Bahl&Gaynor
Investment Counsel

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4Q 2015 Review and Outlook

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Bahl & Gaynor Economic Outlook

"Schizophrenic Squirrel"

2015, in the end, will be categorized by many as a "flat market year." While that comment may appear benign, the roughly zero percent S&P 500 return disguises the raw violence underneath the averages. Many popular and "uncorrelated" assets, such as commodities and MLPs, had among their worst years on record… all at the same time. Not only did asset price movements prove to be extremely correlated, they proved to be extremely negative as well.

The market, battered and bruised from 2015, will enjoy little respite as 2016 brings just as many, if not more, uncertainties than the prior year.

To us, the appropriate analogy is a squirrel faced with crossing a busy highway to get a nut back to the nest. The squirrel, unsure of itself and what lies ahead, faces three legitimate outcomes as it attempts to cross:

1. Making it across the highway safely in good health, nut in hand;
2. Right back where it started as raw fear grips hold. Exposed to existential threat and frozen into inaction;
3. Roadkill.

The lesson: In a scenario where "two out of three ain't good," clearly exercising caution is the appropriate strategy.

Source: Clipartonline.net, 2015.

As we look at 2016, we believe three themes will remain "top of mind." First, we examine the impact of commodities, specifically oil, being even lower for even longer than anyone had anticipated. Second, the dark side of corporate re-leveraging. The consequences of debt-funded buybacks and M&A are beginning to take root as 2015 likely marked a turning point in the corporate default cycle. Third, valuation. Valuation expansion has been the primary driver of index returns since 2013. How should we be thinking about the current state of valuations where growth appears questionable at best?

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Bahl & Gaynor Economic Outlook *Continued*

Similar to our "Schizophrenic Squirrel," we at Bahl & Gaynor view the current economic and market climate as one where risk management and downside protection are of paramount importance. As the potential returns for all asset classes appear somewhat lower going forward, managing the "Lower Frontier" of returns places an emphasis on sustainable income as a primary source of return. We continue to view, and emphasize emphatically, that the foundation of any investment thesis needs to be built on well-capitalized companies that have the ability to withstand volatility.

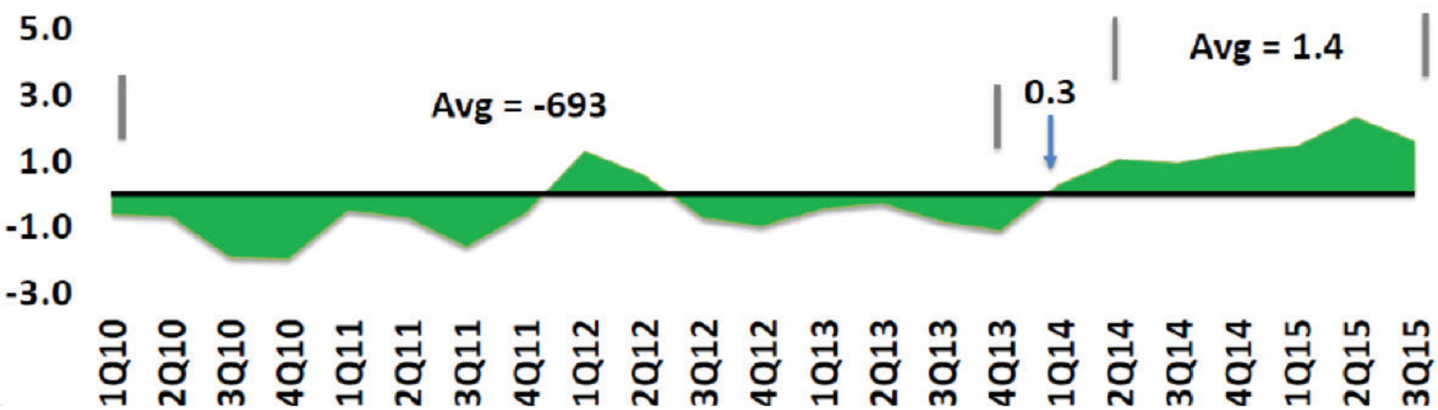
Oil:

The Bathtub Recovery: Lower for Even Longer

In our January 2015 outlook piece, we expanded our longstanding economic view of "Lower for Longer" to include that of oil prices under the subtitle, "There Will Be Blood." Our forecast has proven correct as the supply surplus has expanded.

