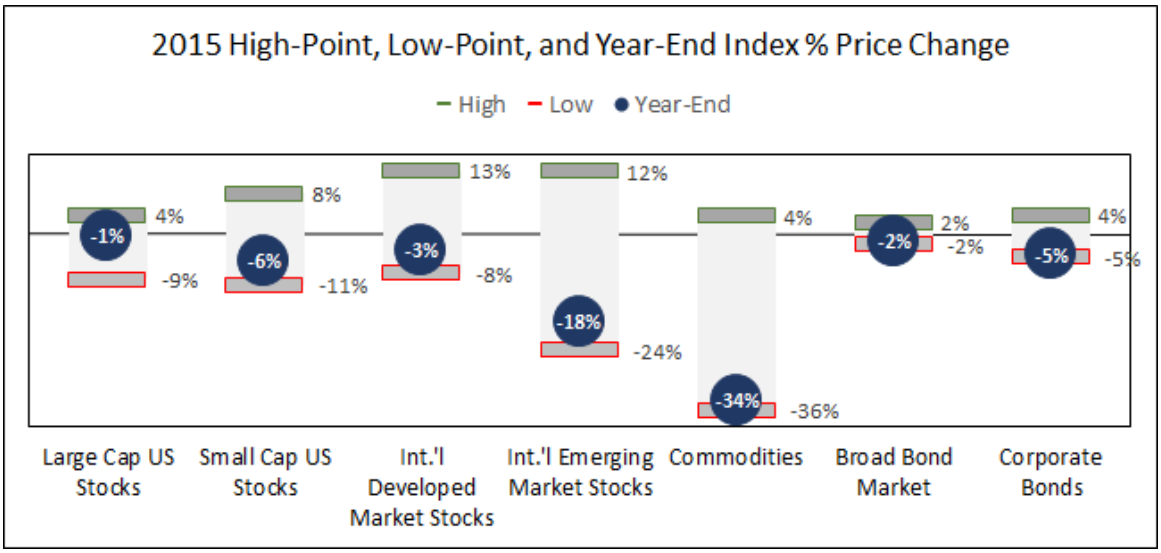
PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
4th Quarter 2015 Investment Commentary
January 15, 2016

Index Returns	4th Quarter	2015 Calendar Year
S&P 500 US Large Cap Index	7.02%	1.23%
MSCI All Cap World Index	4.83%	-2.21%
Barclays Capital Aggregate Bond Index	-0.51%	0.48%
US Core Consumer Price Index - (Inflation)	0.38%	1.96%

At the conclusion of 2015 we observe that, taken alone, the relatively flat returns for the year across major equity and bond indexes obscures the heightened market volatility that began mid-year, as well as the wide differences in returns between different segments of the markets. Also of note, equity markets have declined significantly in the first two weeks of 2016, which we believe is partially attributable to an extension of concerns related to issues we highlighted in last quarter's commentary. This quarter, we discuss the market environment, the continuing rise in volatility and how that factors into our investment process, as well as outline specific issues we expect to be of importance in 2016.

