

# Quarterly Market Overview & Analysis

## LOOKING AHEAD

As we move through the first quarter of 2016, expectations for US growth are deteriorating significantly. Whether this is being driven by a recognition of existing conditions or by election year fears is hard to say. It may be a bit of both. Until those expectations start to change or until we start to see an improvement in the trend of economic data, one must assume the US economy will continue to deteriorate and move toward recession. It is hard to judge how soon a recession would be widely recognized, but it would likely take, at a minimum, a few months of rising unemployment, rising jobless claims and negative monthly jobs reports to convince most people that recession is inevitable. That being the case, we don't see a consensus developing before, at a minimum, mid-year. It could happen quicker but as noted in our following CEO letter, everything in this cycle has taken longer than normal.

If we are indeed headed for recession this year, Treasuries are likely to be the big winners, continuing the early year trend. As US growth expectations fall toward the global mean, it is hard to see how US Treasuries can continue to yield so much more than the bonds of other developed nations for much longer. Other potential capital gains sources will be foreign currency denominated bonds (BWX), TIPs and gold as the dollar falls on those reduced growth expectations. The extent of any dollar fall will have an impact on those assets potential though. Foreign bonds are not cheap – capital gains there would have to come from currency appreciation.

Assuming the dollar continues to fall and gold rise, we expect gold stocks to outperform the metal. If global economic weakness persists and holds down oil prices these companies have leverage to the price of gold. Energy is their largest cost, a significant reason they underperformed the last time gold rose. We expect – and indeed are witnessing now – a lag between the rise of gold and oil and other commodities and if so, the miner stocks are poised to outperform, likely by a wide margin.

We also expect that a weaker dollar will be perceived, rightly or wrongly, as positive for economies outside the US. Stock markets in most of the world are quite cheap –with some exceptions like Switzerland – and any glimmer of hope for their economies could raise prices rapidly. While we have identified what we think are some potential sources of gains this year, we want to emphasize that capital preservation is still our number one priority. The global economy



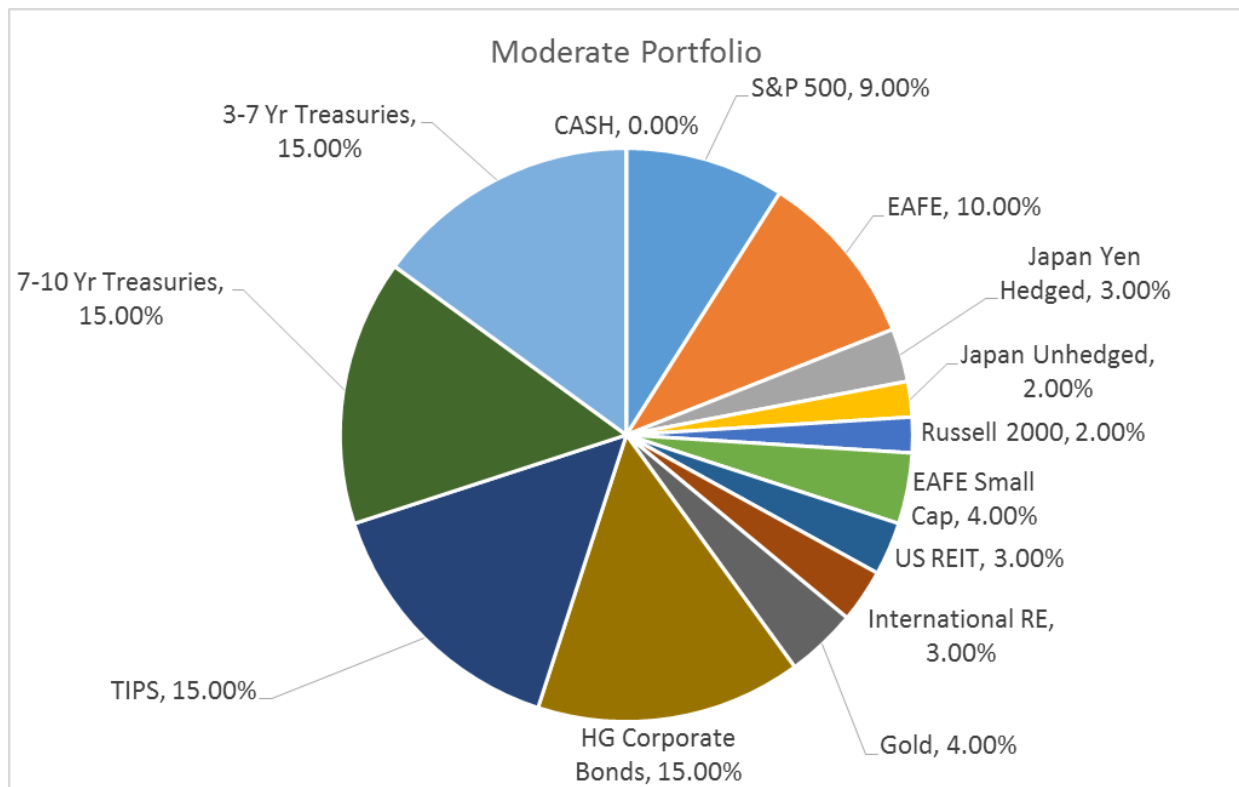
is a mess and there is considerable risk to any outlook since policy is so volatile. We quite simply can't know what the central banks might do next. We also don't know the outcome of the fall elections in the United States and that could have a huge impact on the economy and markets.

## EXPECTATIONS AND STRATEGY FOR 2016

We have identified several investment themes for 2016 and structured our portfolios accordingly.

- US economic weakness persists, moving toward recession
- Interest rates continue to fall
- The US dollar weakens further
- Gold and other weak dollar investments outperform
- Gold stocks outperform the metal
- International stocks outperform the US

Presented for reference is our Moderate Risk Global Asset Allocation Overlay. Although client portfolios differ, based on risk preferences and customization, this allocation reflects our general outlook. As such, our strategy remarks reference these positions, which can change as our outlook evolves.



We expect more activity in our portfolios this year as conditions are likely to be volatile, offering more trading opportunities. We don't expect to expand the bond position as our current allocation should be sufficiently conservative for a run of the mill recession. If something more severe appears likely we may shift more of the allocation to bonds or extend duration but we think it is too early for that. In fact, we just recently took profits on longer duration bonds after the large rally to start the year. Joe has said in the past that he thinks we will see a 1% 10 year note. Will it be this year? On the risk side of the portfolio we may look to establish short positions in US stocks on large rallies; our momentum indicators point to further declines. We also expect to expand the gold position probably through the addition of more gold stocks. If international stocks start to rise based on a falling dollar, we feel comfortable adding those positions given the low valuations.

As the market falls, more companies are falling into our valuation range. Equity screens now are turning up a larger universe from which to choose. Value stocks have been out of style for some time now but it appears the market's fascination with growth stocks is coming to an end – finally. The break in the tech stock darlings recently may have been the final straw. If we are indeed in a bear market – and we think we are – value should outperform as it usually does in a down market. There will come a point where we want to accumulate quality value stocks for the long term. We are hopeful that this is the year we get to do that but it depends at least partly on a business-friendly outcome in the U.S. election.

The last two years have been about avoiding big mistakes. We have made some small ones but we've come through the topping process in good shape. As the trend changes, we should be able to take advantage and make gains. A bear market will provide us with an opportunity to position the portfolio for the years ahead and achieve our client's long term goals.