US-based firms have not cut production and OPEC, for all intents and purposes, completely abandoned its quota for production in a yearend meeting. With Iran coming online in 2016, the pressure of a supply shock will continue to build as the country adds approximately 500,000/bd of incremental supply to an already saturated market (indicated in the exhibit below).

Average imbalance: Supply Minus Demand



Source: Ponderosa Advisors, 2015.

Supply shocks are materially different than the demand shocks the market experienced in 1997 and 2008 (pictured below). Demand shocks are largely "V-shaped" in that once the crisis has passed, demand rebounds very quickly. Supply shocks; however, require supply or production to be cut to align with demand. What results is a classic Prisoner's Dilemma whereby each individual firm is incentivized to continue producing in the hopes that competing firms cut production first. As is the nature of the "wildcatter" mentality, the oil industry tends to be eternally optimistic in its hopes for higher future oil prices. Our view is that the only mechanism for taking production offline is that which is forced through bankruptcy.

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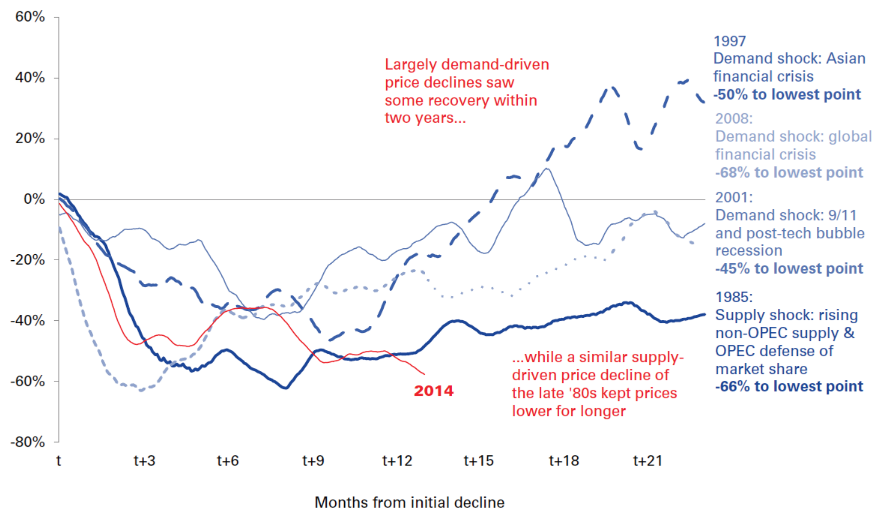
Oil *Continued*

Something special about supply shocks...

Percent change in price of oil from starting point over past bear-market periods, 30-day moving average

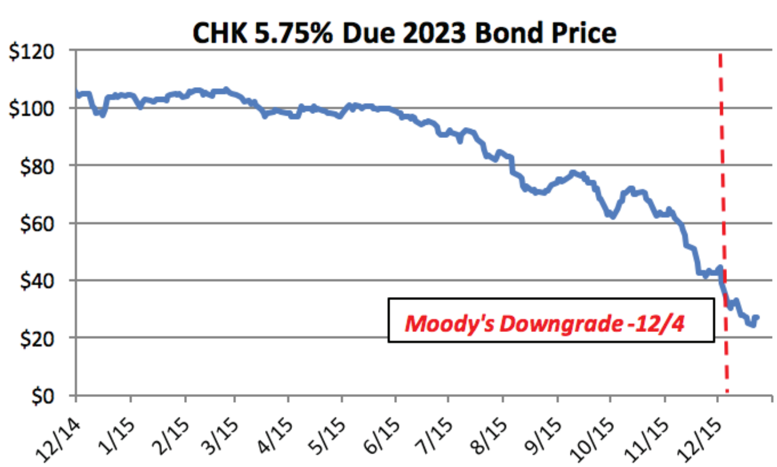


Source: Goldman Sachs Global Investment Research, 2015.

