Economic Summary

Morley Capital Management

Citing a strengthening economy at its December meeting, the Federal Open Market Committee (FOMC) agreed to raise the federal funds rate to a range of 0.50% to 0.75% from the previous 0.25% to 0.50% range. The rate hikes are expected to continue as the dot plots suggest the federal funds rate will increase to 1.40% by the end of 2017, 2.10% by the end of 2018, and 2.90% by the end of 2019. In agreement with the Fed's dot plots, we expect the FOMC to raise rates two times in 2017. This tightening monetary policy could have some braking effects on Gross Domestic Product (GDP) and inflation. We expect fiscal policy to move in the other direction with the expected pro-business policies of the new administration helping to boost the growth rate in GDP to 2.6% in 2017. The full effects of the new fiscal regime are expected to extend into 2018, as the legislative process will take time.

Despite slow overall GDP growth since the recession, several sectors of the economy have experienced significant growth. One of the strongest contributors, auto sales, may have peaked but should continue to be solid. Housing should continue its steady contribution to growth. Generally, expectations are for a broad-based improvement in the economy without any standout sectors. Important for this solid growth will be strengthening business confidence, which should lead to increases in business investment spending. On the demand side, continued increases in employment and wages should benefit consumers. Expected fiscal proposals for lower taxes and deregulation should provide a boost to growth. Offsetting these positives somewhat will be potentially higher interest rates, although they are still at historically low levels.

Major risks to the US economy continue to come from external shocks. One major risk is that of a significant economic slowdown in China, which accounts for approximately 15% of world GDP. Mitigating this risk up to this point has been the Chinese government's policies, which have stimulated its economy. Evidence suggests that China's economy has some room for continued stimulus, though Chinese growth has been accompanied by a troubling and rapid growth of debt. An additional major risk with regards to China is that President-elect Trump's trade policies could ignite a trade war between our two countries. Trade negotiations will require a deft touch to prevent the situation from degrading into a trade war, but the market's performance since the election indicates that investors seem to have faith in the "The Art of the Deal" author, Trump.

Bill Finley, CFA
Chief Investment Officer

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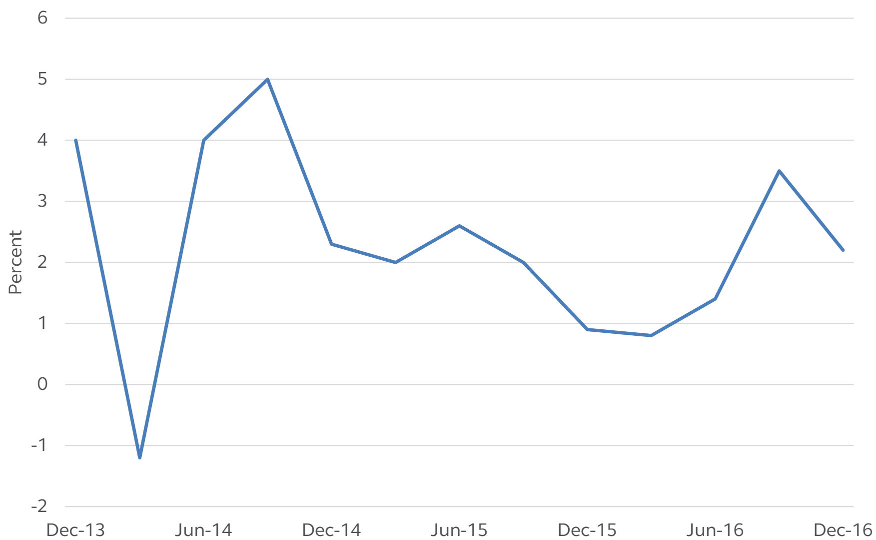
GDP



