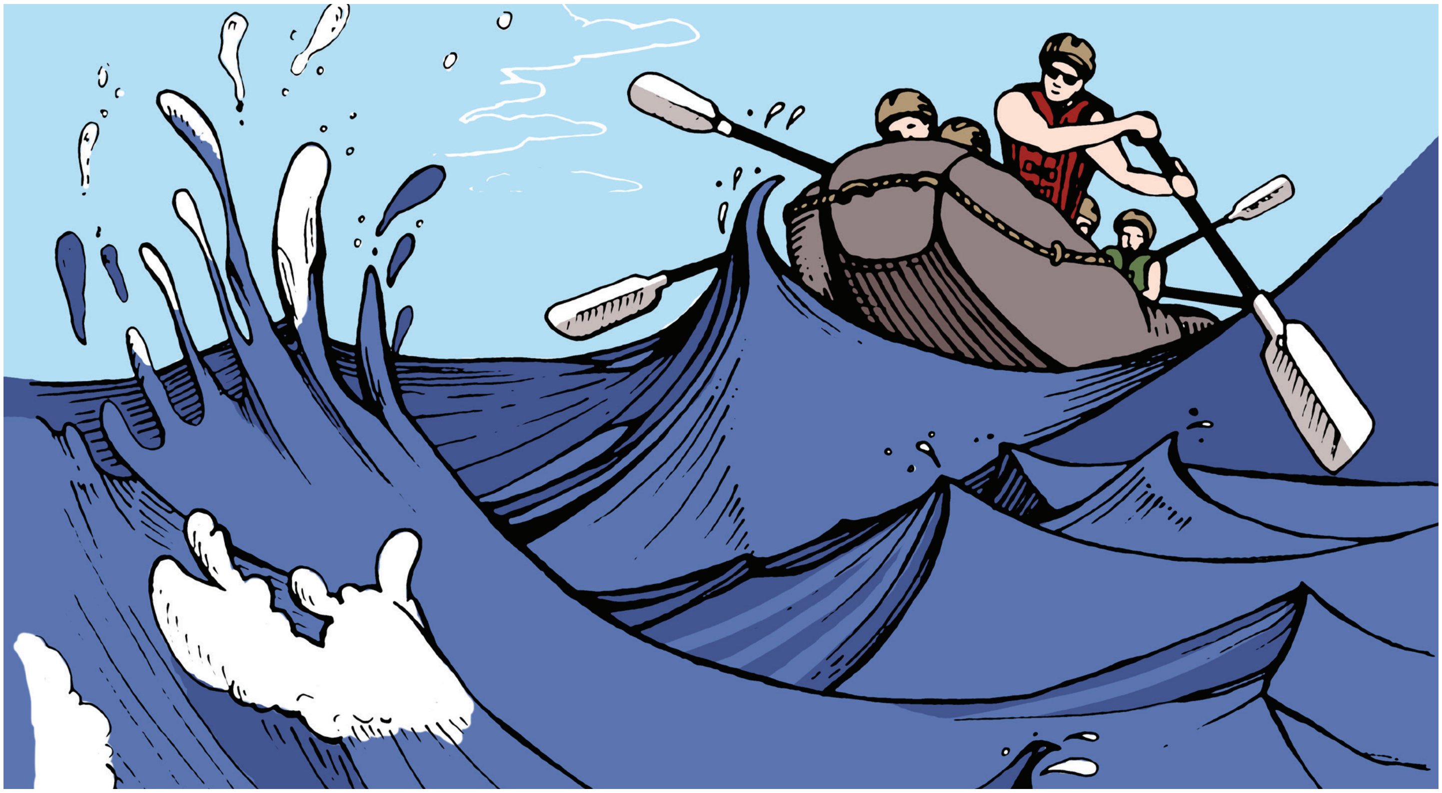
GRESHAM

2016 Annual Outlook

Choppy Waters



The world continues to experience subdued economic growth, low inflation and easy monetary policy from central banks around the world. Divergences across the globe and elevated volatility in capital markets were the central themes within capital markets as we predicted in both our 2015 Annual Outlook (*Divergent*) and Mid-Year Update (*Rollercoasters*). We expect many of these underlying economic and capital market themes to continue, however, market valuations have changed and opportunities have evolved. The easy investment returns enjoyed since the end of the financial crisis have succumbed to the pressures of elevated valuations, the Federal Reserve tightening and oil price declines, which have created significant volatility, bearish sentiment and losses among investors hence our title, *Choppy Waters,* for our 2016 annual outlook. The good news is that valuation changes are creating interesting opportunities for investors willing to be cautiously contrarian within a long-term investment approach that avoids overreacting to volatility and market declines.

Summary

It's always challenging when, during the several week period over which we write our Annual Outlook, markets change so significantly that it requires a partial rewrite. While much of the first version of this report was going to focus on elevated equity market valuations and its implications for reduced returns over the next few years, that story has changed over the first few weeks of the year, as declines have brought equity market valuations closer to long-term averages.

The two largest stories of 2015 and early 2016, with apologies to the Greeks who engineered their third bailout in the last decade, were the decline of oil prices and the increase in equity market volatility. The oil markets have never experienced a decline of this magnitude, even during the global financial crisis. Beginning in 2014 and continuing through 2015, oil prices fell from over $100/bbl. to under $30/bbl. While the economic and capital market consequences have been severe, the long-term benefit of lower energy prices should not be underestimated.

Declines in the broader U.S. market have been significant and some sectors such as energy are now approaching levels not seen since the financial crisis. These declines don't always imply that great investments exist in these sectors, but some attractive investment opportunities are being created as a result of recent declines.

- Since 2012, we have recommended that clients reduce or eliminate their fixed income exposure based on low interest rates and tight credit spreads. Despite the Federal Reserve recent beginning to normalize interest rate policy and credit spread widening, we continue to believe these markets present an unattractive risk/reward proposition and that alternative approaches to portfolio risk reduction are preferred. However, investors without these alternate methods might consider investing in high quality sovereign debt, such as U.S. Treasuries, as shock protection for their portfolios.

- Equity markets, particularly in the U.S., ended 2015 in an overvalued position relative to long-term averages. Recent declines have improved equity markets' long-term return prospects, but we have ongoing concerns about corporate earnings growth, particularly in the energy, industrial and materials sectors. Volatility is creating opportunities for active management that should be realized once fundamentals reassert themselves.

- Since launching a dedicated investment strategy in 2014, we have been relatively bullish on emerging market equities due to lower valuations and the opportunity to add value in these less efficient markets. Our interest from a high-level has proven to be premature given emerging market equity underperformance in 2015 and early 2016. However, active management returns have exceeded even our high expectations, nearly offsetting the relative underperformance of the market and reinforcing our confidence in our long-term approach.

- Private equity remains an important and significant allocation for our clients. Concerns about valuations remain in late-stage venture capital and larger U.S. buyout deals. However, we continue to find interesting investment opportunities in less-efficient areas, including outside the U.S.

- Private real asset investments might be the ultimate contrarian investment at the moment, but severe declines in energy and other commodity sectors have altered the economic landscape, making analysis difficult. Large amounts of capital have been raised to invest in distressed debt opportunities in that space, but we believe these prospects are not as clear as some advocates claim due to rapidly changing underlying asset values.

Capital Markets in Review

As we counseled in reports over the last year, easy returns for investors, driven by nearly uninterrupted increasing markets since the global financial crisis, were likely at an end due to elevated valuations, underwhelming earnings growth and the likelihood that the Fed would begin to raise interest rates. This was certainly true in 2015 and even more so in early 2016.

