2016

Investment Outlook

David L. Donabedian, CFA Chief Investment Officer

ADDITIONAL CONTRIBUTORS:

Gary E. Pzegeo, CFA Head of Fixed Income
Bryan G. Reilly Senior Investment Analyst
Ohm Srinivasan, CFA Senior Investment Analyst

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Change is in the wind. After a challenging 2015, we expect the investment landscape for 2016 will be defined by a new course for monetary policy and political leadership, a new primary catalyst for stocks and an altered roadmap for credit markets and for energy.

In the paragraphs that follow, the Atlantic Trust Asset Allocation Team discusses five key themes that we believe are critical to the outlook. We conclude with our Portfolio Takeaways—specific views on positioning for what promises to be a year of change, complete with surprises and volatility.

Exhibit 1: Returns in 2015 Were Stagnant—Or Worse

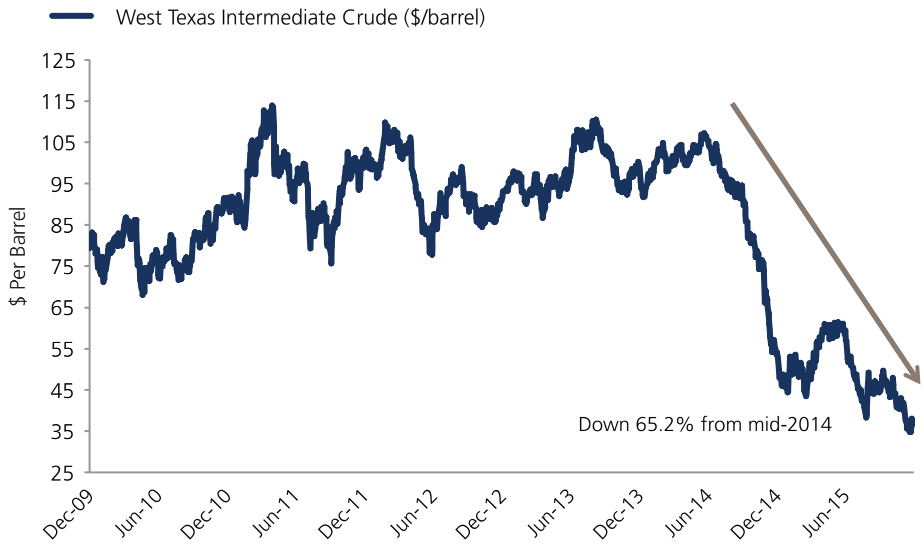
Total Returns as of December 31, 2015	Calendar Year 2015
Stocks	
U.S.	1.4%
Developed International	-0.8%
Emerging Markets	-14.9%
Bonds	
Long-Term Treasuries	-1.2%
Intermediate Govt/Corp	1.1%
Corporate High-Yield	-4.6%
Commodities	
CRB Commodity Index	-23.3%
Oil (Brent)	-45.6%
Gold	-10.9%

Source: Bloomberg, L.P., MSCI.com as of 12.31.2015. Indices used are S&P 500, MSCI EAFE, MSCI Emerging Markets, Barclays U.S. Agg Long-Term Treasury Total Return Index, Barclays Intermediate U.S. Govt/Credit Total Return Index, BofA Merrill Lynch High Yield Master Index, Bloomberg Commodity Index, Bloomberg Brent Crude Oil Total Return and Bloomberg Gold Subindex Total Return.

LOWER ENERGY PRICES: SEARCHING FOR THE BOTTOM

Since the cyclical peak in June 2014, the price of oil has plummeted from $105/barrel to as low as $35/barrel in December[1]—a decline of more than 65%. This has not yet provided a lift to the U.S. economy as a whole, which continues to grow at the same mediocre rate as when oil was above $100/bbl.

Exhibit 2: West Texas Intermediate Crude Oil Price



Source: Bloomberg, data as of 12.28.2015.

Equity markets have not welcomed the energy price decline with open arms, either. The S&P 500 is up just marginally since mid-2014, while international developed markets are down and emerging markets have suffered steep double-digit negative returns.

