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Quant Coalescence

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January, 2016: "But……Isn't cheaper oil good for the economy?"

As of this writing on the evening of January 20th, the equity markets are experiencing their worst monthly loss since February, 2009. Many worldwide equity and commodity markets are already in what is defined as a bear market; being down more than 20% from their highs. In U.S. equity markets, the average stock in the S&P 500 is down 22% from its high, although the index itself is not yet in bear market territory. Oil is down 25% since the start of the year and down 60% since June of 2014. Many investors are asking two things. Why has this happened so fast, like flipping a switch on the first day of trading in 2016 when equity prices started falling? Secondly, why are declining oil prices dragging down the entire world's equity markets? Although markets are too complex to ever point to one reason for a major sell off, one of the factors that is contributing without a doubt does map back to substantially lower oil prices. While it is true that lower oil prices will put more money in the pockets of U.S. consumers and companies that may help other areas of the U.S. economy; initial indications, such as the lack of a rise in retail sales, indicate that most are choosing to save this extra money or it is being eaten up by increasing healthcare costs and other services.

Let's take a look at some of the reasons falling oil prices are a very bad thing for financial markets.

- Although much of the oil drop is due to oversupply from increasing supply in the U.S., et al and now Iran's oil coming back online, it is becoming apparent that the drop is also due to falling demand. This would be a clear indication of slowing growth in the world economy; especially China.

- S&P earnings for the 4th quarter of 2015 are expected to come in at -5.7% year over year. If energy companies were not included, earnings would be -.1%. (*FactSet*) The materials sector is also expected to report negative earnings, due to the drop in prices of all commodities.

- The drop in oil contributes to a stronger dollar, which in turn hurts *all* U.S. companies that do business internationally. The stronger dollar makes our products more expensive if they buy them in their local currency *and* when sales are made in their local currency, that local currency can't buy as many dollars when it is converted back to U.S. dollars.

- Many oil companies in the U.S. are highly leveraged and will be defaulting on debt that they can no longer service at these lower oil prices. This will hurt the earnings of banks that take these losses. Many of these loans are also in the "junk debt market". As those bonds sell off due to increasing default risk, that selloff in the price of these bonds will bleed over into a selloff in equities, which is already happening.

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- The U.S. and other countries are already experiencing large numbers of layoffs in the oil, commodity and materials industries. In addition, companies that provide materials and equipment for these industries are being hurt. Companies like Caterpillar are also letting employees go, as the need for their heavy equipment has fallen off sharply. This will contribute to a weaker U.S. and world consumer, economy and could possibly contribute to further weakness in other areas.

Lastly, in the shorter term and ongoing, the *biggest* reason that dropping oil prices are causing the large selloff in equities is due to the impact of sovereign wealth funds. Sovereign wealth funds are invested assets owned by worldwide governments. In oil exporting countries, these assets are tied to decades of oil profits that have been put to work in the world equity markets, real estate, the expansion of oil producing projects, etc. The world's sovereign wealth funds together have assets of $7.2 trillion, according to the Sovereign Wealth Fund Institute, which studies them. That is twice their size in 2007, and more than is managed by all of the world's hedge funds and private-equity funds combined, according to J.P. Morgan Asset Management.

Equally as troubling, "Energy-exporting countries pulled money out of world (equity) markets last year for the *first time in almost two decades*, halting the "recycling" of oil windfalls," BNP Paribas has said. The trend would continue as energy prices stayed under pressure, the bank predicted last year. Although China is not oil dependent for its revenues to run the country, a slowdown in China will contribute to their need to liquidate assets from their SWF. According to the Wall Street Journal, Norway, who has the largest SWF in the world due to their oil exports, communicated in December that they would be selling equities after the first of the year.

They along with other oil dependent countries have seen oil fall another 25% year to date and this would seem to explain why the first day of trading for 2016 was the start of weakness right out of the gate. It also supports the idea that oil prices continuing to fall is definitely bad for the equity markets and rightfully so. Equities are the first choice of these funds to sell because they are more liquid than real estate and their additional oil investments are beaten down just as oil is. According to Claire Milhench, an energy correspondent out of London, "In July, Saudi Arabia resorted to issuing a bond for the first time since 2007. The International Monetary Fund has warned of the Saudi deficit - estimated at around 20 percent of GDP this year." This debt was issued to keep from dipping into their SWF to pay for the many entitlement programs that keep their people from rising up against the wealthy and suppressive monarchy.

Again, it can't be emphasized enough that oil has fallen substantially from when these actions had to be taken. The longer oil continues to fall or even stays at lows not seen since 2003, oil dependent countries will have no choice but to sell assets from their SWF's to cover government programs and responsibilities. This in turn will contribute to slowing world growth and cause other countries not oil dependent to do the same. One can easily see how this could become a vicious cycle.

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The good news is that your investments at PCM were very conservatively invested going into the New Year, 2016 and we hope to continue on a path that will allow us to be recognized for top performance for 1st quarter, 2016 on our client's behalf and benefit.

As we communicated last month, PCM was again recognized as a "Top Gun" for our performance during the 3rd quarter of 2015 by Informa Investment Solutions. Four of our models were in the top 10 performers out of hundreds of products and money managers.