Chart 1. Performance and Valuations

Market	Index	2015	Performance: Annualized 3 Year	Performance: Annualized 5 Year	Valuations: Forward P/E Dec. 2015	Valuations: Forward P/E Dec. 2014
World Equity	MSCI World	-0.9%	9.6%	7.6%	15.8x	15.6x
U.S. Equity	S&P 500	1.4%	15.1%	12.6%	16.2x	16.2x
International Equity	MSCI AC World ex U.S.	-5.7%	1.5%	1.1%	13.8x	13.2x
Emerging Market Equity	MSCI Emerging Markets	-14.9%	-6.8%	-4.8%	11.0x	10.6x
					Spreads vs. Treasuries	
10-Year Treasury	Citi Treasury Benchmark 10-Year	0.9%	1.0%	4.7%	-	-
Municipal Bonds	Barclays Mgd Money Short/Int	2.8%	2.1%	3.5%	67 bps	72 bps
U.S. High-Yield Bonds	Barclays High Yield Corporate Bond	-4.5%	1.7%	5.0%	694 bps	477 bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	1.2%	-0.1%	5.1%	406 bps	318 bps
Hedge Funds	HFRI Fund Weighted	-1.1%	3.6%	2.3%		
Conservative Hedge Funds	HFRI FOF Conservative	0.5%	3.7%	2.3%		
Commodities	Bloomberg Commodity Index	-26.4%	-17.5%	-13.6%		
Gold	Spot Price of Gold	-10.4%	-14.1%	-6.5%		

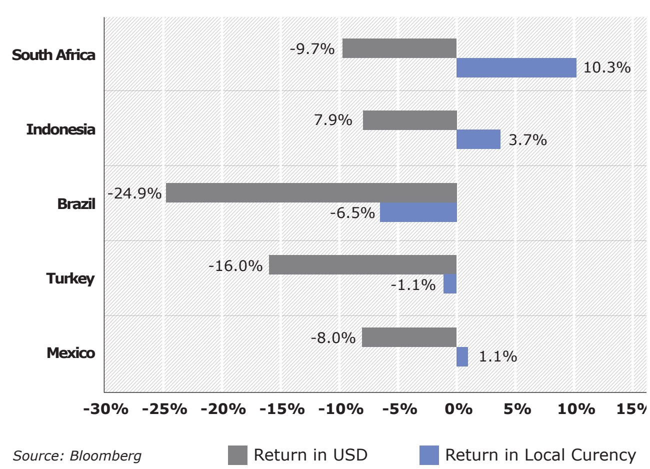
Source: Bloomberg, MSCI, JP Morgan

World equity markets declined 0.9% during 2015, with the U.S. markets increasing 1.4%, international developed markets declining just under 6% and emerging market equities declining nearly 15%, as shown in Chart 1. Over the last five years, world equity markets have returned a respectable 7.6% per year, led by U.S. markets that returned over 12%. During this same period, international markets have returned just over 1% per year, while emerging market equities have declined nearly 5% annually. These long-term performance differentials have been a contributor to the valuation differences we see among these markets, with the U.S. markets being the most expensive and emerging markets being relatively the cheapest.

Emerging markets, with their decline of nearly 15% in 2015, were generally the worst performing equity markets around the world. However, if we neutralize returns for currency effects, emerging markets' performance improved by over nine percentage points and declined a more modest 6%. Chart 2 illustrates the historically high dispersion between equity returns in local currencies and returns from the perspective of a U.S. dollar-based investor. It has been nearly two decades since the importance of incorporating the direct and indirect impacts of currency movement has been so central to investment decisions and results. While the headlines of currency policy have focused on China, the real impact is better illustrated by other countries such as Brazil and Turkey. Brazilian equities have lost nearly 25% per year over the last three years, but just over 6% per year in local currency terms, as the Brazilian real has lost nearly 50% cumulatively over this period.

Chart 2. Dollar Strength has Hurt Returns for U.S. Investors

3 Yr. Annualized Return



Source: Bloomberg

For several years, analysts have worried about the impact on fixed income markets when the Fed began to unwind its bloated balance sheet at the end of its accommodative monetary policies. That process began in late 2015, but the fixed income markets in which the Fed participated have remained resilient. In 2015, broad bond market performance was flat, increasing 0.5% during 2015, led by intermediate U.S. Treasuries, which increased 0.9%.

On the other hand, lower quality segments of the fixed income markets suffered significantly, as problems in the energy sector and expectations for increasing default rates broadly combined to create losses for investors. High-yield markets were down nearly 5% and the lowest rated segments of the market declined 15%, with even greater losses in the energy sector. High-quality municipal bonds performed relatively well, increasing nearly 3%, as short-term credit considerations dissipated and a relative shortage of new issue supply created favorable pricing dynamics.

Many hedge funds experienced a challenging year, particularly in the fourth quarter and early 2016. Further asset growth and crowding in common hedge fund holdings exacerbated losses during declines over the last few months. For the year, hedge funds, as measured by HFR's fund weighted index, declined 1%. Over the last three years, hedge fund performance as a category has been similarly disappointing, increasing 3.6% per annum, which lags the 7.6% performance of world equity markets. Investors in the broad category of hedge funds have likely been disappointed by their investment results unless they were able to gain access to the top performing managers who are often closed to new capital and selective about their investors.

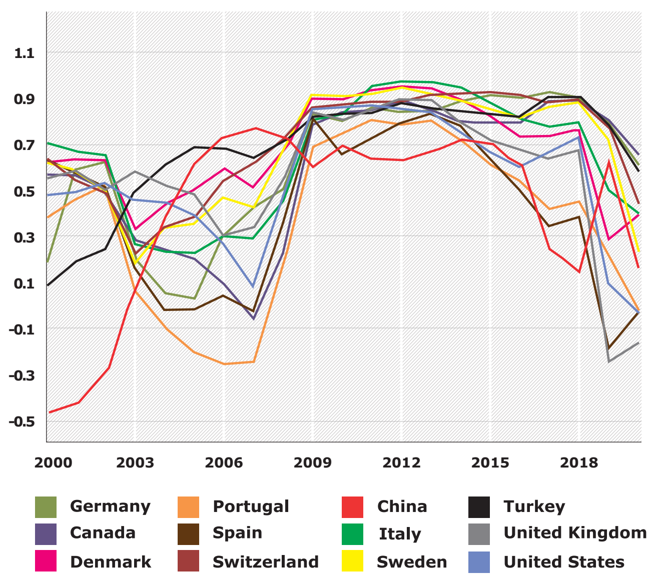
Private investments, when the estimated values are collected in a few months, will be mostly positive, but likely ended their multi-year run of strong performance. One obvious driver to returns was lackluster performance in the public markets and the declining valuation multiples experienced in late 2015 and early 2016. Additionally, we have seen numerous down rounds in venture capital, where additional capital was raised at valuations below prior fundraising rounds, which might reflect a step toward normalizing pricing in later stages of venture capital markets.

Economic Outlook

Global economic growth remains mired in the slowest economic recovery in recorded history and the prognosis does not appear to be improving. Overall, the divergence of economic growth across the globe continues to increase as shown in Chart 3. Important drivers of past global growth, such as China, are slowing, while others, such as Brazil, are in deep recession. Although certain sectors around the globe, such as energy, might be considered in recession, consumer discretionary items are still growing nicely.

Chart 3. Economic Performance for Individual Economies is Diverging

Rolling 10-Year Correlation to World GDP



Source: International Monetary Fund (Data from 2015-2020 based on IMF projections)

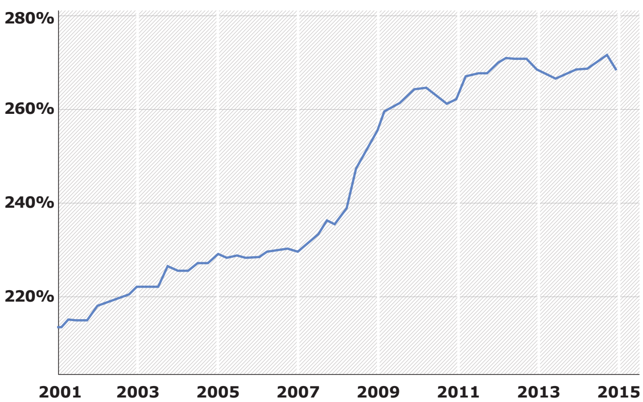
In this divergent world, several economic considerations appear to be the focal point for investors: the potential for a U.S. recession, concerns about a slowing Chinese economy and the related devaluation of their currency, and the impact of declining oil prices.