## **CEO QUARTERLY COMMENTARY**

In trying to look ahead for the next year, I'm struck by how difficult this cycle has been from a timing perspective. Our head of research, Jeffrey Snider, has, I think, been largely correct in his assessments about the global economy but the pace of change has been laborious and acknowledgment of it by the market even more so. And that is what matters in the end. What we think about the economy is really irrelevant to some degree when it comes to investing. This is Keynes' beauty contest and what matters is what the majority thinks. The Fed's influence over the perception of the economy, its forward guidance, its emphasis on language as policy, has frustrated me beyond anything I've ever experienced as an investor. But as last year progressed, it does seem that the rest of the world started to come around to our view, started to acknowledge what we thought was pretty obvious and our performance improved as the year progressed. That has continued into the new year with our Global Asset Allocation overlay/model significantly outperforming the market. Our conservative accounts were up 1.4%, the moderate



down 0.20% while the most aggressive were down a mere 1.21% in January\*. That was a function of overweighting bonds and extending duration as well as a small allocation to gold.

\*Model returns, gross of fees

## The Economic Situation

Jeff would tell you that the US economy and large parts of the global economy are in recession right now. I am not willing to go that far yet although things are certainly moving in that direction. And it may be that when we look back on this period from the future we will know that we were in fact already in recession, but for now I don't think we can say that for sure and the rest of the world certainly isn't ready to acknowledge it. All I can say for sure is that the US economy has slowed to a very slow rate of growth (1.8% year over year growth by Q4 2015). As for the rest of the globe there are certainly countries that are in or very near recession – resource based economies primarily – but the overall global economy still grew last year and likely will this year too, although I'm sure the rate of growth will be frustrating for all.

This business cycle has been elongated – as both Jeffrey and I have written about – by monetary intervention but there is a growing perception that central banks are out of ammunition, so to speak. Investors still can't seem to help themselves when central banks do unexpected things – see the BOJ rate cut into negative territory last week that produced a one day rally – but in general I think the expectation that central banks can fix what ails us is fading. The reality of our situation is finally starting to set in although I think – and believe Jeffrey does too – that most people and certainly most economists have yet to come to grips with the source of the problem. “Secular stagnation” or the “new normal” are phrases that demonstrate nothing more than the bankruptcy of the economics profession, a complete lack of imagination and an unwillingness to acknowledge the profession's errors. The Platonic or Delphic maxim to know thyself certainly comes to mind; secular stagnation indeed.

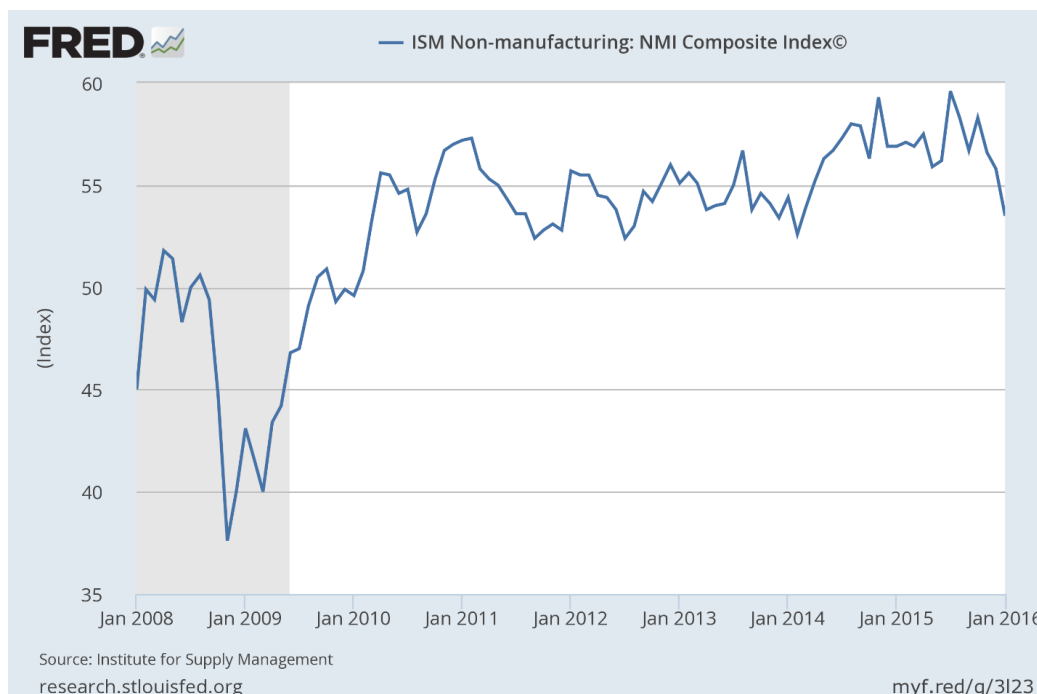
The current situation is one of very slow growth that could easily fall into recession – essentially the same condition that existed when I wrote this last year. The slowdown has been led by the manufacturing sector and more specifically the energy sector. The shale bust is a direct consequence of the stronger dollar and the impact that has had on oil prices. Whether the rise of the dollar is legitimate and based on capital flows or driven by the scramble to cover the global dollar short is really irrelevant to some degree (although Jeff might disagree with that). The fact is that lower oil prices, whether driven by reduced demand, excess supply or just a rising dollar makes much of the new US shale oil production unprofitable; the recently stronger dollar has revealed the mal-investment of this cycle. Indeed, at current prices it isn't just US shale that is unprofitable but large swaths of recent global new developments (see Petrobras). That has placed tremendous strain on the companies involved and the entities or individuals who financed them. There is a ripple effect across the US economy the depth and breadth of which is still



unknown. There was a thought that the US economy could transition to stronger dollar investments without going through a nationwide recession - as we were able to do in the mid-1980s oil bust. Jeffrey and I have our doubts about that as you know and it now appears that the majority and the market is coming around to our view.

A strong and stable dollar would be very good for the US economy and probably the global economy as well. Lower oil prices that reduce the incentive to drill high cost shale oil wells are a good thing. We as a country should leave oil and most resource extraction to underdeveloped countries and concentrate on higher value added, productivity enhancing investments; comparative advantage for the US does not likely lie in the Bakken. Unfortunately, I think the strength of the dollar was based on a fallacy – the US economy was a lot better than the rest of the world, so much that the Fed would raise interest rates to “normal” - and we are likely seeing it unwind even as I write this. As for stability, forget it. The global currency war, the central bank, academic economist obsession with devaluation as a cure for deficient global demand pretty much ensures that currency volatility is here to stay. It is an idiotic policy doomed to fail but it seems to be the only hymn the central bank choir knows.

The fact is that the US economy is not in very good shape right now. There are essentially two sectors holding up growth – autos and housing. There are plenty who will tell you that the US economy is about “services” and that part of the economy is just fine. Jeffrey and I would tell you that is a fallacy too and that it makes perfect sense that the services sector would lag manufacturing. Services are inevitably linked to the production side of the economy and a slowdown in the industrial/manufacturing part of the economy will eventually show up in services too. Indeed the ISM non-manufacturing survey released this week showed a marked slowdown although it is still above the 50 level that indicates expansion.



