777 Third Avenue | New York, NY 10017 | USA | tel. +1.212.355.1234 | fax +1.212.355.8873

Stock Market Development in Q 1

It has been a very tough start for the year, which says a lot about the turmoil in the markets in China reflecting their underlying issues, and the effect on US companies. While exports are 13% of GDP and manufacturing is less than 20% of the US economy, it is a much higher percentage of the profitability of the companies comprised in the S&P 500 TRA Index. So when there is weakness, in particular outside the US in China and other emerging markets it affects US companies, their profitability and their markets, to a greater degree than it might affect the underlying economy. Furthermore, we are in a year of election mania, very modestly rising interest rates in the US, and unresolved questions about the price of oil. Investors react mainly to corporate profits and expectation of corporate profits. Corporate profits were down in 2015 and the trend for 2016 is expected to be somewhat lower. Global growth is expected to be sluggish and uneven in 2016. The net effect of all these developments has been intense volatility at the beginning of the year with the market correcting by 10% followed by a month of recovery and placidity to end the quarter flat. With the impending election noise, we may be in for more of the same skittishness.

Bond Market Development in Q 1

Recession worries and central-bank stimulus in Europe and Japan led to a rally in global debt markets. Bonds worldwide were up 3.1% in Q1 (America Merrill Lynch Index). In the US the 10-year Treasury yield dropped from 2.27% on Dec. 31 to 1.83% with a total return of 3.7%. The demand was driven by slowing global economies and turbulence in stocks and currencies. We do not expect the 10-year treasury yield to go above 2% as we believe demand will remain brisk. Investment –grade corporate bonds returned 3.1% narrowing the spreads to treasuries from 1,75% to 1.47%. With inflation in check and the Fed taking a gradual approach to raising interest rates, the corporate bond market, both investment grade and high-yield, should continue to do well. Selection and dollar-cost averaging are key as markets will remain volatile in our opinion.

Federal Reserve Bank Policy Outlook

It is imminent that central bank policies in most industrial countries with the exception of the US, consisting of QEs and artificially negative interest rates, successfully stimulate their economies. Unless real growth and inflation can be raised to levels that allow central banks to normalize interest rates the markets are likely to be under pressure as high yield bond and equity risk premiums as well as valuations have not adjusted to this paradox of artificially low interest rates. In the US the development is different as labor markets and inflation are tightening. In most metro areas, the unemployment rate is around 4 to 4.5%, lower than the average of 5%. Average inflation tends to rise gradually as unemployment declines and accelerates as the jobless rate moves below 4%. For now the Federal Reserve Bank cut their projected pace of 2016 interest rate increases in March to two from four forecasted last December and left rates unchanged as global economic development is posing a risk to growth, and to help spur price pressures in the US as there still remains an overall weakness in the link between improving labor markets and wages. This is is likely to change and the Fed will have to balance their rate decisions carefully to accommodate the different developments in the US versus the rest of the world. We expect the next rate hike in June.

U.S. Economy

Q 4 GDP was revised up from 1% to 1.4% as recreational consumer spending, in particular, rose 14.2%, which was weather related and is unsustainable in our opinion. Q1 GDP is expected to be soft, however, there is a disconnect between GDP and the employment growth, which confirms that growth is not in jeopardy at this juncture of the business cycle. Non-farm job creation of more than 200 K on a one month average is more than enough to keep up with the gains in working-age population.

Corporate Profits

Corporate profits fell 7.8% in Q 4, 11.5% y o y with weakness in manufacturing and utilities and losses in petroleum and coal products. Domestic profits fell mostly, overseas profits declined 1,7% mainly due to the strength in the dollar. Profit margins continued to shrink in the fourth quarter, falling from 8.3% to 7.5%, the lowest since 2009 and nearly 2.5 percentage points below their cyclical peak. Historically, this happens a few years before a recession. However, some of the recent decline is likely because of the appreciation in the U.S. dollar and the struggles of the energy industry. Still, margins have compressed, which is normal at this phase of a business cycle.

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TN Outlook

We view the overall market as slightly undervalued at this point. The financial services, consumer cyclical, and healthcare sectors are the most undervalued, while the basic materials sector is rather overvalued. Oil price concerns are hurting the financial services sector, while China is in a transition towards a consumer driven economy and as a result there will be less demand in basic materials. The financial services sector is by far the most undervalued. While energy-related credit losses, currently low interest rates, and possible interbank contagion, remain a concern, we believe fears are exaggerated and priced in as most banks' exposure to the energy sector is ultimately manageable. The increasing political rhetoric calling for lower drug prices has weighed on the healthcare sector which is significantly undervalued. We expect pricing power for drug and biotech companies to remain strong, and mergers and acquisitions continue at a rapid pace as large conglomerates look for growth avenues and opportunities to cut costs and taxes, while cash levels continue to build. Excellent clinical data in specialty-care areas such as oncology and immunology are showing an increase in the productivity of drug and biotech companies. We expect U.S. interest rates to remain historically low for an extended period. Investors continue to see the U.S. as a relative safe haven for investment capital, which has actually helped compress 10-year U.S. Treasury yields roughly 40-50 basis points since the beginning of 2016 to historical lows of roughly 1.8%. That said, most REITs are in a much better position to weather potential broader economic turmoil as many are now well capitalized with long-term, low-cost debt. Also, many REITs benefit from long-term leases that can potentially be re-leased at higher current market rents, providing income growth. Lastly, many have traded out of weaker assets into assets with better long-term growth prospects. REITs provide a good alternative to fixed income investments in our opinion. We are also investing in preferred stocks that convert into floating rate notes at a certain point. Especially in the depressed finance sector good value is to be found with yield, in excess of 5% ytc, and solid investment grades. Overall this market remains a stock picker's market in areas that look attractive. Prudent market timing and dollar cost averaging remains important to risk diversify in these continuous volatile markets.