Slow Global Growth

Before addressing the three concerns listed above, it's important to understand that we continue to live in a slow growth world, which makes it more difficult now to overcome challenges. We believe it is a mistake to view the current slowing growth environment as being entirely cyclical. Structural forces, such as the aging of populations in the developed world and China, and high debt levels continue to create headwinds to growth. As we have described in the past, U.S. consumer debt levels have declined over the last few years, but much of this improvement has been offset by expanding government debt burdens. Further, while aggregate U.S. debt burdens have not increased, other developed countries have continued to increase their debt levels since the global financial crisis, as shown in Chart 4.

Chart 4. Debt Levels Continue to Increase

Non-Financial Debt as a % of GDP



Source: BCA Research

At the moment, the current low level of interest rates ensures that debt servicing costs remain low and, consequently, these high debt burdens are unlikely to cause a crisis in the near future. However, these borrowings are essentially pulling consumption forward and lowering potential future growth rates, increasing the likelihood that we will remain in a muted growth environment for an extended period.

The good news is that the slow-growth environment we have experienced over the last few years avoided many of the typical economic imbalances that we might see in the later stages of an economic cycle, such as tight labor markets or strained capacity utilization. While some might find this to be damning with faint praise, it does come with the benefit of low inflation, which allows central banks to continue their accommodative monetary policy. In the past, most recessions have been triggered, or at least preceded, by significant monetary policy tightening and not by minor policy changes such as the recent U.S. Fed tightening, which appears to be nothing more than a proverbial toe in the water. As a result, despite softer economic readings around the globe, the global economy seems likely to stay in its muddle along mode for the foreseeable future.

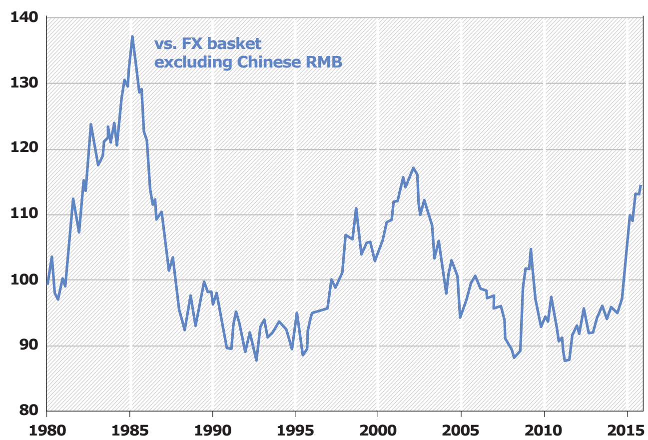
U.S. Economy Heading Toward Recession?

Some analysts are beginning to suggest that the U.S. economy may be heading toward a recession. While the energy sector is likely in full depression and materials and export sectors may be dipping into recession, consumer-oriented sectors appear to be relatively sound. With roughly 70% of the U.S. economy comprised of consumption and services, it seems that a slowing of overall economic growth rather than a broader decline into recession, is likely.

Surprisingly, our discussion of the U.S. economy needs to start with the U.S. dollar. The rise of the dollar over the last few years was one of the sharpest on record, as shown in Chart 5. This dramatic development is having profound effects on manufacturing segments of the U.S. economy that rely on exports for their end markets.

Chart 5. The Furious Rise of the U.S Dollar

Real Effective Exchange Rate, Index, July 2005 = 100

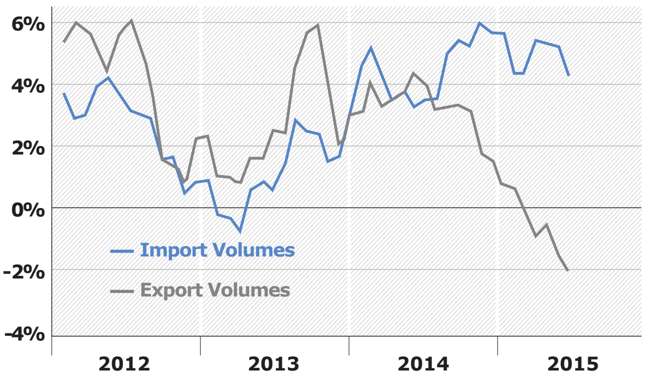


Source: JP Morgan, Bank for International Settlements November 2015

Recent business surveys have shown a widening gap between services and manufacturing activity, as shown in Chart 6. The decimation in the U.S. energy sector combined with declines in export sectors have given analysts good reason to question broader economic growth prospects for the U.S.

Chart 6. The Dollar's Strength Is Hurting Trade

Annual % Change

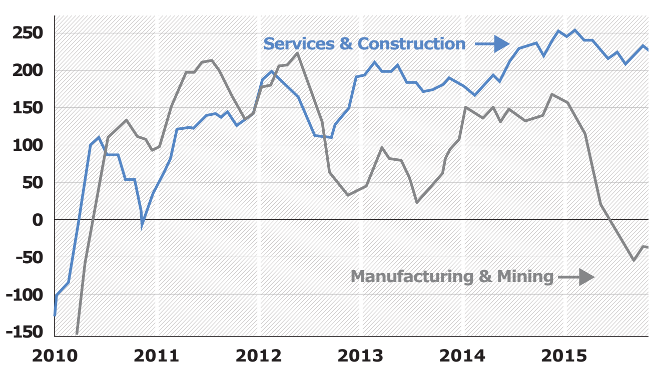


Source: BCA Research

However, the good news is that the consumer remains strong. Consumer spending is healthy in the U.S. and globally, where it is expected to grow between 3% and 4% in 2016. Sustained consumer spending is reliant on growth in employment, wages and consumer credit. American employers added nearly 300,000 jobs in December, the biggest gain of the year and unemployment held steady at 5%. The U.S. economy has added jobs for 63 consecutive months, which is the longest such string on record. And we are witnessing these broader gains despite the contraction in employment in the manufacturing and mining sectors, as shown in Chart 7.

Chart 7. Domestically Oriented Labor Markets Holding Up

Monthly Change in Payrolls, Thousands, 6-Month Avg.



Source: JP Morgan, Bureau of Labor Statistics

As a result, U.S. labor markets are finally tightening and wages are rising. Average hourly earnings were up $0.62 in December, the strongest month-over-month annualized gain of this recovery. Longer-term, we expect continued spending strength as U.S. consumers adjust to the most recent decline in gas prices.

Despite robust consumer spending, we still expect the U.S. economy to slow during 2016. Early estimates for fourth quarter 2015 GDP of 0.7% came in below analysts' expectations and well below both second and third quarter GDP estimates. However, once the energy sector stabilizes, history suggests that cheaper energy should support economic growth and boost demand. As a result, we feel many analysts are overly-pessimistic about the possibility of the U.S. economy falling into recession.

Emerging Markets

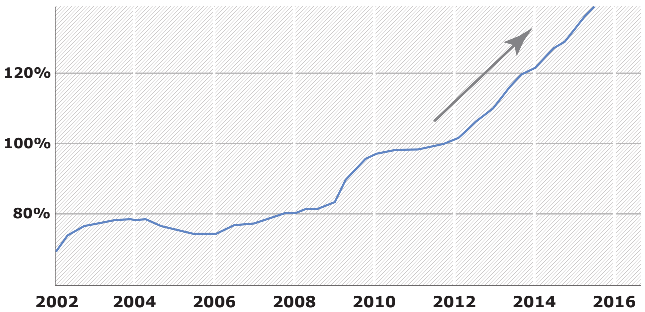
Many emerging market economies have been buffeted by a perfect storm of declining resource prices and the contraction of manufacturing and trade in China. Slowing growth and the related issues of currency declines have given investors just cause for concern.

According to independent research firm BCA Research, the estimated median growth rate for the 152 emerging economies slipped to 3.2% in 2015. Except for 2009, this was the lowest level since the Asian crisis in the late 1990s. The downturn in oil and other natural resource prices is hitting several emerging economies particularly hard. Economically-important countries, like Russia and Brazil, who rely on commodity exports for a significant portion of their revenue, are struggling. Additionally, Brazil's recession, which is entering its second year, is arguably its worst in several decades.

