Welcome to the Low-Return Environment

By Robert Stein, CEO

2016 OUTLOOK

My outlook for 2016 is a low-return environment. Both for stocks and fixed income (although investment conditions as of this writing still favor risk assets). In addition, there are conditions supporting opportunities in other assets, which should help diversify investment portfolios. For now I believe the expected return for domestic equity markets is still positive. I expect there is more upside potential before the next recession hits. However, appreciation will likely come with more volatility, which is more the historical norm than the market conditions of the past few years.

The much-anticipated recent rate hike by the Federal Reserve has raised questions as to whether fixed income assets will pose competition for stocks. The answer as we see it is "No". The Fed's actions did not have much impact on rates. The "big move" by the Fed, if you want to call it that, occurred more than a year ago when the Fed stopped its aggressive easing. Note the real rate of interest is still zero (or below). As with the weather, going from a negative number to zero is not much of a "warming trend." While fixed income will produce some return, it will likely be low. At the same time, I do not believe holding fixed income assets comes with a wealth destroying price. I think the next few years should be flat or dare I say even negativebut that will not destroy portfolios.

Macroeconomic data continues to tell the story. Readings such as nonfarm payrolls are currently above the recent and longer-term trend of the past 10 years. When these conditions exist, risk assets are generally rewarded. (Meanwhile, inflation remains well below the Fed's 2% target.) However, a strong U.S. dollar, the precipitous drop in crude oil prices impacting the energy sector and weak demand from abroad (i.e. China) have created unsettling market conditions. As we have seen in early 2016, the markets are nervous and some investors are waiting on the side lines as cash levels are near records.

2015 Review

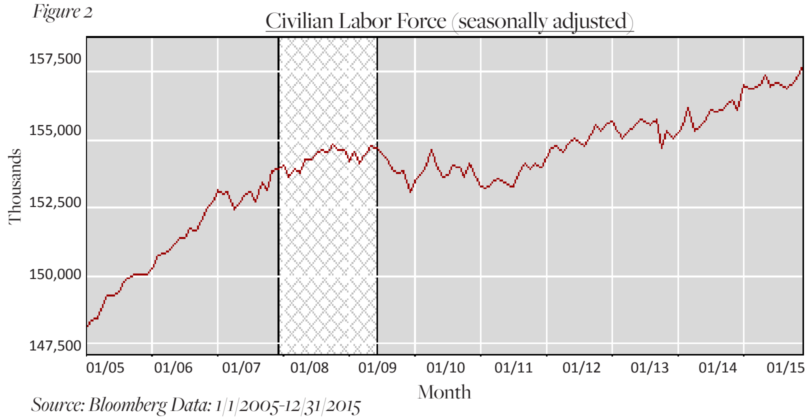
The story of 2015 was one of moderation and divergence. The U.S. economy grew by 0.7% annualized rate in the fourth quarter of 2015. For the year as a whole, real GDP grew by 2.4% on an average basis, same as in 2014. However, the overall trend has been positive for the past six years (Figure 1).

Figure 1

Source: Bloomberg, Data: 1/1/2005-12/31/2015

Since the "Great Recession," the U.S. economy and other developed economies have done an amazing job of reallocating resources and jobs to productive areas. In the U.S., this reallocation helped push total GDP to more than $18 trillion (a record). The U.S. civilian workforce (see Figure 2) has grown to more than 155 million people (also a record).

