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YEAR-END RECAP

Continued improvement in US business conditions has finally allowed Federal Reserve officials to abandon their zero interest rate policy, setting up a test of whether the economy, with less central-bank support, is capable of generating a self-sustaining expansion in investment by households and businesses. Substantial improvement in labor market conditions, strength in household consumption and improving business investment, amid signs there is a good chance inflation readings over the medium term will meet the Fed's targets, have strengthened the Fed's conviction we are in a self-sustaining expansion, contributing to their decision to increase the Fed Funds rate by 25 basis points, the first such increase in over 9 years.

Despite assurances by Fed officials that future rate increases would be gradual, some investors remain concerned the expected impact of higher interest rates on the already-strong dollar will further diminish demand for US exports and depress commodity prices, crimping growth in the industrial economy. In addition, there are worries the strong dollar that has hit commodity prices and companies in emerging markets which borrowed heavily by issuing dollar-denominated debt during the low-rate period, will find it difficult to pay off those obligations possibly triggering destabilizing outflows of capital. These concerns, along with worries about expected bankruptcies in the energy sector, have raised the specter of a possible recession. Widening spreads in the high yield market are cited as harbingers of a slowdown. Despite these concerns, we believe the likelihood of a recession in the next year or two is quite remote, less than 25%. Our view is supported by our Economic Model and the Leading Indicators (LEI) which are signaling expansion.

CURRENT SITUATION

Despite exogenous shocks, geopolitical tremors and the unpredictable ebbs and flows of quarterly GDP, the US economy has made a substantial recovery since the

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financial crisis and 2008-09 recession. The headline unemployment rate, which peaked at 10% in October 2009, has declined to 5%, creating about 13 million jobs since the nadir of employment in early 2010. Total non-farm payrolls are now 4½ million higher than prior to the recession. Following two months of relatively modest jobs gains, employers added 271,000 jobs in October bringing the average monthly increase since June to about 195,000 which is roughly consistent with the monthly pace of around 210,000 in the year's first half. However, even with these impressive increases the US remains below full employment and further job gains are expected as the expansion progresses.

- A significant number of individuals now classified as out-of-the labor force would likely accept jobs in an even stronger labor market. Many of those not looking for a job are not counted as unemployed including most retirees, teenagers, young adults in school, and those staying at home to care for children and other dependent family members.

- Some who are counted as out of the labor force might be inclined to seek work if the likelihood of finding a job rose or if the expected pay was higher.

- Other individuals who report they are working only part-time but would prefer a full-time job and cannot find one, are another potential source of job seekers.

The rate of increase in labor compensation provides another possible indicator of the degree of labor market slack. Until recently, labor pay had grown only moderately, at average annual rates of 2.25%. More recently, however, there has been a pick-up in the growth rate of average hourly earnings for all employees and of compensation per hour in the business sector. While it is probably premature to conclude these more rapid rates of increase will persist, a sustained pick-up would likely signal a diminution of labor market slack.

Beyond the important labor market picture, overall economic activity as measured by real GDP, continues to expand at a moderate rate. Over the first three quarters of this year, real GDP is estimated to have grown at an annual rate of 2.25%, close to its average pace over the prior five years. Many forecasts, with which we agree, expect growth roughly along those same lines in the current quarter and a moderate acceleration in 2016. Additional contributions to growth from the tax and spending legislation Congress has passed, along with the recently enacted highway bill, could boost 2016 GDP, bringing GDP growth to 2.6% - 2.7%.

As noted above, growth this year has been curbed by *weak net exports* which have subtracted ½ percentage point, on average, from the annual rate of real GDP over the past three quarters. Economic growth abroad has slowed, dampening increases in US exports, and the US dollar has appreciated substantially since the middle of last year, making our exports more expensive and imported goods cheaper, keeping a lid on domestic inflation.

By contrast, household spending, business fixed investment and residential investment, which represent 85% of aggregate spending, have increased at an annual rate of 3% this year, outpacing real GDP. Household spending, spurred by cheaper energy costs and job growth, has been strong in 2015, with purchases of new motor vehicles especially solid. These same factors have contributed to consumer confidence which has risen since 2014. Increases in home values, along with reductions in debt, have pushed up the net worth of households, which also support consumer spending. Finally, despite the recent Fed rate increase, interest rates for borrowers remain very low by historical standards creating a favorable environment for consumers considering the purchase of cars and homes.