Since the global financial crisis, many countries have squandered the opportunity created by healthy economic expansion to make needed reforms and reduce debt levels. Borrowings and debt levels in some emerging market countries are reaching disturbingly high levels, as shown in Chart 8. Many of these countries, such as Brazil, Turkey and South Africa, are now facing capital outflows and declining currency exchange rates, which makes it difficult to lower interest rates to stimulate growth for fear of exacerbating this condition. This is particularly problematic for those countries with large foreign-denominated debt, as their revenue is denominated in a local currency that is declining while their liabilities are denominated in an external currency that is increasing.

Chart 8. Emerging Market Debt at Elevated Levels

% of GDP



*Source: BCA Research (*GDP-weighted average of 17 emerging countries)*

The good news is that some emerging market countries, to the extent they could control things, learned lessons from the Asian crisis in the late 1990s. Today, the percentage of external debt relative to local-currency denominated revenues is far lower for many countries, making the possibility of a full-blown emerging market crisis and the potential for broader contagion less likely.

While the fears of an emerging markets crisis are overblown, it does appear as if emerging markets will not be the global growth engine that many had hoped might pull the developed economies out of their malaise.

China

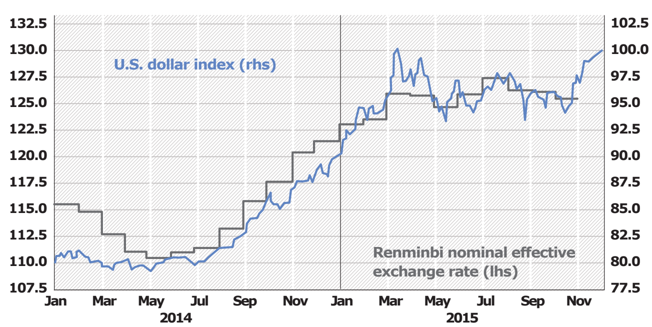
China remains the largest unknown in the emerging markets and possibly the entire global economy. While the Chinese economy is clearly slowing from its 7% growth rate of the last several years and 10% growth rate in the prior decade, its GDP growth rate of 5.5% to 6.5% is enviable by nearly all standards. The primary concerns driving much of the market volatility are the potential depreciation of the renminbi, the related government interventions and the possibility of capital flight that might exacerbate currency declines.

It's no secret that the Chinese government is focused on transitioning from an export and fixed investment-driven economy to one more focused on consumption and services. This transition has been underway for many years and will continue for many more. Consumption has grown from a very low base and one analyst recently estimated that consumption and services now account for over 50% of the Chinese economy. As this transition continues, it is important that the manufacturing and export segments of the economy continue to contribute. Unfortunately, China's currency policy is having a strongly negative effect on achieving this goal.

Historically, the Chinese renminbi has been pegged to the U.S. dollar. Regrettably, the U.S. dollar has experienced one of the sharpest spikes in history over the last several years and the peg required China to intervene in these markets and create a similar increase in the renminbi as shown in Chart 9.1. The change in the renminbi relative to other emerging market currencies is shown in chart 9.2. As a result, large segments of the Chinese economy, particularly manufacturing and exports, have been rendered uncompetitive, similar to the dynamics in the U.S. caused by the rise in the dollar. The recent weakness in the Chinese economy is largely isolated

Chart 9.1. The U.S. Dollar Peg Forced the Renminbi Higher

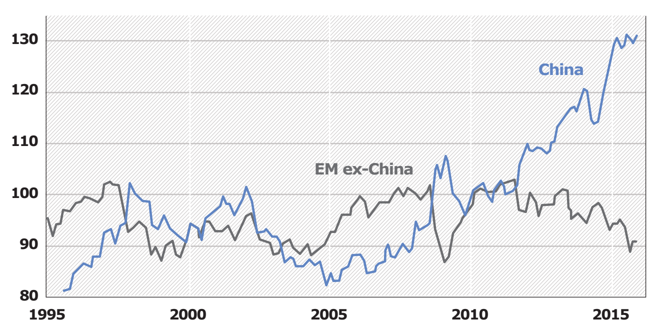
Index



Source: Gavekal Data/Macrobond

Chart 9.2. Renminbi Under More Stress than Other EM Currencies

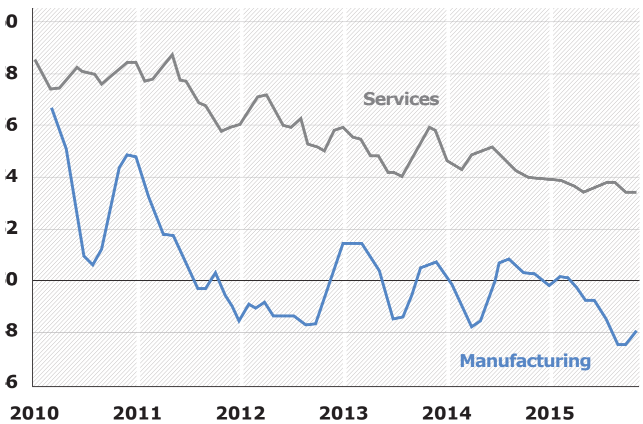
GDP-Weighted Broad Real Effective Exchange Rates



Source: BIS, IMF, JPMAM. November 2015 to these manufacturing sectors, as shown in Chart 10, and most of the overall slowdown in growth can be attributed to the rising currency effects.

Chart 10. Chinese Service Sector More Stable than Manufacturing

PMI, 3-month average (50+ = expansion)



Source: JP Morgan

To remedy this problem, the Chinese wisely chose to shift their currency peg to a basket of currencies rather than linking it strictly to the U.S. dollar. In addition to resetting their currency to a broader benchmark more representative of their global trade flows, it appears the Chinese government is attempting to unwind these recent damaging gains by slowly allowing the renminbi to depreciate.

The challenge for the government is to manage the currency downward to restore competitiveness while not inducing a panic that creates uncontrolled downward pressure on the currency and unintended consequences for the broader economy. As the government has intervened in an attempt to manage an orderly currency level reset, the markets have reacted poorly to the perceived manipulation. The Chinese government appears to lack credibility for the shift to its new trade-weight basket target as it has done a poor job articulating its goals.

For all of its government's gaffes and miscommunications, we still believe the direction of Chinese policy is correct in order to restore the competitiveness of the Chinese manufacturing sectors. Unfortunately, as is typically the case with China's often clumsy reform efforts, we will see it take two steps forward and one step back and experience volatility along the way to a better long-term outcome.

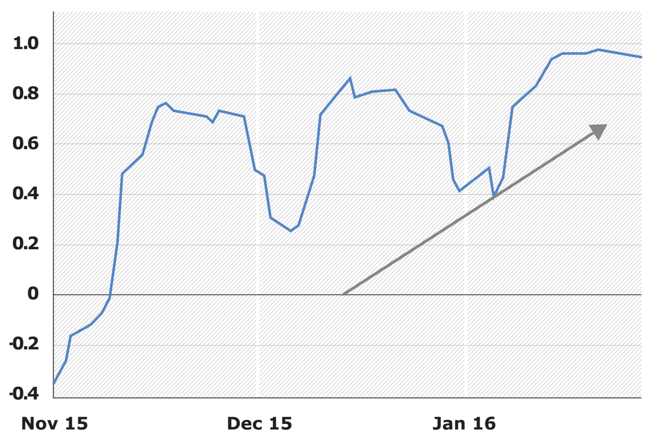
Oil and Energy Markets

Oil prices have dominated economic and capital markets discussions for more than a year to the point where stock market movements over the last few months have become nearly perfectly and positively correlated with the price of oil, as shown in Chart 11. Investors have become fearful of the potential spillover effects that accelerating distress and bankruptcies in this sector could cause on the larger global economy. Ironically, lower oil prices are historically a positive for the global economy, lowering manufacturing costs and increasing effective disposable income for many consumers, implying that the longer-term relationship between oil prices and the economy should be negative.

