THE YEAR AHEAD

WHAT TO EXPECT IN 2016 (AND BEYOND)

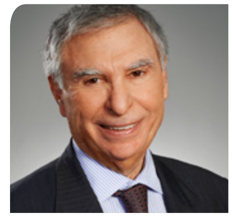
January 2016

It is again time to put in print in one place some specific speculations on what may happen in the coming year. We do this with the intent of getting investors to think about what could happen and factor that into their decisions on how to adjust their portfolios to take advantage of opportunities while at the same time being aware of the risks. What I typically try to do is include those elements where I believe the odds are high enough of an occurrence to have consideration when constructing a portfolio.

I must say it has been more difficult to come up with specific speculations around which I have some confidence. There appear to be more variables in play than normal with most residing outside the US. Within the US, at least through the first part of the year, we are likely to see a continuation of what has been experienced in 2015. I have been tempted to simply republish last years "What to Expect..." piece. There is real possibility of more of the same.

As we have pointed out in recent blogs we expect the dispersion in company performance and stock performance to continue against a backdrop of slow growth and continued difficulties in the energy and commodity patch. The investment opportunities will be very specific in both equities and fixed income. This will likely call for a reduction in risk in the core of a portfolio with the addition of managers who, historically, have done well in a more volatile environment. The opportunity set may look very different as we get toward the middle of 2016. Many of the expectations we spell out below will most likely unfold as we get later into the year. A single set of prognostications at the beginning of this year that prove to hold for the full year require more prescience than most of us can bring to the party—certainly this year. This will be a year in the public markets that will require nimbleness. The opportunity set away from the public markets may prove to be more attractive with less volatility.

Maybe this will become clearer as we move through some of our speculations for 2016. This year in particular, these expectations are designed to make one think about risk and some of the uncertainties



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we are facing as we move into 2016. I have tried to move beyond the momentum of what we have just been through in the markets to speculate on what could happen before the year is over. I have provided some specific observations in a Q&A format which will repeat some of what you may discover in the Expectations below. I would urge you to read the paragraphs before moving to the Q&A. The paragraphs tell more of a story. The Q&A has declarative statements, which must always be taken with a grain of salt, but are easier sound bites. Let us proceed.

UNITED STATES: THE ECONOMY CONTINUES TO GROW, BUT PERFORMANCE DISPERSION INCREASES AGAINST A BACKDROP OF PROFIT DISAPPOINTMENTS

In an economy that experiences real growth in the 2–3% range combined with low inflation, the differences in profit performance among companies become more stark. With activist money managers nipping at their heels, corporate boards push through an even higher level of management changes combined with a pickup in M&A activity spreading through a wider variety of companies. While we will see a few large combinations similar to Dow/DuPont, many of the corporate actions will involve spin-offs or targeted acquisitions of smaller companies without the capacity to grow their own businesses. Don't look for significant premiums in these transactions. In contrast to past patterns, the value proposition may be in the buyer as opposed to the seller. Premiums may occur when the bidding comes from outside the US, e.g., China. Some of the consolidations will come out of credit issues primarily in the energy and commodities space. We do expect commodity and energy prices to stay low at least through the first half of 2016. Recognize that financial restructurings do not necessarily remove capacity from the market place. In fact, with reduced financial burdens, the ability and necessity to continue producing is increased.

While slow growth may produce credit issues beyond the energy and commodity sectors, they will be very specific. In general, the credit markets—both public and private—may offer some of the best investment opportunities for 2016. In both equities and credit, given the dispersion in results, active managers, in our view, will likely outperform the indices.

THE REST OF THE AMERICAS: STILL SOME ECONOMIC ISSUES BUT AN IMPROVING PICTURE AS ONE MOVES FROM NORTH TO SOUTH

Canada in many ways is a large natural resource company. Until the energy picture improves there remain issues as a new and different government starts to grapple with the current environment. In addition, while the Canadian banks avoided much of the turbulence experienced in the US from the mortgage fiascos, their housing market has gotten somewhat extended from growth that occurred under the umbrella of high energy prices in the early part of this decade.

On the other hand we see elements of reform and a better competitive environment globally in **Mexico**. Lower energy prices have slowed development and reform in this sector, but other sectors continue to move forward. This remains a good story of growth, reform and development.

