ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Third Quarter, 2016

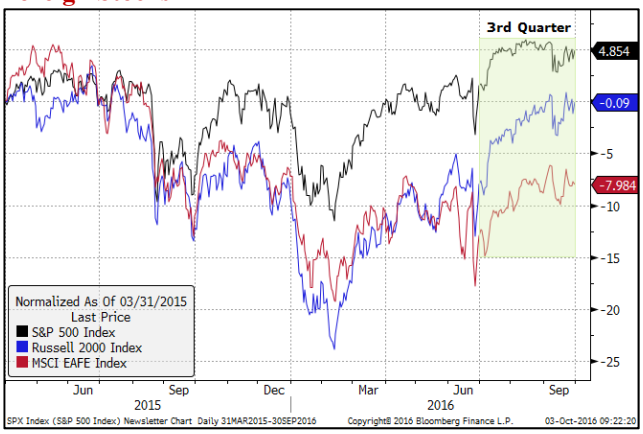
Table 1: Benchmark Returns as of September 30, 2016

INDEX	3rd Quarter, 2016	YTD	Last 12 months
US STOCKS			
S&P 500 Index (large-cap stocks)	3.85	7.84	15.43
Russell 2000 Index (small-cap stocks)	9.05	11.46	15.47
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	6.43	1.73	6.52
MSCI European Monetary Union Index	7.78	(0.04)	3.55
MSCI Emerging Markets Index	9.03	16.02	16.78
COMMODITIES			
US Dollar Index (DXY)	(0.71)	(3.21)	(0.92)
Gold	0.13	24.76	18.72
Oil (WTI)	(0.19)	30.24	6.99
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	0.46	5.80	5.19
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(0.55)	15.45	13.82
Barclays Municipal Bond Total Return Index	(0.30)	4.01	5.58
Markit iBoxx USD Liquid Investment Grade Idx (corporate bonds)	1.35	10.48	10.15
Markit iBoxx USD Liquid High Yield Index (high-yield bonds)	5.09	13.76	12.07
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	0.88	12.71	10.87

Source: iShares.com & Bloomberg

Global stocks as measured by the broad based indices generated strong returns during the third-quarter, 2016 (Table 1). US large cap stocks extended their rally following the "Brexit" setback (as global central banks responded with even more liquidity) for the first part of the quarter, and then traded sideways from mid-July through quarter-end. Small cap and foreign stocks continued their advance through the end of the quarter (Chart 1).

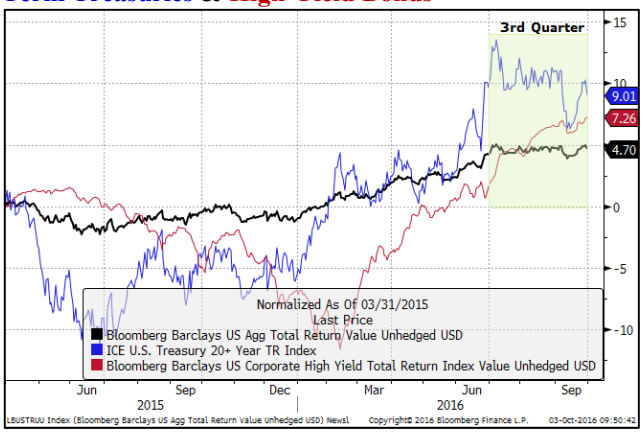
Chart 1: Large Cap Stocks, Small Cap Stocks & Foreign Stocks



Source: Bloomberg

Bond market returns were mixed with long-term Treasuries generating slightly negative returns, "core" (broad based investment grade) bonds posting slightly positive returns and high-yield bonds, which tend to be much more correlated with US stocks, generating very strong returns (Chart 2).

Chart 2: US Core/Investment Grade Bonds, Long-Term Treasuries & High-Yield Bonds



Source: Bloomberg

During the quarter, and in some cases since the beginning of the year, there have been some notable changes in relative performance within the equity markets.