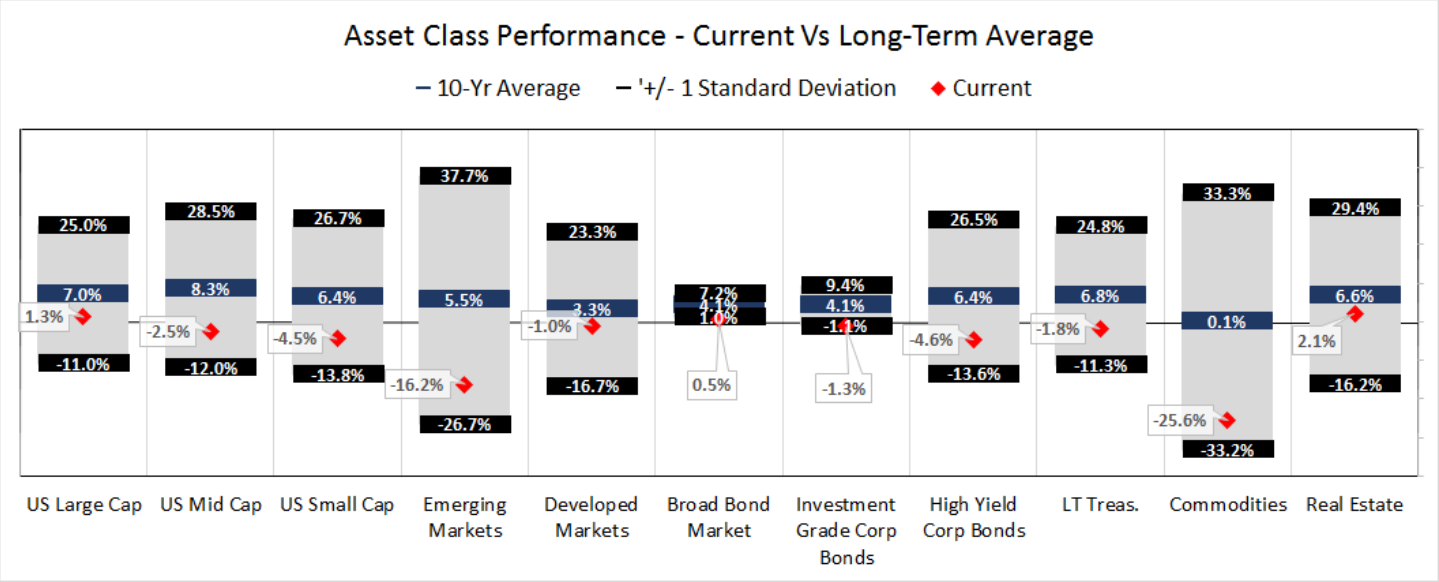


Market Environment – 2015 and Current: During the 3rd quarter of 2015, major stock market indexes declined by more than 10% for the first time since 2011. Benchmark indexes recovered to varying degrees through the end of the year, but during the first two weeks of 2016 markets have again declined abruptly by more than 10%. The magnitude and frequency of these market corrections[1] is consistent with our view that the low volatility experienced in the preceding five to six years is giving way to a persistent increase to more historically normal levels of volatility.[2]

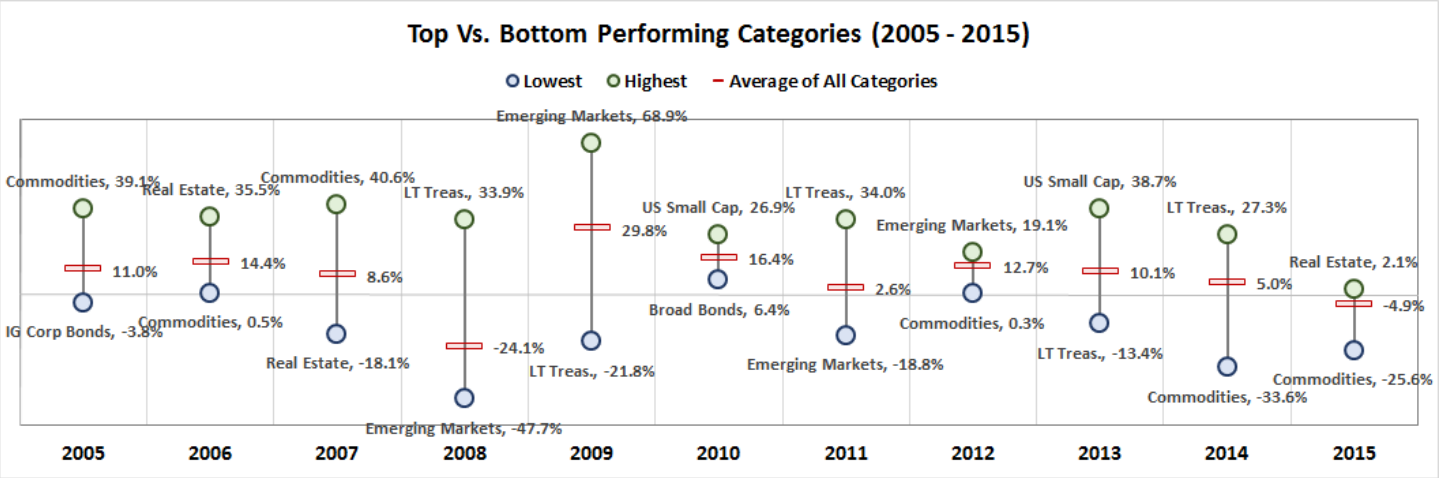
It is important, given the growing persistence of higher volatility, to put recent performance across multiple asset classes and market segments into a long-term context. The chart below depicts current returns for indexes tracking

[1] A market correction is generally defined as a decline in price/level of at least 10%, but less than 20% from then-current levels.
[2] See our Interim 3rd Quarter Investment Commentary for more detailed discussion of increasing volatility.

major investment categories relative to their long-term averages and a reasonable range above and below the average.



