"LIFT-OFF" SCHMIFTOFF

Many economic and political stories for 2015 were far from bright. In this letter, we discuss several key challenges, point to aspects of the markets that fared better, and review our own investment positioning. Was the Fed's interest-rate increase a harbinger of a long-awaited resurgence of global economic growth? Our headline tells the story.

2015 was another year of sensational headlines that included several terrorist attacks, a "proxy war" in the Middle East, a nuclear agreement with Iran, a missed debt payment by Puerto Rico, another debt showdown in Greece, and the first interest rate increase in the U.S. since 2008. The list could go on. But for all of 2015's turbulence, the year ended a wild ride with most developed markets falling within a 5% plus-or-minus range of flat (in U.S. dollar terms). The same could not be said for their emerging market brethren.

Highlighted by the tumultuous summer swoon in Chinese equity markets, 2015 was a year some may want to forget for Emerging Markets. Investors, and even casual news readers, may recall the one-month 35% collapse in the Shanghai stock market between June and July 2015. Just when one might have thought it was safe to go back in the water, what people are now calling "Black Monday" hit the Shanghai markets on August 24, dropping nearly 8.5% in one day, followed by "Black Tuesday," which saw an additional plunge of 7%. We were not immune here in the U.S., with the Dow dropping 1,000 points upon opening on Black Monday.

From the perspective of full-year returns, Brazil fared much worse. Its markets are down more than 40% since the end of 2014 in U.S. dollar terms. While not an emerging market, our neighbors to the north also had a difficult year: Canadian markets were down more than 25%. We're dragging Canada into this because—at the risk of oversimplifying—a country's returns in 2015 boiled down to whether or not its economy is heavily influenced by commodity prices (Canada) or its assets (or liabilities) were priced in U.S. Dollars.

THE DECLINING PRICE OF OIL: SUPPLY OR DEMAND?

Let's unpack that statement. One of the year's biggest headlines was the continued and pervasive decline in energy prices. Benchmarks for the space, West Texas Intermediate (WTI) and Brent Crude, both declined approximately 40% in 2015. We addressed the notion in our 4th Quarter 2014 review that there is no "correct" price for a barrel of crude, quoting our colleague Duncan Smith:

"We need not get bogged down with input streams and dynamic assumptions to conclude that there is no single, global value of a barrel that is 'right'… oil is one-third politics and two-thirds supply and demand. I'll leave it to the reader to determine which of these can change the price so dramatically in 90 days."

Well, from its high in June 2014, oil has now retrenched over 70%: a full 540 days later. We've clearly moved from the one-third realm of political influence to the two-thirds dominance of supply and demand. The answer to whether or not oil's collapse is truly about oversupply or a lack of demand is a significant piece of the Rosetta stone for energy markets in 2016.

On balance, we believe that the issues wreaking havoc on the oil market are more supply-related—and are thus not a dire statement about where we are in the global economic cycle. Demand has continued to grow, even as more oil-consumption alternatives have taken market share in autos and energy production. Consumption growth in the U.S. has averaged 3.2% since 2013, while China's consumption growth has averaged over 9% since that time. By International Energy Agency (IEA) measures, world demand grew by 1.8 million barrels per day in 2015. The IEA projects (admittedly 33% slower) growth of 1.2 million barrels per day in 2016.

So demand doesn't appear to be the problem; what's defied logic is the world's oil producers' willingness to continue pumping briskly in spite of significant price declines. Since 2013, U.S. production from shale has grown at a 19% rate, while OPEC production has increased at a 4.5% rate—well above the rate of consumption growth.

That said, 2016 is likely to see production declines as the effects of lower capital expenditures and the shelving of major (expensive) exploration and production activities take hold. Further, accelerated decline rates in production from non-conventional oil plays are not being replaced as quickly,

given the flexibility in completion activities by the U.S. shale oil players.

Oil production, just like any commodity, favors the lowest-cost producer. Right now, that's Saudi Arabia, as well as others in the Middle East. Some estimate that it costs Saudi's government-controlled corporation, Saudi Aramco, as little as $10-20 to produce a barrel of oil. Saudi Aramco owns more than 15% of all global oil deposits. Compare this to U.S. shale production costs of $40-50/barrel or Canada's Oil Sands production costs of $70-80/barrel. This gives Saudi crude a dramatic economic advantage and emboldens their current beggar-thy-neighbor strategy of maintaining production levels and putting downward pressure on oil prices.