While stocks aren't generally considered "safe", there are areas of the stock market that are considered more conservative and others more aggressive. We can evaluate the relative performance of the two categories by tracking and comparing various indices. Some examples are listed below:

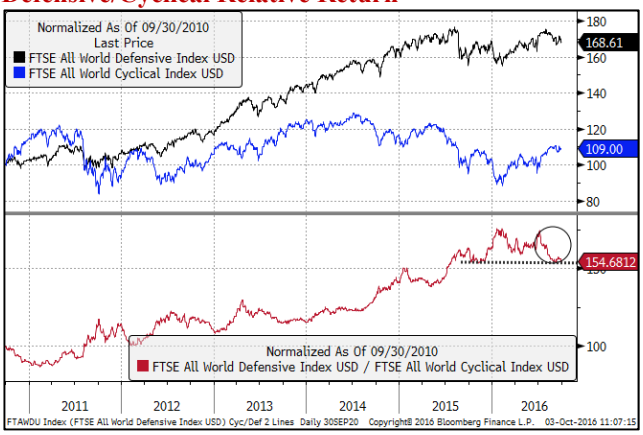
"Conservative"	"Aggressive"
Defensive stocks (consumer staples, utilities, telecom, healthcare)	Cyclical stocks (energy, industrials, financials, technology)
Stocks with historically low volatilities	Stocks with historically high volatilities
Large cap stocks	Small cap stocks

In 2011, "safe" / "conservative" stocks began a long period of outperformance. However, during 2016 – particularly during the third-quarter – this trend seems to have reversed. This can be seen in Charts 3, 4 & 5. In each of these charts, the red line in the lower half illustrates the *relative* performance of the index represented by the black line ("conservative" stocks) versus the blue line ("aggressive" stocks).

An important driver of the relative strength in these stocks since 2011 has been the 'quest for yield' (the income component of investment returns) as interest rates on the safest bonds have declined to historic lows. There seems to be a financial bubble associated with every decade (Nifty

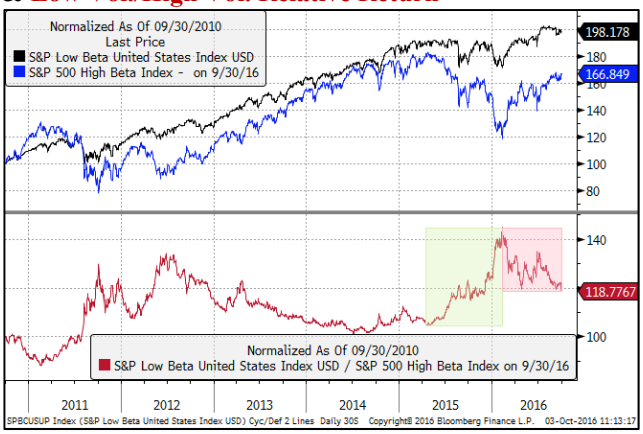
Fifty, gold, Japanese stocks, tech stocks, US housing). This time, it may be a bubble in safety as the interest rates paid on global government bonds are at or near all-time lows with $11.6 trillion of global corporate and government bonds trading at *negative* interest rates. Buying and holding these bonds to maturity actually *guarantees* a loss.

Chart 3: Defensive Stocks, Cyclical Stocks & Defensive/Cyclical Relative Return



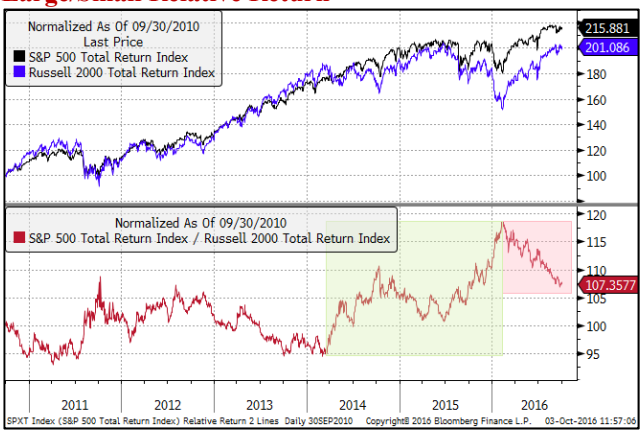
Source: Bloomberg

Chart 4: Low Volatility Stocks, High Volatility Stocks & Low Vol./High Vol. Relative Return



Source: Bloomberg

Chart 5: Large Cap Stocks, Small Cap Stocks & Large/Small Relative Return



Source: Bloomberg

As bond yields have dropped, riskier assets with relatively high yields (securities paying high rates of income) have gained favor. This has driven these traditionally conservative areas of the stock market to strong performance relative to more aggressive alternatives. The result is that dividend and low volatility strategies are trading at the 83rd and 96th relative valuation percentiles of their 1967 – 2016 respective ranges.