Figure 2



Source: Bloomberg Data: 1/1/2005-12/31/2015

ASTOR INVESTMENT MANAGEMENT LLC
111 S. WACKER DRIVE, STE. 3950
CHICAGO, ILLINOIS 60606

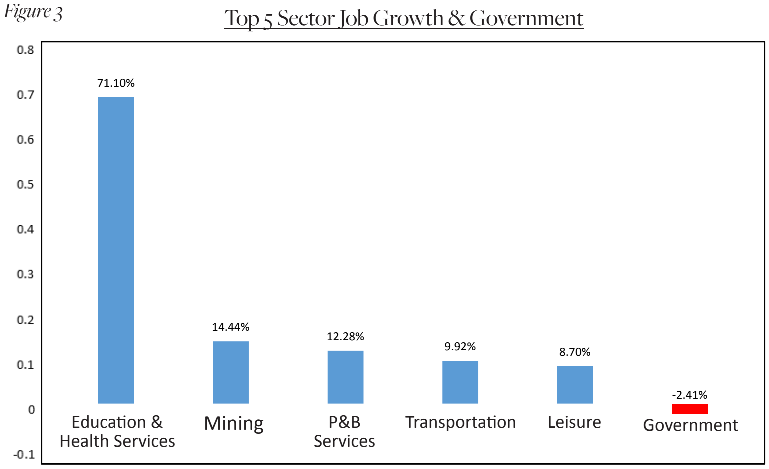
(800) 899-8230 . info@astorim.com

Steady job creation resulted in a drop in the unemployment rate over the course of 2015 from 5.7% to 5.0%. Although employment declined in the energy sector, the service sector (and not just fast-food, restaurants, hotels, and part-time jobs) expanded by 230k in December.

As Figure 3 shows, the quality of jobs is improving as well. Positions in health care, mining, and professional services are leading the charge in the modern job market. Notice that these are private sectors creating jobs, not government. This environment can only be good news.

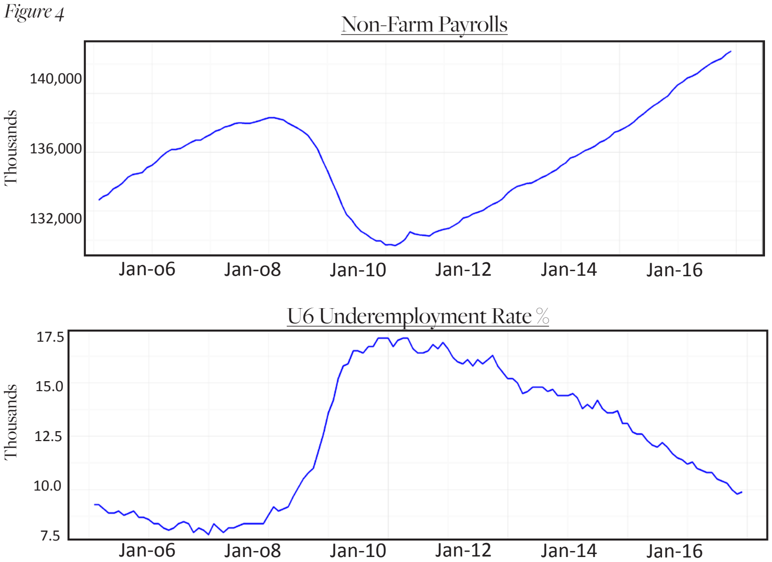
Taking a longer-term view (Figure 4), U.S. nonfarm payrolls consistently increased for the past six years and the underemployment rate has moved steadily back to pre-financial crisis levels.

Figure 3



Source: Bureau of Labor Statistics Data: 2000 - Present

Figure 4



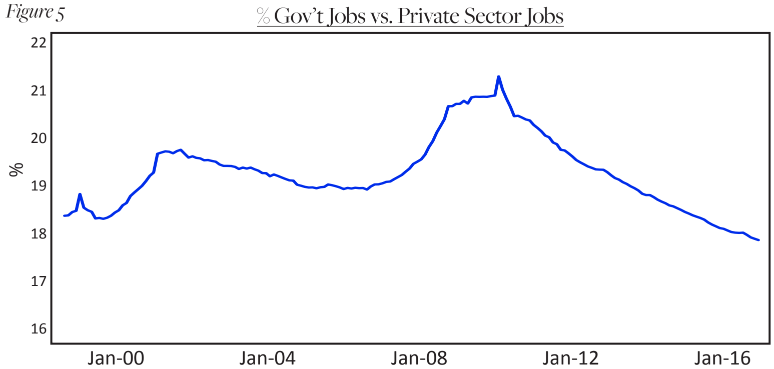
Source: Bloomberg Data: 12/31/2005-12/31/2015

While some will argue the participation rate is at decade lows, this fact has little to do with economic growth rate, nor has it had much impact on stock market returns. Although this decline is potentially problematic, it is more of a social problem than an economic one.

Government Tailwind Ahead?

To study this environment of what is widely perceived to be big government, more regulation, and unfair (or at least complicated) tax structures, I have to look through my pure economist glasses. What I see might be surprising: over the past five years or so, government jobs have actually declined as a percentage of total jobs!