Source: Bureau of Economic Analysis

Highlights

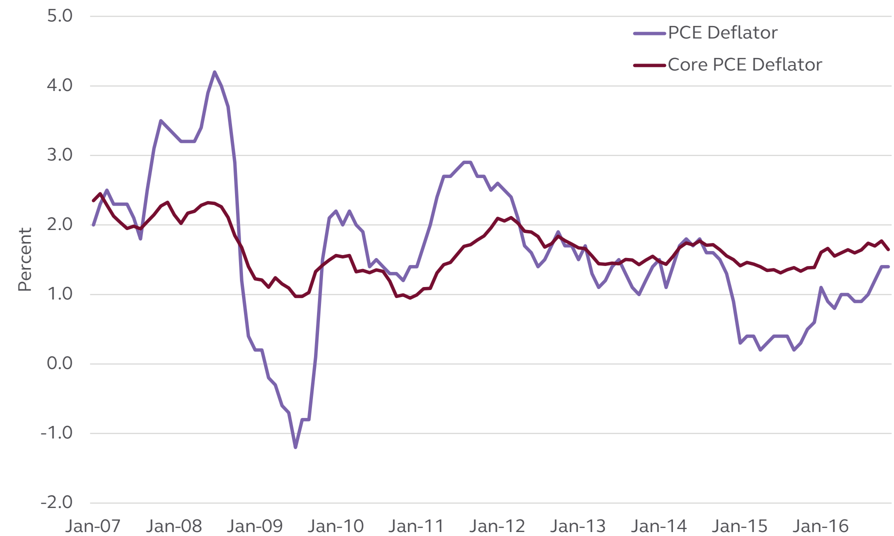
GDP growth rebounded strongly in the 3rd quarter, rising at an annual rate of 3.5%, compared to a growth rate of 1.4% in the second quarter. The Bloomberg consensus is for growth of 2.2% for the 4th quarter.

Markets reacted strongly after the election; equities rallied and rates rose. The market view is that Trump policies will be pro-business and growth. That view has not given much weight to the tail risk of trade wars.

Outlook

We expect the inflation-adjusted annual rate of growth to be 1.6% for 2016. We have raised our forecast for 2016 by 0.1% due to the rebound in the 3rd quarter. We expect growth to slow in the 4th quarter of 2016 by 2.2%, matching the Bloomberg consensus estimate, and by 2.6% in 2017, spurred by the pro-growth policies of the new administration.

Inflation



Source: Bureau of Economic Analysis

Highlights

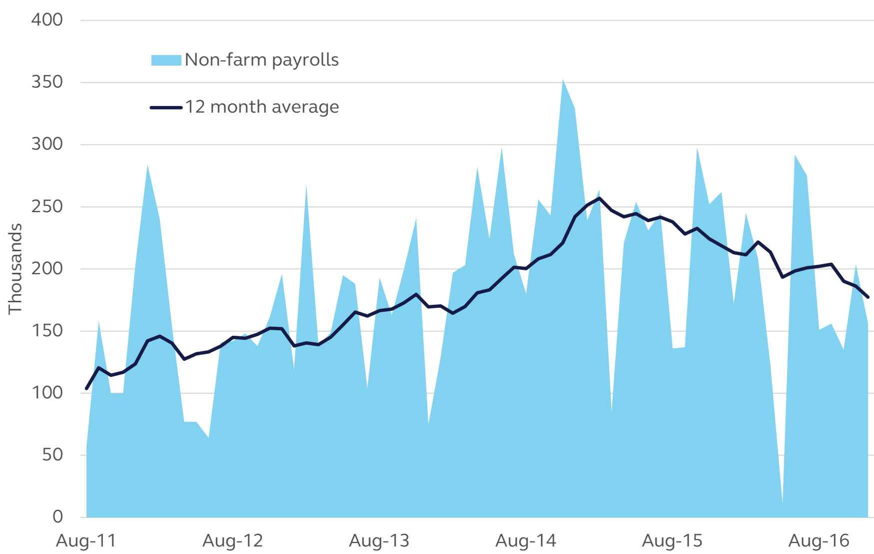
The core personal consumption expenditures (PCE) price index, the Fed's most closely watched inflation indicator, moved up slightly during 2016, though remained below the 2% policy target. The broader measure, PCE price index, which includes energy and food prices, rose more sharply, primarily due to the increase in fuel prices.

According to the Aruoba Term Structure of Inflation Expectations prepared by the Federal Reserve Bank of Philadelphia, the near-term inflation outlook has risen over the year while longer-term expectations have shown more modest upward adjustments.

