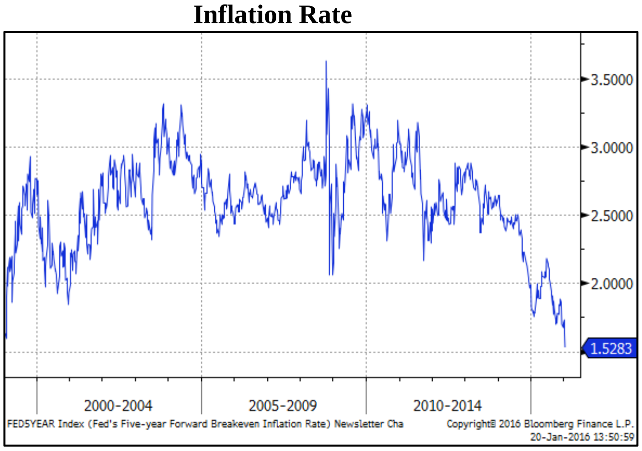
ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Fourth Quarter, 2015

2015 was a decent year for the US economy:

- Real (inflation-adjusted) gross domestic product grew at a 2.2% annual rate (year over year through the third quarter) - nothing to write home about, but still better than most other major economies, which continue their struggle to recover from the financial crisis. Both the Eurozone and Japan grew by less than 2%.
- The US labor market continued to strengthen during the year - the unemployment rate fell from 5.8% to 5%, new job growth creation averaged a healthy 210,000 per month (nonfarm payrolls), and wage growth ticked higher to 2.3% (average hourly worker earnings, year over year through November).
- Inflation remained subdued - the core Consumer Price Index (CPI) rate rose to 2% in November, its highest since July 2012. However, the Federal Reserve's preferred inflation measure, the core Personal Consumption Expenditure rate, remained stuck at around 1.3%, well below the Fed's 2% inflation objective. Meanwhile, the market's five-year estimate for inflation beginning five years from now, a model the Federal Reserve uses in setting rates, is approaching a record low as commodity prices tumble (chart 1).

Chart 1: Fed's 5-Yr. Forward Breakeven Inflation Rate

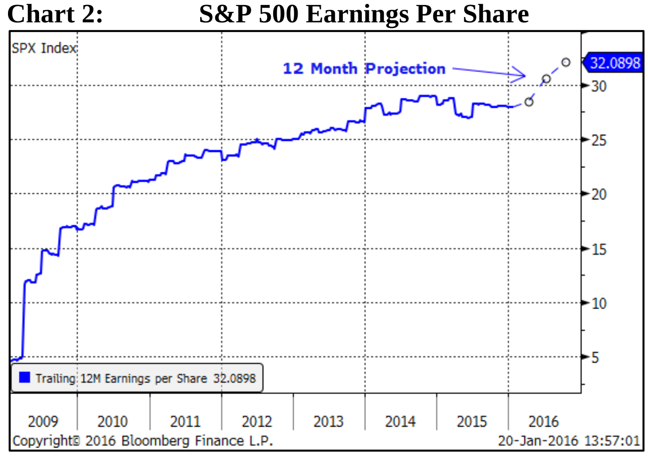


Source: Bloomberg

Corporate earnings on the other hand were weak in 2015. Reported earnings for the S&P 500 are expected to decline 6% to 7% for the year based on estimated fourth quarter numbers. Much of the weakness is due to the carnage in the energy sector. It is interesting to note that consensus estimates are for S&P 500 earnings per share to jump 19% in 2016 (chart 2). This would require a tremendous increase in both sales growth and new highs in profit margins…pretty optimistic.

The economic data were strong enough in December for the Fed to initiate its long-anticipated first interest rate increase since 2006, after having cut the federal funds rate to near 0% in late 2008. On December 16, it raised the fed funds rate by 0.25% to a target range of 0.25%–0.5%. Investors had been expecting this, and global stock markets signaled their immediate approval by moving higher on the day.