Only three of the 11 categories included achieved positive return in 2015: US Large Cap stocks, Broad Bond Market, and Real Estate (comprised of Real Estate Investment Trusts). While returns for other eight categories were negative, and returns for all categories were below their respective 10-year averages, only returns for the Broad Bond Market and Investment Grade Bonds categories were below the lower range of long-term category returns.



History also demonstrates that, while the 10-year average of all 11 categories is positive, returns between market groupings vary widely over shorter time periods. While it may seem tempting at times to buy and sell based on the recent performance of each category, maintaining broad portfolio diversification along with rebalancing portfolios provides exposure to all asset classes while systematically taking gains from overheated areas of the portfolio and reinvesting into areas that may be under-appreciated at the time, but have much greater potential to outperform in following periods.

In managing client portfolios, we have always recognized that volatility is inherent to markets, so we built our process around understanding and managing it. We remain focused on minimizing volatility via portfolio diversification, and ultimately benefiting from it in the long-term through systematic portfolio rebalancing.

We view the following factors as significant contributors to increased volatility during 2015, and key drivers of risk and return for markets going forward.

Global Monetary Policy: Policy changes as well as uncertainty related to the direction and timing of future actions by central banks of the US, the European Union, Japan, and the People's Republic of China (PRoC) most significantly impact global markets. We have outlined the current status of each central bank's monetary policy below:

- **U.S.**: In December of this year, the US Federal Reserve raised its target for the fed funds rate from 0% to between 0.25% and 0.50% and signaled that it would continue raising rates in increments over the next three years. The change in interest rates also comes after the Fed wound down its six-year series of Quantitative Easing programs at the end of 2014. While the Fed has indicated it will continue to be cautious in raising rates, all signs point to less accommodative monetary policy going forward.

- **European Union:** The European Central Bank (ECB) continues to implement accommodative monetary policy by lowering interest rates as well as carrying out Quantitative Easing. In December, the ECB lowered the Deposit Rate (the rate which it pays banks for deposits of excess reserves), from -0.2% to -0.3%. A negative Deposit Rate means that banks currently pay interest to the ECB in return for its deposits of excess reserves, which is an extraordinary attempt to maximize lending and stimulate economic activity. In addition, the ECB has an approved program to purchase $1.12 Trillion of bonds on the open market, in an effort to stabilize prices and boost liquidity and inflation.

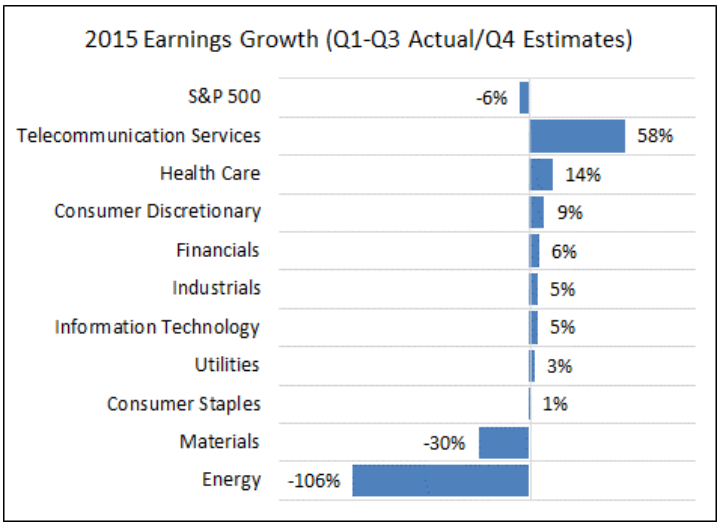
- **Japan:** The Bank of Japan is also highly accommodative in its policy, and has been the most aggressive in its use of Quantitative Easing programs, buying not only its own government's bonds, but also exchange-traded funds of Japanese equities and Japanese Real Estate Investment Trusts. In October, the Bank announced plans to increase the growth of its monetary base from 60 trillion to 80 trillion Yen per year in an attempt to increase inflation to its 2% target.