We continue to believe that oil and gas market declines are largely a supply problem (i.e., too much) rather than a demand problem (i.e., too little). Chart 12 shows both the rig count (new wells being drilled) and oil production from the three largest shale oil fields in the U.S., the Bakken, Eagle Ford and Permian basins. The oil rig count has clearly declined as companies have decreased the drilling of new wells that are no longer economic with the price of oil near $30/bbl. There is a lagged relationship between rig count and production, as shale-based wells tend to begin producing rapidly and then decline relatively quickly. As a result, U.S. shale production is expected to decline sharply in 2016, which is a positive for oil prices, but longer term unknowns, such as supply accelerations by Iran and Libya, cloud this forecast.

Chart 11. Oil Prices are Influencing Capital Markets

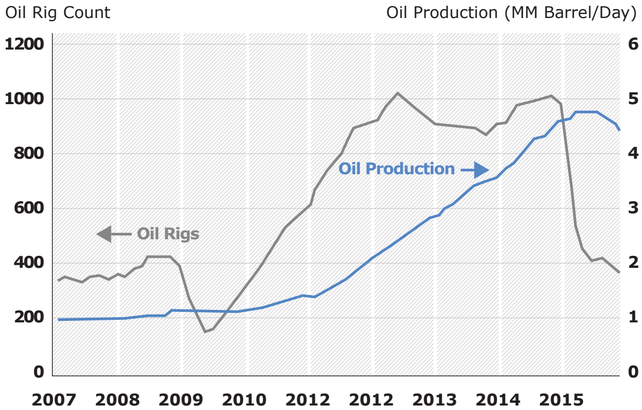
20-day Correlation Between S&P 500 and Brent Crude Oil Prices



Source: Financial TImes, Thomson Reuters Datastream, Paul McClean

Chart 12. Oil Production is Beginning to Decline....

Key U.S. Shale Oil: Bakken, Eagle Ford, Permlan

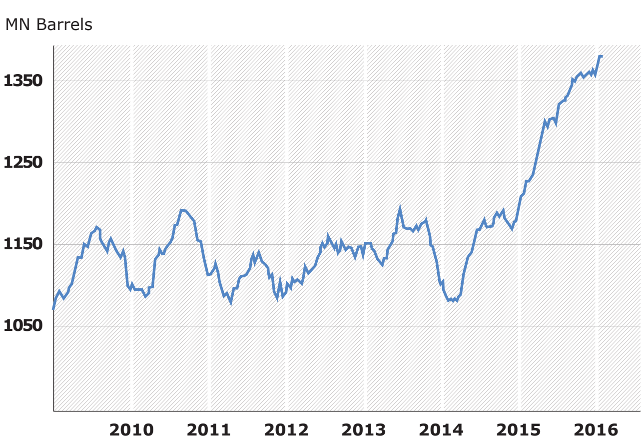


Source: JP Morgan

However, before oil can return to an equilibrium price, the world must work through a significant supply backlog. Oil inventories remain near all-time highs, as shown in Chart 13, suggesting that near-term price relief for producers is unlikely. Most energy analysts believe that the ongoing rationalization of production will begin to diminish inventory excesses during the coming year. Estimates of future oil prices vary widely, but, barring a recession, we believe equilibrium prices will climb above $40/bbl. and possibly above $50/bbl. into late 2016 and 2017. A reset to prices at this level will be beneficial for consumer demand and allow the industry to return to a profitable state, albeit not without short-term economic rationalization that will involve bankruptcies and consolidation.

Chart 13. ...But Supply Remains Elevated

U.S. Crude and Product Inventory



Source: BCA Research

Central Banks: Out of Gas

Late last year, according to Federal Reserve Chair Janet Yellen, we reached "the end of an extraordinary seven-year period." The recent rate increase was one of the most anticipated and telegraphed events in financial market history. It was also surprisingly un-impactful, except to the extent market forces drove the value of the U.S. dollar higher, which in turn had significant effects on U.S. and global economic activity.

Analysts are widely divided on whether raising rates was an appropriate course of action, but it is clear that the stronger dollar and lower oil prices both help explain why the Fed delayed its rate increase as long as it did. Going forward, the Fed has signaled its intention to tighten at a slow pace, projecting four increases this year, but the market is expecting an even slower pace. We expect that further rate increases will be slowed or delayed indefinitely given weakness in the manufacturing sector, the severe problems in the energy sector and low inflation around the globe.

The more important long-term question is whether central banks are "out of gas" in the event of an economic downturn. Over the last eight years, central banks have been very aggressive with monetary policy, primarily in the form of lower interest rates, to fight the residual growth headwinds in the aftermath of the global financial crisis. While monetary policy has been helpful in producing our current meager growth rates, we have likely reached the limits of its effectiveness. The ability for lower interest rates, below their current near zero and sometimes negative levels, to trigger increased lending is unlikely and the wealth effect of increasing asset prices appears to be reaching a ceiling. Reaching the limits of monetary policy effectiveness raises the worrying question: "What impact can monetary policy have in the event of an economic downturn?" Fortunately, this is not a question that we will likely need to answer in the very near-term, as the answer of "Nothing" is not very appealing.

Capital Markets: Too Much Gas

As a result of accommodative central bank policies, capital markets are suffering from "too much gas," as easy money has created elevated valuations in most segments of the capital markets. Whether markets unwind these excesses quickly, as we glimpsed in January, or slowly through earnings growth and valuation normalization, investors should recognize that investment returns over the next few years will likely be below historical averages. However, we still believe attractive investment opportunities are available.

Fixed Income: Interest Rate Markets

The macro environment remains supportive of fixed income investments. A slow growing global economy allows central bank policies to remain accommodative and keep interest rates low. While the Fed has begun the process of normalizing interest rates, other central banks remain focused on easy monetary conditions to stimulate growth.

In the U.S., interest rates have been well behaved in the aftermath of the first Fed tightening, with the ten-year Treasury bond trading just below 2%. Over the last few years, many analysts had become concerned about the unknown impact on fixed income markets from the Fed beginning to unwind its bloated balance sheet. Further, there is no reason to believe that U.S. Treasury yields will rise much in the immediate future, given the slow growth and low inflation we are currently experiencing along with the modest pace of Fed rate hikes expected over the next year.

Globally, interest rates are even lower across most European Union countries, as shown for three of them in Chart 14. In Germany, yields are negative out to nearly ten years and BCA Research estimates that roughly 40% of all European government debt across all maturities is trading at negative yields. It seems inconceivable, but Italy, despite all of its problems, can borrow for ten years at interest rates 70 basis points below the U.S. and a country like Portugal is not far behind. These low-yields are uninspiring conditions for debt investors or more broadly savers in the global economy.

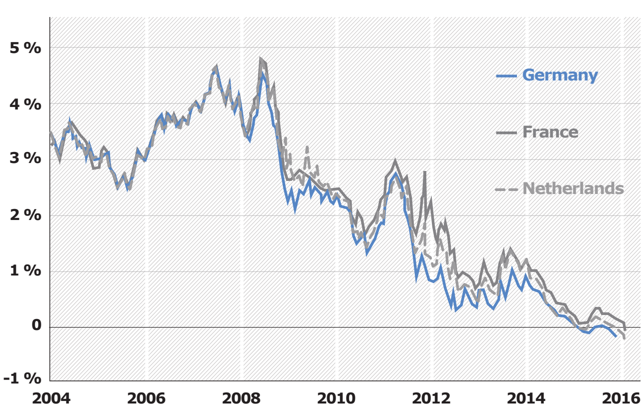
Fixed Income: Credit Markets

In U.S. credit markets, such as corporate and high-yield debt, spreads have widened. As a result, these areas were among the worst performing asset classes in 2015. The Barclays U.S. High-Yield Index declined 4.5% in 2015, and the lower rated segments of this universe declined 15% or more. For years, we have cautioned that tight credit spreads provided a poor investment proposition for investors and credit oriented investment should be minimized. This advice has benefited investors for several years, as low returns have now given way to widening spreads and losses for investors.