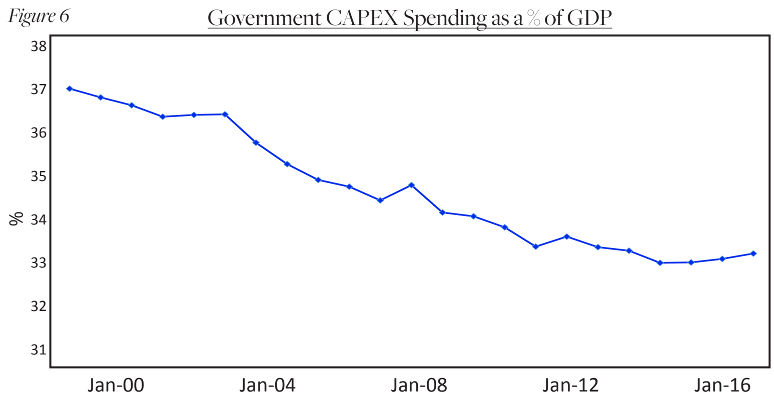
Figure 5



Source: Bureau of Labor Statistics Data: 2000 - Present

In addition, government capex spending (non-debt) as a percentage of GDP (see Figure 5) declined while tax receipts and corporate profits hit all-time levels. To be clear this statement is not a political but, rather, economic.

Figure 6



Source: Bloomberg Data: 1/3/2010-9/30/2015

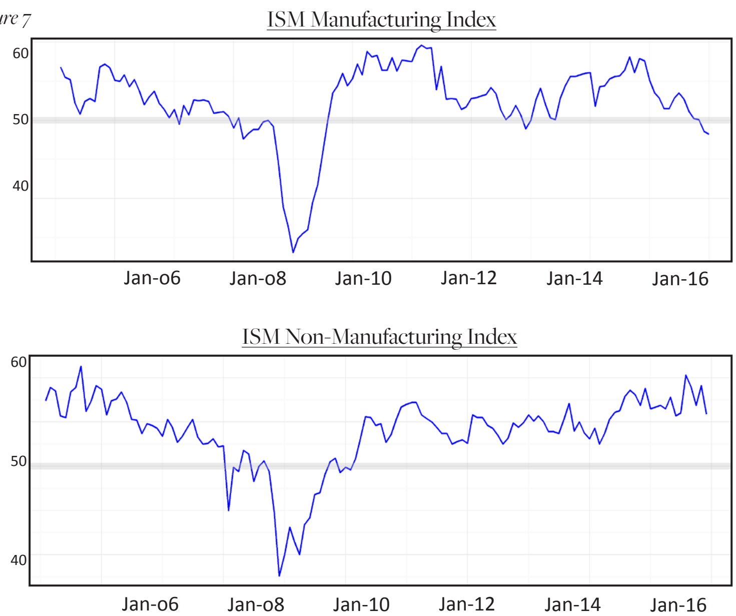
The government is expected to add jobs this year and increase expenditures which will add to GDP and employment trends in 2016. We all can argue about the long-term effect, but I believe it will likely be a tailwind in 2016 — and occur while no one is looking. I see a scenario where the emphasis will be on the private sector and corporate earnings while the government quietly adds to the economy.

Is U.S. Manufacturing a Worry - or Not?

U.S. manufacturing output has been declining and the manufacturing sector (as illustrated by the ISM Manufacturing Index) is below trend. While some might describe this sector as being in a recession, my opinion is the situation appears to be temporary (or, in Fed-speak, "transitory") due mostly to declines in energy and commodity production and prices. However, manufacturing jobs in the U.S. have rebounded back to 2010 levels and will likely climb with economic growth. In other words, although manufacturing has fallen mainly due to changes in the energy sector, it was accretive and helped lift the economy from the recession. Moreover, much of the gains in output and employment are still accretive and above 2010 levels even with the contraction in the sector. If we do find a bottom in manufacturing I think this event will be an additional tailwind to economic growth. Will it be in 2016? I am not sure, but I think it will be before the expansion is over.

We must also understand the U.S. is no longer a manufacturing economy (a point we will stress throughout 2016). Non-manufacturing continues to pull more weight in the economy and is a 10% larger contributor to GDP than it was a decade ago. The U.S. economy is diverse which gives it the ability to withstand and even thrive in the midst of a recession in one of its pillars of growth (see Figure 7).