- **PRoC:** Since November, the People's Bank of China has been more aggressively reducing its benchmark lending and deposit rates, as well as the required reserve ratio for banks within the country, in an effort to smooth the economy's transition from an export-led to a consumer-led economy. The government has additionally taken steps to loosen the Yuan's peg to the US Dollar, which has resulted in a decline of the currency's value and should lower the prices of Chinese goods to the US and other countries, thereby increasing export levels.

Until the US Federal Reserve raised rates in December, major central banks' monetary policies were accommodative across the board. Up to that point, the assurance of a government-financed backstop coming out of the 2008 financial crisis led to a six-year period of reduced uncertainty and lower volatility. The Fed-induced calm acted as an anesthetic to risk-averse investors who were starved for yield as a result of the Fed's zero-interest rate policy, causing them to shift away from bonds and toward equities, further stabilizing and driving up equity prices. It is not surprising that an end to those conditions is contributing to increased market volatility.

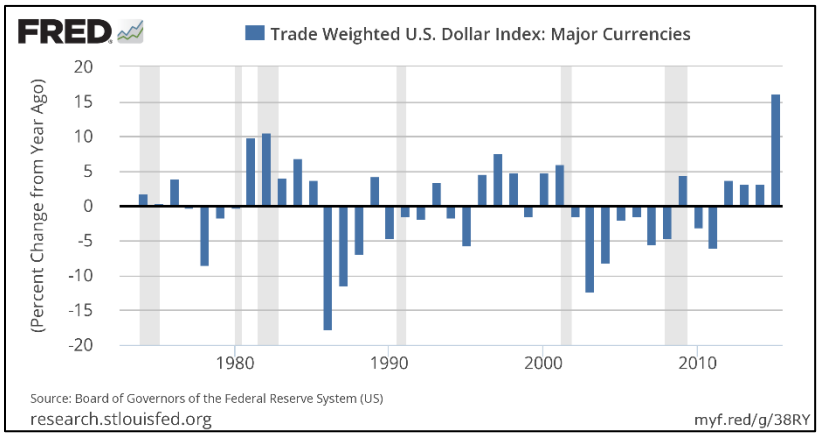
Corporate Profitability: Operating profits for US companies in the S&P 500 Index are expected to decline by close to 6% for the year, which will be the first calendar-year decline since 2008. If earnings growth is broken out by sector, the only sectors with negative growth are Energy and Basic Materials. Without those sectors, earnings growth is expected to be 5.7% for the year.

The continuing decline in oil prices (-45.6% and -30.5% in 2014 and 2015, respectively) and other commodities flowed through to energy and basic materials companies. Energy companies were hit not only with declining sales due to lower prices and declining demand, but also because they are required to revalue reserves annually at the average of the preceding 12-months' price. The increase or decrease in reserve value is accounted for as an expense, which reduces reported earnings and profitability.



For investors, the question becomes whether negative earnings growth will spread to the rest of the sectors, which could possibly occur as a result of the strengthening dollar and/or an economic recession…

Strengthening Dollar: The US Dollar increased in value against currencies of major trading partners by nearly 11% in 2015. That is a larger year-over-year increase than any other calendar year since the index data began in 1974. The Dollar's strength results to a large extent from its position as the dominant global reserve currency as well as its perceived safety as a store of value; but the significant increase in 2015 can be attributed in large part to the expected increase in interest rates relative to other economies as the Fed raises rates, as well as the continued decline in rates and increase in monetary base of other economies still employing aggressively accommodative monetary policy.