Much has been written about the U.S. energy boom of the last decade, and with good reason. Ten years ago, U.S. oil fields were pumping less than 4 million barrels per day. Today, that figure is more than 9 million per day.[2] Along with significant expansion of natural gas output, this rebirth of the energy industry has been one of the few sources of strong economic growth coming out of the Great Recession. That also means, however, that when the sector comes under pressure, it can be a bigger drag on the economy. That was the case in 2015, as the plummet in prices led to layoffs and huge cuts in energy capital spending projects.

Looking ahead, we anticipate that consumers may spend more of their energy savings in 2016, providing a bit of a lift to the economy. However, we likely have not yet seen the bottom of the energy capital spending cycle.

There are many fundamental and technical factors behind oil prices being a headwind for the stock market, but the most important reason may be psychological. The extent of the oil price decline, as well as intense weakness in most other commodity prices, has taken investors by surprise. It begs the question "If the bottom is falling out of prices, is the bottom falling out of demand for everything across the globe?"

Currency markets have seen significant shifts due to the inverse relationship between oil prices and the U.S. dollar. The stronger U.S. dollar is a form of tightening for the economy, as it slows exports and lowers imported inflation. Meanwhile, the related declines in many emerging market currencies have boosted the liabilities of their foreign obligations and prompted capital flight risk.

Credit markets have also been impacted negatively in recent months (see next section). In short, the significant decline in energy prices has been a destabilizing force for global financial markets.

When it comes to the oil market, identifying the primary reason for the 65% price decline is key to figuring out what the future looks like. We believe the key is an unprecedented set of circumstances on the supply side of the market. As previously mentioned, there has been a huge increase in U.S. production over the last decade. Even with the plummet in price, production levels have remained stubbornly high. The international supply story is even more dramatic. In early December, OPEC adopted an "every country for itself" philosophy. At least for now, OPEC has ceased to be a cartel, and pricing discipline has been forsaken.

Meanwhile, demand for crude oil has *increased* continuously since 2009. As of November, global demand for crude was growing 2.3% vs. a year ago.[3] This is why we are not inclined to view the energy price decline as a "canary in the coal mine" foreshadowing a global recession.

Where does this leave the outlook for oil prices? As this year progresses, we expect to see supply and demand come into better balance. It may take a couple of years to clarify, but we envision that an equilibrium price of $55-$65/barrel will re-emerge. This is well above current prices, but also well below the levels of 2011-2014, when oil breached $100/barrel on a regular basis.

CORPORATE CREDIT: FLASHING YELLOW OR RED?

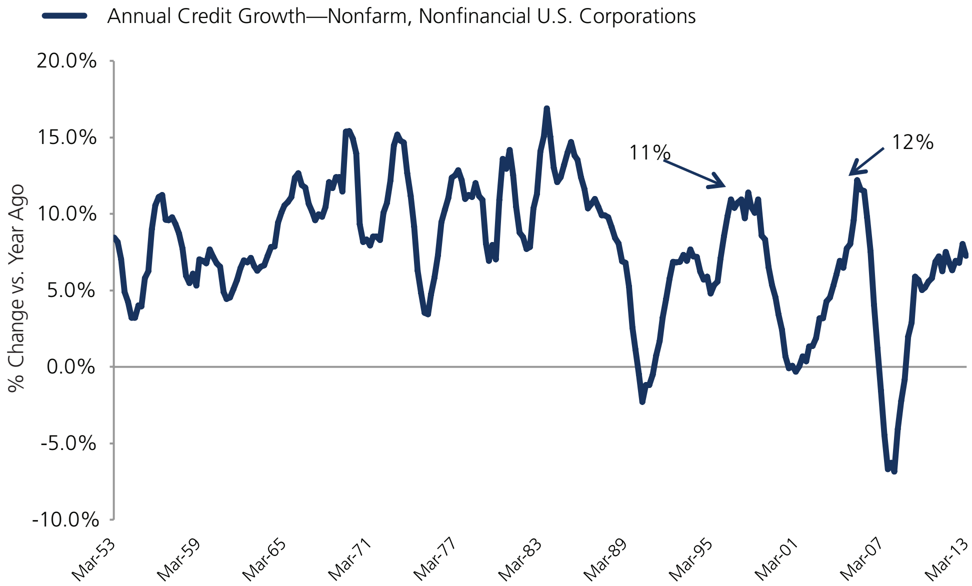
The market for U.S. debt is about twice as large as the value of the stock market. Therefore, trends in credit quality can tell us a lot about the state of corporate America, with implications for bond and equity valuations. Some issues of concern emerged in 2015, and how they play out this year will impact the direction of markets and the level of volatility.