Figure 7



Source: Bloomberg Data: 12/31/2005-12/31/2015

The service sector, in particular, remains strong (as shown in Figure 7). Robust demand for labor and wage inelasticity in the service sector should also help spur consumer spending. Spending is an important driver of GDP growth. To support the point we return to the steady improvement in the employment situation (Figure 4). I think the labor market is clearly telling the more accurate story.

Corporate earnings in 2015 encountered headwinds from a strong U.S. dollar and lower energy prices. These factors could result in a correction, but stability is the more likely scenario, in my view. While headlines about oil prices and challenges around the globe have and will increase market volatility, I think it is unlikely these events will have a lasting effect on stocks. I believe stability in commodity prices and the dollar will lead to more predictable earnings for multinational companies in 2016. Predictability, as I see it, is more important than correcting imbalances. This scenario would be positive, as earnings for more than half of the companies in the S&P 500 are partially tied to overseas economies and commodity prices.

Energy - Looking for Stability?

Everyone is asking the question: where is the bottom for energy prices? While there are more guesses than answers right now, one of the themes I have written about before is how the energy market reacts to prices. The cure for high prices was, well, high prices. The industry became more efficient and were incentivized to drill more and produce more. Supply increased as higher prices drove down demand: until the two intersected. Unfortunately, no bell rang to signal we were at equilibrium. Drilling, fracking, and extracting continued until supply outpaced demand and market forces pushed prices lower. However, the leverage and loans made to companies were supported by drilling, fracking, and extracting, as well as inventories. As prices declined below expectations, the resulting pressure on balance sheets and liabilities encouraged even more production at lower prices. It is better to pay the banks something rather than nothing at all.

In time, the cure for low prices will likely be lower prices, once again readjusting supply and demand. This situation will likely take a bit longer than when higher prices were the cure for high prices. In energy markets, there are beneficiaries of lower prices, especially consumers. Also, every producer needs petroleum products or energy products to make their widgets. Although loans to energy-related sectors total about 3% of outstanding bank debt, the larger population ultimately will benefit from lower prices. (A sharp contrast to, say, housing, in which hardly anyone benefits from lower home values.) Lower energy costs combined with higher wages and lower consumer goods prices should support increases in spending to offset the damage caused by lower oil prices. I think the benefits will take a few quarters to filter through the system.

Currencies

A strong U.S. dollar has had a short-term impact on the earnings of multinational corporations. (As stated earlier, companies with overseas businesses and earnings make up more than 50% of the S&P 500 Index.) It is no surprise many companies that failed to grow earnings above and beyond expectations blamed the rising dollar. While the Fed telegraphed a rate hike for almost a year, the dollar did not wait for the increase and had been appreciating for some time before the December rate hike. Aggressive stimulus by Japan and the ECB which added support to the greenback created even greater rate differentials. However, a rate differential is not the only reason to support a currency: in the long run I think it is hardly a factor. Trade flows and balance of payments are larger factors but more important to corporations with exchange rate exposure is stability.

For companies, visibility is valuable for planning business expenditures and inventory building. When a move gets this far along, hedging tactics or trade flow changes are more likely to mitigate the impact of further moves while countermoves become accretive or at least non-issues. In other words, further movement in the dollar will likely have a much greater impact on corporate earnings and a reversal will have less benefit. My opinion is that multiyear appreciation will likely lead to more stability with little impact on the U.S.

Corporate Debt

As a result of the recent rate increase, people are worried about bond liquidity, especially if we are entering a period of rising rates. 2015 saw a 29% decline in average daily trading volume in corporate bond markets. The decline was attributed to the Fed's rate hike decision, a much-anticipated action since it was first proposed in early

2015. I am not overly concerned about liquidity on the trading front as global demand for interest-bearing assets is high. I think this issue is more a reflection of fixed-income portfolios adjusting. In the U.S. since July 2014, yield spreads have risen as much as 92%.

However, as Figure 8 shows, credit spreads have widened by several percent over the past two years. I am not overly concerned at these levels because I believe most of the widening is due to the issues within the energy sector. Outside of the U.S., Europe's corporate bond market is selling at recession levels. There is worry the bond market issues will spill into the global economy. In addition, China has a corporate debt-to-GDP ratio of nearly 1.6. Companies have levered up. If the yield spreads continue their upward trend, those companies may have few places to sell their debt.