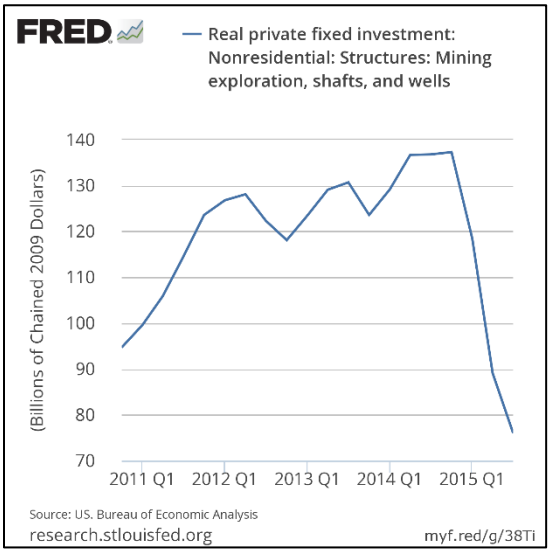


A rising valuation of the Dollar can not only reduce demand for products exported from the US, but it can also reduce overall sales if companies are not able to increase prices of goods and services sold internationally to compensate for the lower value of local currencies against the US Dollar. A handful of companies who have already reported fiscal year 2015 results have indicated that changes in currency valuation reduced sales and/or profitability by between 2 to 9%.[3] Currency values are notoriously unpredictable, but the factors that led to an increase in the Dollar are still present, and we expect the strengthening Dollar to continue to impact companies that have significant exposure outside the US and are not able to adjust.

A separate concern is dollar-denominated debt in emerging markets. As emerging economies actively seek to devalue their currency against the Dollar to encourage exports, they risk the solvency of companies whose ability to service debt priced in Dollars declines as the value of the Dollar increases relative to their local currencies. While the direct impact on emerging market stocks and bonds would be significant, there are also indirect risks to the liquidity of the global financial system, should that segment of the system become distressed.

[3] See Factset Earnings Insight; January 8, 2016.

US Economic Conditions: Economists forecast 2015 growth in US Real GDP of 2.1%, which meets annualized growth in the 3rd quarter of 2015, and is slightly lower than 2014 growth of 2.4%. Private Investment and Net Exports are both expected to contribute to lower growth this year, as indicated by contributions of -0.11% and -0.26% to 3rd Quarter GDP growth, respectively.



Declining private investment largely reflects the energy sector's reduction in capital expenditures for new equipment in response to the -70% decline in oil price since mid-2014. The impact of declining oil prices also reaches to the labor market, with total employees in the mining and logging sector declining from a peak of 913,000 in December, 2014 to a current level of 782,000 - a net reduction of 131,000 jobs.

The majority of indicators for the labor market in aggregate, however, indicate continuing improvement. The unemployment rate is holding steady at 5%, initial jobless-claims are still at multi-decade lows, and Wages & Salaries have recently been growing at a higher rate than GDP. That said, there are still some labor market indicators that are less clear. The labor force participation rate is still declining, meaning more of those eligible for the labor force are either aging or opting out. In addition, average hourly earnings are growing more slowly than wages in aggregate, meaning that net job creation is being accompanied by a slower growth in pay at the individual level.

Personal consumption expenditures, which represent approximately 70% of total GDP, continue to contribute to overall GDP growth. One bright-spot that was expected to emerge from the downturn in the energy sector is an increase in spending, but we have not observed a significant increase in consumption expenditures that could be attributed to lower energy prices. In fact, it appears that at-least some of the benefit consumers have realized from lower energy prices has been saved instead of spent, as evidenced by an increase in the personal savings rate from 4.7% in Q3 of 2014 to 5.2% in Q3 of 2015.

In terms of the business environment and its contribution to productivity, we have observed declining corporate profits and sales at the national level, which mirrors lower earnings expectations for the narrower group of companies belonging to the S&P 500, which we discussed above. It is likely that these trends are primarily the result of the declining sales and profitability of the energy sector, but we are monitoring these indicators closely for signs of further and more wide-spread weakening.

Overall, the economy is growing slowly, but it is still growing and is likely to continue. We are concerned given indications of weakening that were not present until recently, but we also see those as being heavily influenced by two trends that, alone, should not drive the entire economy into negative growth. A recession is not likely, but it is possible, and we will continue to monitor leading indicators of economic health.

While identifying and observing market drivers is a necessary part of our investment process, we recognize that those observations are only of value if we understand them within the context of your long-term objectives. We appreciate the trust you place in us as advisors, and look forward to speaking with you soon.

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