Coming out of the Great Recession, the early stages of the credit cycle saw borrowers fixing some of the mistakes that helped cause the financial crisis. Balance sheet repair was the dominant strategy as companies sought to reduce leverage. As the business cycle matured and organic earnings opportunities waned, companies have pursued other avenues to bolster the bottom line and have turned increasingly to the credit market to finance those efforts.

Consequently, financial leverage has risen, and borrowers have gotten somewhat more aggressive while lenders (bond investors and banks) have become somewhat more relaxed in their extension of credit. The dominant use of newly issued debt has shifted away from refinancing and toward mergers and acquisitions. This is typical late credit cycle behavior.

Credit expansion by corporate borrowers has been controlled for most, but not all, sectors of the economy. Use of credit in the aggregate is currently lower than we have seen at prior cycle peaks (Exhibit 3).

Exhibit 3: Overall Credit Growth Reasonable



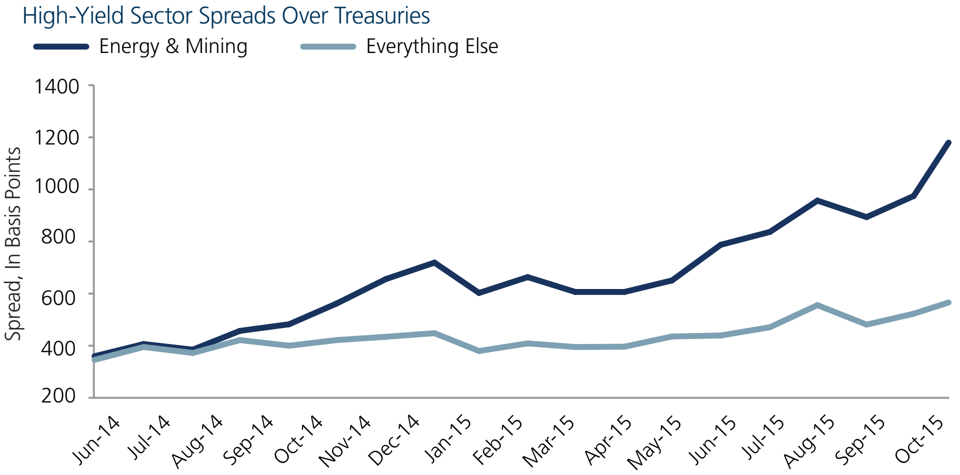
Source: Federal Reserve as of 12.10.2015.

During 2015, however, stresses emerged in what had been a fast-growing sector of the corporate bond market—energy and mining. As discussed in the prior section, U.S. energy production has been in a secular boom—one financed largely with debt. Much of it was below investment grade, or "high-yield." Over the last decade, high-yield energy and mining debt outstanding grew 20% per year while all other sectors averaged just 7%.[4] The tumble in energy prices and commodities in general has placed enormous financial pressure on many energy exploration, production and service companies as well as miners of other goods like copper and aluminum. Defaults and distressed exchanges will likely be the focus for some of these borrowers in 2016.

Companies in other sectors and in higher-quality tiers continue to find access to debt capital, but they have not come through recent events unscathed. Credit spreads—the interest rate premium demanded over Treasury yields for taking on credit risk—have expanded for all sectors. While nowhere near the risk adjustment made in the energy/mining space, credit spreads for high-yield borrowers in other parts of the economy have widened by nearly two percentage points (Exhibit 4), and higher-quality investment-grade borrowers have seen financing costs grow by over one-half of a percentage point since the middle of 2014.

While the cost of borrowing has risen over the last year, it has done so from near record-low levels. Outside of the energy/mining sector, the current cost of capital has not proved to be restrictive in prior cycles, and we expect debt markets to remain open to these borrowers. At the same time, investors holding distressed assets and facing shareholder redemptions could look to sell performing assets given liquidity constraints in the market for the previously mentioned stressed sectors. This is a potential source of volatility for high-yield bond investors even outside of the energy/mining sector, and an issue the Fed will need to follow closely in its monetary policy deliberations.

