MD SASS

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Third Quarter Outlook

U.S. ELECTIONS, INTEREST RATES AND CORPORATE PROFITS

As the U.S. economy continues in its 8^{th} year of expansion, real U.S. GDP growth proceeds at the roughly 2% annual rate posted over the past 5 years. We continue to expect moderate sustainable growth with low inflation and interest rates in the absence of the events that trigger recessions. Equity markets don't die of old age or at the initial stage of Central Bank tightening; instead, bull markets typically end when economic growth peaks a few months prior to recessions. The Consumer Confidence index is at its highest level since August 2008, and employment is continuing to increase along with modest wage growth. These factors should drive future growth in consumer spending and the economy.

The equity market overall is about fully valued, in our view, but there are pockets of significant over and undervaluation that represent an investment opportunity. In this extremely challenging market environment, 90.2% of U.S. active equity managers underperformed their benchmark indices in the 12 months ended 6/30/16, according to Standard & Poor's. Many smart, active managers have been frustrated with this stock market which has ignored undervalued stocks with strong earnings growth while the herd has flocked to high dividend paying stocks and passive funds. In the first 8 months of 2016 passive funds attracted almost $110 Billion in new investments whereas actively managed U.S. equity funds suffered $166 Billion in outflows, according to Morningstar.

We have witnessed many past episodes of crowd psychology (psychosis) in our 44 year history and are convinced that superior stock selection will again prove very rewarding when and as the equity yield mania dissipates. We are also mindful that some of the following macro concerns may result in short term market volatility:

U.S. ELECTIONS - the outcome of the upcoming Nov. 8th election is unlikely to materially change the ultimate market or macroeconomic outlook. However uncertainties leading up to the election are likely to result in heightened volatility. Currently the odds favor a Hillary Clinton presidential victory and a Democratic win in the Senate. A Clinton victory largely represents the "status quo" except for potential corporate tax reform which would include overseas earnings repatriation and tax collections on it. This repatriation will likely be used to fund increased infrastructure spending, helping the Government to pivot to greater reliance on fiscal vs. monetary stimulus. Although Democrats seem likely to win the Senate, the next government will be closely divided politically. Congressional majorities alone don't equal control, particularly in the Senate where unanimous consent and absolute supermajorities of three fifths are required for approving legislation. Neither party will end up with a Senate supermajority.

A surprise Trump victory would bring heightened policy uncertainty, possible trade wars, uncertain foreign policy, and potential negative short-term financial market implications. However, the equity market is likely to recover quickly with the U.S.' system of checks and balances to keep government from getting too powerful in any one of its three branches. The Brexit vote, with its uncertain impact on the euro area and the U.K., is a possible footprint for a surprise Trump win. The post-vote U.K. equity market reaction was sharp but short-lived.

CORPORATE EARNINGS – S&P 500 earnings have posted five consecutive quarters of year-over- year earnings declines since they peaked in 1Q15, but the trend is turning less negative. Earnings declines fell from -6.5% year over year in Q1 to -3.5% in Q2 and are estimated to drop -1.6% in Q3 (based on bottom up estimates) as the drags of a higher U.S. dollar and lower energy prices continue to fade. Healthcare and Information Technology sectors have the greatest likelihood of positive earnings surprises. Until after the bond market's record low yield in early July it seemed earnings didn't seem to matter because of the mindless move to yield-oriented stocks.

If oil prices trade around current levels of $50 then the headwind to profits from collapsing energy earnings is behind us. One risk to monitor carefully is the headwind of weak pricing power and a strong dollar coupled with slowly rising wages, a combination which can squeeze profit margins and hurt earnings. Without stronger earnings momentum, price-earnings ratios for equities are unlikely to expand further.

INTEREST RATES – while bond yields may remain anchored at relatively low levels, there is a strong possibility that we have already seen the low in U.S. Treasury yields after a 35 year bond bull market. The post-Brexit record closing low on July 8th for 10 year US Treasuries was 1.36%, down from its peak of over 15% in September 1981. The greatest excess is in long term bonds of weak foreign governments and in the approximately 1/3 of sovereign debt, or about $12 trillion, which now trade at negative yields. With regulations causing investment banks to significantly reduce market-making since 2008, liquidity is shrinking, making trading in low quality bonds more difficult for investors in the future.