However, this strategy is not without consequences. More than 80% of Saudi Arabia's budget is funded by oil revenues. As such, lower oil prices are having a direct effect on the populace in the form of new taxes, and are prompting a financial restructuring of the Middle East's second-largest economy—and the world's nineteenth largest economy—by GDP. Fortunately for the Saudis, they currently have over $600B in foreign reserves and over a trillion dollars in assets they can monetize (see recent rumors regarding an IPO and/or "joint downstream subsidiaries" of Saudi Aramco). To place this in a broader perspective, in 2014, OPEC members owned more than 81% of the worlds' oil reserves. These resources suggest that "lower for longer" is the new reality of the oil market.

OIL AND POLITICS

There is another story developing in 2016 that may have a dramatic impact on oil prices: the recent breakdown of Saudi-Iran relations. Following the Saudi execution of Shiite cleric Nimr al-Nimr, violent protesters set fire to the Saudi Embassy in Tehran. Iran's Supreme Leader, Ayatollah Ali Khamenei, warned Saudi officials they will face "divine" revenge; Saudi Arabia responded by cutting diplomatic ties and giving Iran's ambassador 48 hours to leave the country. Saudi Arabia is mostly Sunni, while Iran is mostly Shiite. The execution was ordered because Nimr al-Nimr threatened to lead Saudi Arabia's Shiite minority to secession, and openly criticized both the Saudi and Bahraini royal families. To some extent the rift may have much of the Middle East, and even nuclear-ready Pakistan, taking sides. To date, nothing much more than posturing has occurred, but to put it succinctly, this is kind of a "big deal." We're hoping that Nimr al-Nimr doesn't become another Franz Ferdinand.

OTHER COMMODITIES IN RETREAT—AND CHINA'S SLOWING DEMAND

While Oil was a big story for 2015, many people may not have been as aware of the pricing pressures on other major commodities like Industrial Metals: Steel, Iron Ore, Lead, Zinc, Tin, etc. Many of these markets' declines exceeded 40-50% in 2015. We think these materials are a better indicator of the health of the global manufacturing economy than oil. In 2015, they did not tell a pretty story. But it's tough to pinpoint to what degree these price collapses are due to true economic doldrums, or just the overly reactive pendulum swings of Chicken-Little trading. Commodities as an asset class were down almost 25% in 2015.

Thus far, many point an accusing finger to the largest consumer of commodities: China. Consuming almost 50% or more of industrial materials (and over 12% of oil globally), China's manufacturing activity (or lack thereof) should have a significant impact on the pricing of commodities. Since December 2014, PMIs (Purchasing Managers Indices) in China have been below 50, suggesting contraction.

But manufacturing is not the "only" story in China. Its transition from being the world's largest manufacturer to one of the worlds' largest consumers is ongoing and choppy. China's services sector continued to expand throughout 2015; large-ticket items like vehicles and luxury goods have been on a tear. With a burgeoning middle class—currently the size of the entire U.S. population—Chinese consumerism can and will be a boon to global GDP growth.

Of course, one hiccup in that thesis has been the recent weakness in the Yuan. With the Yuan's peg to a strengthening U.S. dollar, China has been forced to use its foreign exchange reserves to support its currency. In fact, China has used over $500B of its reserves since the summer of 2015. However, with approximately $3.3 trillion left in reserves, China can't support its currency at that kind of pace indefinitely. Earlier this month, China further acquiesced and allowed the Yuan to depreciate further. While a weaker Yuan may help Chinese exports by making them cheaper to trading partners, it reduces the buying power of the worlds' second-largest economy. Understandably, this also has an influence on how China's future economic growth is perceived.

EMERGING MARKETS: CRUSHED BY THE STRONG DOLLAR

Given China's general growth concerns, coupled with the dependence of many developing markets on the world's appetite for commodities, the Emerging Markets (EM) had a very challenging 2015. EM equities were down 5.4% in local currency terms—and down 14.6% in U.S. dollar terms. Local currency EM debt was down 14.9% in spite of the significantly higher yields for debt in these markets.