As I said above, there are really only two sectors that are holding up growth at this point – housing and autos. Both of these sectors are obviously affected by interest rates and credit availability so with rates low and the agencies and the Fed buying up mortgages it isn't surprising that these two are what is left standing. When we look at an overview of the US economy the two sectors are obvious outliers:

<b>Economic Growth &amp; Investment</b>	<b>Prior</b>	<b>Consensus</b>	<b>Actual</b>	<b>Year Over Year % Change</b>
Industrial Production	-0.9%	-0.2%	-0.4%	-1.75%
Manufacturing	-0.1%	0.0%	-0.1%	
Capacity Utilization	76.9%	76.9%	76.5%	-3.2%
Chicago Fed Nat'l Activity Index	-0.36		-0.22	
Existing Home Sales	4.76M	5.2M	5.46M	7.70%
Personal Income	0.3%	0.3%	0.3%	4.50%
GDP	2.0%	0.9%	0.7%	
Leading Economic Indicators	0.5%	-0.1%	-0.2%	
Non-Farm Productivity	2.1%	-1.8%	-3.0%	0.30%
<b>Production</b>				
Empire State Mfg Survey	-4.59	-4.00	-19.37	
Philly Fed Survey	-10.2	-4.0	-3.5	
ISM Non-Mfg Survey	55.8	55.5	53.5	-5.64%
ISM Manufacturing Index	48	48.3	48.2	-10.58%
Chicago PMI	42.9	45.5	55.6	-6.40%
Dallas Fed Mfg Index	-21.6	-14.0	-34.6	
Richmond Fed Mfg Index	6		2	
Kansas City Fed Mfg Index	-9		-9	
<b>Consumption &amp; Distribution</b>				
Retail Sales	0.4%	0.0%	-0.1%	2.20%
Less Autos	0.3%	0.2%	-0.1%	
Less Autos & Gas	0.5%	0.3%	0.0%	
Wholesale Sales			-1.0%	-4.60%
Motor Vehicle Sales	17.3M	17.5M	17.6M	4.99%
Domestic Vehicle Sales	13.9M	13.6M	14.2M	
Consumer Spending	0.5%	0.1%	0.0%	3.40%
<b>Inventories</b>				
Business Inventories	-0.1%	0.0%	-0.2%	



	Inventory/Sales			1.38	4.55%
Wholesale Inventories	-0.3%	0.0%	-0.3%		
	Inventory/Sales			1.32	7.32%
<b>Orders</b>					
Factory Orders	-0.7%	-2.8%	-2.9%		-6.6%
Durable Goods	-0.5%	0.2%	5.0%		-0.6%
	Ex-Transportation	-0.5%	0.0%	-1.2%	-3.2%
	Core Capital Goods	-1.1%		-4.3%	-7.5%
<b>Trade</b>					
Trade Balance		\$-42.2B	\$-43.0B	\$-43.4B	
	Exports			-0.3%	-4.8%
	Imports			0.2%	-3.1%
<b>Inflation</b>					
CPI		0.0%	0.0%	-0.1%	0.7%
	less food & energy	0.2%	0.2%	0.1%	2.1%
GDP Price Index		1.3%	0.9%	0.8%	
Import Prices		-0.5%	-1.4%	-1.2%	-8.2%
Export Prices		-0.7%	-0.5%	-1.1%	-6.5%
Employment Cost Index		0.6%	0.6%	0.6%	2.0%
Unit Labor Costs		1.9%	4.4%	4.5%	2.8%
PCE Price Index		0.1%	0.0%	-0.1%	0.6%
	PCE Core	0.2%	0.1%	0.0%	1.4%
FHFA House Price Index		0.5%	0.5%	0.5%	5.9%
Case Shiller HPI		0.8%	0.7%	0.9%	5.8%
Farm Prices		3.4%		-2.2%	-11.0%
<b>Employment</b>					
New Jobless Claims		277K	280K	285K	0.35%
Job Openings		5.349M		5.431M	
Labor Market Conditions Index		2.7		2.9	-58.57%
Non Farm Payrolls		262K	188K	151K	-31.67%
	Private Payrolls	251K	180K	158K	-35.44%
	Unemployment Rate	5.0%	5.0%	4.9%	
	Participation Rate	62.6%		62.7%	
	Avg Hourly Earnings	0.0%	0.3%	0.5%	2.5%
	Avg Workweek	34.5Hrs	34.5Hrs	34.6Hrs	0.0%
Challenger Job Cuts Report		23622		75114	41.60%
ADP Employment		267K	190K	205K	



## Construction

Housing Market Index	60	62	60	5.3%
Housing Starts	1.179M	1.200M	1.149M	6.40%
Housing Permits	1.282M	1.217M	1.232M	14.40%
Construction Spending	-0.6%	0.6%	0.1%	8.20%
New Home Sales	491K	500K	544K	14.70%

## Other

Consumer Sentiment U of Mich.	93.3	93	92	-6.20%
NFIB Small Business Optimism	94.8	95	95.2	-5.18%
Consumer Confidence Conference Bd.	96.3	96.0	98.1	

Just look at the green items in the year over year change column; it won't take long, there aren't many. The major positives are income and consumption in the form of existing home sales, new home sales and automobiles. The income figure is interesting because it doesn't appear to be a lack of income growth causing the economic slowdown; it is just that individuals have opted to save rather than spend, a function, one assumes, of their outlook for the economy. It may be that consumption is being held back this year in particular due to uncertainty surrounding the election, a topic I'll return to later.

Businesses have been overly optimistic about sales for several years now and that is reflected in one of the most negative figures in the chart – inventories. Inventories have piled up at all levels of production from manufacturers to wholesalers to retailers. Production is already being cut in response and that is likely to get worse at least in the first half of the year and possibly quite a bit longer. Slowing production is reflected in the industrial production, capacity utilization, factory and durable goods orders, all of which are down year over year. We also see weakness in the trade figures with both exports and imports down for the full year for the first time since 2009.

The real problem with the economy is the lack of productivity growth which was up a mere 0.3% in the last year. That is, unfortunately, pretty normal for the period since the Great Recession. As Jeff pointed out recently, that lack of productivity and miniscule population growth means the employment figures really don't make a lot of sense. There is little reason for employers to add to payrolls with no sales growth – or sales contraction in many cases for the multi-national companies – and rising costs. Walmart recently announced a large number of store closings and it isn't coincidence that they are closing stores in areas where the minimum wage has been hiked. One way to raise productivity at the firm level is to close underperforming operations and reduce head count, something that factored into my recent purchase of Walmart stock. And the stock is just plain cheap to boot.