As such, we believe we are in the early innings of a massive high yield default wave with high severities. Similar to the financial crisis in 2008, the rating agencies are behind the ball in downgrading exploration and production (E&P) companies. With many "BB-rated" firms trading at distressed levels or on the verge of imminent default, the faith in ratings providing a guidepost for credit quality in the energy sector seems to be misplaced. Considering the popularity of BB high yield strategies, the aggregate exposure to leveraged energy is more pervasive than many investors initially realized.

The risk to the Energy sector is that cutbacks in production (forced or voluntary) come too late or potentially in concert with a drop in aggregate demand. With storage capacity already being tested, continued overproduction could depress oil prices to cash extraction costs which are estimated to be as low as $20/barrel by Goldman Sachs. Let that sink in... $20/barrel. Such a decline would likely extend what is currently viewed as a "U-shaped" recovery to one where the trough is longer and deeper than anticipated, such as a bathtub.

Chesapeake Energy Bonds Dropped 70% Before Being Downgraded from BB



Source: Bloomberg, 2015.

Corporate Balance Sheets:

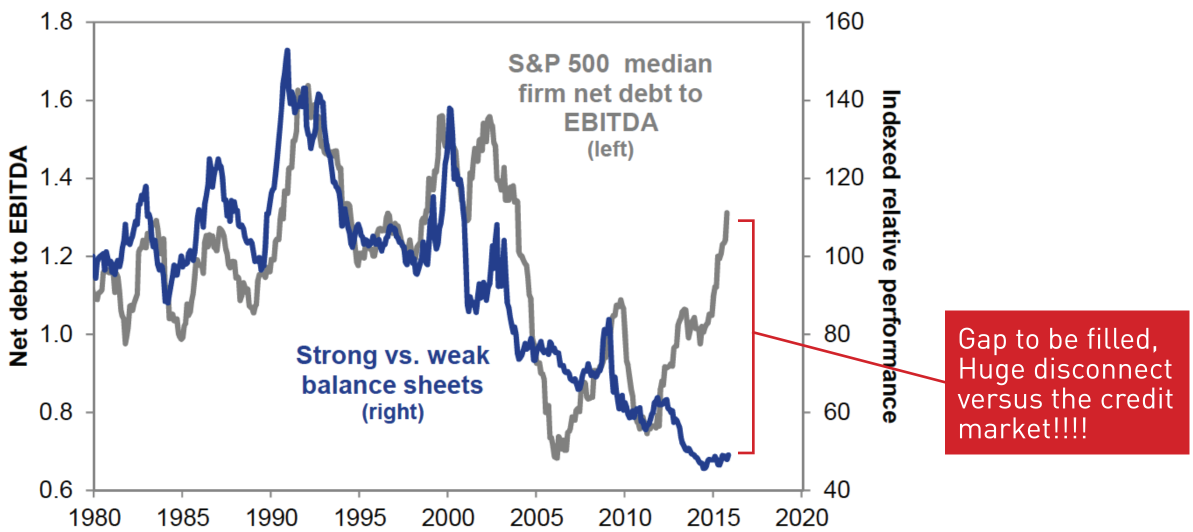
The Ghost of Buybacks and Ill-Advised M&A Past

Those chains you heard on Christmas Eve were not the shackles of the "Ghost of Christmas Past" from Charles Dickens' *A Christmas Carol*. Rather, they were the sounds of struggle from Corporate America's bondage resulting from the debt-fueled buyback and M&A binge of the past half decade.

Of particular concern in this struggle is that net leverage has risen to levels not seen since the financial crisis for the investment grade market and the technology bubble for the high yield market. Both of those periods ended poorly for risk assets and corporate access to financing was only available under the most punitive and restrictive of terms. As shown in the case of Chesapeake Energy above, access to capital markets can be removed within a matter of weeks, if not days, as investor sentiment shifts.