PERFORMANCE RECOGNITION: 3rd Quarter, 2015

Informa Investment Solutions' (PSN) Ranks PCM "Top Gun" Products

- **PCM Protective Equity** - (Top 10/#5) All Cap Universe *(543 products in the All Cap universe)*
- **PCM Diamond** - (Top 10) US Balanced Universe *(314 products in the US Balanced universe)*
- **PCM Global Macro** - (Top 10/#2) Global/Intl Balanced Universe
- **PCM Global Tactical** - (Top 10/#8) Global/Intl Balanced Universe *(297 products in the Global/Intl balanced universe)*

The January allocations theme is "risk off" with a very heavy bias towards cash equivalents. The slight allocations to equities stayed conservative as well, with utilities and consumer staples a common theme. Belgium and New Zealand equities showed up in the international allocations and the currency allocations stayed with the U.S. Dollar and the Japanese Yen. Both of these currencies do well in "risk off" scenarios and this month has been no exception.

PCM Strategies: 01.2016 Allocations*

*(Please note that performance numbers on the website for indexes do not include dividends and are appropriately calculated sequentially.)

1. PCM US Bond Total Return Index sm: Inverse high yield bonds and cash equivalent.
2. PCM Absolute Bond Index sm: 1-3 month U.S. Treasury bills.
3. PCM Absolute U.S. Sector Index sm : Utilities, consumer staples and cash equivalent
4. PCM U.S. Industries Total Return Indexsm: , : Utilities, consumer staples, REIT's and aerospace
5. PCM Absolute Equity Income Indexsm : Dividend paying equities, utilities and REIT's
6. PCM Emerging Market Total Return Equity Indexsm: 100% cash equivalent.
7. PCM Total Return Portfolio Indexsm and PCM Stable Growth Plus+ Portfolio Indexsm: Cash equivalents are heavy in the allocation of portfolios, which are seeing a small fraction of the downward move that

equities and commodities seen so far for 2016.

8. PCM Global Tactical Indexsm: For the second half of January are now in utilities, the Japanese Yen, 20 year U.S. Treasuries and cash equivalent after starting 2016 with exposure to New Zealand, Belgium, consumer staples, Utilities and cash equivalent.
9. Global Macro Indexsm: Heavy cash equivalent and the U.S. dollar
10. PCM Alpha 1 Indexsm: Cash equivalent first 2 weeks of year and now in 7-10 year U.S. Treasuries
11. PCM Absolute Commodities Indexsm: Cash equivalent all month.

***We have enhanced our website AGAIN at http://www.pcminvestment.com. You can now see performance of our indexes (previous day and month to date) on our streaming ticker. We include performance for both our indexes and our composites, as applicable. You will be asked to enter your email address to get into the website. There will be no password required, so you won't have to worry about forgetting it. This is partly due to helping us stay in compliance with requirements in our industry that we know who has reviewed our website content. Please use the website link above to see all of our indexes and composites.

In addition to the above mentioned "Top Gun" performance awards from Informa Investment Solutions, PCM composites have been previously recognized for performance by Informa Investment Solutions; the PCM Absolute Bond Compositesm for the three year performance ending the 4th quarter of 2014, as well as previous awards for 1-year trailing performance and 3-year trailing performance. As of 2nd quarter 2014, the PCM Absolute Bond Compositesm and the PCM Absolute Commodities Compositesm both won a "Top Gun" award for performance in their respective category for the 1-year trailing performance period, with the PCM Absolute Bond Compositesm also winning the "Top Gun" award for 3-year trailing performance. The PCM Alpha 1 Compositesm was awarded the "Top Gun" performance award for the 1st quarter of 2014. We are very pleased to see these particular multi directional strategies being recognized, as the PCM Absolute Bond Strategysm and PCM Alpha 1 Strategysm are particularly timely for where we are in the current market cycle.

To view Morningstar Fact sheets of all of our index models, please visit our website at ww.pcminvestment.com under the "PCM multi-directional Strategies" tab.

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About "PCM Quant Coalescence"

Welcome to Provident's "Quant Coalescence" communication. We suspect that many of you are no different than us. That is to say that when our quantitative models rebalance every 2 weeks for some indexes or once a month for other indexes, you sometimes find yourselves asking "What is behind a rotation into that ETF?" This communication is our opportunity to "unite for a common end" with our clients and partners; keeping you updated on our thoughts and perspectives. As you know, our indexes are based on an absolute approach: we strive to make money in up markets or down markets, while trying to greatly minimize loss in any market environment.

Our indexes are also quantitative, reflective of our systematic, unbiased and technical approach. Since our indexes are unbiased, the quantitative models would obviously at times rotate into positions that cause us to scratch our heads. Nevertheless, being so close to the analysis as it unfolds, allows us to quickly begin to validate the fundamental reasons behind the quantitative "following of the money." At other times, the trades are not validated right away; the story unfolds as the days pass. We have been very excited about many of these "validations" and "ah ha" moments. We had another "ah ha" moment when we decided that these insights would also be interesting to those who have entrusted us with their financial peace of mind. Our goal is to be short and to the point, specific to what is happening in our indexes rather than a lengthy macroeconomic perspective.

For further disclaimers and disclosures, see our website for index disclosures and composite disclosures.