Moving further south, if the project stays on schedule, by mid-year the expanded **Panama** Canal should be in operation with the ability to receive the Post-Panamax cargo ships that carry two to three times the previous loads that could make it through the canal. This will change patterns of traffic to the east and west coast ports of the US from East Asia, reduce transportation costs, and most likely produce a shift of traffic via the Suez Canal back to Panama. It could likely result in some increased infrastructure spending for some of the US ports as well as the supporting rail and truck traffic from these new patterns of shipping. An under-the-radar change that could have some unintended consequences positive and negative.

With the **Argentina** election leading to major change combined with elections in **Venezuela** and pressure on **Brazil** to change, the center of gravity on reform and a better investment environment in South America may be moving in the right direction. There is no question that the overall economic situation in South America is quite dependent on exports of hard and soft commodities. Until the commodity supply/demand picture improves, it may be difficult for the overall investment environment to improve significantly. We may be entering an environment where some prices are falling below operating breakeven. Let's keep in mind, though, that energy is a big part of the cost of extraction and refining for most hard commodities. Miners and refiners will keep producing if there is a dollar contribution toward fixed costs. With the metals priced in dollars for the most part, the currency weakness many of these countries have seen is a further reduction in costs. It is possible as we get later into the year modest increases in demand combined with reductions in supply may shift the patterns. At the same time, it is highly unlikely that we will see major improvements in governance and economic results early in the year in these three countries mentioned. However, the tone has shifted. This is an opportunity for the US to affect the rate and quality of change in these three important South American countries with an impact on the whole continent. While the change in our relations with Cuba gets media attention, a similar reaching out by the current administration to change relationships with the three countries is a real possibility. One will be able to find all of the varieties of investment opportunities within the Americas with similar risk characteristics as exist throughout the rest of the world. This is a slight overstatement, of course, but just saying...

One does have to be careful of what is going on with capital flows. The countries in South America are dependent on export growth primarily tied to commodities. While Argentina may be coming out the other side of its ability to access the capital markets, it is not clear that other countries can make it through this period without some degree of financial stress. But, the Americas represent an unusual somewhat isolated set of investment opportunities across the equity, fixed income, and fixed asset markets, both public and private.

EUROPE: ECONOMICALLY BETTER, BUT POLITICALLY WORSE

This is the same title we used last year. The addition of the immigration issues to a general reaction against the austerity that has been put in place leads to reduced economic and political coordination among the European countries. Talk of closing borders will likely produce greater immigration issues in the near term and certainly conflicts among the countries. There is a macro bet one can make based on continued QE of some form from the ECB combined with a relatively weak currency and relatively lower valuations. This seems like a crowded bet. However, we are beginning to see more dispersion by country and by company against a heightened backdrop of geopolitical risk and engagement. Again, this is another place where active management can produce decent returns, but the volatility and variability within the public markets will make the timing of investments more difficult. I think we need more time to sort out these markets.

CHINA: CHINA USES ALL FISCAL, MONETARY AND STRUCTURAL TOOLS AT ITS DISPOSAL TO CONTINUE THE TRANSITION TO A SERVICE ECONOMY WHILE PUTTING A SAFETY NET UNDER ITS INDUSTRIAL SECTOR

The country takes steps to slow down the capital outflows that have been occurring in anticipation of a continued weakening currency. While the currency weakens modestly relative to the dollar, the one-way trade ultimately becomes problematic. The currency stabilizes and capital outflows shift their mix to an even bigger share of global FDI.

China has been the all-time consumer (and in some cases, producer) of the four biggest metal markets in the world: iron ore ($225B), copper ($130B), aluminum ($90B), and nickel ($40B). If you add these numbers, these markets at these prices represent less than $500 billion in a global economy of over $79 trillion. Yes, these resources are at the core of industrial and infrastructure activity, but there is a global shift from industry to services taking place, similar to China's. China produces close to 50% of all iron ore and aluminum and has been the consumer of 50% or more of all four of these metals. As the Great Recession occurred, China stepped up its internal investments to offset what was happening in the rest of the world and became the driver of demand and price increases. Prices peaked in 2011; supply increased, and demand growth began falling as well as prices. But, China's commodity consumption is still growing at 3%–4%, but with consumption down elsewhere, demand hasn't quite caught up with supply.