Chart 2: S&P 500 Earnings Per Share

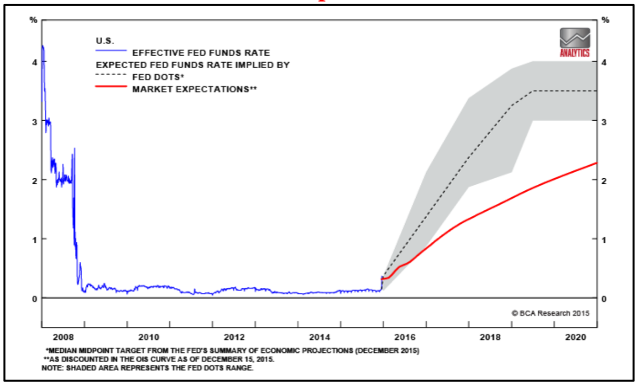


Source: Bloomberg

The Fed has emphasized its members expect the pace of future rate increases to be gradual. Specifically, the median federal open market committee (FOMC) participant forecast is for the fed funds rate to rise one percentage point to 1.375% by the end of 2016, and then to 2.375% by the end of 2017. This implies four quarter-point increases each year. However, money markets remain far more timid about normalization than do Fed officials. Money market expectations for the pace of 0.25% rate hikes in the next 12 months are close to two. Likewise, the proxy for the terminal rate is 2.4% versus 3.5% for the median Fed forecast. Chart 3 shows this divergence graphically. The gap between markets and the Fed keeps widening over the next three years and stays wide throughout the forecast horizon.

While economic growth was acceptable, 2015 was a difficult year for global financial markets. As Table 1 illustrates, US large cap stocks (S&P 500 Index) and high quality fixed income (Barclays US Aggregate Bond Index) were only slightly positive, municipal bonds delivered strong returns (S&P National AMT-Free Municipal Bond Index) and the US dollar continued to strengthen. However, most other broad based measures of the equity, fixed income and particularly the commodity markets were strongly negative. The slight gain in the S&P 500 covered the fact that most of the stocks that make up the index posted negative returns as just a handful of big technology/Internet companies (Facebook, Amazon.com, Netflix and Google – collectively referred to as the "FANGs") generated huge gains. A measure of the S&P 500 that weights each stock equally fell 4.1% for the year. Energy was hit particularly hard with oil prices hitting an 11-year low in December (chart 4).

Chart 3: Effective Fed Funds Rate
Fed Implied Fed Funds Rate
Market Implied Fed Funds Rate



Source: BCA Research

Table 1

INDEX	4th Quarter, 2015	Full Year 2015
US STOCKS		
S&P 500 Index (large-cap stocks)	7.04	1.38
S&P 500 Equal Weight Index (large-cap stocks)	4.49	(4.11)
Russell 2000 Index (small-cap stocks)	3.59	(4.41)
FOREIGN STOCKS		
MSCI EAFE Index (developed foreign markets)	4.71	(0.82)
MSCI All World Ex US	3.91	(3.04)
MSCI Emerging Markets Index	0.66	(14.92)
MSCI BRIC Index (Brazil, Russia, India, China)	1.30	(13.46)
MSCI China	3.31	(11.14)
COMMODITIES		
US Dollar Index	2.37	9.26
Gold Spot $/oz.	(5.27)	(12.11)
Silver Spot $/oz.	(5.02)	(13.46)
Oil (West Texas)	(20.79)	(38.76)
GSCI Commodity Total Return Index	(16.63)	(32.86)
BONDS		
BarCap US Aggregate Bond (investment-grade bonds)	(0.57)	0.55
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(1.38)	(1.59)
Barclays Municipal Bond Total Return Index	1.69	3.26
Barclays US Credit Bond Index (corporate bonds)	(0.52)	(0.77)
Markit iBoxx USD Liquid High Yield Index	(1.48)	(5.03)
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	(1.63)	(6.58)

Source: iShares.com, Morningstar & Bloomberg

Last year's markets were driven in large part by oil and the four Ds: Deflation, Deleveraging in the emerging markets, monetary policy Divergence and US Dollar strength. In a ZIRP (zero interest rate policy) world, currency strength weakens growth. The strong US dollar has been a *de facto* tightening of monetary conditions as it is restrictive rather than reflective of a strong domestic economy.

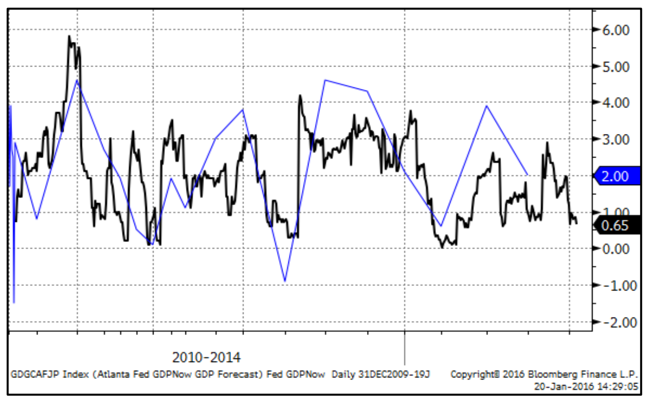
Chart 4: Oil (West Texas Intermediate)

Source: Bloomberg

The Fed based its decision to raise rates last month on the view that US growth would continue to hold up. We are concerned that it won't.

- The Atlanta Fed's GDPNow model indicates that the economy grew by less than 1% (annualized) in the fourth quarter (chart 5).