Exhibit 4: Corporate Borrowing Costs on the Rise



Source: Bank of America, Atlantic Trust as of 12.23.2015.

THE FED GOES ITS OWN WAY

During the financial crisis of 2008-09, countries around the world were united in employing extraordinary monetary and fiscal policy actions to support the global economy against the forces of deflation. This included cutting interest rates and taxes, while increasing money supply and public spending. As the crisis atmosphere subsided, fiscal policies began to diverge. The U.S. and U.K. opted for austerity, while Japan, China and many emerging markets continued to implement what they hoped would be pro-growth government spending increases and/or tax reforms.

Until recently, however, the world's major central banks remained on the same page, advocating extremely low (or negative) interest rates and direct asset purchases (i.e., quantitative easing) as catalysts for stronger growth, reduced risk of deflation and greater incentive for economic and financial risk-taking. This convergence of the Federal Reserve, European Central Bank (ECB), Bank of Japan (BOJ), Bank of England (BOE) and—more sporadically—the People's Bank of China (PBOC) was *the* linchpin for the equity bull market in recent years, as well as for the extraordinarily low levels on government bond yields.

While widely expected, the Fed's decision in December to raise interest rates makes official that monetary policy divergence is underway. Meanwhile, the European Central Bank recently dropped policy rates further into negative territory. The PBOC is cutting rates as well, while the BOJ continues to employ aggressive easing, including negative interest rates and purchasing equities and government bonds.

Exhibit 5: Fed Policy Divergence

Region	Real GDP Growth	Core Inflation Rate	Current Central Bank Policy Rate	Recent Direction of Interest Rates	Current Quantitative Easing?
U.S.	2.1%	2.0%	0.375%	Higher	No
Eurozone	1.6%	0.9%	-0.30%	Lower	Yes
Japan	1.6%	0.9%	0.005%	Lower	Yes
China	6.9%	1.5%	4.35%	Lower	No

Notes: Date represents most recent readings in each region; GDP and inflation rates are annual % changes; policy rate is midpoint of central bank range.
Source: Bloomberg, as of 12.30.2015.

Disparate policy does not necessarily mean that any of these central banks are wrong. For instance, there is plenty of data to support the Fed's decision to tighten gradually—a 5% unemployment rate, growing incomes and an improving housing market all support the notion that extraordinary action is no longer necessary. The other central banks mentioned above can point to data showing that the threat of deflation persists and hyper-stimulus is still needed.

The risk is that central banks focus primarily on home country conditions and not enough on *global* economic and financial linkages. Since the fall of the Berlin Wall and China's entry into the World Trade Organization, these linkages are an inextricable part of how the world works. From a financial markets perspective, this has been a mostly positive development over the last generation. However, as 2008 painfully illustrated, it can also mean that there is no place to hide from economic or policy excess.

Thus, while the Fed's divergence from its central bank colleagues around the globe is not inherently bearish, it does raise the risk that a monetary policy mistake emanating from any country could reverberate globally. We will be evaluating closely the likely path of U.S. interest rate hikes. Our current thinking is that the Fed's projection of a 100 basis point (1%) cumulative short-term rate hike over the course of 2016 may be aggressive given weak conditions in many other economies as well as the strong U.S. dollar. Flexible assessment of conditions has been a strength of this Fed, and we believe that will very much be required in 2016.

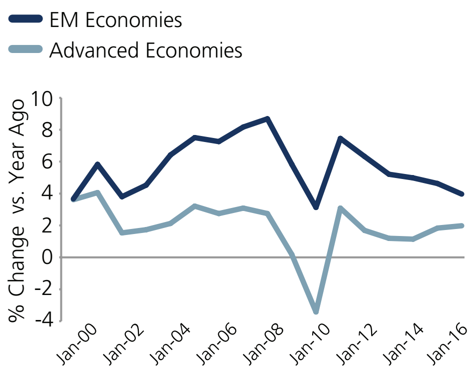
CHINA AND DEVELOPING ECONOMIES: EMERGING OR SUBMERGING?

"Eventful" would be a politically correct way to describe emerging markets (EM) in 2015. The MSCI EM Stock Index was down about 15%,[5] but that does not fully capture the stresses that plagued most of these countries. Government and corporate bond markets also fell as perceived credit risks grew, and key currencies such as the Brazilian real, Russian ruble and Turkish lira fell more than 20%.[6]

After decades as the world's "growth miracle," most emerging economies have succumbed to the demand weakness afflicting the developed world. This has produced slower economic growth, falling corporate profits and rising concern about a significant increase in debt levels in certain countries. The bear market in commodity prices has placed additional pressure on many EM exporting nations as well.