China's focus will continue to be maintaining political and economic stability as it transitions from an industrial export-driven economy to a consumption/services economy. Let's assume that the Chinese leadership actually does know (as well as any country leaders can) what is happening economically in China, even if the rest of the world doesn't. They are trying to accomplish this while introducing some elements of reform, e.g. fighting corruption, that may actually produce slower growth than might have occurred otherwise. This will not be a smooth transition, but the transition is occurring. We have to watch what is happening in China, but I would posit that our attention should be focused on Europe, and to some extent, the Middle East. A pickup in growth, which will likely show up in commodity prices and numbers from the services sector, may be the next signal from China, which may not come until much later in the year. In the meantime, services, technology and the Silk Road Initiative will offer some interesting

Chinese investment opportunities. In addition, China continues its push to create its own intellectual property. The patent battle between the major economies may become the real story over the rest of the decade.

INDIA: HAVING TAKEN IMPORTANT GEOPOLITICAL STEPS, NARENDRA MODI TURNS HIS ATTENTION INTERNALLY WITH MODEST SUCCESS

While India turns out to be the fastest growing large economy in the world, it happens in spite of attempts by minority parties and the states to put roadblocks in the path of reform. India embraces its role in China's Silk Road Initiative, which results in both its own infrastructure spending as well as FDI by China. India continues to add to its technological portfolio with patent filings and a specific focus on the medical area. In addition, with 600mm citizens still off the electrical grid, India looks to distributed alternative energy with help from both China and the US. This is the one place where the US can actually have a positive interaction with India. While the stock market looks relatively rich, the growth pattern and an expectation of continued reform attracts private and corporate capital.

RUSSIA: LOW OIL PRICES, OIL FLOWS, SANCTIONS, AND THE COST OF FORAYS OUTSIDE OF RUSSIA RAISE THE STAKES FOR THE LEADERSHIP AND CHANGE RELATIONSHIPS

Lifting the US oil export ban changes the West's relationship with Russia as crude can flow from the US to Europe reducing its dependence on other sources, specifically Russia. A total revisit of sanctions, Syria, Iran and the Ukraine takes place before the end of the Obama administration. The question on timing may be a determination by Putin of whether it is best to work with the current US administration or take his chances on the next one. At these prices while Europe would be an oil buyer it is not clear who would be the incremental seller.

While lower oil prices continue to have a major financial impact on Russia and affect negotiations on the topics listed above, the US sees an opening to change the relationship with Russia and Putin sees the same. While the dialogue and negotiations are not smooth, a different path is set for the new administration. As I said in last year's "Expectations", Russia has an educated population and the ingredients for being an important economic player on the world stage. The current path will not get them there and will add to geopolitical volatility as long as it continues. It can still lead to regime change. Technologically, Russia continues to advance and remains one of the top ten patent filers even while the rest of Asia, led by China, South Korea and Japan, puts distance between itself and the western world.

THE REST OF THE WORLD (AND OIL)

We could spend time discussing the rest of the emerging markets and the turmoil in the Middle East. In all instances the most significant elements to watch are the capital flows as many of these countries see reduced demand at lower prices for what they offer while their fiscal budgets are more rigid. The capital to support the expenditures has to come from somewhere. Borrowing is problematic. The capital accounts primarily represented by their sovereign wealth funds have to be the source. Much of that capital is invested in developed country public securities as well as less liquid investments in the same areas. Depending on how long low growth and low prices remain, we could begin seeing a measurable impact of this selling on markets. And the excess capital will move toward the more liquid markets with lower currency risk. We have seen what the lack of liquidity can do to values within the US markets when relatively small amounts are in play. This may offer real opportunities for the buyers with capital, but the dollar amounts may at some point overwhelm the markets. We will be watching this as an element of risk away from the fundamentals of individual investments.

The oil situation, while representing a dramatic shift in beneficiaries, at these levels becomes more problematic. While the users of energy benefit, we are getting closer to country risk and expanding the list of energy related companies that will ultimately suffer. This ties in to the capital flow discussion above. These levels add an element of risk to the overall global capital markets. There may be unintended consequences.

RISK

The biggest issue for investors as we enter 2016 is defining the degree of risk one is prepared to take in the portfolio relative to what may be an environment where conventional stock and bond investments and weightings provide limited return. In one of our recent blogs we go into some specific thoughts and have spelled out our views as well in the opening paragraphs of this "Perspective". You can read the higher degree of uncertainty as you have gone through this piece. It does tend to push us toward hedged strategies, systematic trend followers and, where suitable, less liquid strategies. Yes, I know we are talking our own book. However, in my conversations with managers of more diversified portfolios there is a realization that less correlated strategies may do well this year. The exception, as discussed above, may be the credit markets away from commodities and energy both in the liquid and illiquid space. This year will require a more intense analysis of what is happening as we move through the next few months. The opportunities may become more apparent by mid-year. A mid-year rewrite may be a necessity.