Outlook

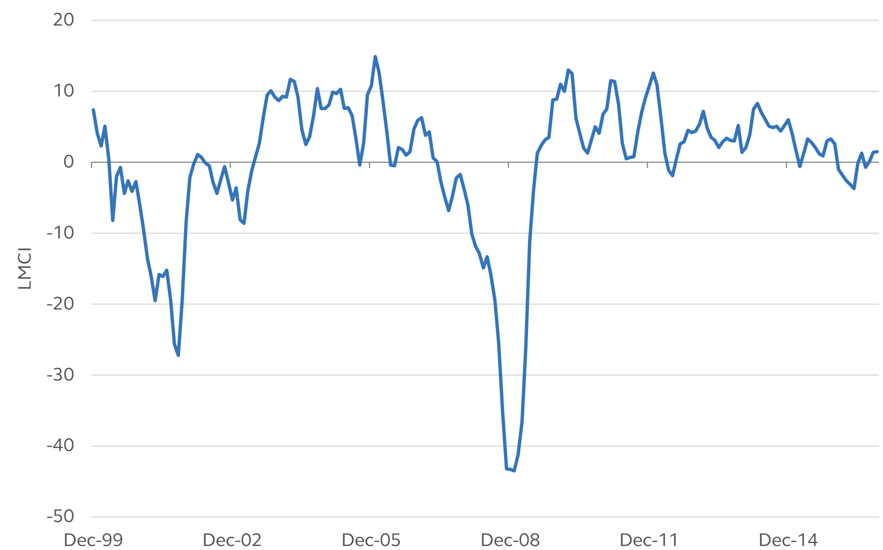
The most recent FOMC minutes suggested that the committee members view near-term risks to the inflation outlook balanced around the 2% policy target. Absent further increases in major core components, such as rents and clothing, inflation is not likely to exert major pressure on the FOMC to tighten monetary policy.

Non-Farm Payrolls



Source: Bureau of Labor Statistics

Labor Market



Source: Federal Reserve Bank of St. Louis

Highlights

The Non-Farm Payrolls (NFP) metric has been a widely-watched metric to gauge the health of the world's largest economy as well as gain insight into the path of future fed funds rate hikes. The economy has generated positive NFP growth since the Great Recession.

The NFP 12-month moving average indicates a decline in the number of new jobs added since 2015. The average has fallen to 180K; the lowest level since early 2014. December payrolls totaled 156K.

Outlook

We expect an extended recovery. Job growth should continue at a good pace, though at a slower rate than we experienced coming out of the recession.

Highlights

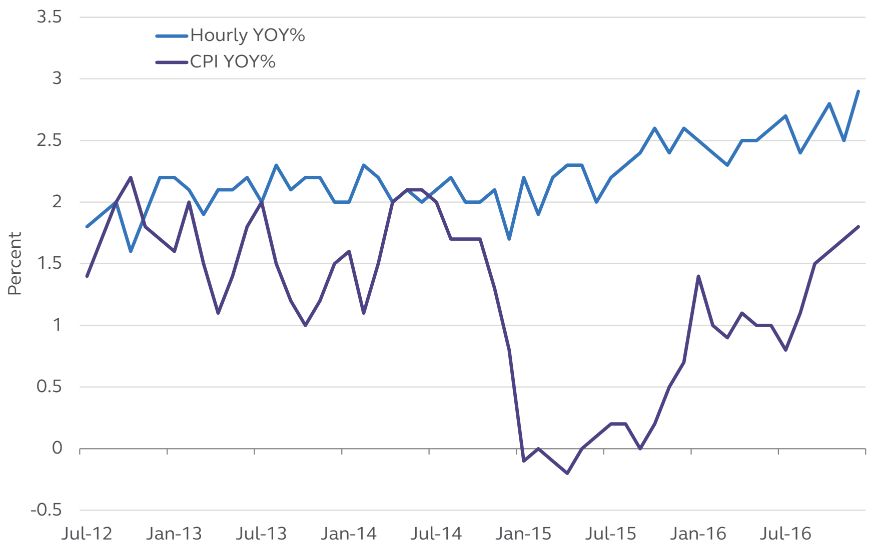
The Fed's preferred measure of labor market health, the Labor Market Conditions Index (LMCI), is in recovery after a steady decline in the first half of the year.

The LMCI tracks month-over-month changes in 19 different labor market indicators and rose 1.5% in November, reflecting strong growth in the 3rd quarter and future optimism with expected fiscal stimulus.