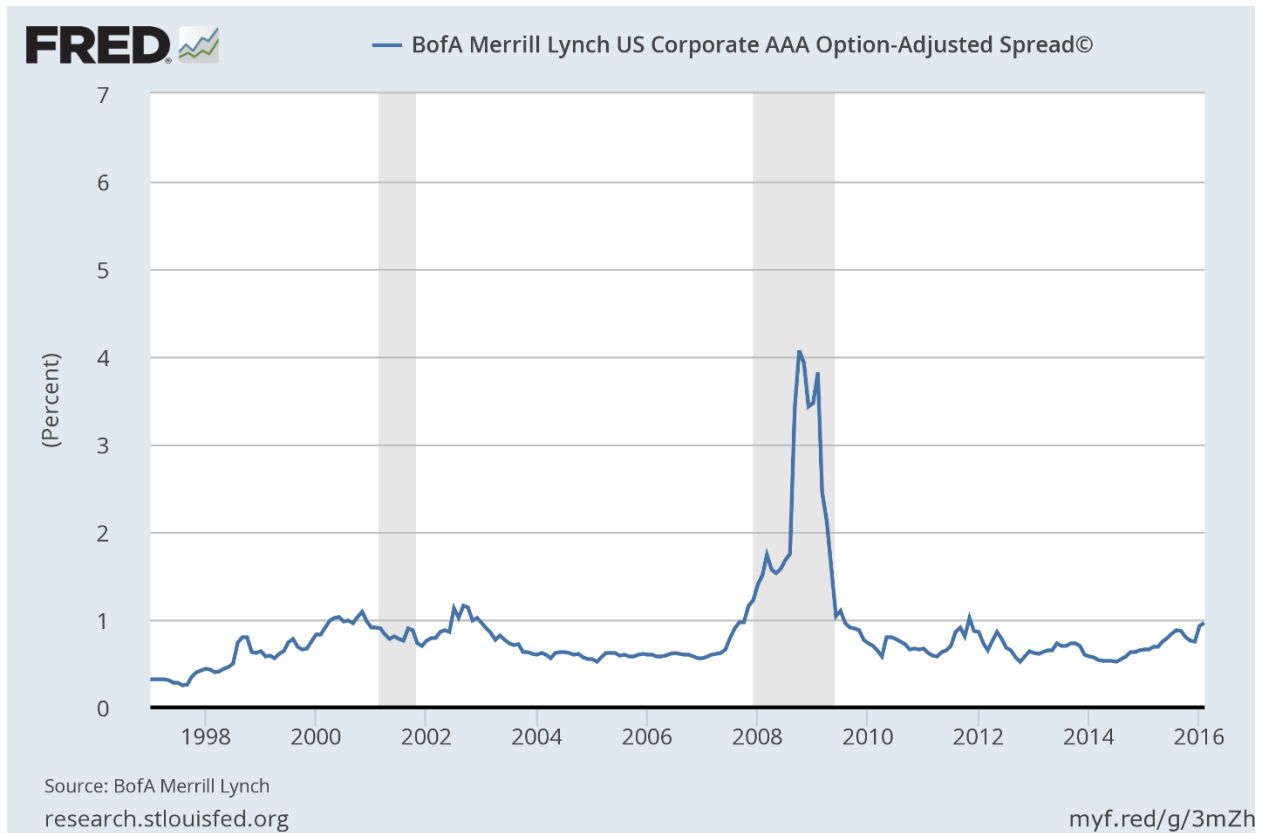




The lack of productivity growth in turn is linked to the lack of investment. Core capital goods orders are down 7.5% year over year, led by the reduction in energy investment. The energy sector had accounted for a larger than normal portion of capital spending in recent years – about double its historic average – and it has just fallen off a cliff. The pullback in investment is spreading beyond the oil patch though. Of the companies that have reported earnings so far this quarter the number of companies reducing or keeping capex level outnumber the ones expanding by two to one.

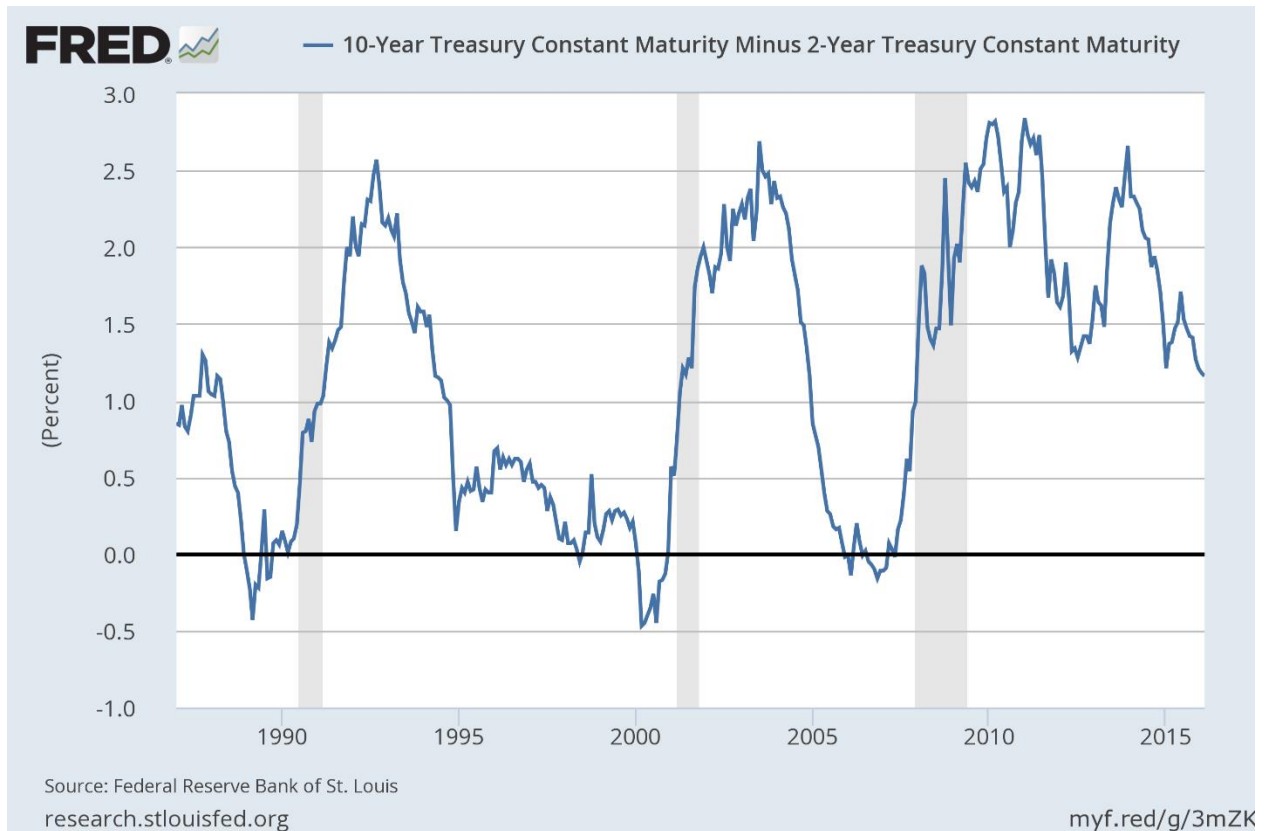
The stress in the energy sector is reflected in credit spreads across the spectrum of ratings from junk to AAA. The ML HY spread is now over 8%, a level that prevailed just prior to the last two recessions. It should be noted, however, that the 8% level was breached in the Euro crisis in 2011 without a subsequent recession. In addition, we do not have a very long data set with these spreads so one should be careful about drawing hard conclusions based on a short history. As for the AAA spread, it is elevated but that is solely due to the change in Exxon bond prices. As far as I know there are only 3 AAA companies left: Johnson & Johnson, Microsoft and Exxon. And JNJ and MSFT bonds have barely moved relative to Treasuries. Credit spreads are definitely a warning sign although not definitive; a recession is obviously not guaranteed at these levels even if the odds have increased greatly in recent months.





The yield curve continues to flatten as the Fed tightening and expectations of more raise short term rates while long term rates continue to fall. While the curve is far from the flat or inverted we normally see before recession I am cautious about saying this is an all clear for the economy. The curve generally steepens rapidly just before the official onset of recession. That is due to the Fed cutting rates or the anticipation of the same by the market. Short rates fall faster than long rates. We could easily see a steepening here if expectations regarding future monetary policy continues to price out rate hikes. Right now though we don't have a flat curve and we don't have a rapid steepening as we would expect right before recession. We're just stuck in the middle. Could we get a recession without seeing a significant move in the curve? I highly doubt that but I suppose anything is possible. I would note that Japan's last two recessions were not preceded by a flat or inverted curve, evidence that at the zero bound old rules don't hold.





There are plenty of reasons to suspect that we are headed for or already in recession. Jeff can cite you chapter and verse on the number of economic indicators that are already at levels or rates of change that have never been seen outside recession. The fact is though that despite all that, the US economy is still not in an official recession. Growth for the full year 2015 came in exactly as it did last year, +2.4%. Employment continues to expand, at least if the official numbers are to be believed. And despite Jeff’s concerns in that regard, I do think the numbers are largely correct. The problem is not one of quantity – at least not yet but that may be changing – but quality. The jobs being created are not high quality, high paying jobs and the number of multiple job holders continues to expand. The vast majority of America is struggling to make ends meet.

The rate of job creation – and that is a generous term in this economy since so many jobs are a result of government fiat (Obamacare) or government regulation (Dodd-Frank) or government coercion (Obamacare again) – is falling as corporate earnings and margins appear to have peaked for this cycle. The rate of 151,000 jobs in the latest report was down over 30% from the same month a year ago and the workweek is unchanged. Corporate earnings peaked a year ago and are now down 5.1% from that peak with Q4 still to be reported and likely down further. While many, including most prominently the Fed, have pointed to the employment picture as evidence the economy is still healthy, the fact is that employment is a lagging indicator and it is starting to



fall as the other economic statistics already have. I can't begin to express my alarm that the Fed is basing monetary policy primarily on a lagging indicator.