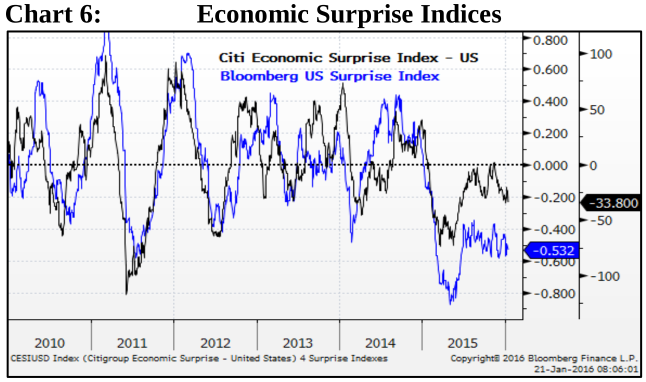
Chart 5: Atlanta Fed's GDPNow GDP Forecast
US Real GDP



Source: Bloomberg

- Economic surprise indices have hooked lower (chart 6).

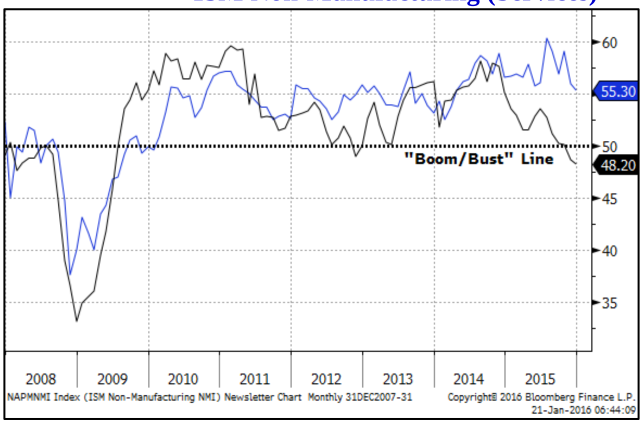
Chart 6: Economic Surprise Indices



Source: Bloomberg

- Industrial production and real business sales are contracting.
- The fundamentals underlying corporate credit (return on capital, profit margins, and debt coverage ratios) have weakened.
- The most recent Fed Senior Loan Officer survey shows that lending standards for commercial and industrial loans have begun to tighten.
- While the service sector as measured by the ISM non-manufacturing index has held up, the manufacturing ISM fell to 48.2 in December, marking the second consecutive sub-50 reading, and the worst showing since June 2009 (chart 7).

Chart 7: **ISM Manufacturing**
ISM Non-Manufacturing (Services)



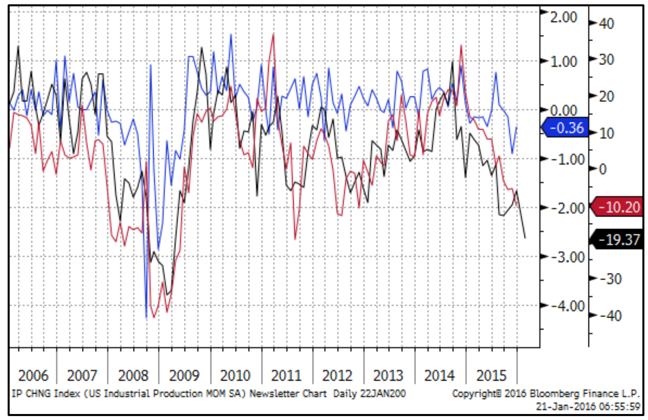
Source: Bloomberg

The US manufacturing sector has taken a definitive turn for the worse, with its first release for 2016 implying a large decline in factory production to levels last seen during the 2007-09 economic recession. Almost all of the Empire State manufacturing survey components pointed to a very weak start to the new year. The headline general business conditions index fell more than 13 points to minus19.37 in January (chart 8). That is the lowest reading in the headline index since March 2009. The Empire survey is usually a good indicator of other more widely followed manufacturing reports.

Looking out, the performance of stocks and other risk assets will hinge on whether incoming data support higher prices. At this point, it's hard to be too optimistic.

Stock prices so far in 2016 are off to their worst start since the Great Depression. The negative price action has had a familiar ring to it: still declining oil prices and weakness out of China and the rest of the developing world. These primary forces underlying equities are likely to persist at a time when profit margins are under strain due to rising labor costs and selling price deflation. Consequently, businesses are likely to become more conservative, shifting into a profit margin preservation mindset. At this point, not much is expected of the world in terms of growth, risk appetite is biased to the downside, and weak data from China to the US hasn't helped at all.