Residential and business investment have also advanced nicely this year. The same factors supporting consumer spending have supported further gains in housing. And outside of the drilling and mining sector, where lower oil prices have led to substantial cuts in outlays, business investment spending has posted gains.

So, on balance, the moderate average pace of GDP growth so far this year which we have characterized as "muddling along" has been sufficient to bolster the labor market, moving it closer to maximum employment. However, inflation continues to run well below the Fed's 2% target as measured by the PCE (price index for personal consumption expenditures). Taking into account the effects of lower energy prices and the downward pressure of the strong dollar on import prices, it appears that the underlying rate of inflation in the US has been running at a 1.5% to 1.75% rate and will likely drift higher.

SOME HEADWINDS AND TAILWINDS

As noted earlier, the higher foreign exchange value of the US dollar, as well as weak growth in some foreign economies, has restrained demand for US exports. Lower crude oil prices have reduced activity in the domestic oil sector. We expect the drag on US economic growth from these headwinds will diminish in the next

few quarters as the global economy, stimulated by accommodative monetary policies, improves and as the adjustment to prior declines in oil prices is completed. While geopolitical uncertainties in foreign economies still pose risks to US economic growth, the downside from these risks from abroad have lessened since late summer.

Among the emerging market economies, recent data support the view that the downturn in China, which a number of forecasters incorrectly predicted would lead to a financial meltdown, will likely continue to be modest and gradual. Recent forecasts for 2016 GDP growth in China center around 6.7%, not far from those of the current year. China has taken numerous actions to put a floor beneath its economy this year and there is room for them to adopt further measures such as widening the fiscal deficit, reducing industrial over-capacity, slashing costs for business, cutting unsold property inventory and fending-off financial risks, if necessary, by adopting more flexible monetary policies. A number of the other emerging market economies have eased monetary and fiscal policy this year, and economic activity in these economies has improved. Accommodative monetary policy is also supporting economic growth in the developed economies. A pick-up in demand in many advanced economies, including the EU, and stabilization in commodity prices should, in turn, boost the growth prospects of emerging market economies.

While we focus heavily on *monetary* policy, a tailwind that is largely overlooked in many forecasts we have seen relates to US *fiscal* policy. This year, the effect of federal fiscal policy on real GDP has been roughly neutral, in contrast to earlier years in which the expiration of stimulus programs and fiscal policy actions to reduce the federal budget deficit created significant drags on growth (i.e. 1.5 percentage points in 2013 and about ¼ percentage point in 2014 relative to what it would have been otherwise). Also, the budget situation for many state and local governments has improved as the economic expansion has played out, increasing the revenues of these governments, allowing them to increase their hiring and spending following several years of cuts in the wake of the recession. Looking ahead, total real government purchases of goods and services should have a modest positive effect on economic growth over the next few years. A change in administrations following next year's elections is also likely to bring with it new initiatives to increase stimulative spending.

THE FED

While the Fed raised policy interest rates for the first time in nearly a decade last week, its statement reflected continued caution. It signaled officials will need to be convinced that underlying inflation is rising before they deliver additional hikes. We expect the next rate increase to take place at the March meeting, the first of four during the year based upon our forecast of a firming in core PCE inflation alongside further labor markets tightening. We expect this move to be accompanied by a fall in the unemployment rate to 4.8% during the first quarter of next year. If these developments materialize, it would require a significant dollar rise due to financial market stress to convince the Fed to pass on a rate increase in March. The risks that financial market developments slow the Fed's path are high. To the extent that Fed action represents an appropriate response to a US expansion that stands on solid footing, we expect the net effect of US developments to be positive for the global financial markets, including our own.