Do these markets represent good value at this point? Certainly things have improved, but they don't appear to be anything more than average relative to historic norms. Chart 15 shows high-yield debt spreads over the last few decades. While spreads have generally widened over the last few quarters, it is the energy sector that has experienced the largest widening, resulting in losses for investors.

Chart 14. European Funding Costs at New Lows

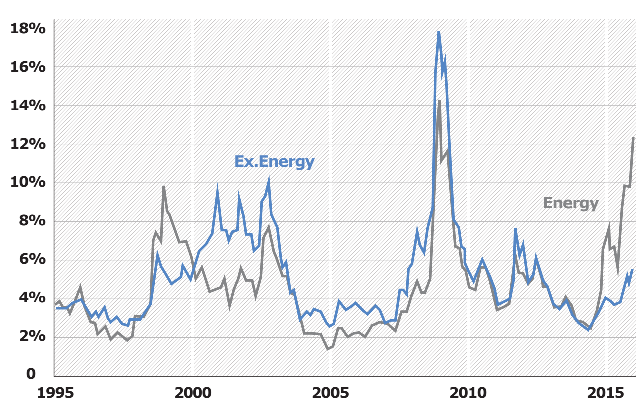
5 Year Bond Yields



Source: Bloomberg

Chart 15. Energy Credit Markets are Not Cheap

U.S. High-Yield Corporate Bond Spreads



Source: JP Morgan Spread to Worst Over 10-Year Treasury

Compounding the impact of losses in the energy sector is the surge of below-investment grade issuance in this sector over the last few years, which has increased the overall percentage of energy debt in the high-yield market. High-yield issuance by energy companies is up 5x or more from "normal" levels in the 1990s and 2000s. As a result, energy company debt as a percentage of the high-yield market increased from under 4% in 1999 to nearly 20% in 2014.

More broadly, the two most troubling aspects of today's debt markets are the systematic erosion of creditor protections and the potential lack of liquidity driven by implementation of the Volker Rule, which is causing banks to reduce their market making and positioning capacity in debt markets.

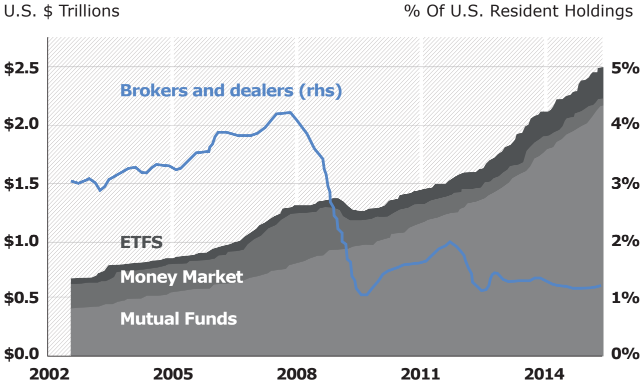
Bondholder protections, in the form of covenants, have reached an all-time low. Covenant-lite loans represented 70% of U.S. loan issuance in 2015. We were concerned about the level of issuance instituted just prior to the financial crisis when covenant-lite loans constituted roughly half of this level, but current underwriting standards imply that a lack of investor protection is becoming the rule, rather than the exception.

Even more concerning, and possibly the most important reason to avoid debt markets at this point, are the regulatory changes that have severely restricted bank activities in these markets, causing bid/ask spreads to widen and liquidity to dry-up. Chart 16 shows bond holdings by investor type. As bond holdings by traditional investors, such as mutual funds and ETFs, have continued to rise, broker-dealers have systematically reduced their inventories. We have yet to fully test this lack of liquidity, with the possible exception of recent stress in the energy sector, but we believe that further stress on the debt markets could create unexpectedly high mark-to-market losses. The silver lining to this bleak scenario is that it might provide a more attractive entry point for investors.

Chart 16. U.S. Retail Investors Continue to Buy Bonds

U.S. $ Trillions

% Of U.S. Resident Holdings



Source: JP Morgan, Bank of International Settlements (BIS)

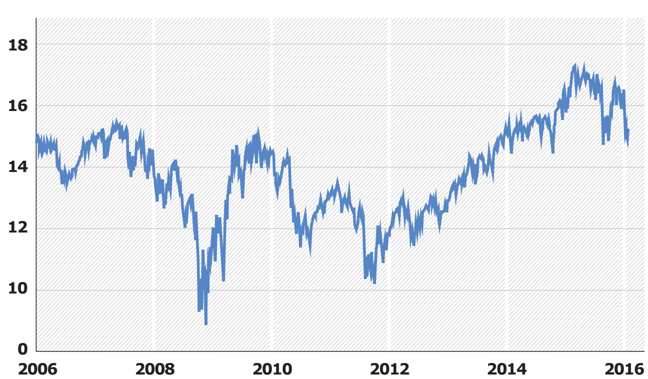
Global Equity Markets

It is quite common for equity markets to experience weakness at the beginning of a central bank tightening period. While the recent Fed tightening was mild, this time was no exception as world markets declined over 10% in January after a lackluster 2015. With stretched valuations, historically high corporate profit margins, slow earnings growth, high margin balances and severe stress in the energy sectors, investors are nervously reacting to even the slightest hint of bad news. High volatility is the new normal while these stretched conditions remain in equity markets.

Equity market valuations, even after the recent correction, remain elevated. During the lows of January, the S&P 500 reached a multiple of forward four-quarter earnings estimates close to its ten-year average of 14.7x forward earnings, as shown in Chart 17. Even with a market rebound from those recent lows, we can still confidently state that the U.S. equity market is not cheap.

Chart 17. U.S. Equity Valuations Remain Elevated

S&P 500 Forward P/E



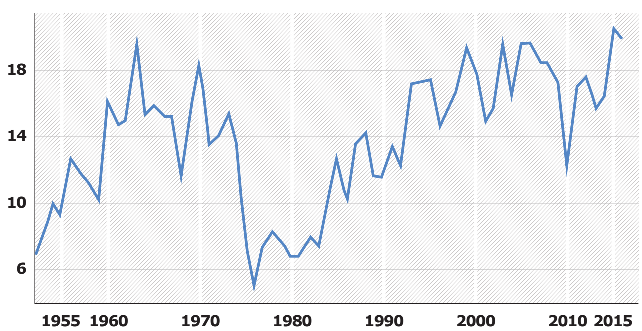
BCA Research

Further, as we described in our 2015 Mid-Year Update, examining the median valuations may be more instructive than looking at the S&P 500 Index, which disproportionately weights larger companies. By this measure, as shown in Chart 18, U.S. equity markets appear even more expensive. All things being equal, this would suggest there is less value in smaller stocks and the breadth of overvalued stocks is much higher than during the technology bubble 15 years ago.

Corporate earnings also remain a concern. S&P 500 earnings for the fourth quarter of 2015 are predicted to decline for the third consecutive quarter. This continues a trend we have witnessed over the last few years of ongoing deterioration in analysts' forward looking earnings estimates, as shown in Chart 19. However, there is some consolation for the broader economy. Excluding energy, where operating earnings were expected to be negative for first time since data was collected in 1967, S&P 500 earnings were expected to grow 5% for the year.