Chart 8: **NY Fed Empire Mfg Survey**
Industrial Production
Phili Fed Business Outlook

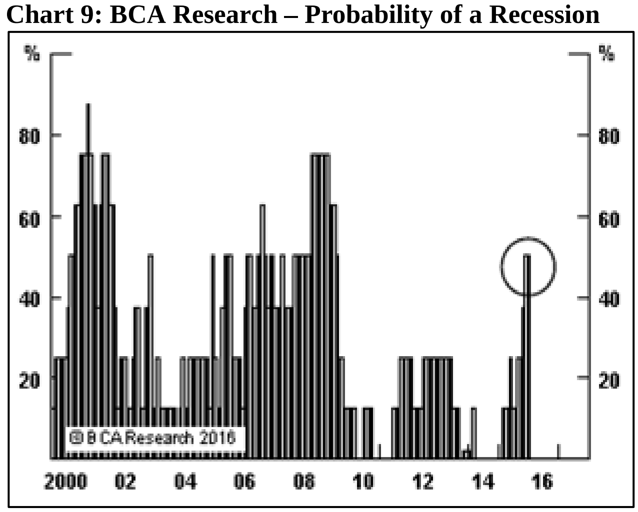


Source: Bloomberg

Global liquidity, which is a key driver of the value of financial assets, has also downshifted significantly, especially with the Fed in tightening mode. China's aggressive deleveraging is likely to spread through the rest of the emerging markets, warning of ongoing deflationary backlash and weaker global growth.

A policy mistake (if it hasn't already happened) by the Fed is a serious risk. Based on recent rhetoric, it would likely take a major bout of market turmoil before the Fed will worry about economic backlash. For now, though, the FOMC seems content to ignore the lengthening list of economic red flags (deflation, profit contraction, trade contraction, manufacturing contraction, etc.). In fact, a recession warning indicator published by BCA Research based on the percentage of the eight economic and financial variables which are behaving as they have during past recessions is now at levels that preceded the Great Recession (Chart 9).

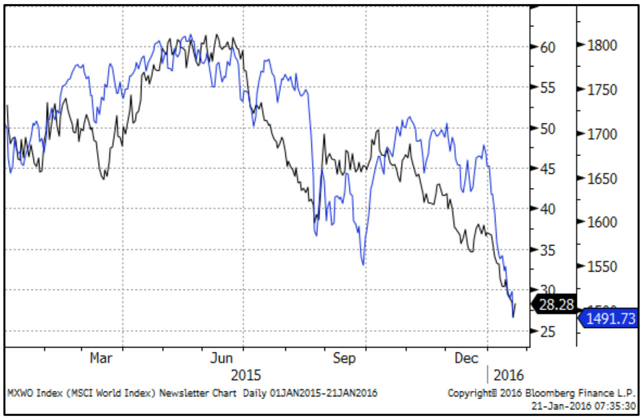
Chart 9: BCA Research – Probability of a Recession



Source: BCA Research

Low oil prices are good for the majority of the economy over the long term. However, global stocks have become highly correlated with the price of oil recently (chart 10). It seems unlikely that risk assets will stabilize and move higher without some stability in the oil markets.

Chart 10: Oil (West Texas Intermediate)
MSCI World Stock Index



Source: Bloomberg

Benjamin Graham wrote, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." Currently, the market is "voting" based on the price of oil and news out of China. Looking beyond the here and right now, oil will stabilize, investors will adjust their expectations for China, and it will be corporate earnings, economic growth, and central bank policy that will again drive financial assets.

After seven years of economic recovery, it has become increasingly difficult to make an optimistic case for the intermediate term outlook based on the trends in data we are seeing. With that said, the decline in risk assets so far this year has resulted in a deeply "oversold" market based on a number of indicators on a short term basis. Setbacks of this nature are oftentimes followed by swift recoveries of at least part of the decline. We are therefore reluctant to sell into the current decline.

During 2015, we became increasingly conservative. In January we eliminated our emerging market stock and tactical fixed-income allocations. In late August we sold our clients' real estate investment trusts (REITs) and high yield bonds. Overall, we ended the year:

- Approximately 5% underweight stocks,
- with all (or most in some cases) of our bond weighting in very high grade bonds, and
- overweight large cap stocks relative to small caps.

These moves went a long way toward mitigating the effects of the weakness in many markets and asset classes.

A turn of the calendar does not require a change in strategy. Being defensive remains vital because deflation, economic disappointment and policy errors are likely to remain challenging for "risk assets".

Our allocation and equity tilts remain conservative, though not all-out defensive…yet. However, we expect to reduce risk exposure even further in the event of meaningful rallies. Our strategy takes into account the weak risk/reward profile of equities without the expectation of a recession-driven bear market.

-Brant Kairies
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