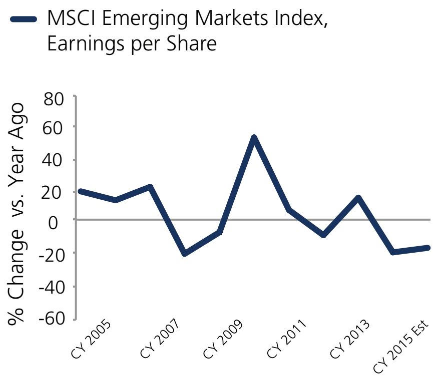
Exhibit 6: Flagging Growth and Earnings

EM Economies



(2015 and 2016 data are IMF forecasts.)
Source: IMF, WEO, data as of 12.28.2015.

EM Earnings Swoon



MSCI Emerging Markets Index, Earnings per Share.
Source: Bloomberg LP, data as of 12.28.2015.

The prescription for flagging demand in the developed world—very low interest rates and extraordinary monetary stimulus—is off the table for most EM countries. That is because of the risk of capital flight by international investors, potentially resulting in further currency pressures. China's boom—long a source of export potential for other EM countries—has slackened and is an unlikely safety valve for the foreseeable future. While the long-term EM growth story is viable, there is no easy or quick way out of the current dilemma, and we remain unenthusiastic about near-term return prospects for both the equity and bond markets.

A broader question is whether the troubles afflicting EM countries could snowball into a global recession. The answer will likely be determined by China. Though still considered an emerging country because of high poverty levels and less accessible financial markets, China is much more than that. It is the second-largest economy in the world; and from 2004-2014, China accounted for one-third of all the economic growth on the planet.[7] The significant slowdown in its real GDP growth rate over the last four years—from 10% to under 7%—has been a major factor in the worldwide plummet of commodity prices and has hurt other EM nations that had banked on exporting perpetually more of everything to China.

China's slowdown and sporadic signs of financial stress largely stem from years of massive investment in real estate and infrastructure. The country is now faced with industrial overcapacity, an overhang of real estate and significant debt levels held by businesses and local governments that financed the boom. Meanwhile, the hoped-for surge in China's consumer society has not picked up the slack.

When the world's growth engine sputters, it is a big deal. Continued deterioration in China's economy would greatly raise the odds of a global recession. The good news is that Chinese authorities seem to have reached this same conclusion. In recent months, they have employed policies consistent with stabilizing the country's growth rate at something north of 6%. They have devalued the yuan, cut interest rates and produced a number of demand- and supply-side economic reforms designed to foster growth. Another important step would be for the central government—with its $3.5 trillion in reserve assets—to assume the debt of overleveraged local governments, where most of the financial stress exists.[8] If this falls into place, we believe China and the global economy will avoid a hard landing in 2016.

U.S. STOCK MARKET: EARNINGS TAKE THE WHEEL

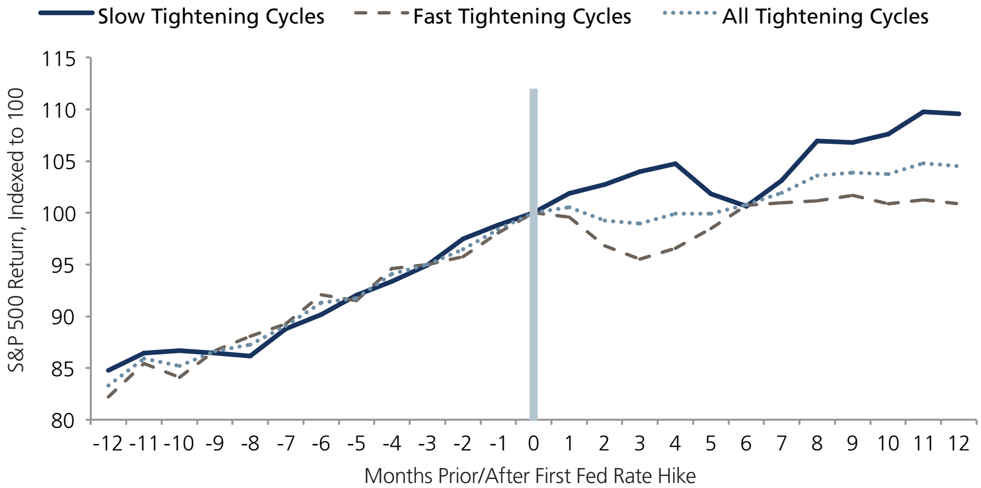
Multiple factors go into valuing public companies and the stock market as a whole. Often though, there is a dominant variable that seems to drive the market trend in one direction or the other. Over the last three years, this "first among equals" factor has been ultra-accommodative monetary policy. The Fed's zero interest rate policy and multiple rounds of quantitative easing stoked liquidity and the incentive to migrate toward risk assets like stocks.