Outlook

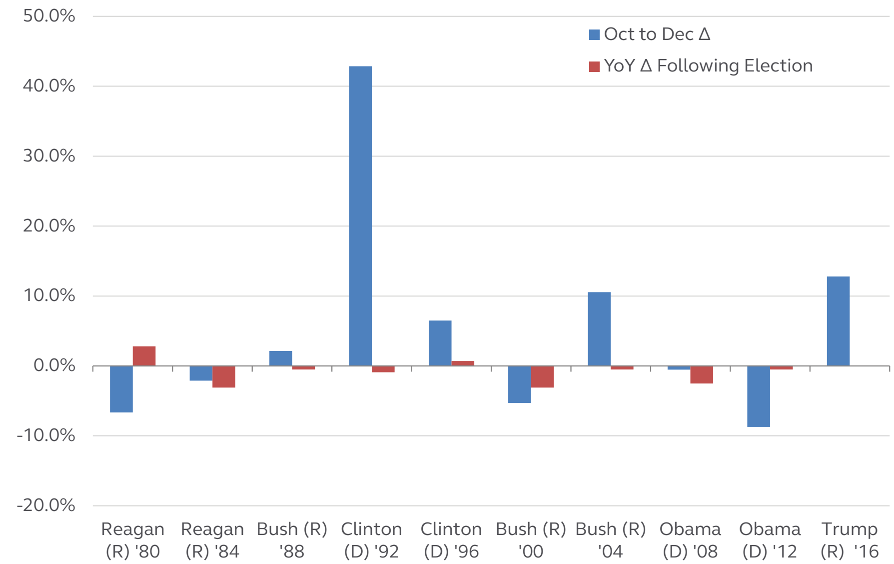
Since the election, optimism has been exhibited of an extension in the long recovery we have experienced. We believe this should lead to more jobs and rising wages.

US Wages



Source: Department of labor

Consumer Confidence



Source: Bloomberg

Highlights

The US unemployment rate, 4.7% at the end of December, has been cut in half since reaching a post-recession high of 10% in October 2009. Wages typically increase at a faster rate when the unemployment rate drops; however, overall wages have recovered relatively slowly over the past few years.

Wage growth has struggled to meaningfully outpace the Consumer Price Index (CPI) since the recession. Over the past year, however, wage growth has begun to pick up; wages increased at an annual rate of 2.9% versus CPI at 1.8%.

Outlook

We expect wage growth to remain near current levels in the coming months as employment continues to grow, though the marginally more positive wage data seen in the 4th quarter of 2016 could likely continue. That said, a number of factors could limit wage growth: 1) other countries in the global economy currently have lower wage costs than the US, 2) a significant number of people may rejoin the US labor force as the economy improves, and 3) potential policy changes in the US given the new administration.

Highlights

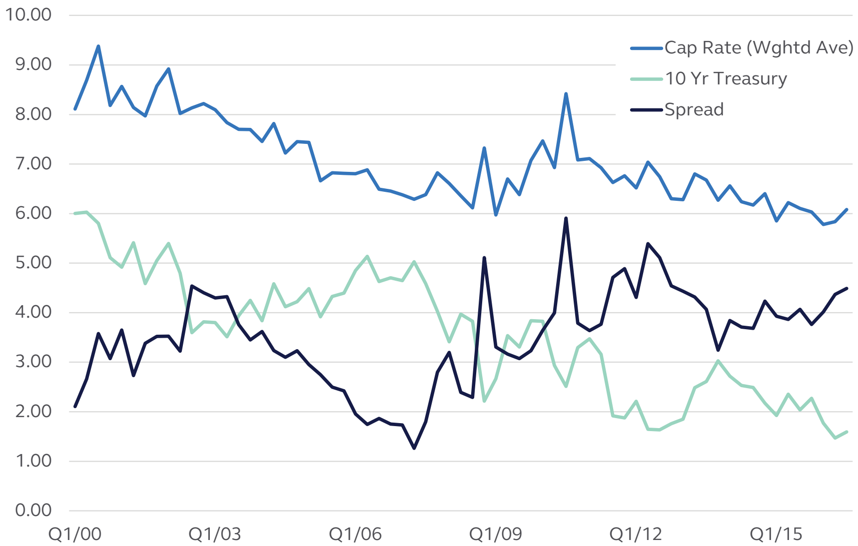
While a surge in consumer confidence following a presidential election might be expected to contribute to year-over-year GDP growth, this has seldom been the case historically. Since 1980, a rise in consumer confidence coincided with GDP growth only during the year following President Clinton's second election win in 1996.

The most recent surge in consumer confidence, following President Bush's election in 2004, was followed by a decrease in GDP from a solid 3.8% to 3.3%. Slowing GDP in 2005 was due in part to the Fed raising rates, which is likely to happen in 2017.

Outlook

Consumer confidence indicators should be combined with other factors if they are to be predictors of economic performance. In combination with improving small business confidence, investor confidence, and low GDP levels in 2016, we expect substantial growth in 2017, different than the historical norm.