Chart 18. Median Stock Valuations are Still Expensive

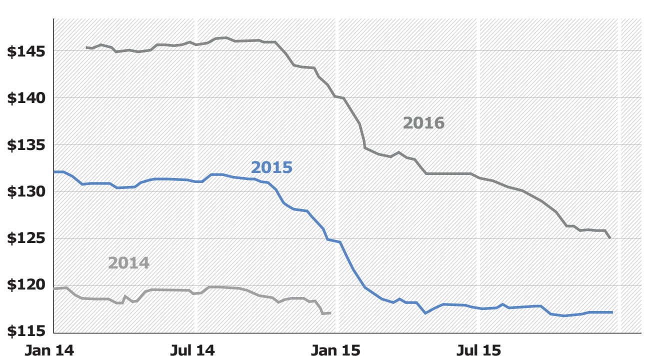
U.S. NYSE: Median Price-to-Earnings Ratio



Source: Kenneth French Database, Dartmouth Tuck School of Business

Chart 19. Earnings Forecasts Continue to Decline

Consensus S&P 500 Earnings per Share Forecasts

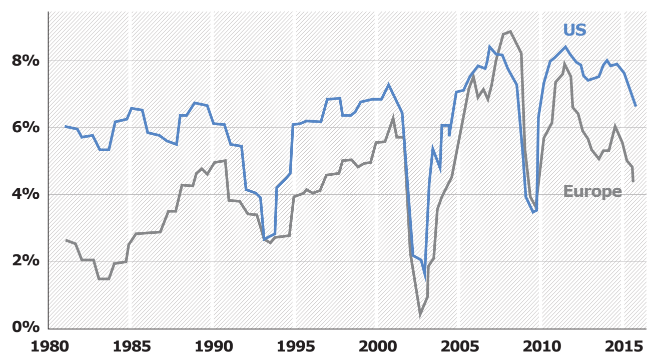


Source: JP Morgan, Thomson Reuters IBES

Equity valuations are generally less stretched outside the U.S. Currently, European equities trade at a 15% P/E discount to the U.S. Additionally, European profits have more room to rise given that profit margins are close to long averages than in the U.S., as shown in Chart 20. Margins in Europe, which converged with those in the U.S. from 2005 to 2010, are now two percentage points, or over 30%, below U.S. margins. For equity investors, ensuring global diversification within their portfolio at this point in the cycle is important, as it appears better relative opportunities may lie outside the U.S.

Chart 20. Europe Is Providing Opportunities to Improve Profitability

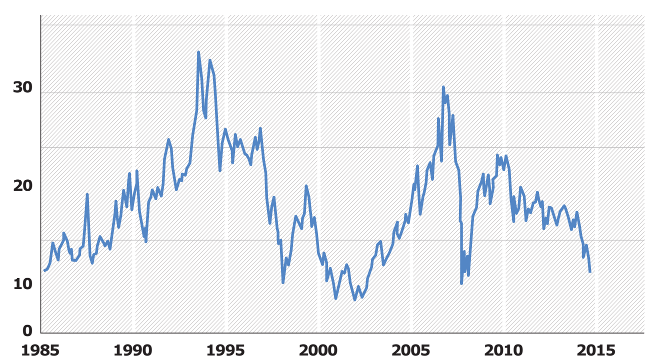
Net Profit Margin (Ex-Financials)



Source: JP Morgan

Chart 21. Emerging Market Valuations at Trough Levels

U.S Cyclically Adjusted P/E Ratios



Source: BCA Research

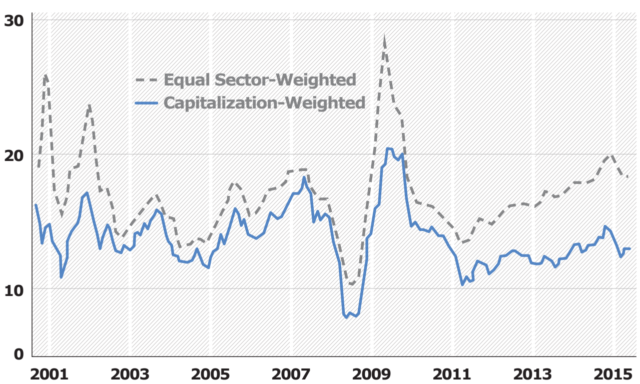
Emerging Markets Equity

Price-to-earnings ratios in emerging markets remained relatively depressed. According to BCA Research, cyclically-adjusted price-to-earnings ratios have reached their lowest level since 2008, as shown in Chart 21. Equity market declines of 15% contributed to these markets becoming more attractively valued, but the effect was partially offset by lackluster earnings for many of the big benchmark companies in these markets. Additionally, declines in some emerging market currencies contributed to poor performance for U.S. investors, but did not make these stocks any cheaper. For context, in local currency terms emerging market equities declined just under 6%, indicating that much of the declines were driven more by currency declines rather than simply corporate earnings or equity market selling.

As is always the case with emerging markets, the question of valuation across these diverse economies and sectors is not easy to ascertain. For example, differentials in valuations across sectors and countries within emerging market countries remain at their widest levels, as shown in Chart 22. Valuations on an equally-weighted sector basis are attractive relative to other opportunities around the globe, but not nearly as attractive as the traditional capitalization-weighted indices would imply. These valuations can be misleading to investors who attempt to generalize across these markets. Some of these companies are worthy of investment, but many others are poorly run, state-owned enterprises facing energy-related headwinds that are fundamentally damaging their historical business franchises. These are difficult markets for most investors to understand and exploit effectively.

Chart 22. Not All Emerging Markets are Cheap

Emerging Markets Forward P/E



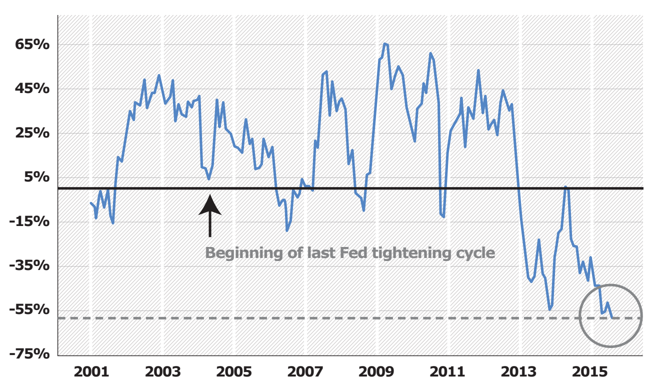
Source: BCA Research

Our clients will remember that our more recent interest in publicly-listed emerging markets, in contrast to our long-standing and ongoing interest in private equity and venture capital investments in China, increased significantly in 2014 with the formation of a dedicated emerging market equity strategy. From a top-down perspective, our timing appears to have been early, but our implementation (related to specific investments) nearly made up for the declines in the overall market. We believe the value of true active management, rather than traditional benchmark hugging approaches, in these very inefficient markets proved its worth during the difficult period in 2015.

Have emerging market equities corrected enough? It's hard to pick the bottom, but it is clear that investor sentiment is terrible and the outflows from these markets remain extreme. Capital flows in emerging markets as a whole experienced their first year of overall outflows in 27 years. Further, a recent poll of global emerging market fund managers showed their most bearish sentiment on record. After being overweight for the past 15 years, these managers are now underweight by over 50%, as shown in Chart 23. Many individual frontier and emerging country markets are trading close to their 2008-2009 lows.

Chart 23. Fund Managers are Leaving Emerging Markets

Relative Weighting of Emerging Makets vs. Developed Markets in Global Funds



Source: Bank of America Merrill Lynch Institutional Investor end of year survey

Investors who are willing to wade into these markets should do so with a multi-year investment horizon. We continue to advise that investors should avoid traditional, western-style benchmark hugging strategies common to mutual funds, separate account managers and ETF investments, which disproportionately overweight large inefficient companies.

Within emerging markets, the Chinese stock market was the ultimate rollercoaster, partially inspiring the title of our 2015 Mid-Year Update: *Rollercoasters*. Building on strong gains from 2014, the market increased 60% in the first half of 2015 before plunging 40% in the following three months. We won't recap our more detailed discussions of the causes of the declines in Chinese equity markets, except to say that these markets are highly inefficient and present great opportunities for fundamental investors who can exploit oversold situations. We continue to believe that the Chinese government is committed to capital market reforms, but this will be a long process for investors. The ability to have a long-term perspective and endure periods of high volatility are required to exploit these inefficiencies as we have successfully experienced over the last few years.

Hedge Funds

Hedge funds, while not an asset class per se, continued to produce underwhelming performance for investors in 2015 with the HFRI Fund Weighted Index declining 1%. As a group, hedge funds have not outperformed U.S equities since 2008 and investors are increasingly becoming frustrated with their hedge fund allocations. According to EVestment, hedge fund inflows for 2015 were just $44 billion, a decline of roughly 40% compared to the previous year.