Figure 8

BarCap U.S. Corporate HY YTW (10-Year Treasury Spread)

Source: Bloomberg, Data: 12/31/13-2/2/16

Housing

Housing has been in a recovery mode for the past several years, albeit, unevenly throughout the country. Stricter lending standards have eased and a glut of inventory has finally been worked off. Real economic factors such as mortgage rates and wages are more important today. Based on the current employment trends and housing affordability, I expect this sector to be a bright spot in 2016.

Figure 9

Housing Price Index

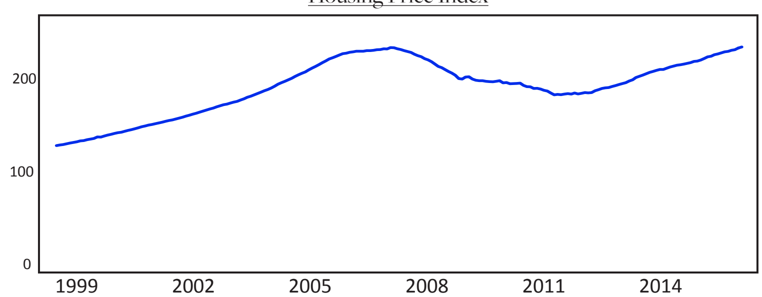
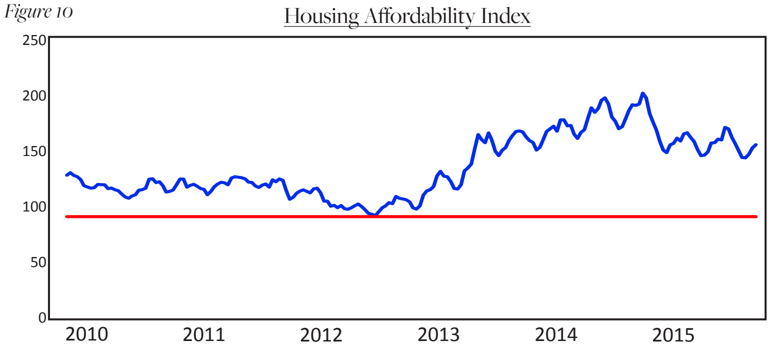


Figure 10

Housing Affordability Index



Source: St. Louis Federal Reserve Data: 1999-Present

Demographics are now starting to favor home ownership as Baby Boomers downsize and the Millennials start families. Millennials are nearly as numerous as Boomers, unlike Gen Xers who were a fraction of the size of the Boomer population. As Figures 9 and 10 illustrate, average home prices are steadily rising while the affordability index remains above 100*. These conditions appear stable and growth in the housing sector should add support to the economy in 2016. Even subpar growth in the economy and low returns in the stock market should not derail a fairly steady housing market.

Looking through the Risk Asset Lens

As we continue our recap of 2015, we should survey the landscape through the risk-asset lens. For most money managers (including Astor) 2015 was a challenging year. 2015 had its share of shocks to the market, including geopolitical events and a pronounced economic slowdown in China. China's slowdown has hit emerging markets harder than the U.S. and required further intervention by the Chinese government and support from the PBOC. Along with the aforementioned Fed actions to raise rates, sharp declines in oil and commodity prices were prominent features of the 2015 landscape.

One of the fundamental theories in the investment industry is risk vs. return. In order to be compensated for taking on more risk, investors expect higher rates of return. The table in Figure 11 shows interesting differences between the risk levels of various equity indices and their subsequent returns. While the large cap focused S&P 500 Index experienced positive returns, small and mid-cap indices experienced negative performance with lower or marginally higher volatility. The risk vs. return equation appears off-balance.