Commercial Real Estate



Source: Bloomberg

Highlights

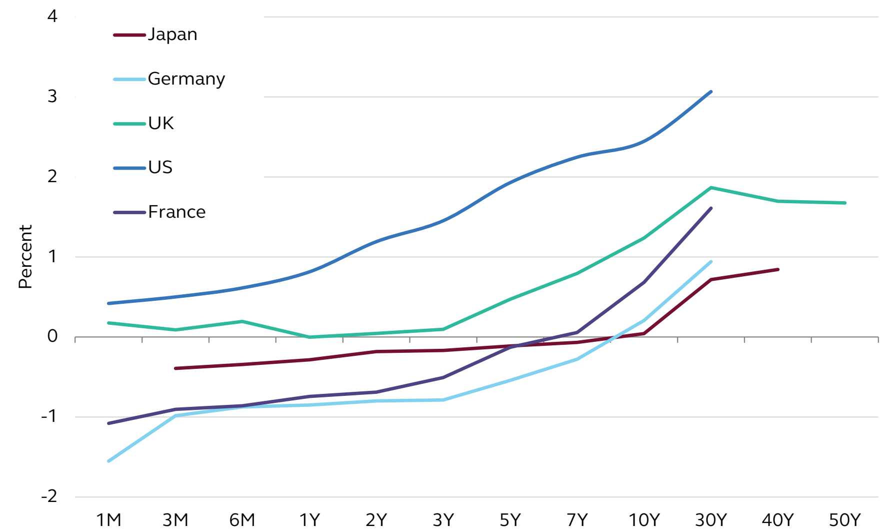
Absolute capitalization (cap) rates have been declining since 2010. At the end of the 3rd quarter, average cap rates were at historically low levels, around 6%. Investors, though, still find the 4% spread over 10-year Treasuries attractive, which has led to new construction in the multi-family sector. Multi-family has had a marginal impact on GDP, contributing between 0.3-0.4%.

Multi-family net operating income (NOI) has been consistently growing since 2010 as vacancies are at historic lows. Rental growth, however, has started to slow and there has been recent weakening in the luxury segment, which comprises 85% of new apartment construction.

Outlook

Commercial real estate prices are 22% higher since the pre-crisis peak. As interest rates rise and absolute cap rate levels rise, net operating incomes will need to rise in order to maintain current valuations. We expect to see some weakness in the market if growth does not continue, especially in weaker sub-sectors such as retail and new luxury multi-family construction. Moreover, moves by policymakers may encourage foreign investors to shift their mix of investments and invest less aggressively in the US.

Global Rates



Source: Bloomberg

Highlights

US Treasury rates remain attractive relative to rates of major European countries and Japan. Further spread widening between the US and other countries has been caused by continued divergence of monetary policies.

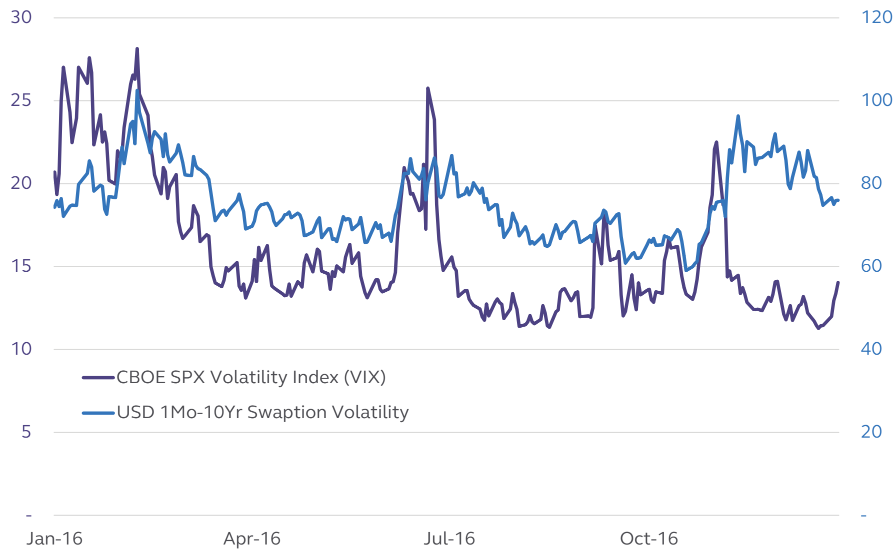
In the US, signs of accelerating growth increased expectations of further FOMC rate increases. Meanwhile, the European Central Bank and Japan continue aggressively easing monetary policies, reinforcing historically low and, in some cases, negative rates abroad.

Post-election enthusiasm over prospects of fiscal stimulus also helped to push US rates substantially higher.