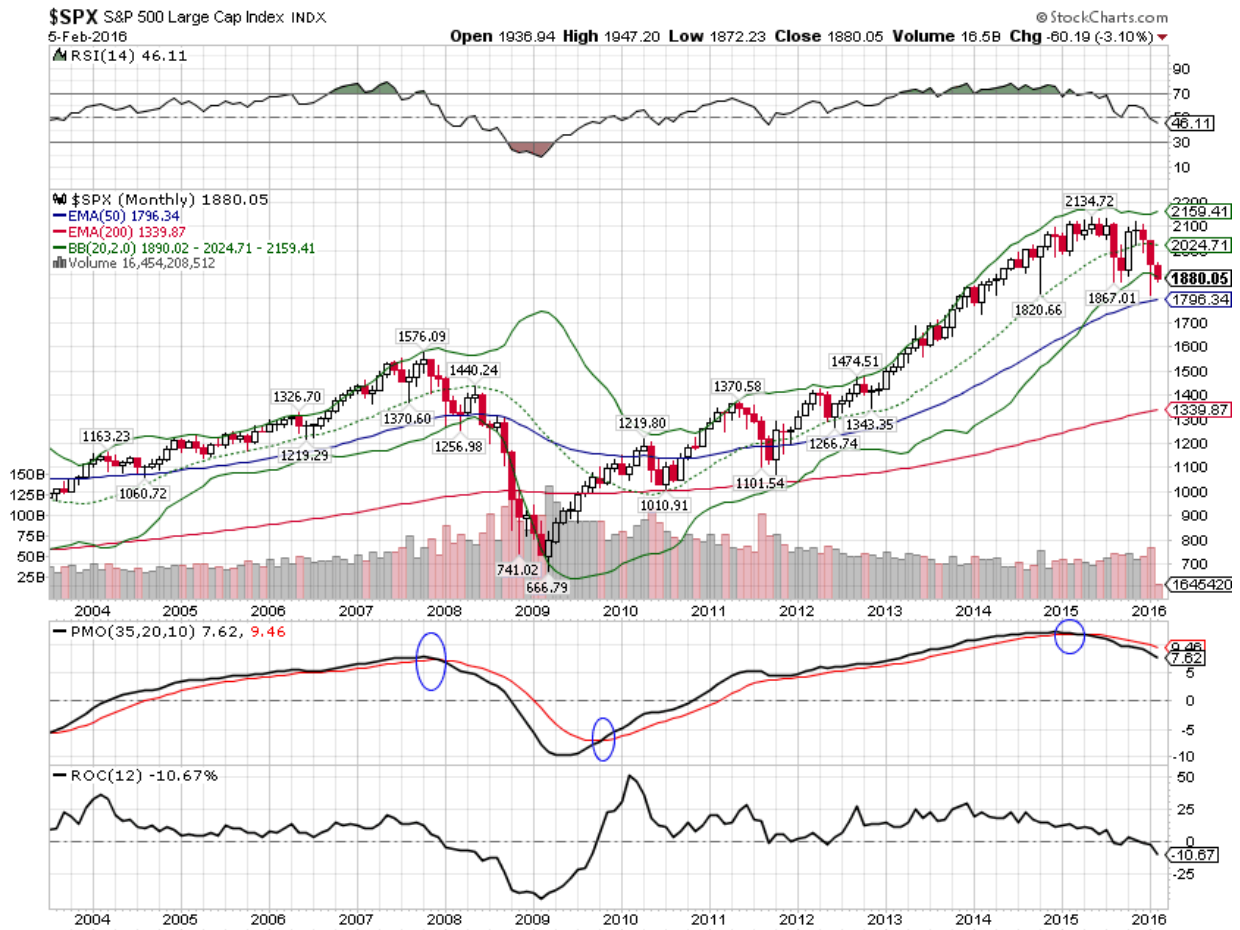
So, now here we are two years into this period of limbo, still wondering if and when a recession will start. The two most reliable warning signals for recession – the yield curve and credit spreads – disagree. The yield curve is in the middle of its historic range still well above flat and nowhere near inverted. Credit spreads are at levels often associated with recession and that is across the spectrum of ratings. However, most of the stress – not all by any means – is confined to the energy sector.

The other indicators I use for asset allocation are valuation and momentum. I won't bore you with another dissertation on the various methods of stock market valuation; suffice it to say that despite the minor correction in stock prices since the peak last May (11.9% for the S&P 500), the US stock market is still highly valued. International markets are not as highly priced. Price to sales ratios in Europe are about half the US while Emerging markets are even cheaper. Market cap/GDP, CAPE and other reliable valuation techniques show foreign markets to be not just cheaper than the US but cheap in general. That has not kept the S&P 500 from outperforming the MSCI World index for the last three years and six of the last eight. Over the long term, there is little difference between US and international with each outperforming about half the time. Just proof once again that valuation is a lousy timing tool.

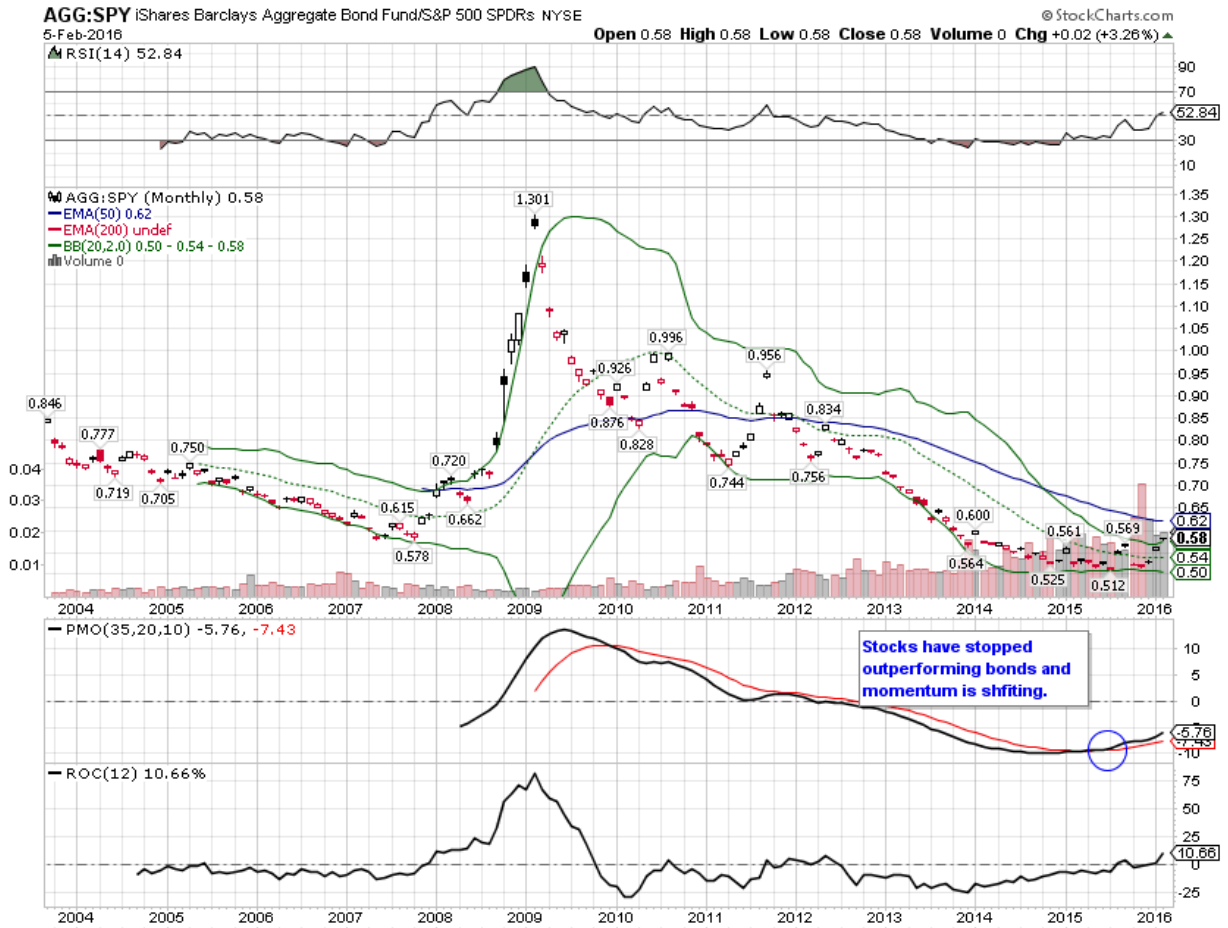
Momentum has been shifting for most of the last year, again a process that is taking much longer than it has in the past. Momentum isn't just shifting within asset classes – stocks from upward momentum to down – but also across asset classes – from stocks to bonds and gold. It is an interesting process that can also provide insight into the economy. In fact, George Soros – one of the greatest investors of all time regardless of his politics – says that we should always look to markets to tell us about the future of the economy and not the other way around. When momentum is shifting from junk bonds to Treasuries that not only has an impact on our investments today but it has an impact on the economy and therefore our investments tomorrow.