Below are three wild cards, which, if nothing else could provide some good cocktail party conversation. One can't put a high probability on occurrence or possible timing on any of these outcomes (certainly not the earthquake—hah, that may have gotten your attention). I have listed them in the order of probability. You can figure out whether I start with the highest or lowest.

INFLATION SURPRISES IN THE SECOND HALF OF 2016

The Fed's inflation favorite, the core personal consumption expenditure (PCE) index, is only 1.3% year-over-year with the last number actually flat month-over-month. If this number stays well below 2% odds are the Fed Funds rate will stay lower longer. There is a wild card to watch. It does relate to energy. But, one will point out, energy is not included in the core PCE calculation. That is true. However, the impact of a reduction in oil prices and energy in general doesn't just affect consumers' transportation and heating costs—putting more money in their pockets. It affects businesses as well, reducing both their energy and transportation costs and, in some businesses, the cost of hydrocarbon-based feedstock as a part of their product. When I hear, anecdotally, that a friend in the paint business is experiencing record profits because of a reduction in cost-of-hydrocarbon-based goods, transportation costs and maybe a bit of a lift in remodeling and new home construction, I can translate that into similar experiences in other industrial and commercial businesses. It does add to corporate profits. While it is difficult to make a precise calculation, the 50% reduction in oil and gas prices over the last year could easily have added $90-$135 billion to the more than $2 trillion in pre-tax corporate profits. That 4%-5% pickup in profits may have reduced the price increases that, otherwise, would have been needed to make up for part of the labor cost increases that were being incurred. That addition to profits will hold as long as energy prices stay flat. There will be a more modest additional lift to profits if prices stay at this even lower level. This will not be an every year increase to profits. Thus, if corporations want to show increasing profits this year they may have to look for price increases to offset the continued more than 2% annual increase in unit labor costs. If energy prices continue to stay around these levels or rise, the direct impact on the core PCE index won't happen, but the indirect effect of having to absorb the increased labor costs without additional energy offset could start showing up in final price increases. Excess supply in certain industries could mitigate the ability for certain companies to raise prices, but by sometime in 2016—maybe mid-year—we could start to see more price increases. It will not happen across the board, but specific company and industry analysis could turn up some profit surprises, positive or negative, as the energy transfer of wealth dissipates. The Fed will notice.

THE ELECTION RESULTS DO CHANGE THE PARTY IN POWER EVEN THOUGH THE POPULAR VOTE IS PROBLEMATIC

As the Republican Convention in mid-July approaches it becomes evident there will be no clear candidate with the votes to be named on the first or second ballot at the convention. It also becomes clear that without winning Ohio and Florida it is extremely unlikely that a Republican ticket can win the presidential election. Even then the party will have to pick up an additional 13 electoral votes from states the party failed to win in 2012. After a rather contentious convention, the party selects as their nominees the two candidates whom they believe have the highest odds of winning those two states. In the national election the Republican slate captures enough electoral votes to win. It is a close vote in which the Democratic slate actually wins the popular vote given the overwhelming majorities in New York and California. Much can happen between now and mid-July that changes this outcome. This is an unusual election.

AN EARTHQUAKE ON THE RECENTLY DISCOVERED CUSHING FAULT CAUSES MAJOR DAMAGE AND THROWS US OIL MARKETS INTO TURMOIL

I don't want to go the route of Iben Browning, forecasting an earthquake in late 1990 on the New Madrid fault that has yet to occur. However, we are seeing daily tremors in Oklahoma in the vicinity of the Cushing storage facility and pipeline system. In 2015 Oklahoma had more quakes of 3.0 or higher than any other state. Yes, that includes California. Some recent studies have identified a fault, named the Cushing fault, in the region where there is increased risk of a major earthquake in part from the introduction of ground water from fracking activity and tertiary recovery. I don't know enough to make the mistake Iben did of putting a date on when an earthquake could occur, but if there is a disruption of the storage and pipeline systems in Cushing, for whatever reason at whatever time, it could push up the prices of refined product from shortages of crude and possibly lower further the price of crude as producers struggle to find storage and other shipment means for what they are producing. Gulf Coast refiners will likely bid up crude prices to keep the refineries going, but producers will need to move what they are producing by any means possible. It will be an interesting tug of war between the domestic producers and the refiners re who is in the best position to bargain. In the meantime offshore producers will step in to deliver oil to the Gulf Coast refiners who account for close to half of the production in the US.