The December rate hike signals a path toward normalization, which means higher interest rates. Nevertheless, Fed rate hikes need not spell the end of the bull market. Historically, when the Fed undertakes a more shallow, drawn-out tightening phase, stocks perform reasonably well (Exhibit 7). This slow and deliberate pace of increases is our base case.

However gradual this path to higher rates is likely to be, monetary policy has peaked as a potential bullish ingredient for stocks. We view price-to-earnings multiples as reasonable—but not cheap—as long as inflation remains contained. However, like 2015, we do not assume a shift higher in valuations (so-called "multiple expansion"). With the Fed moving away from maximum support and little expected from valuation, that leaves corporate profits as the key driver of equity markets in 2016.

Exhibit 7: Stocks Can Advance When the Fed Acts Gradually

Based on 12 Tightening Cycles Since 1945



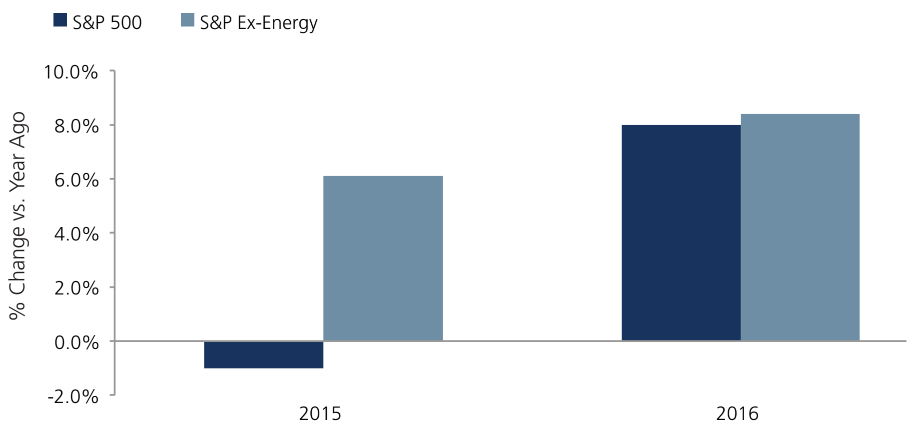
Source: Strategas as of 09.30.2015.

This could be construed as a problem since, when all is said and done, we expect S&P 500 profits in 2015 to be flat—and perhaps worse. However, we think the profits outlook for 2016 will be more constructive. An analysis of the earnings plateau of 2015 shows that two related factors had a highly detrimental impact—the very strong dollar and very weak energy prices. Since the oil price peak in mid-2014, the trade-weighted value of the U.S. currency has risen by more than 22%.[9] This has produced a very challenging environment for exports and overseas revenues of U.S. companies.

Meanwhile, the crash in oil and gas prices caused a 60% decline in energy sector profits. As illustrated in Exhibit 8, while the Wall Street consensus expects 2015 earnings to be down slightly for the S&P 500 companies in aggregate, they would be up moderately outside of energy. Analysts also expect that in 2016, overall earnings will grow solidly, with energy being much less of a drag.

Exhibit 8: Wall Street Expects an Earnings Rebound in 2016

Consensus Analyst Projections, S&P 500 Earnings per Share Growth



Note: Bottom-up consensus expectations.
Source: S&P, Thomson Financial, Compustat, FactSet and RBC Capital Markets as of 12.23.2015.