The Fed clearly wants higher interest rates and the futures market is pricing in a 68% probability of a fed funds hike in December. Rising populism and reluctance by Central Banks to add further monetary policy support is likely to result in a global pivot toward looser fiscal policy. Governments are likely to increase fiscal stimulus (infrastructure spending) until they stimulate more demand and inflation, which could spell a selloff in bonds.

In the equity market, the impact of ultra-low interest rates has been an almost mindless stampede into pricey dividend oriented bond proxies - -Utilities, Telecom & Consumer Staples - - during the first half of 2016. Then, after bond yields started moving up slightly from 1.36% at the low of the 10 year Treasury on July 8th, there has been a sector rotation into Technology, Industrials, Financials, Consumer Discretionary (areas of emphasis in our portfolios). In this period many high P/E Utilities, Telecom and Consumer Staples have since declined. Healthcare stocks have remained under pressure by political rhetoric on drug pricing and several have reached prices that appear significantly undervalued.

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Fixed Income Outlook

It's coming. Sooner or later, but probably sooner.

The bond market has begun to anticipate a gradual increase in interest rates, perhaps beginning in December 2016 with a 0.25% increase in the Fed's discount rate. Many interest rate forecasters anticipated this increase in July of this year, but the Fed deferred action in the wake of weak global, U.S. economic data and the unknown market and economic reaction to the U.K.'s decision to leave the European Economic Community (Brexit). While these factors remain considerations, the economic and market reactions to Brexit have been subdued and many forecasters expect the U.S. to have a relatively strong second half of 2016.

While the financial markets may initially react negatively to a Fed rate increase, we expect the reaction to be more muted after the market absorbs the initial shock. Nonetheless, the trend in interest rates is likely to be gradually higher, posing a risk to longer term bonds. We continue to advise short and intermediate term holdings in U.S. Government Agency Mortgage Backed issues.

Below is a table showing the total return (income plus or minus price change) of various Treasury benchmark maturities, assuming an equal increase in yields from their levels on October 1, 2016, along the range of maturities. Even after such an interest rate increase, yields would still be far below their long term averages.

		Total Returns If Interest Rates Increase	
Maturity (Years)	**Yield**	0.50%	1.00%
1	0.59%	0.59%	0.60%
2	0.76%	0.37%	-0.10%
5	1.15%	-0.51%	-2.38%
10	1.59%	-2.06%	-5.95%
30	2.32%	-7.61%	-16.38%

Source: Bloomberg

Over the course of a year, we believe that investing in one through five year duration portfolios holding U.S. Government agency Mortgage Backed issues (MBS) could substantially outperform Treasuries due to three main factors discussed below. We continue to urge clients to focus on shorter duration strategies with less exposure to downside risk. Please note that client durations vary based on each client's duration target and we are happy to analyze the specific exposure of your portfolio upon request:

1. MBS issues offer a substantially higher yield due to investor concerns that they will be refinanced in the current unusually low interest rate environment and investors fear that they

will have to reinvest the proceeds at lower yields and lose the premium prices that these issues sell for in the current market.

2. Rising interest rates will make the economic benefits of refinancing less attractive and therefore further increases the yields to average life of these holdings as interest rates increase.
3. Housing turnover slows when interest rates rise, resulting in lower mortgage payoffs because homeowners selling their current home and paying off their low interest rate mortgage have to take out a higher interest rate mortgage when they buy the next home in a higher interest rate environment. This additional cost reduces the benefits of "trading up" for younger families and "downsizing" for empty nesters.

When and as interest rates rise bond market volatility will increase and some short term price declines will be likely occur. Over a several month holding period, we believe this could be offset by the higher yields provided by shorter term MBS portfolios. Accordingly, we believe any major market disruptions may present buying opportunities in this sector.

We are always pleased to discuss our views, strategy and clients' evolving circumstances and needs in more detail with clients.

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