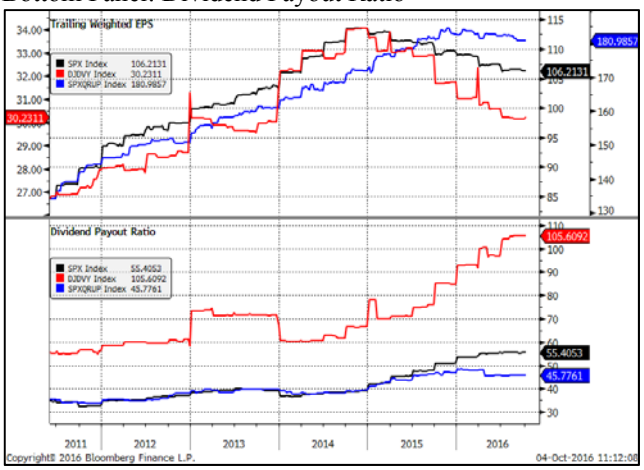
In contrast, stocks in the "High Quality" group are only at the 40th percentile of their relative valuation range. These companies are characterized by greater earnings stability, strong balance sheets, strong free cash flow, high returns on equity, strong dividend growth (though not necessarily high dividend yields) and a low dividend payout ratio (the percentage of net income a firm pays to stockholders in dividends).

The chart below (Chart 6) illustrates earnings per share (top panel) and the dividend payout ratio (bottom panel) for three specific areas of the US stock market: the S&P 500 Index (black lines), the Dow Jones Select Dividend Index (red line) and the S&P 500 High Quality Rank Index (blue line).

Chart 6: S&P 500, S&P 500 High Quality Rank Index & Dow Jones Select Dividend Index

Top Panel: Earnings Per Share

Bottom Panel: Dividend Payout Ratio



Source: Bloomberg

As can be seen, even though large-cap US stocks (S&P 500) have advanced 9.3% including dividends (5.3% excluding dividends) since 2015, corporate earnings (earnings per share) have declined. This is particularly true for the highest dividend paying stocks (Dow Jones Select Dividend Index). However, earnings for the stocks that make up the S&P High Quality Rank Index have been much more resilient.

As earnings have declined, the percent of net income paid as dividends has increased, particularly for the highest yielding stocks which, in aggregate, are distributing 105% of net income as dividends to shareholders. This ratio reflects the fact that a record number (44) of S&P 500

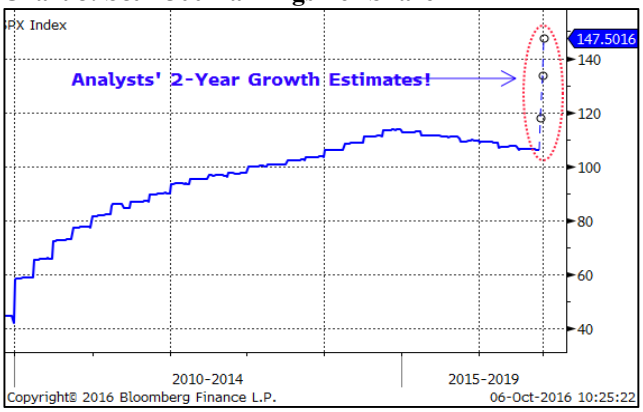
members have dividends above their earnings according to Factset. When share buybacks are included in total cash paid to shareholders, the payout ratio for the overall S&P 500 is greater than 100% of cash flow as buyback spending exceeded earnings for 137 companies within the S&P 500 during the second-quarter. As with earnings per share, the dividend payout for high quality stocks has remained much more stable. The message here is that dividend sustainability for this group is less of a concern.

The combination of declining earnings and higher stock prices has also accelerated the rise in stock valuations. The current price/earnings ratio has risen to the highest level since 2009 (Chart 7) and the price/earnings ratio for the median stock on the New York Stock Exchange having risen to the highest level since 1950. What's absolutely amazing is that the consensus of analysts' estimates is for S&P 500 earnings per share to grow 39% over their 2-year forecast period (Chart 8), especially given forecasts for economic growth are quite low at 1.5% for 2016 and 2.2% for 2017 (Chart 9).