Figure 11

Index	12 Mo. Standard Deviation	Performance	Sharpe Ratio (2%)
S&P 500 Index	13.66%	1.38%	-0.05
S&P 400 Index	11.85%	-2.18%	-0.35
Russell 2000 Index	14.48%	-4.41%	-0.44
S&P 500 Pure Value Index	15.15%	-10.23%	-0.81
S&P 500 Pure Growth Index	12.70%	1.72%	-0.02

Source: Bloomberg Data: 12/31/14-12/31/15

If we dive into the underlying stocks of the S&P 500 Index, we see a minority contributed to the overall performance in 2015. The annual return across the stocks in the Index averaged about -1.10%. How¬ever, without the "Horsemen of Technology"—Facebook, Am¬azon, Netflix, and Alphabet/Google (known as FANG)—2015 would have been a decidedly negative year. The combined contribution of these few key large cap tech stocks to the annual return of the S&P 500 was close to 4% (Amazon, alone, provided about 1.7% to the index). Removing the performance of one of these tech "horsemen" could have had a material impact on the performance of the Index. Re¬member, the S&P 500 Index is a market-cap weighted index, which means a few larger names with outsized returns can move the nee¬dle one way or the other. (The 20 smallest companies in the Index, meanwhile, had an average return of about -40% for the year.)

By the close of 2015, the 10-Year Treasury rate was slightly lower than at the beginning of the year, while the S&P 500 Index ended the year about flat. For some, it paid to sit through the volatility, although

*Readings above 100 mean a family earning the median income has more than the necessary amount of income to qualify for a conventional loan.

most of the gains were concentrated in large-cap growth stocks as shown above. Small cap and value were punished, in my opinion, mostly due to uncertainty over low interest rates which had been their safety net.

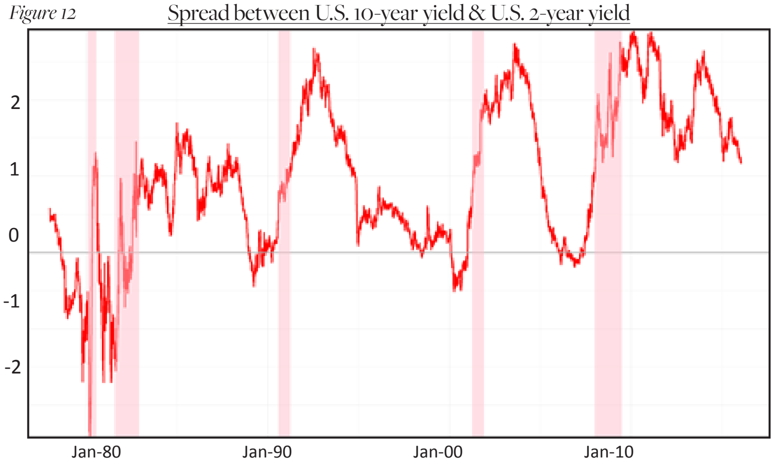
2016: New/Different Pillars Hold the Economy "Steady as She Goes"

In 2016, I expect the diverse economy to show its advantages. I believe housing and financial stocks should take the lead as technology and healthcare take a breather. Additionally, I think rotations out of large-cap growth and technology should begin in 2016, as smaller-cap and value benefit from more clarity on the economic front.

It would seem unlikely various segments of the total equity market, each representing thousands of stocks, will have long-term deviations from each other. While sectors/segments come in and out of favor, over time stocks (like other assets tend to) revert to the mean. I expect demand for risk-free assets is expected to offset the Fed's rate actions, meaning bonds will basically go nowhere. That is to say I expect yields will increase and prices will decline but not result in anything noteworthy to cause wealth destruction. There will be opportunities to "add some English to the ball" (i.e. to adjust portfolios) so as not to let duration risk hurt portfolios, but not enough to lose sleep over. I expect short-term rates will begin to normalize, but the 2-Year Treasury will have a long way to go to reach the GDP's 10-quarter average, which is the long-term historical relationship. In other words, rate increases are unlikely to derail this economy, even if they are more persistent than anticipated. I believe a yield flattening will likely occur during 2016, but an inverted curve or levels that signal contraction are not yet on the horizon.

I believe Figure 12 shows we are far from recessionary or economy slowing slopes. The forward looking yield curve has accounted for further Fed rate hikes and looks none the worse for it.