We expect domestic demand in the U.S. to remain reasonably healthy—a very important variable for corporate revenue growth. While many have worried that high profit margins have nowhere to go but down, we see relative stability, as revenue growth should absorb unused capacity. While the pace of corporate share buybacks may slow a bit, we still expect this trend to restrict share count and produce a modest plus for earnings per share.

Employing a sum-of-the-parts analysis to the above variables leads us to an expectation of roughly 5% operating earnings growth per share for the S&P 500 in 2016. We consider our forecast to be the middle ground—better than 2015 but not as bullish as the consensus forecast of market analysts.

In summary, we expect stock market performance to be more closely tied to earnings and less to monetary policy. Despite our expectation of a fairly low profit trajectory, we believe it is sufficient to allow the bull market to continue. Volatility should persist and create attractive entry and exit points on individual stocks over the year. Respectable earnings growth along with earned dividends should provide a favorable return profile relative to most fixed income investments. ■

1 Bloomberg, as of 12.31.2015.

2 Yardeni Energy Briefing, as of 12.12.2015.

3 Oil Market Intelligence, as of 11.30.2015.

4 BofA Merrill High Yield Index, as of 9.30.2015.

5, 6, 9 Bloomberg as of 12.30.2015.

7 IMF Direct, data as of 3.26.2015.

8 The Wall Street Journal, data as of 10.07.2015.

PORTFOLIO TAKEAWAYS

The five themes we addressed are by no means exhaustive. There are many other issues and events bound to influence markets in 2016. In the political arena, the U.S. elections will garner an enormous amount of attention. However, elections usually provoke short-term volatility rather than truly altering the market trend. The exception occurs when election results change the rules of the road. With that in mind, Britain's referendum on whether it continues as part of the European Union may be more momentous. While a date has not been set, the British government is leaning toward some time in 2016.

We hope this analysis provides a good sense of what Atlantic Trust believes are the critical drivers of the investment outlook over the next year. Below we summarize our views.

Asset Class	Fundamental Assessment for 2016	Asset Allocation View
U.S. Equities	Mediocre earnings growth (<>5%), but better than 2015	Bull market continues, but single-digit returns likely
	Forward P/E ratio stable in 15.5x - 17.5x range	Overweight Equities vs. Fixed Income
	Dividend growth, share buybacks, M&A continue	Emphasize large-cap stocks
	Stock selection key: widening dispersion of returns by active managers	
International Equities	Policy flexibility (more stimulus) a support for Europe and Japan	Overweight developed markets vs. emerging markets
	Developed international has higher earnings growth potential than U.S.	Stock selection key: consider "go anywhere" global portfolios (including U.S.) to own highest-quality names
	More dollar strength, but much smaller advance than 2015	Currency hedging still viable, but not as crucial to returns
	Emerging countries' earnings bear market continues	
Fixed Income	Deliberate Fed tightening: 2-3 small rate hikes	Below-benchmark duration as the Fed retreats from extraordinary measures
	Modest rise in yields with further yield curve flattening likely	Favored income sectors: high-yield muni, floating rate and nonagency mortgages
	Risk of wider credit spreads as perceived default rate rises	High-yield corporate debt and emerging market debt remain out of favor due to commodity-driven default/currency headwinds
	Municipal credit conditions remain strong in most locales	
Commodities	Bear market less intense in 2016	Too early for a portfolio inflation hedge
	Recovery potential limited by slow global economy and strong dollar	
Hedged Strategies	"Low return world" for stocks and bonds	Attractive risk-adjusted returns vs. traditional asset classes
	Equity market volatility similar to 2015—spikes likely	Core: long/short equity focused on fundamental stock picking
	Expect wide dispersion of returns—less concentrated than 2015	Balance with uncorrelated strategies that perform well in rising interest rate environments, e.g., volatility arbitrage, shorting, tactical trading
	Benefit from higher short-term interest rates	
Private Markets	Key support: continued economic growth and IPO/M&A activity	Diversified PE portfolio likely to earn a 3-4% liquidity premium over public stocks in the long term
	Key concern: 4 years of strong PE fundraising—potential crowding	With elevated valuations in some sectors and dry powder waiting to commit, selectivity is key
	Interest rate forecast neutral: below average rates, but slowly rising	Small market buyout, global buyout and private credit strategies attractive; large-company LBO not attractive

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