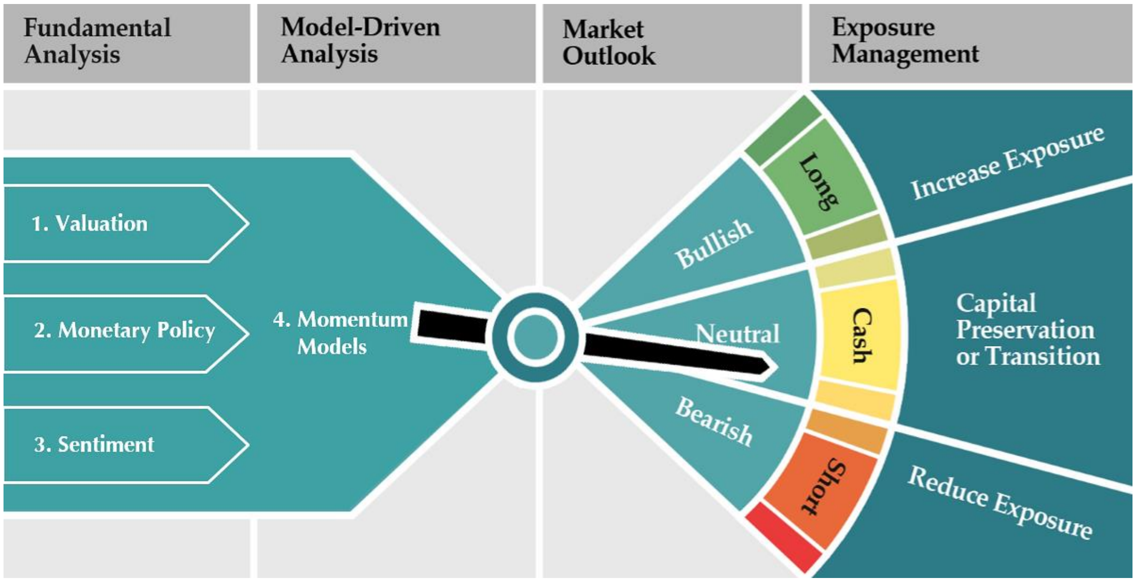
While the widely expected December 2015 quarter-point hike in the federal funds rate had little effect on stock market action in the two weeks following the announcement, the 7% plunge in the Chinese markets on the first trading day of the new year reverberated around the world. In response to the decline, stock markets worldwide, including the U.S. market, declined significantly.



A brief look at the four pillars of our investment process indicates the following:

1. **Monetary policy** and credit spreads—The recent rise in credit spreads and the disruption in the high yield market (the problems of Third Avenue Management, LLC, and other bond managers) have degraded our credit models. A significant and further widening of credit spreads would be alarming and we believe would most certainly bring on a bear market and recession.
2. **Stock market breadth**—While the S&P 500 Index is just now declining from its all-time highs, only about 35% of its stocks are above their 10-and 30-week moving averages. We believe this type of divergence between large capitalization stocks and the rest of the market is not healthy. We would like to see broader market participation to give us more confidence in potential future gains. Continued poor breadth would be a sign of negative divergences.
3. **Investor sentiment**—We will be closely watching investors' reactions to the decline in the global markets and the recent interest rate hike. Sentiment remains neutral as of our last readings.

4. **U.S. stock market valuation**—Valuation levels have now matched the 2010 high in terms of the median price-earnings (P/E) ratio on the S&P 500 and are now at the highest level in a decade. Other measures of valuation, such as the price-sales ratio, Robert Shiller's CAPE ratio, stock market capitalization as a percentage of GDP and margin debt are at or near historic highs. There is little room for error in the expectations for future earnings growth.

In view of the decline in China's stock market and other markets throughout the world, we note that one of the main reasons the Federal Reserve (Fed) waited until December to raise the federal funds rate was because of concern over the foreign markets in general and emerging markets in particular. We had the pleasure of hearing former Fed Chairman Ben Bernanke speak at a luncheon in San Francisco a few weeks ago. Bernanke commented that while the status of the U.S. economy was important, further economic weakness in Europe, Japan and China could present formidable headwinds to a U.S. recovery. He noted that if the U.S. economy failed to attain "lift-off," the federal funds rate could well be lowered back to zero. Bernanke also stated that the uncertainty around future rate hikes would likely result in more volatility for the capital markets. We continue to believe that our strategy is ideally suited to this more volatile stock market environment. If the Fed does reverse course and become more accommodative, we would be quick to follow the adage "don't fight the Fed" and move to the long side.