Chart 7: S&P 500 Price/Earnings Ratio

Source: Bloomberg

Chart 8: S&P 500 Earnings Per Share

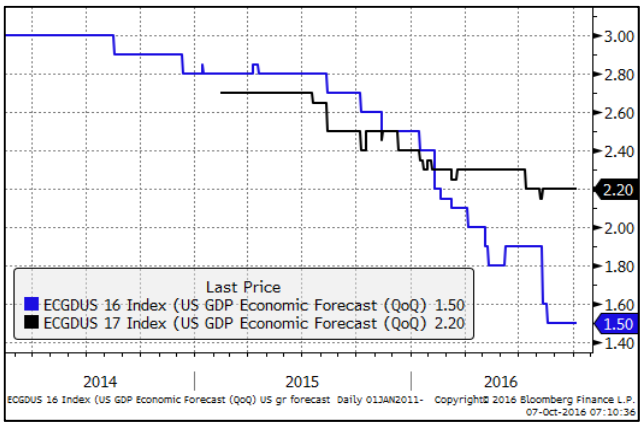


Source: Bloomberg

Two of the primary forces that drive stock prices are central bank monetary policy and corporate earnings. With earnings down and stock prices up, the push from stimulative monetary policy has been stronger than the pull from weak corporate earnings as the markets have come to expect the continuation of global central bank policy support – at least until economic growth and corporate earnings growth materializes. For now, though, global monetary policy is unquestionably the most influential factor driving the financial markets.

While stocks and other risk assets have generated strong returns this year, corrective forces are gathering and the risk/reward tradeoff is looking increasingly less compelling, in part because the rally has not transitioned from liquidity-driven to earnings-driven.

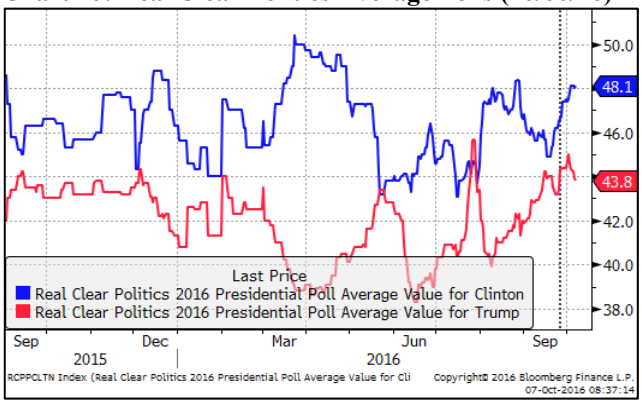
Chart 9: US GDP Forecast as of 10/6/16 – 2016 & 2017



Source: Bloomberg

As the presidential election nears, political risks are also rising. After tumbling in the polls in the weeks following the Democratic convention, Trump's numbers have rebounded (Chart 10). While we don't expect a Trump victory, we think the race is too close to call at this point and that it's likely that the polls understate his odds (especially in the betting and prediction markets which place his odds at between 19% and 35%, Chart 11) as the pollsters may not be accurately estimating the likely turnout among various demographic groups. This happened in the UK where many younger people who supported "remain" didn't bother to vote (despite telling pollsters that they would) while older voters turned out in droves.

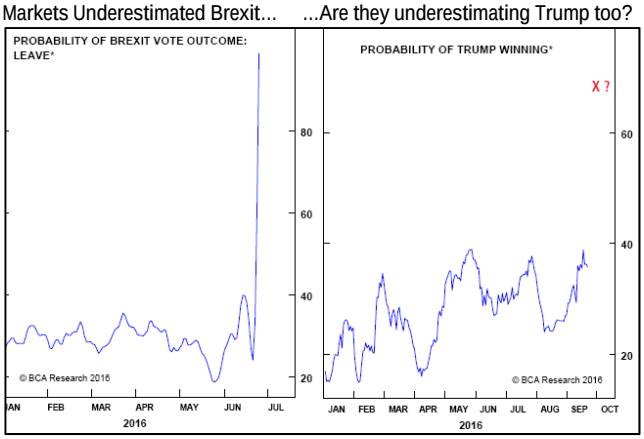
Chart 10: Real Clear Politics Average Polls (10/06/16)



Dotted vertical line: Sept. 26 – first presidential debate
Source: Bloomberg

Chart 11

Markets Underestimated Brexit... ...Are they underestimating Trump too?



**Average of Predictit and Oddschecker Probabilities*
Source: BCA Research

We live in a society where capitalism is $1 = 1 vote, but democracy is 1 person = 1 vote, and the average citizen is fed up with stagnant income growth and inequality, lax financial regulation, fiscal austerity, etc., and is willing to vote for change – regardless of the impact on the broader economy. Tina Fordham, Citigroup's London based chief global political analyst, summed it up nicely when she said "There is something more subtle going on about public expectations and exhaustion and a sense of corruption, elite abuse of power, and lack of control."