OUTLOOK

Looking ahead, the drag of large declines in prices for crude oil and imports over the past year and a half will diminish in 2016. With less downward pressure on inflation from these factors, and some upward push from a further tightening in US labor and product markets, we expect inflation to rise toward the Fed's 2% objective over the next few years. Employment gains are also likely to continue, bringing the headline unemployment rate below 5%. The availability of jobs, more disposable income in consumer's pockets due to low energy costs, further improvements in consumer's balance sheets and the recovery in housing prices will underpin consumer confidence and consumption at about a 3% rate. We fail to see a further steep rise in the US dollar's value in 2016 which will help stabilize US manufacturers' competitive positions. All in all, we expect the economy to grow at a 2.6 - 2.7% rate next year.

EQUITY INVESTMENT STRATEGY

As we approach the holidays, near-term stock market sentiment has soured as investors have focused on a number of concerns. There is pressure on the high yield bond market where additional Third Avenue-like events are possible. Investors also fear the US dollar rally will continue, acting as a headwind on earnings. Stock market leadership has grown very thin with just a handful of large cap stocks holding up the S&P 500, an imbalance that will not continue forever. Global growth remains tepid. Oil prices continue to slide putting pressure on

industrials and the high yield space. Equity valuations are no longer compelling. While these criticisms are fair, oil is nearing stability thanks to reduced US shale output. The US dollar is not likely to surge to fresh highs as the Fed's tightening will be extraordinarily gradual and the high yield markets have already undergone enormous price dislocation and, in our view, are assuming default rates far beyond ordinary levels. Keep in mind the Third Avenue fund is not representative of common practices or holdings even among high yield mutual funds.

Looking ahead, any stability in the US dollar and the price of oil should bolster confidence in a $125 S&P 500 earnings per share estimate for next year, bringing the current price/earnings ratio to 16.1 times. At this level, the US market appears to us to be about fairly valued. Other market valuation measures we are aware of confirm this conclusion. As for portfolio strategy, we remain fully invested within portfolio guidelines as fixed income alternatives to stocks remain unattractive. Particularly attractive from a longer-term valuation standpoint are financials, energy, and industrials to which we added this fall, although exposure to these sectors has temporarily detracted from performance this year.

Beyond the stock market's short-term preoccupations, the bull market in US equities should continue in 2016 as the economic expansion, moderate as it is expected to be, advances. Sustained and significant market declines are rare outside of recessions. Given strong US consumer fundamentals, the likelihood of a domestic recession over the next 1-2 years appears quite low.

We expect S&P 500 earnings per share growth of 8 – 9% in 2016. More importantly, there is little reason to believe the US is in danger of a downturn. Business cycles do not end simply due to the turn of the calendar. Cycles typically peak following a sustained period of excess investment where the economy overheats and policy makers are then required to tighten monetary conditions to prevent unacceptably high levels of inflation. The current expansion has produced few examples where investment in the US has been excessive. On the contrary, most major areas of the US economy such as housing and business capital expenditures have not even recovered to trend levels. The only area that experienced an overheating has been investment in the energy sector. But in contrast to the bursting of the housing bubble, falling oil prices should have an intermediate term net positive economic impact with the longer-lasting benefits to the consumer outweighing the short-lived decline in energy exploration investments and related capital expenditure declines to energy infrastructure suppliers.

While the S&P 500 has tripled from its early 2009 trough, the current US bull market does not appear excessive in terms of its length, pace of price appreciation or valuation when compared to historical US bull markets. S&P 500 earnings per share growth stalled in 2015 but should rise by high-single digits in 2016 as the economy accelerates and the headwinds from weak oil prices and the strong dollar fade. Moderately above-average market valuations are justified in a moderate growth, low interest rate environment. As we see it, the largest downside risks are a hard landing in China, rapidly rising US inflation and aggressive Fed tightening. The biggest upside risks are faster consumption growth from a healthier US consumer.

Our equity investment platform continues to include a component targeted at 15% in stocks domiciled abroad in both developed and emerging markets. The balance, our core equity portfolio, remains broadly diversified and fully invested.

FIXED INCOME STRATEGY

There has been no change in our fixed income strategy which is focused on principal protection. Bond portfolios are structured with an ultra-short ladder of high quality corporate bonds maturing, on average, in less than a year. Portfolio durations approach 1.

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As we near year-end, members of our firm join me in wishing you and yours safe and enjoyable holidays and a happy and healthy New Year.

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