TRILLIUM | # Economic and Market Outlook

September 30, 2015 (3rd Quarter)

ALLOCATION

We continue to emphasize stocks over bonds, believing that the balance of risk and return for the remainder of 2015 and for 2016 favors high quality stocks. We acknowledge that further temporary drops in the equity markets may be ahead, but in keeping with the theme of this review, we believe that one year from now, investors who take a measured response to the current volatility will prove wiser than those unnerved by recent market gyrations.

MARKET REVIEW

At the end of the Second Quarter, we noted that the economic and valuation underpinnings of the U.S. stock market were reasonable, but that several areas of increased risk are likely to increase day to day volatility, and could affect the timing of the Federal Reserve's expected change in direction from an extraordinarily expansionary monetary policy to a merely extremely expansionary policy. We also noted that economic slowdowns in China, much of Europe, and countries with significant energy and commodity exports, such as Brazil, Canada, and Russia, provide multiple opportunities for additional volatility in currency flows and interest rate adjustments. We were correct in the direction, but underestimated the extent of the increased volatility.

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The third quarter of 2015 reinforced our strongly held belief that operating in an increasingly complex market environment requires thought, not reaction. Since our last Economic and Market Outlook, the Shanghai stock market dropped by 30%; the MSCI Europe, Asia, and Far East (EAFE) Index dropped by 10%, the All Country World Index dropped by 9%, U.S. small stocks dropped by 12% and U.S. large stocks dropped by 6.9%, all measured in dollar terms. Intra-quarter declines were even larger. Two-year U.S. Treasury yields were unchanged for the quarter, but 10 year U.S. Treasury yields fell by 0.3%, as the Federal Reserve declined to raise short term interest rates, after widely signaling that short term rates would soon be rising.

After spending much of the year in a very-low volatility market, volatility spiked in August, concurrently with an 11% drop in the S&P 500 index during the one week period from August 18 to August 25. On August 24, circuit-breakers halted trading in a number of stocks at the market open, but automated trading programs, designed to reduce risk by selling equity exposure as volatility increases, fed into the selling, leading to wide-spread pricing anomalies, such as a the Vanguard Dividend Appreciation ETF being down 35% intraday while the underlying stocks were down an average of 5%. Interestingly, the more liquid stocks in the S&P 500 dropped significantly more than the smaller, less liquid stocks in the Russell 2000, supporting the conclusion that automated- and panic-selling were ruling the market that day. A few moments thought by a rational investor would have yielded the insight that it was best to wait out such an unruly market.

We have also seen reactive analysis about the major concerns on investors' minds during the quarter: What will be the effect of slowing Chinese growth, and what will be the result when the Federal Reserve begins to raise interest rates? Neither of these questions can be answered by simple extrapolation or regressions based on past experience. Fundamentally, we are operating in different economic territory.

Slowing Chinese economic growth will also decrease China's imports, leading to a growth slowdown in the primary exporters to China: Japan, South Korea, other Asian countries, the United States, and Germany, but the impact differs based on how significantly export-based the economy is. We do not expect the direct effect on U.S. economic growth to be significant: the U.S. economic recovery is firmly established, and will continue at a measured pace, supporting corporate earnings for domestically focused companies; we continue to expect U.S. economic growth of approximately 2.5% in both 2015 and 2016. For the U.S., exports to China, Russia, and Brazil are just 2% of GDP; for Germany, exports to these countries are 5% of GDP, leading to a significantly greater impact from slowing worldwide markets for Germany than for the U.S. European recovery has been supported by the robust size of the European Central Bank's quantitative easing program, but Europe's underlying economic recovery is both more tenuous and much more exposed to declining growth in emerging markets. Thus, we expect U.S. economic growth to continue at a 2.5% rate, but we expect slowing growth in European countries.

Slowing Chinese growth, low inflation, and declining stock markets apparently stayed the Federal Reserve's move to raise interest rates. Unfortunately, after multiple quarters of market anticipation of rising rates, the Fed's inaction led to an worldwide equity market selloff of 5.6% over the next 8 days, as investors expressed their anxiety that the Fed saw deteriorating economic conditions ahead. Since the end of the quarter, worldwide markets have rallied between 2% to 9%, and oil prices have rallied slightly, reflecting slightly reduced concerns about economic growth.

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THIRD QUARTER 2015 RETURNS

During the third quarter, we maintained maximum equity exposure for clients where we have the ability to allocate between stocks and bonds. At the end of the third quarter, bond returns, measured by the Barclays Government/ Credit Intermediate Bond Index, were modest but positive, at 0.95% for the quarter and 2.68% for the past twelve months. In contrast, stock returns were broadly negative. Large capitalization stocks, as measured by the S&P 500, had returned -6.94% for the quarter, -5.29% since December 31, and -0.62% for the past twelve months. Small- and Mid-Capitalization stocks, measured by the S&P 1000, dropped during the quarter, with a total return of -8.73%, but managed a +2.1% return for the past twelve months. The MSCI Europe, Asia, and Far East Index (EAFE) returns reflected the shift in concern from tension over Greece to declining growth in China, returning -10.16% for the quarter and -8.11% for the past twelve months. The MSCI All Country World Index (ACWI), which has an approximately 50% exposure to the U.S., and 10% allocation to emerging markets, returned -9.33% for the quarter and just -6.11% for the twelve months, measured in US Dollars.

Oil prices dropped during the quarter, with West Texas Intermediate oil ending the quarter at $45 per barrel, down 23% in the quarter. With the entire S&P 500 down for the quarter only Utilities managed a positive return, of just 4.4%, while Energy dropped by 19% and Materials by 17%. For the past twelve months, Energy was the worst performing sector, down 31%, while Consumer Discretionary, a bright spot in the U.S. economy, added 11.4%. After dropping by 2.3% in the Second Quarter of 2015, the Federal Reserve's US Dollar Trade Weighted Index gained 2.6%, resuming the upward trend in place since July 2011.

VALUATION

Current valuations for U.S., European, and Japanese stocks do not look excessive. U.S. economic growth continues to be solid, even if moderately slow. Job creation has been strong, inflation is well contained, and our positive view on the U.S. economy should support current stock valuation, allowing for growth in line with earnings. However, as a result of slowing European and Pacific Rim economic growth, corporate earnings for the S&P 500 are expected to be only modestly up in 2015, with about 10% growth expected for 2016. Currently, the S&P 500 index is at 16.2 times expected earnings for the next twelve months, a bit above the 25 year average of 15.7 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 24.8 times earnings, 1.2 standard deviations above the average since 1881, but below the 25 year average of 25.6 times earnings. Compared to the current S&P 500 earnings yield of 6.2%, the yield on the 10 Year Treasury Inflation Protected Security is just 0.55%, indicating that stocks should return about 5.6% more than bonds.