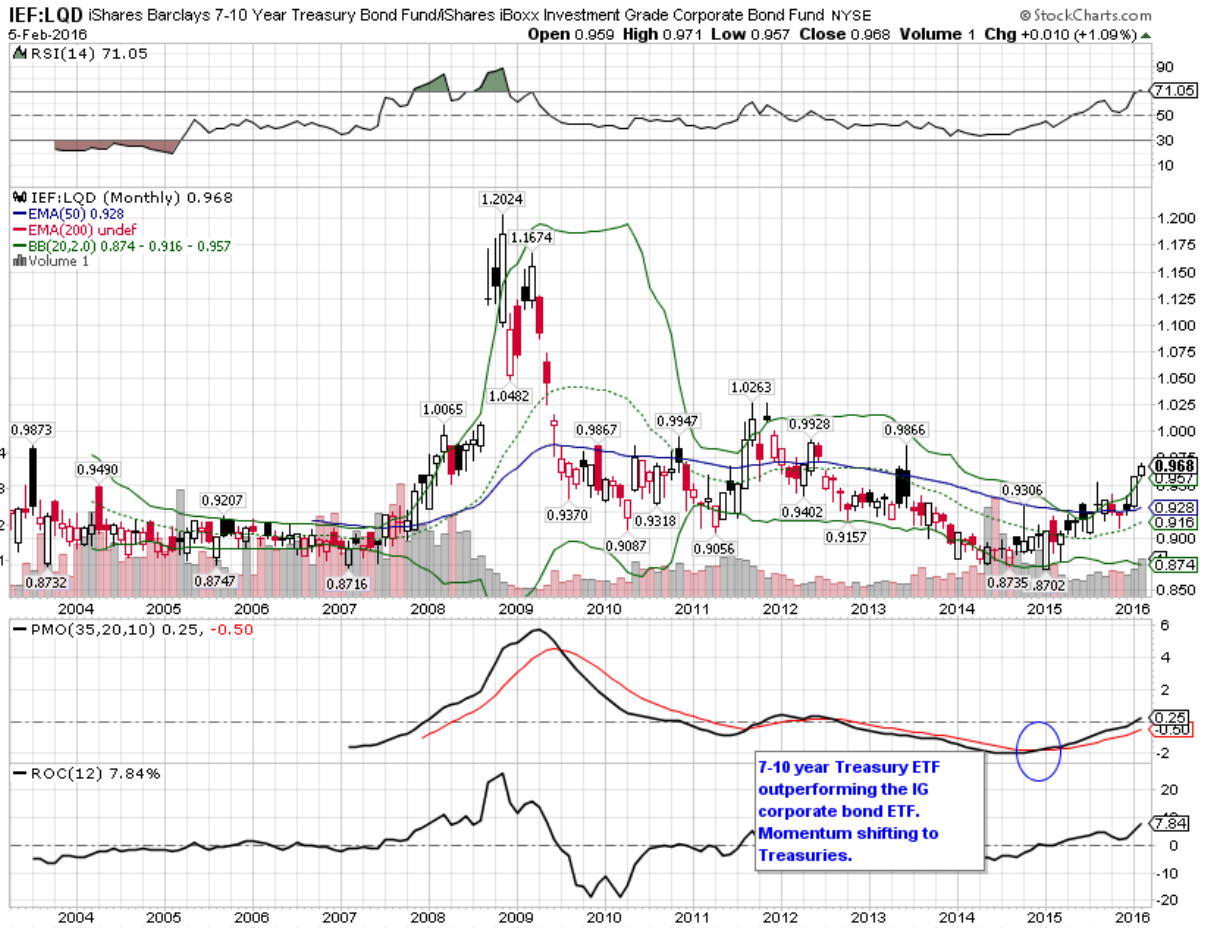
Momentum for the S&P 500 peaked some time ago and the trend is now down:



## Momentum is shifting from stocks to bonds:



Further, momentum is shifting from credit bonds to Treasuries:



The outperformance of Treasuries versus High Yield is even more pronounced:



Obviously, these are not new trends; we shifted out of junk bonds over two years ago although we do still own investment grade corporates. If we are headed into recession these trends will continue with the long end of the Treasury curve continuing to outperform all other bonds. If we are able to avoid recession, these markets should provide us with advance notice that the stress is being relieved. So far, I see no evidence of that.