While the market has exacted its toll on commodity-related issuers, in aggregate, there are still enormous opportunities to improve the credit quality of one's portfolio. Historically, there has been a clear correlation between well-capitalized companies outperforming their weaker counterparts during periods of rising corporate leverage. However, that relationship has not held since 2011 as the market has *rewarded* higher leverage (indicated in the exhibit below). The unwinding of this "greed is good" theme has the potential to be as disastrous and unforgiving as that of the Energy sector, specifically the MLP industry, witnessed in 2015.

Historically low rates encouraged firms to lever without penalty (as of December 10, 2015)



Source: Goldman Sachs Global Investment Research, 2015.

Bahl & Gaynor views the rotation into strong balance sheet companies as one of the biggest macro themes in 2016. Capital markets rewarding leverage and risk-taking were a clear consequence of the Quantitative Easing (QE) "easy money" policies of yore. The Fed landscape has now reversed. We are now formally in a rate hike cycle and the Fed's balance sheet has flat-lined with the next move likely to be contractionary. Strong balance sheet companies have outperformed at the start of the past three rate hike cycles. The fact pattern as we enter 2016 is even more supportive of that trend continuing, if not exceeding, in swiftness and magnitude, the reversals observed in prior cycles.

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Valuation:

The Lower Frontier

From most traditional lenses, the aggregate equity market appears expensive. On a headline basis, the forward P/E of ~17.0x is in the 88th percentile of observations over the past 40 years.

However, most long-standing bulls will argue current valuation levels are fully supported by the prevailing interest rate environment and stubbornly low inflation. The TINA (There Is No Alternative) thesis has worked well through the 2012-2014 bull market; however, real holes in the armor of higher-yielding strategies were exposed in 2015. We fear that when the fundamental story/thesis deteriorates, the "tourist" money chasing yield will exit quickly. Examples of disorderly "tourist" exits have already been seen in the MLP and high yield markets over the past few months. These exits have been wrenching.

> *"I fear crashes, of course, but I also fear that this all adds up to a world where stocks and bonds are rationally offering less return... This could be a permanent situation or at least a very long-term situation."*
>
> Cliff Asness, Founder & CIO, AQR, 2015.

Earnings growth in 2016 represents the primary risk to current valuations. Given the significant challenges in Energy and energy-related Industrials, 2015 earnings growth will be negative. With significantly negative commodity price comparisons, 1H16 looks to be flat with all of the expected recovery coming in the back half of the year. At Bahl & Gaynor, that smells like hope to us and the cardinal rule is: "Hope is not an investment strategy." We see real potential that aggregate earnings growth could also witness a "bathtub" recovery, which would have a decidedly negative impact on valuations, specifically those predicated on high expectations coming into the new year and a 2H16 bounce.

In an environment where low expected returns are forecasted across all asset classes, the importance of income as a component of total return will be paramount. Not just the aggregate amount of income, but the *stability* and *growth* of that income. For example, if mid-single digit returns can be expected for equities, the income component can potentially represent >50% of the total return.

The Falling Efficient Frontier

Note: Based on four assets, US stocks, 10yr Treasuries, IG, HY. Marker indicates portfolio with highest Sharpe ratio. Source: Morgan Stanley Research, Bloomberg

Source: Morgan Stanley, 2015.

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The Bottom Line

At Bahl & Gaynor, we seek to provide consistency. The three risks/themes we addressed in this outlook: oil, corporate leverage and valuations, will remain "top of mind" as the year progresses. They will continue to be focal points in our portfolio alignment and conversations with clients. We reiterate that the theme of a rotation into strong balance sheet companies will be the preeminent investment theme for 2016.

In summary, we believe Bahl & Gaynor's investment strategy of owning well-capitalized companies with established moats should provide *downside protection* and a *growing income stream* in a challenging year ahead.

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