This is just one of many possible tail risk disruptions to the supply of crude into the market place. It may be the most unlikely one. However, spending a few basis points on tail risks in a portfolio related to oil and distillate prices may prove to be a good investment.

Q&A

As I have said, this will be a year where the uncertainties around outcomes remain high. The dispersion of results offers an opportunity for return, but that will have to come from uncorrelated investments, for the most part. The best money managers will make their decisions on much more specific information than is provided here or in most "outlooks" for the year 2016. I have added below a summary of some of the questions that appear to be on most people's minds, which gets a bit more specific. Specificity is hard to come by in the investment business and the half-life of most specifics is quite short. You can see a bit more detail and some other questions that have come up primarily from the media on the blog mentioned at the beginning of this document.

As many of you who on occasion read the Altegris blogs, you have seen me write that "Past Performance is Not Indicative of Future Results." Given some of the dispersion we did see in 2015, this may be a time when last year's performance may be more indicative of this coming year's results.

Below are some of the consistent questions that have come up from those looking for answers.

Q: Taking into consideration the rollercoaster some equity investors found themselves on this past year, particularly in August, what are the biggest risks facing investors in the stock market in 2016?

A: *There's a long list of factors impacting the stock market as we begin the New Year. The global slowdown, a strong dollar and the Federal Reserve's late-in-the-game rate change, to name a few, all add a degree of uncertainty for investors. I would also stress two other factors that will play into investor returns: another year of profit disappointment driven by wage increases and the end of the oil dividend for many corporations.*

Q: What will be the biggest surprise for investors over the next 12 to 18 months?

A: *Inflation could pick up a lot faster than widely anticipated. I would encourage investors to keep an eye on wage growth.*

Q: How are you advising clients looking to allocate assets and potentially reinvigorate their returns entering into the New Year?

A: *To the extent an investor doesn't need liquidity, the opportunities in the less liquid parts of the markets will likely benefit from a growing illiquidity premium. Just don't buy a daily liquidity fund that has been buying illiquid securities to juice returns.*

Investors experienced no to low equity returns in 2015. We're predicting more of the same for equities in 2016. It may prove to be a good year for true equity hedge fund managers. In terms of fixed income, we're anticipating some credit accidents, but on balance, no major credit meltdowns. The recent moves in the high yield markets may have provided some opportunities if one does very specific credit analysis security by security. Activist and event-driven managers are likely to experience favorable returns as M&A activity continues to be strong going into 2016. As we have seen this in 2015, sometimes an activist approach doesn't work, but I think over time it does. This recent action does open up opportunities for those who have a longer time horizon and are dealing in the less liquid parts of the markets. I recently made a point (of which I stole from one of our own, Greg Brucher) "...investors buy and hope, activists buy and influence, and private equity firms buy and fix." There will be a lot of situations open for fixing over the next few years.

Q: Looking forward to the next 12 months, on which sectors are you taking a bullish or bearish stance?

A: *We're relatively positive on defense stocks, technology and healthcare. In terms of technology, we're actually favoring old tech over new tech, particularly companies involved with the cloud, cyber security and have been spending on R&D. Moore's Law continues to be operative.*

Consumer staples and most fast food companies are where we're currently bearish. While staples tend to be a more defensive sector that does relatively well in slow growth environments, changing eating and drinking habits among Americans are going to make it tough for these companies to keep up and generate meaningful returns. I brought this up in last year's "What to Expect..." Once again, it is company by company, but they won't all be making the adjustments to new habits in a timely fashion. We will likely see more management changes in the sector. That may produce buying opportunities.

Q: If you had to give 2016 year-end targets for a handful of major market indicators and indices, what would they be?

A: *Take the point estimates with a grain of salt because on any given day those numbers can and will change. But overall the market may keep pace with nominal GDP results in spite of the profit picture looking quite weak.*

- ***S&P 500:*** *2,120 (but with big dispersion)*
- ***Dow:*** *18,100*
- ***10-year Treasury yield:*** *2.65%*
- ***Gold:*** *$1150*
- ***Crude oil (WTI):*** *$52 (this was my target before this latest downdraft and I'm sticking with it—at the moment)*
- ***Fed Funds Rate:*** *0.75%*

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