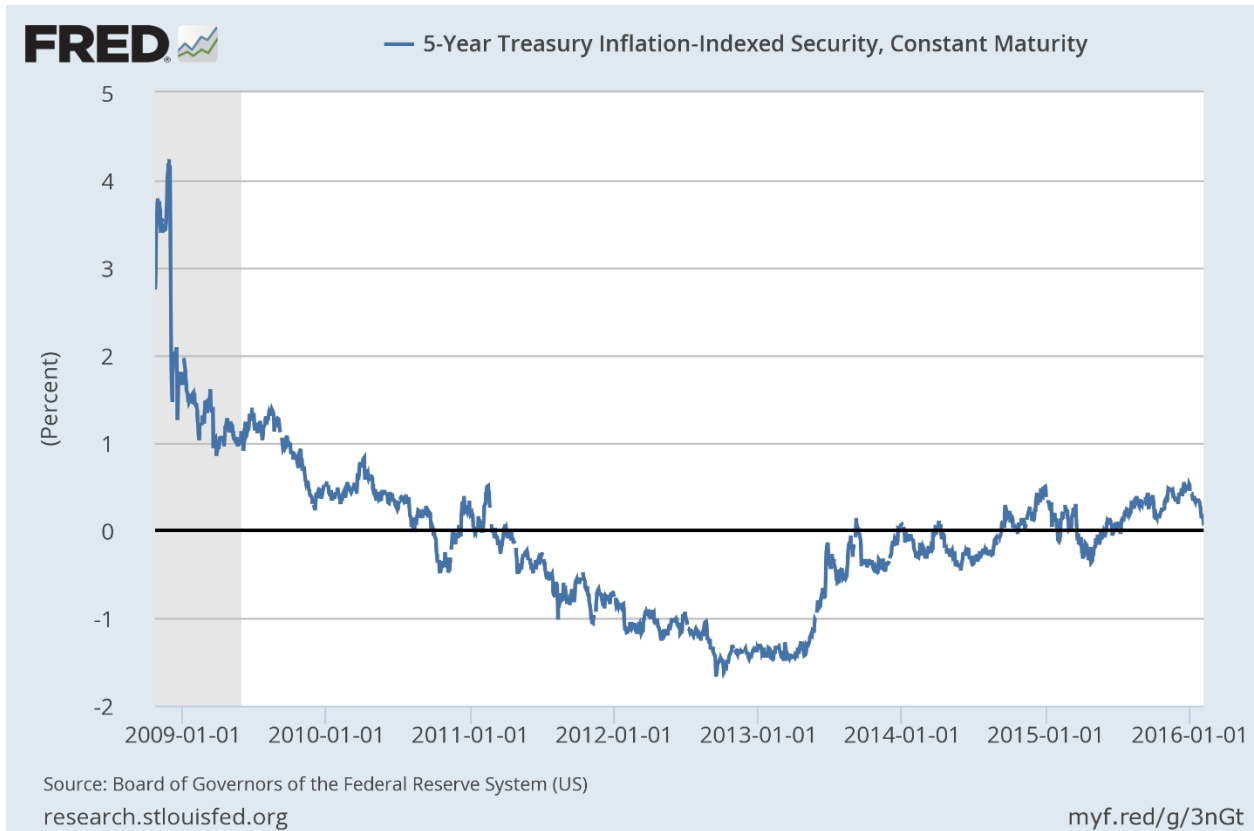




Another trend, much earlier in its development, is the outperformance of gold versus stocks. Over the last six months gold has outperformed the S&P 500 by nearly 20% while over the last year the performance is almost equal. This trend is really about the US dollar which peaked nearly a year ago and has recently turned down to support.



The trend in gold is being driven by real interest rates which appear to have peaked and started to fall again. Real interest rates are highly correlated with real growth and when they are falling, the dollar tends to fall and gold tends to rise. This renewed weakness in real yields is improving the performance of our TIPS ETF which has been a laggard on the bond side of our portfolios:



TIP iShares Barclays TIPS Bond Fund NYSE

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5-Feb-2016

Open 111.48 High 111.62 Low 111.32 Close 111.39 Volume 554.8K Chg -0.31 (-0.28%)

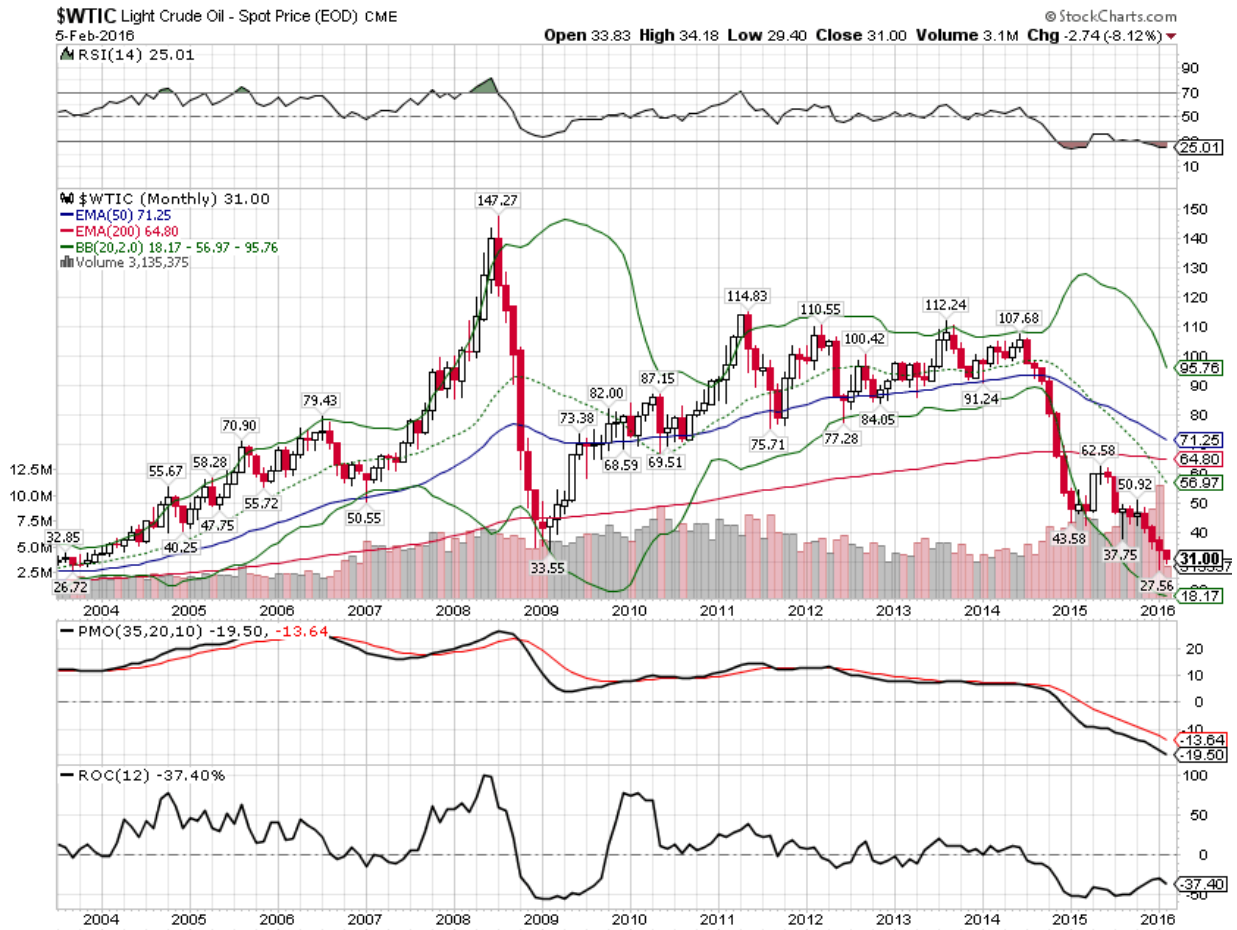
▲ RSI(14) 62.50

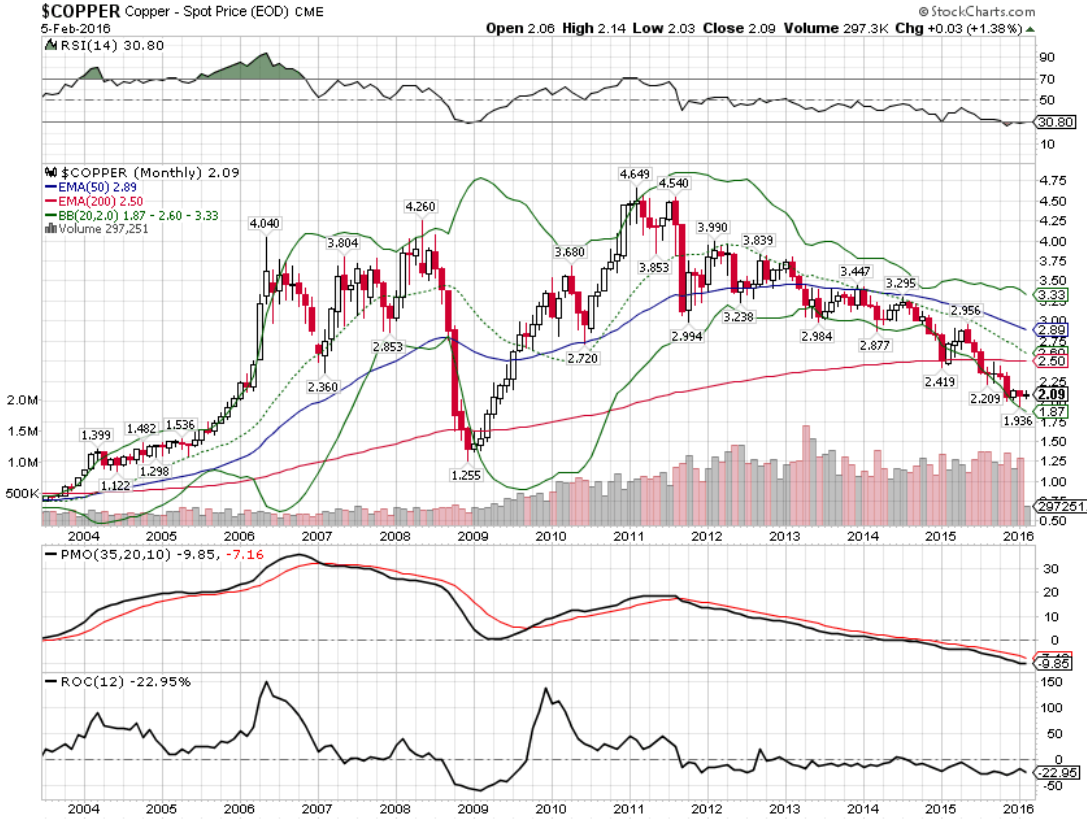


I would point out though that while gold has performed well in relation to stocks, the long term momentum for gold itself has yet to provide a clear buy signal. It would seem that further economic deterioration that drives down real rates and the dollar will be required before a full commitment to gold is warranted.