Both candidates realize this and seem to be competing for who has the bigger fiscal package. The implication is that fiscal spending will accelerate regardless of which candidate wins. It will be difficult for members of Congress to oppose spending increases given broad based support in the populace regardless of party affiliation. Greater fiscal spending is bearish for bonds because it increases economic growth, the outlook for inflation and the supply of bonds.

Where we stand today is that, *if* elected, Trump's unpredictability and anti-globalization views would hurt US stocks initially. This would be followed by a recovery similar to what happened following Brexit as investors fall back on the notion that the effects of a non-conformist US President will be limited by a system with an institutionally sound system of checks and balances.

Longer-term, as populism rises, potential economic growth goes down. When we restrict the free mobility of capital, limit free trade and curb immigration, the returns on capital fall. In a nutshell, populism forces a larger share of the production pie away from capital owners/providers and towards a smaller pool of available domestic labor. Of course, this is why populism always appeals to the masses.

In economic jargon, this issue comes back to a debate on equity versus efficiency. If the US limits the mobility of capital by moving away from free trade agreements, companies that could once freely move their capital to the areas that best maximized their return will no longer be able to do so. Therefore, all else equal, this leads to less "efficient" use of capital and real returns on this capital will fall. But, with this lower "efficiency" comes an increase in "equity" (i.e. a more equitable distribution of domestic income). So, we end up with more equitable sharing of the economic pie by giving up some efficiency. However, giving up some efficiency in order to provide more equity has negative consequences for return on capital. If we go down the populist path, potential economic growth (GDP) will go down, returns on capital will go down, and long-term inflation risks will rise. Therefore, the overall size of the pie shrinks.

A simplistic analysis suggests that lower potential growth, lower returns on capital and higher risks of future inflation all work to weaken the US dollar and lower the real value of US equities. Further complicating matters is the relationship we have with our trading partners. For the past 30-plus years, foreigners have sold us their goods, and we've paid them using US dollars. Since their success depends on continuing to sell us goods, they never sold their US dollars – if they did, it would weaken the US dollar and make their goods harder to sell to us. Instead, they bought things like US Treasuries, US corporate bonds, US real estate and US stocks. Now they hold trillions in US dollar assets. If we put up barriers and stop the flow of foreign goods, why would they continue to hold these assets which were acquired from previous sales? They probably wouldn't, further pressuring the US dollar.

In contrast, a Clinton victory is more supportive of the markets given that her policy stance is viewed as safer and more predictable. With that said, I think we would still see a minor pivot to higher trade barriers because the masses are clamoring for equity over efficiency.

The bottom line is that we believe that if Trump remains the underdog in the polls and betting markets, but actually wins the election, we'll get a sell-off that will most likely be followed by a quick recovery which may only last until Trump reveals his true policy colors and the implications of a move toward populist policies begin to be priced into the financial markets.

INVESTMENT STRATEGY

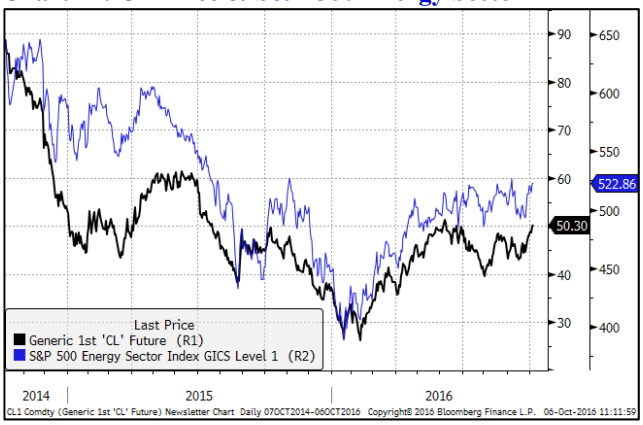
Political risk, combined with the current stock market fundamentals discussed earlier and an overall sense of investor complacency (based on derivative markets for risk protection) give us more than enough reasons to remain defensively positioned.

We remain underweight stocks relative to what we consider "benchmark" allocations. Within the US stock market, we are overweight large cap stocks relative to small caps with overweights in the health care and energy sectors.