Outlook

We believe the divergence of monetary policies and relative attractiveness of yields in the US support a continued strengthening of the US dollar against the Euro and the Yen.

Volatility



Source: Bloomberg

Crude Oil

Source: Bloomberg

Highlights

US equity (VIX) and rates (swaption) volatility moved sharply higher during three periods of 2016: January - China growth fears and the plunge in crude oil; June - Brexit vote; and November - US elections. The first two periods saw both equity and rates volatility subsequently decline; however, following Trump's presidential victory and the Republican sweep of Congress, the two volatility measures have diverged, with a sharp decline in the VIX while the volatility in rates remains elevated.

The decline in the VIX post-election may be due to the steady rally in stocks on expectations for stronger growth and more pro-business policies under the new administration. Stock prices and equity volatility tend to be negatively correlated.

The sustained rise in US rates volatility post-election may be attributed to lower market depth and greater uncertainty regarding Fed monetary policy given expectations for debt-funded fiscal stimulus measures and inflationary pressures under the Trump administration.

Outlook

While the divergence in equity and rates volatility moderated somewhat during the final weeks of 2016 as a result of year-end rebalancing led by large pension funds, continued monetary policy uncertainty in the US and geopolitical risks abroad are likely to keep rates volatility elevated in 2017, relative to equities,

Highlights

WTI Crude has doubled during 2016, from first half lows of around $25 to a less volatile second half ending above $50. The increase in prices is largely attributable to speculation of production cuts by OPEC; however, the results of these perceived cuts have yet to be fully realized. The reduction of volatility in oil prices has helped in stabilizing the global economy.

Oil consumption expectations for 2017 are materially less than what we have seen in the last couple of years. After demand of 1.9M barrels per day (bbl/d) in 2015 and 1.4M bbl/d in 2016, the International Energy Agency is estimating just 1.3M bbl/d in 2017, while OPEC has even less demand projected at 1.15M bbl/d.

Outlook

Oil pricing will continue to be highly dependent on OPEC negotiations and global trade policy, as well as supply and demand technicals. Despite the price increases we have seen in oil in 2016, we believe that oil prices will remain range-bound ($50 - $55 per barrel of equivalent oil) as market participants, including OPEC, negotiate in an effort to bring supply in balance with softening demand.

Macroeconomic Outlook

Morley
Capital Management

	Base Case (65%)	Tail 1 (25%)	Tail 2 (10%)
Description	**Modest Growth**	**Prolonged weakness (w/high chance of recession)**	**Inflation / Stronger than expected growth**
	Growth forecast is lowered to 1.50%, due to second quarter growth of only 1.2% and third quarter rebound of 2.5%. Autos and housing continue to be solid. Inventories should be rebuilt. Weaker corporate profits remain a headwind. Core PCE will remain below the Fed target of 2%. The Fed will raise rates less than their projections suggest. The Fed will only raise rates one time in 2016. Oil prices have rebounded, but should remain under $55 per barrel. Soft landing in China. Japan struggle to grow under current programs. Europe has a slow recovery. Low global rates and the strong dollar make U.S. term rates attractive and mute their rise.	Even after a large credit expansion in the first quarter China can't prevent a severe slowdown. This leads to a significant global slowdown. Emerging market economies suffer as demand for commodities drop. Some type of global credit event could also trigger a slowdown. The slowdown spills into the U.S. economy. The current recovery in the U.S. ends and unemployment increases. Global conflicts and terrorism that disrupts growth presents another risk. Also, the result of the U.S. elections could be a global trade war. The equity markets decline, reducing household wealth. The Fed raises rates too soon and must reverse course.	Stimulus programs are effective and China grows at a believable rate of 7%. The UK and EU come to amicable terms on the UK exit. Growth in the European economies improves to above trend. Japan's growth accelerates as monetary stimulus works. The threat of terrorist attacks is reduced and the Middle East problems improve. The U.S. economy grows above potential as consumer and capital spending accelerate. The drop in the unemployment rate leads to rapid wage growth. The Fed is slow to react to inflation.
GDP	1.50% in 2016	Below 0.50%	Greater than 3.50%
Change in rates	2 Yr 0.90%, 10 Yr 1.75%	Sharply Lower / 100 bps (10 Yr. UST)	Sharply Higher / +150 bps (10 Yr. UST)
Change in curve	Little change	Bull Flattener - long-term rates decrease faster than short-term rates	Bear Steepener - long-term rates increase faster than short-term rates
Volatility	Remains High	Higher	Higher

12 month forward-looking view developed by the Investment Team