Figure 12 Spread between U.S. 10-year yield & U.S. 2-year yield

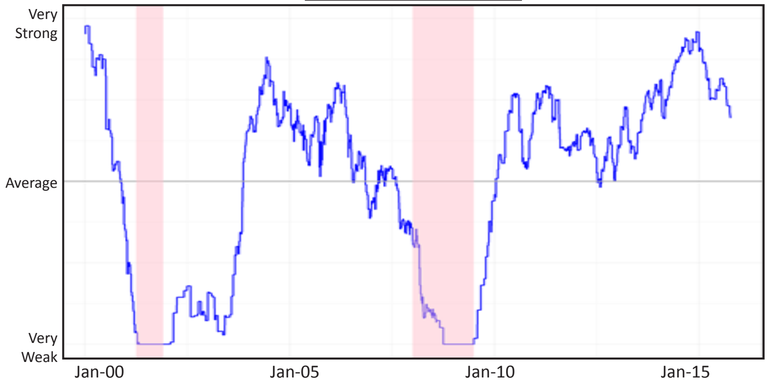


Source: Bloomberg Data: 1/1/1975-12/31/2015

What the Astor Economic Index® is Saying

As I take a look at the underlying data of the Astor Economic Index®, I remain cautiously optimistic about owning high levels of stocks in a portfolio. As Figure 13 shows, the Astor Economic Index® remains above average, although it has declined from the highs at the end of 2014. As would be expected, Astor reduced a level of beta over the course of the year. I expect the impact of this reduction to be felt as 2016 evolves. If conditions deteriorate more, I expect to reduce further, but if conditions remain at current levels or improve throughout the year, I expect we will increase portfolio risk levels.

Figure 13 Astor Economic Index®



Source: Astor Data: 1/1/2000-12/31/2015

The Astor Economic Index® and the aggregate of all indicators are above the long-term trend. Given the cyclicality of the economy, this state will change one day—but not today. I believe growth and support to the economy will come from different areas then in the past few years: and that scenario is already starting to show. Services, housing, and even the government will likely be tail winds this year. If manufacturing or emerging economies come back to life, growth could surprise on the upside over the next 18 months. While there is much to be cautious about as well—rising rates, weak demand, and deflationary pressures—I do not think there is reason to hit the "panic button" because of uncertainty or increased volatility.

I maintain my steadfast belief in our research and investment process, which will help us discern internal market issues. Over a longer time horizon, there will likely be mean reversion across asset classes and market segments. Therefore, absent a drastic change in the economic picture, I expect us to stay the course in our investment models. As I have stated before, I believe selling out of positions and reallocating because of a quarter or two of underperformance is imprudent and not how Astor invests. Our focus is and always will be on longer term market trends based on economic analysis. If the economy changes, I believe we will begin to reduce risk exposure as conditions change.

For now, my analysis points to a low-return environment, albeit one in which risk assets are still rewarded. Seeking out the best opportunities and appropriate levels of allocations will become more important. Admittedly, a low-return environment calls for patience, and even enlightenment among investors. Current conditions are what they are, and we cannot pretend otherwise. Or, as I like to say somewhat jokingly "you cannot yell at a nickel because it's not a quarter." Better to have a nickel than nothing at all.

ASTOR
Investment Management

DEFINITIONS:

Astor Economic Index®: The Astor Economic Index® is a proprietary index created by Astor Investment Management LLC. It represents an aggregation of various economic data points: including output and employment indicators. The Astor Economic Index® is designed to track the varying levels of growth within the U.S. economy by analyzing current trends against historical data.
Beta: A quantitative measure of the volatility of a given portfolio, relative to the S&P 500 Index, computed using monthly returns. A beta above 1 is more volatile than the index, while a beta below 1 is less volatile
Capital Expenditure ("CAPEX"): Capital expenditure represents capital used to purchase or upgrade physical assets.
GDP – Gross Domestic Product ("GDP") is a measure of the output of an economy.
Growth: Growth refers to stocks considered to have higher potential for capital appreciation and often have high price-to-book and/or price-to-earnings ratios.
Housing Affordability Index: A measure from the National Association of Realtors designed to show whether a family earning the median income as calculated by the U.S. Bureau of the Census can afford the national-median priced, existing single-family home.
ISM Manufacturing Index: The ISM Manufacturing Index is a diffusion index from the Institute for Supply Management that provides information on the sentiment of surveyed participants within the manufacturing industry.
ISM Non-Manufacturing Index: The ISM Non-Manufacturing Index is a diffusion index from the Institute for Supply Management that provides information on the sentiment of surveyed participants outside of the manufacturing industry (i.e. services).
Large Cap: Large cap refers to stocks with market capitalizations in excess of $10 billion.
Nonfarm Payrolls: Nonfarm payrolls is an employment measure from Bureau of Labor Statistics that represents all paid U.S. workers except government and private household employees.
Participation Rate: The percentage of the civilian labor force that is either employed or seeking work.
Real Rate: The Real Rate is an interest rate adjusted for the impact of inflation.
Risk Assets: Risk assets typically refer to investable assets that have a high level of volatility such as equities and commodities.
Small Cap: Small cap refers to stocks with market capitalizations less than $2 billion.
S&P 500 Index: The S&P 500 Index is an unmanaged composite of 500 large capitalization companies.
Unemployment Rate: The U6 Unemployment Rate is a more expansive measure of unemployment than the official U3 rate. The U6 measures the amount of total unemployed individuals in the civilian labor force including marginally attached workers and part time workers for economic reasons.
Value: Value refers to stocks considered to be undervalued compared to peers as they have low prices based upon certain ratios such as price-to-book and price-to-earnings.
Volatility: Volatility is a statistical measure of the dispersion (i.e. standard deviation) of prices for a security or portfolio over a defined period of time.
Yield Curve: The resulting line on a graph consisting of bond yields on the y-axis and time-to-maturity on the x-axis.
BarCap US Corporate HY YTW – 10 Yr. Treasury: This index represents the difference between the Barclays Capital US Corporate High Yield Yield to Worst and the US Generic Government 10 Year Yield. The index is designed to represent the interest rate differential between high yield bonds and US Government bonds.

DISCLOSURES:

Equity prices can fluctuate for a variety of reasons including market sentiment and economic conditions. The prices of small and mid-cap companies tend to be more volatile than those of larger, more established companies. It is important to note that bond prices move inversely with interest rates and fixed income investments can experience negative performance in a period of rising interest rates. High yield bonds are subject to higher risk of principal loss due to an increased chance of default. Commodities can have a substantial risk of loss due to leverage. Currencies can fluctuate with changing monetary policies, economic conditions, and other factors. International markets have risks due to currency valuations and political or economic events. Emerging markets typically have more risk than developed markets. Real estate investments can experience losses due to lower property prices, changes in interest rates, economic conditions, and other factors. Investments in specific sectors can experience greater levels of volatility than broad-based investments due to their more narrow focus.

The Astor Economic Index® is a proprietary index created by Astor Investment Management LLC. It represents an aggregation of various economic data points: including output and employment indicators. The Astor Economic Index® is designed to track the varying levels of growth within the U.S. economy by analyzing current trends against historical data. The Astor Economic Index® is not an investable product. When investing, there are multiple factors to consider. The Astor Economic Index® should not be used as the sole determining factor for your investment decisions. The Index is based on retroactive data points and may be subject to hindsight bias. There is no guarantee the Index will produce the same results in the future.

All information contained herein is for informational purposes only. This is not a solicitation to offer investment advice or services in any state where to do so would be unlawful. Analysis and research are provided for informational purposes only, not for trading or investing purposes. All opinions expressed are as of the date of publication and subject to change. Astor and its affiliates are not liable for the accuracy, usefulness or availability of any such information or liable for any trading or investing based on such information. There is no assurance that Astor's investment programs will produce profitable returns or that any account with have similar results. You may lose money. Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve results that are similar to those shown. Factors impacting client returns include individual client risk tolerance, restrictions a client may place on the account, investment objectives, choice of broker/ dealers or custodians, as well as other factors. Any particular client's account performance may differ from the program results due to, among other things, commission, timing of order entry, or the manner in which the trades are executed. Clients may not receive certain trades or experience different timing of trades due to items such as client imposed restrictions, money transfers, inception dates, and others. The investment return and principal value of an investment will fluctuate and an investor's equity, when liquidated, may be worth more or less than the original cost. An investment cannot be made directly into an index. Please refer to Astor's Form ADV Part 2A Brochure for additional information regarding fees, risks, and services.

312151-364

ASTOR INVESTMENT MANAGEMENT LLC
111 S. WACKER DRIVE, STE. 3950
CHICAGO, ILLINOIS 60606

(800) 899-8230 . info@astorim.com