We continue to expect oil to approach $65 over the next few years on rising global demand, peaking inventories,

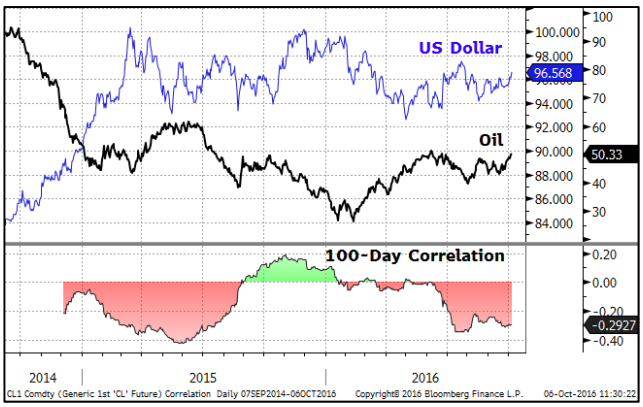
possible OPEC production cuts and capital spending cuts that are still working their way through the sector – especially at the large integrated oil company level. Energy sensitive stocks should benefit from the move higher in the price of oil we anticipate (Chart 12). One of the main risks to this view is that we're wrong about the US dollar and it strengthens instead of weakens because the price of oil and the dollar are negatively correlated (Chart 13).

Chart 12: Oil Price & S&P 500 Energy Sector



Source: Bloomberg

Chart 13: Oil Price & US Dollar

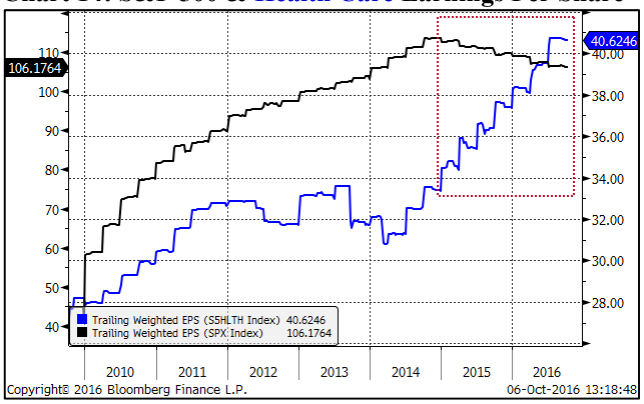


Source: Bloomberg

We also continue to favor the health care sector. In contrast with the overall market, stocks in this sector have seen steady growth in earnings per share since 2014 (Chart 14) and relative valuations are at the low end of their historic range (Chart 15). While this group has a below average dividend yield, dividend growth is supported by non-cyclical revenue and earnings growth that benefit from demographic tailwinds. It's dividend payout ratio has been in the mid-40s since 2014 whereas the S&P 500 has seen its payout ratio rise from 37 to 55 over the same period.

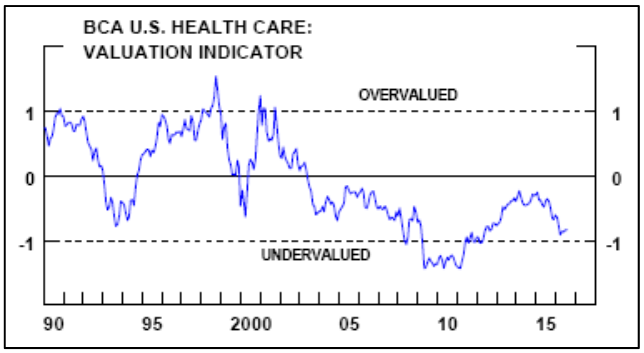
It is also likely that we will increase our allocation to High Quality stocks during the fourth-quarter as we believe the characteristics of the companies in this group (see page 2) will lead to superior returns in the environment we anticipate going forward.

Chart 14: S&P 500 & Health Care Earnings Per Share



Source: Bloomberg

Chart 15



Source: BCA Research

Within fixed-income (bonds), we are not making any big duration bets at the moment. We are maintaining broad based exposure to the bond market as a stock market hedge. We have, however, taken a position in floating rate securities. As discussed in last quarter's *Review and Outlook*, these loans are higher up in the capital structure than high yield bonds, yet have higher yields (on a quality matched basis) and, since the interest rates on these securities are tied to market interest rates, they are far less sensitive to rising interest rates than bonds with a fixed interest rate. These securities also have a lower default rate and higher recovery rate than high yield bonds.

-Brant Kairies
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