This relative shift in performance away from stocks to gold is not a general shift to commodities, at least not yet. Crude oil and copper, for instance, show no signs of turning higher. This confirms that the move in the dollar is driven by growth expectations. These industrial commodities are driven by supply and demand factors beyond the scope of the value of the dollar and it does not appear there is any expectation of a demand revival.

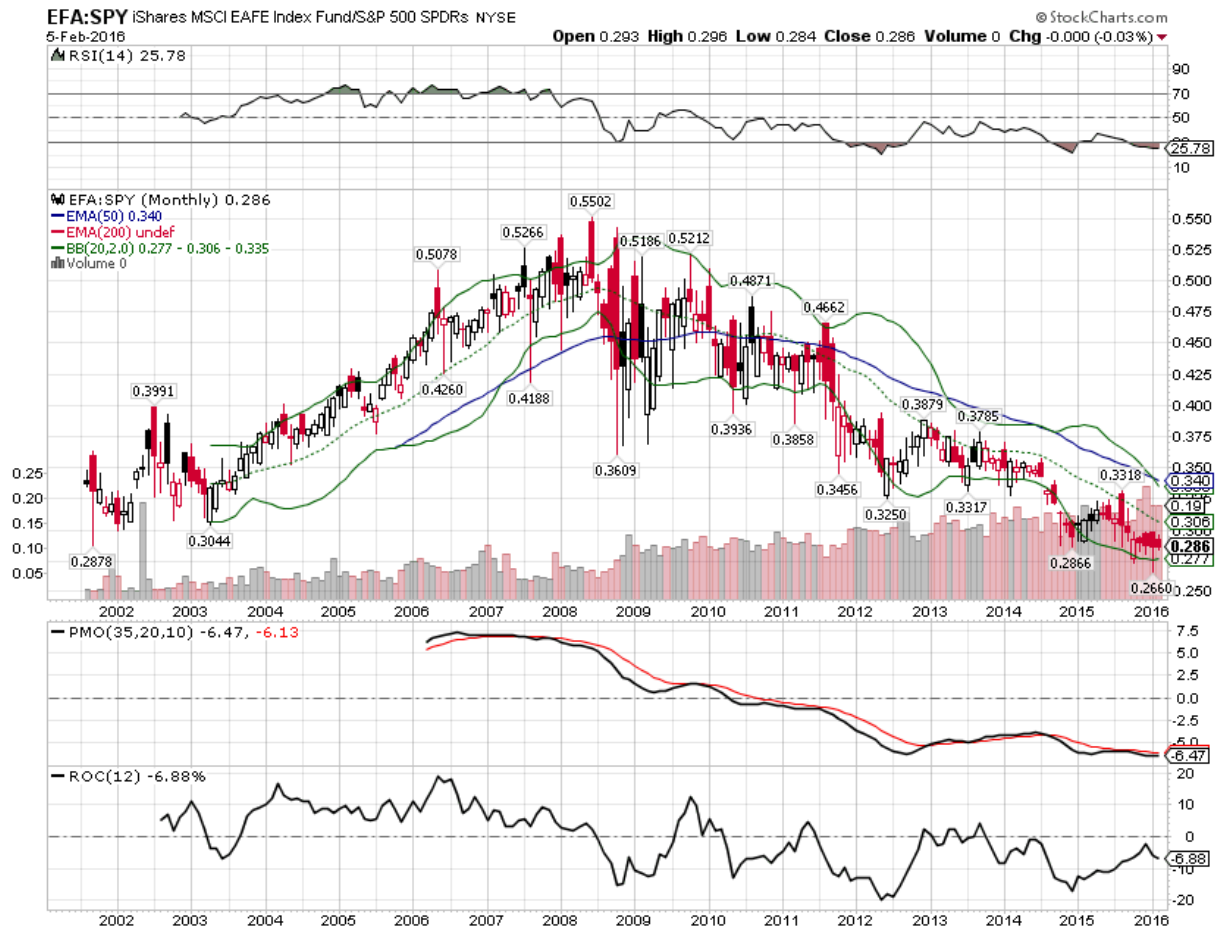




Within stocks, the trend of the US outperforming international markets tried to reverse at the beginning of 2015 but reverted to trend later in the year. EAFE and the S&P 500 have performed almost exactly the same so far this year.



It will be interesting to see how this changes if the dollar continues its recent fall. Certainly, the trend of the dollar has a large impact on the relative performance of the two indexes with EAFE outperforming throughout the weak dollar period from 2002 to 2008:



While I do not expect a repeat of the '02 – '08 weak dollar period I do think the dollar has likely seen its peak for this cycle. There just isn't a sufficient difference in growth between the US and the rest of the world to justify a continual rise in the dollar. To the extent that a rising dollar has created problems in the global economy – due primarily to outstanding dollar debts – a falling dollar should, at least theoretically, relieve some of that pressure. We don't know yet though how much damage was done, what kind of losses have already been incurred by global banks. Certainly, we know that negative interest rates have not been kind to the European banks with UBS, Credit Suisse and Deutsch Bank reporting large losses recently. We also saw a large drop in Japanese bank stocks after their announcement of negative rates (something that quite caught me off guard after Kuroda had just recently rejected negative rates as a potential policy measure; never trust a central banker).

If the stress on the global dollar debtors is relieved even partially by a weaker dollar, we may yet avoid a global recession. It remains to be seen whether those debtors will take advantage of a weaker dollar period to refinance their debts. I suspect that a large part of the rise in the dollar





was actually driven by exactly that. We know that at least some Chinese companies have been doing so. What many see as capital flows is actually the repayment of dollar debts. There is certainly capital coming out of China but at least some of the Yuan/dollar imbalance is being driven by dollar debt repayment. But there is still much to be done before the global dollar short is neutralized.

The key to markets this year, as it was last year, is the course of the dollar. I believe it has peaked for this cycle but much of what happens in foreign exchange markets over the coming year will be decided by the actions of central bankers. And perhaps more significantly, voters. The US elections this year could have a major impact on how the US is viewed, a statement as ambiguous as I meant it to be. The US desperately needs better economic policy that includes regulatory relief and major tax and spending reform. None of the current front runners have offered a competent economic plan, one that would inspire confidence here or abroad. I hope that changes before the election either by a change in the front runners or a change in their plans.

More than anything though we need a competent monetary policy and that is something that must be driven by political leadership. There is likely some pain to be endured to extricate ourselves from the mess we've managed to make over the last 15 years or so. It will take a strong President with a cooperative Congress and a focused central bank chief to persevere through the transition. A tall task perhaps but one we've accomplished before.



Joe Calhoun

Chief Executive Officer

Alhambra Investment Partners

*"Wealth preservation and accumulation through thoughtful investing."*

*For information on Alhambra Investment Partners' money management services and global portfolio approach to capital preservation, Joe Calhoun can be reached at: **jyc3@alhambrapartners.com** or **786-249-3773**.*

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