WEEKLY MARKET REVIEW

FEBRUARY 23, 2016

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- *Inflation is still a factor in the markets, when will it likely re-assert itself?*
- *What do higher interest rates mean for the financial sector?*
- *What's on sale?*

CLS INVESTMENTS

Market Performance

Stock Market	LAST WEEK	QTD	YTD '16
Total U.S. Market[1]	+3.11%	-6.73%	-6.73%
Domestic Large-Cap Equity[2]	+2.91%	-5.85%	-5.85%
Domestic Small-Cap Equity[3]	+3.93%	-10.95%	-10.95%
International Equity[4]	+4.37%	-8.11%	-8.11%
Developed International Equity[5]	+4.44%	-9.08%	-9.08%
Emerging Market Equity[6]	+4.22%	-6.60%	-6.60%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '16**
U.S. Bonds[7]	+0.15%	+1.93%	+1.93%
Cash Equivalent[8]	+0.00%	+0.02%	+0.02%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]iShares MSCI Emerging Markets Index [7]Barclays Capital U.S. Aggregate Bond Index [8]Barclays Capital 1-3 Month U.S. Treasury Bill Index

Week in Review

In a holiday-shortened week, the market continued to take its lead from oil prices. A strong equity rally began the week as oil prices rose above the psychologically significant $30/barrel level. The market peaked mid-week and went lower after a benign release of minutes from the Federal Open Market Committee (FOMC) Wednesday that essentially shut the door to an imminent rate hike. Even considerably stronger readings on Producer Price Index (PPI) and Consumer Price Index (CPI) data did not influence the general consensus that we'll see no rate hikes in the very near future. However, there are some encouraging signs that inflation may have bottomed.

So, Let's Talk Inflation

CPI data came out last Friday in an interesting report. In short, while inflation was unchanged from the prior month, it was clearly above market expectations.

Inflation is now up 1.4% over the last year. "Core" prices (goods excluding food and energy) were up 2.2%. Earnings, adjusted for inflation, were up 1.1%. These numbers are still lower than those most of us are used to seeing, but inflation is not down and out. Inflation is happening – and it is steadily moving higher.

Think about it. Gasoline prices dropped nearly 5% in January. These are the lowest levels since March 2009. And overall, prices still went up.

Here are some of the notable sub-data that up-ticked:

- Core services +3.0% from +2.9% year-over-year (YOY)
- Core goods -0.1% from -0.4%, the least negative in two years
- Housing +2.10% from +2.07%
- Primary rents +3.71% from +3.68%
- The all-important "owners' equivalent rent" (OER) +3.16% from +3.14%
- Medical care +3.0% from +2.58% YOY
- Medicinal drugs +2.21% from +1.66%
- Professional services +2.08% from +1.92%
- Hospital +4.32% from +3.96%

Bottom line, inflation is still a factor in the markets and will likely re-assert itself. In the words of Mike Ashton, an inflation analyst we follow at CLS:

"And all of this means that higher inflation remains in our future. The notion that deflation is some kind of existential threat makes as much sense as the notion that alien invasion represents an existential threat: possible, but not something that ought to keep us awake at night worrying. Inflation expectations do not drive inflation - it is the other way around. Inflation is headed higher, whether people - and the FOMC - expect it, or not."

If inflation is indeed moving higher, what can we expect to see in the markets and how will CLS portfolios react? Specifically, how are we moving portfolios now?

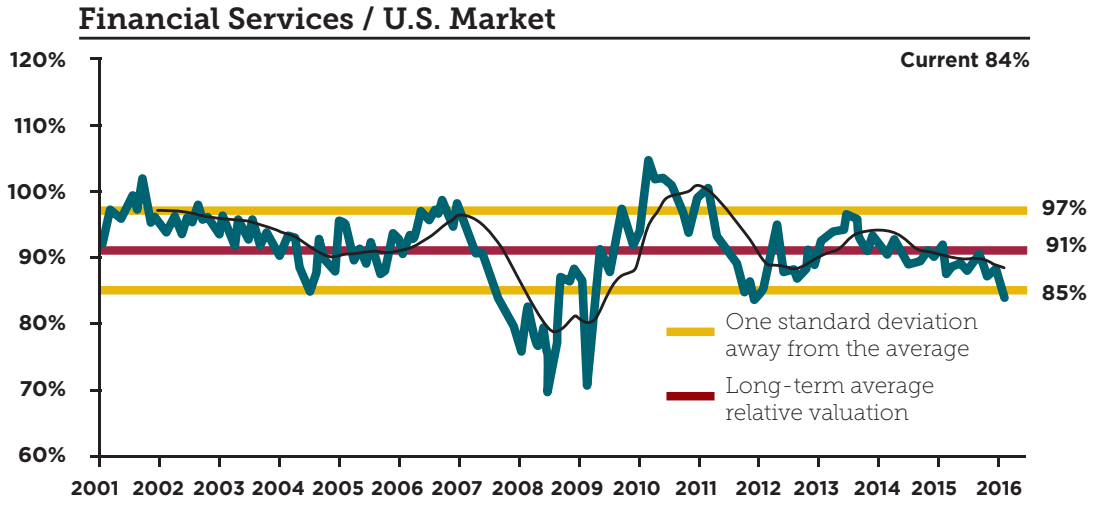
- The Federal Reserve (Fed) will likely keep raising short-term rates this year. This will make money market funds more attractive.
- Longer-term rates are more likely to rise than fall (assuming the stock market doesn't falter). Thus, we are keeping our portfolios with below-average duration ("interest-rate sensitivity"). In other words, if rates do rise, we shouldn't slip as much as the bond market.
- It will be easier for corporations to pay interest on bonds when interest rates are low and their business outlook is positive. As such, we have been buying corporate bonds, both investment-grade and high-yield.
- Inflation-linked bonds, like TIPS, we are expecting outperform conventional nominal Treasury bonds. We have been buying these up.
- The financial sector – the one that is beat up nearly as much as energy – has historically been one of the best to own when rates rise.