Despite lackluster performance, hedge fund managers remain in control of an estimated $3 trillion of capital and the industry's growth, both in terms of capital and people, has resulted in pronounced "crowding effects" as more managers share the same portfolio holdings. The consequence is readily apparent during periods of market stress when managers look to reduce exposures at the same time, which compounds selling pressure and exacerbates price declines. We witnessed this dynamic in late August and September, as market stress triggered an unwind not only in acknowledged crowded positions, but also in less-crowded stocks as a follow-on effect of general hedge fund selling.

On the bright side, indiscriminate selling often creates attractive entry points for managers to buy fundamentally sound companies that should lead to strong future returns. The crowding effect has added an additional risk factor for hedge fund investors and short-term performance has become more volatile, sometimes even more volatile than equity markets themselves. When this crowding dynamic is in effect hedge fund investors who believe that these strategies will provide downside protection for their portfolio as they might have in the past, are likely to be disappointed.

While overall results for hedge fund returns were poor, there are always managers and strategies that are able to buck the trend. In 2015, manager performance dispersion was particularly wide. According to Morgan Stanley, the performance dispersion between top and bottom decile managers was a whopping 25 percentage points, proving that manager selection in hedge funds matters more than in any other marketable securities strategy area. It is our belief that investors who only have access to "average" hedge fund managers are bound to be disappointed by their investment results and the high fees that they pay. As a result, they should consider avoiding the area entirely.

Private Investments

2015 was another very active year for private equity investments and transactions, particularly in the U.S., and it was most acute among the larger deals. Elevated public markets valuations and easy availability of financing encouraged many managers to transact at high entry valuations. Moreover, large institutional investors have lowered their returns expectations for private equity investments in conjunction with lower expected returns from public equities, which has negatively affected the risk/reward proposition for private equity investors.

Unfortunately, there has been a spillover effect of high valuations in large private equity deals into mid-market deals. For the discriminating managers in this area whom we prefer, the effect on our portfolio is slower capital calls as managers invest at a slower pace, and higher distributions as managers sell more companies. As frustrating as this might be for investors attempting to build positions, we support our managers' prudent approach as the alternative can produce disastrous investment results.

While valuations in U.S. large and now middle-market transactions have become elevated, we continue to find opportunities in less trafficked areas. We have made selective commitments to distressed/turnaround managers, which could be productive if default rates and general corporate stress continue to rise. We also have found opportunities in Europe due to challenged banking systems, regulatory changes and less efficiently managed legacy companies. Additionally the volatility in Asian public markets in 2015 resulted in opportunities for select private equity investments, such as take-private deals.

In venture capital, 2015 was a very active year. The frenzy was most acute in later stage investments as non-traditional venture capital investors flocked into the space belatedly attempting to capture the success of technology companies from the last few years. Even in venture capital, valuation discipline is important to ensure that investors are rewarded for the high risks they are undertaking. We continue to focus our venture investments in higher quality startups at relatively earlier stages both in the U.S. and China.

Investment Themes

It was a challenging investment environment throughout 2015 and especially during the first few weeks of 2016. We expect the coming year to be equally challenging. Investors will face high valuations, slow global growth, a challenged profit growth environment and continuing distress in the energy sector, all of which are causes for concern. Further, geopolitical risk in the Middle East, Europe and many emerging market economies may provide the spark for new market episodes. As a result, we expect the capital markets to experience elevated volatility and periodic declines that will challenge investors to remain committed to their long-term investment approach.

With that background, we offer the following investment themes to guide investors:

- Cash offers poor long-term returns, essentially guaranteeing a loss to the purchasing power of assets. However, some investors may want to consider modestly increasing cash balances to ensure they avoid selling during periods of market decline.

- Bond markets offer similarly un-compelling long-term returns due to low interest rates and limited prospects for further price appreciation. This has been the case for the last several years and we continue to recommend that investors eliminate or reduce fixed income holdings to the extent feasible within the constraint of their investment policy and risk tolerance.

- One caveat on the unattractiveness of low interest rate sovereign debt is the potential protective nature of such an allocation. As we have entered a more volatile world subject to an increasing frequency of unanticipated market shocks, owning high-quality sovereign debt, such as U.S. Treasuries, can provide protection during these periods. While expected yields and returns for these bonds are low or even negative, this still might be an appropriate strategy if it is the only defensive strategy within a portfolio, i.e., it can be viewed as the purchase of portfolio insurance.

- Despite recent spread widening, credit markets, such as corporate and high yield bonds, still do not appear to offer compelling value. In the energy sector, where spreads have widened the most, investors should be very selective, as moving up in the capital structure (e.g from stocks to bonds) only offers investor protection if the value of the underlying asset is preserved through the distressed period. This may not be the case for some energy assets that are not economically viable with lower oil and gas prices.

- The question of currency exposure has become centrally involved in decisions to invest in some regions or countries outside the U.S. While this has always been a consideration, increasing divergences in economic cycles and central bank policies are creating an even greater challenge. We believe this also creates opportunities as many currencies, such as the Brazilian real, have already depreciated significantly.

- Global equity market valuations remain stretched and profit growth remains challenged. This is particularly true in the U.S. Investors should maintain lower return and higher volatility expectations for equity allocations. We continue to recommend caution by rebalancing portfolios to capture gains frequently and perhaps reducing overall equity exposure in favor of lower-volatility, less-correlated alternatives.

- Non-U.S. equity investments offer more compelling valuations and better potential for corporate profit margin expansion. Global equity portfolios should be tilting in this direction after years of U.S. equity markets' outperformance. Once again, currency considerations are important, but the recent historic rise in the U.S. dollar supports this shift as well.

- Our recommendation to begin overweighting emerging market equities appears to have been premature based on relative performance in 2015. However, many of these markets now appear to be closer to a point of capitulation resulting from large investor outflows. Valuations are more attractive than for developed equity markets, but economic cycles among these economies remain highly divergent. Currency considerations and a long-term investment horizon are particularly important in these allocations. As we always caution, emerging markets should not be considered a homogenous economic group or single asset class given the wide diversity across these countries. As a result, we believe true active management in these markets is a requirement, not an option.

- Hedge funds should remain a core allocation for a portfolio in this part of the investment cycle and investors should look to increase their exposure, but only if they have access to high-quality investment solutions. Well-structured portfolios with highly capable managers can exploit volatility and market dislocations to provide equity-like returns with much less market exposure. On the other hand, allocations to median (read "mediocre") managers often found on typical open-architecture platforms of banks and broker dealers undermine the purpose of this allocation through poor performance that does not remotely justify their higher fees. If this is the opportunity set available to investors during the volatile markets ahead, they might do better remaining in cash.

- Private investments remain a core allocation within a portfolio. Once again, this is an area where the quality of the implementation (i.e., manager selection) is at least as important as the allocation itself. Within private investments, we remain concerned about late stage venture and larger buyout valuations. We have become more interested in Europe, given the relative lack of competitive capital, and distressed emerging markets, such as Brazil. Our interest in China, particularly in early venture and growth capital, which has been very productive thus far, remains high.

In sum, caution should be investors' *modus operandi*. Specifically, this means investors should avoid excessive use of leverage and evaluate risk and pricing in absolute terms to avoid the most overvalued areas of the capital markets. Contrarianism should once again be a fruitful approach, remembering that just because a market or an asset has declined does not mean it is an attractive opportunity. And now, maybe more than ever as we move from a beta driven market to more of an alpha driven market, it is important for investors to have access to very talented, experienced and thoughtful managers who focus on producing performance rather than growing assets under management.

About Gresham

Gresham Partners is an independent investment and wealth management firm that serves its clients as a multifamily office and an outsourced chief investment officer. Gresham has been serving select family offices, foundations and endowments since the firm was established in 1997. Today, we manage or advise on over $4.7 billion for about 80 clients located nationally. A copy of Gresham's Client Composite performance record is available upon request. Past performance is no guarantee of future results.

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