Clearly, currency exposure was a significant story in 2015. As U.S. dollar holders, on a purchasing power basis, we've benefitted handsomely from the 22% increase over the last 18 months. Americans travelling to Europe will be pleased with how many more Prada handbags and bottles of Châteauneuf-du-Pape they can afford. But for U.S. dollar investors in overseas markets, these currency moves can wipe out an otherwise successful venture. As an example, Europe ex-UK was up 9.1% in local (Euro) currency over the course of the year. Once an investor converted those investments back to U.S. dollars, this return was erased to .1%.

While currency effects have been frustrating, U.S. investors would be wise to remember that the exact opposite was happening from about 2001 to 2008. Remember when the Euro reached almost 150% the value of the dollar? During that time frame, we had the benefit of rising international markets along with a weakening currency. Translating those investment returns back to dollars, investors received an extra boost. But from its low point in 2008, our currency has seen a Jetstream-like tail wind—appreciating more than 30% against the Euro. We saw an eight-year cycle of U.S. dollar weakness; we've now had an eight-year cycle of U.S. dollar strength. We're not suggesting that large currency moves happen in eight-year increments, but this trend may be getting a bit long in the tooth.

Even if U.S.-dollar strength continues, we caution investors from thinking it's time to hedge currencies. Generally speaking, these moves offset each other over time and cause too much consternation over an unreliable bet. Further, it should be noted that since the recent Fed "lift off" in short-term interest rates, the Euro has only marginally decreased in value relative to the dollar. Call it a typical "buy the rumor, sell the news" outcome: We may have witnessed the bulk of U.S.-dollar strengthening prior to "lift off." However, if the dollar continues to strengthen, the Fed's "lift-off" may end up being a very short flight (hence, the title of this quarterly letter).

PROSPECTS FOR INTERNATIONAL MARKETS—AND AN UNCOMPROMISING REVIEW OF RECENT TACTICS

Looking ahead, we see reasons to be optimistic about moderate growth, particularly for overseas investments. While Emerging Market economies may still be weak, forward-looking expectations of economic growth have been lowered to realistic levels. For example, expectations regarding China's GDP growth rate used to hover "over 7%," but now one hears rumblings of a "2.4%" growth rate. Lower hurdles are more easily surmounted. Expectations for Japan and the Eurozone were equally dismal over the last year; but with just a modicum of cyclical growth, declining unemployment, and better relative valuations, these markets appear poised to deliver better returns. Indeed, small-cap companies in the developed foreign markets were some of the best performers in 2015: Two indications of a recovering global economy.

For U.S.-domiciled investors, particularly those who pursue the time-honored strategy of diversification, 2015 was likely a frustrating year. When returns are hard to come by and investors are disappointed, the natural reaction is to act. Do something, anything—change the asset allocation, fire a manager, go passive, chase the few things that did work (buying high) and dump those that didn't (selling low).

We naturally try to analyze what we did well—and what poorly—while recognizing that good *decisions* do not always result in good *returns* for at least two broad reasons:

1. When investing, we need to focus on probability. A probability of 90% that something will happen also means a 10% chance it won't. That shouldn't make us give up on the 90%, since it will work over time.

2. Timing: the reporting period was too short or off kilter for the return pattern, i.e., something may be working but take longer to appear. Asset-return patterns are generally subject to mean reversion, but these may not fall conveniently into quarter- or year-end review periods.

Of course, we may also have made a poor decision: We didn't see what was coming, didn't act when we should have. Or the particular implementation—the manager or structure of the investment—didn't do very well. At Halbert Hargrove, we perpetually review our strategies and

decisions, knowing full well that we're not perfect. We acknowledge that we do not "know" what the future will hold and as such, continue to recommend diversifying so that any individual decision will not make or break our clients' long-term objectives.

Fortunately, through our ongoing research and investment due diligence, the vast majority of the investment strategies we deployed over the last few years have been additive to the returns of our portfolios, namely: reinsurance, variance risk premiums, call overwriting, managed futures and micro-cap exposures. While the volatility of markets in 2015 was advantageous to these strategies, not all strategies work all the time. For instance, our moving average strategies experienced a relatively difficult 2015, but have provided a welcome reduction in volatility thus far in 2016.

Succeeding in the challenging game of investing is often about being patient, protecting capital when the expected payoff to risk-taking is poor, and taking risk when the payoff is attractive. It's also decidedly about controlling what you can control—volatility—through thoughtful portfolio construction. The keys here are reducing the chance of a big loss that could substantially set back a portfolio's long-term performance expectations—and knowing that by reducing volatility, the mathematics of compounding wealth improves.

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