Financials Beaten-Up in a Good Way

Higher interest rates should benefit the troubled financial sector, which has received a lot of negative press recently, especially from foreign banks. And they have been beaten-up badly.

The chart below reflects relative performance of financials versus the Russell 3000. It's ugly, but is it also an opportunity?

Financials have traded at a 9% discount to the overall market since 2001. At the end of January, it was trading at a 16% discount, its largest since the 2008/09 financial crisis. And shortly before the crash, financials went on a tear, significantly outperforming the rest of the stock market. Is it too soon to buy? Perhaps. (The arguments and discussions we are having in CLS research meetings have been interesting.) Either way, expect CLS to increase financial exposure in the months/quarters/years ahead.



Portfolio Moves

As mentioned in my last commentary, my investment philosophy centers on "safety first." One way to help mitigate investment risk is to buy when prices are lower. "Buy when stuff is on sale," as we like to say at CLS.

Following our "buy when stuff is on sale" approach, we have added to the extremely-beaten-down master limited partnerships (MLPs) sector, which takes its cue from oil prices in some strategies.

Lastly, we have aggressively added to actively-managed fixed income ETFs. Currently, TOTL (SPDR DoubleLine Total Return Tactical) is a top position in many of our core products. In spite of having a shorter duration than its other active, fixed income counterparts, it has generated more than a 1% return so far this year under very treacherous market conditions. This is another reason to own fixed income in diversified portfolios.

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Marc Pfeffer
Senior Portfolio Manager

Marc Pfeffer joined CLS in 2011, continuing as Senior Portfolio Manager for the Milestone Treasury Obligations Fund, which CLS incorporated into its fund family in January 2012. In his current role, he is responsible for the daily management of the fund, as well as oversight and development of new products and services to meet the liquidity and cash management needs of CLS clients. Additionally, Mr. Pfeffer is manager of the CLS Flexible Income Fund and co-manager of the CLS Global Growth Fund. He has 25 years of investment management experience, having worked previously at Goldman Sachs Asset Management and Bear Stearns.

Mr. Pfeffer graduated from the State University of New York with a Bachelor of Science degree, and from Fordham University with a Master of Business Administration degree. He holds his FINRA Series 7, 63, and 65 licenses.

The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large cap stocks. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI EAFE International Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Equity Baseline (EBP) is a blended index comprised of 60% domestic equity (represented by the Russell 3000 Index) and 40% international equity (represented by the MSCI ACWI ex US Index), rebalanced daily. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

The Consumer Price Index (CPI) is an index created by the U.S. Bureau of Labor Statistics which measures the weighted average of prices of a basket of goods in order to assess inflation levels. Relative valuation is a method of evaluating the financial worth of a company by comparing its value to the value of its competitors. CLS calculates the relative valuations consisting of a composite of the price-to-earnings ratio (P/E), price-to-book ratio (P/B), price-to-sales ratio (P/S), put-call ratio (P/C), and the price-to-dividend ratio (P/D). The price-to-earnings ratio is a valuation method obtained by dividing the market value per share by the earnings per share. The price-to-book ratio is used to compare a stocks' market value to its book value by dividing the current closing price of the stock by the latest quarter's book value per share. The price-to-sales ratio is a valuation metric for stocks calculated by dividing the company's market cap by the revenue in the most recent year; or, equivalently, divide the per-share stock price by the per-share revenue. The put-call ratio is a ratio of the trading volume of put options to call options. The price-to-dividend ratio shows how much a company pays out in dividends each year relative to its share price by dividing the annual dividends per share by the price per share.

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