First National Bank

2016 OUTLOOK

*"The pessimist sees difficulty in every opportunity.
The optimist sees opportunity in every difficulty."*

Sir Winston Churchill

First National Bank Wealth Management 2016 Outlook

In 2015, volatility returned to the markets and investors once again had to battle their inherent psychological biases. After three straight years of consistent double-digit stock market returns, it was disconcerting for many to see their portfolios relatively flat and even briefly turn negative. Last year, we predicted that the days of double digit stock returns had ended and returns would be harder to come by. With the Federal Reserve ending its zero interest rate policy, we share a similar message with you in 2016. We are prepared for another low-return environment where elevated periods of volatility persist.

The 2016 Outlook, our flagship annual piece, has been designed to be informative, helpful and easy to use. Inside, you will find a summary of what we feel are the most important world events, our conclusions based on these findings and how we are using this information to construct your portfolios.

We look forward to hearing from you, working with you and customizing solutions to meet your financial goals. Together, we are confident we can navigate 2016 and all it will bring.

Kurtis D. Spieler, CFA
Senior Managing Director
Investment Management

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What is your assessment of economic conditions?

- The U.S. economy benefited from a strong job market that saw the unemployment rate fall to 5%. This is the lowest level since April 2008.[1]
- The expected benefits from low oil prices proved to be elusive. Lower oil prices were good for consumers, but the dramatic cuts in labor and investment spending in the energy sector weighed on growth.
- The U.S. dollar appreciated during 2015, which negatively impacted net trade and the profitability of multi-national companies. The inverse relationship of oil and the U.S. dollar is illustrated in the chart.

Will the current U.S. economic expansion continue during 2016?

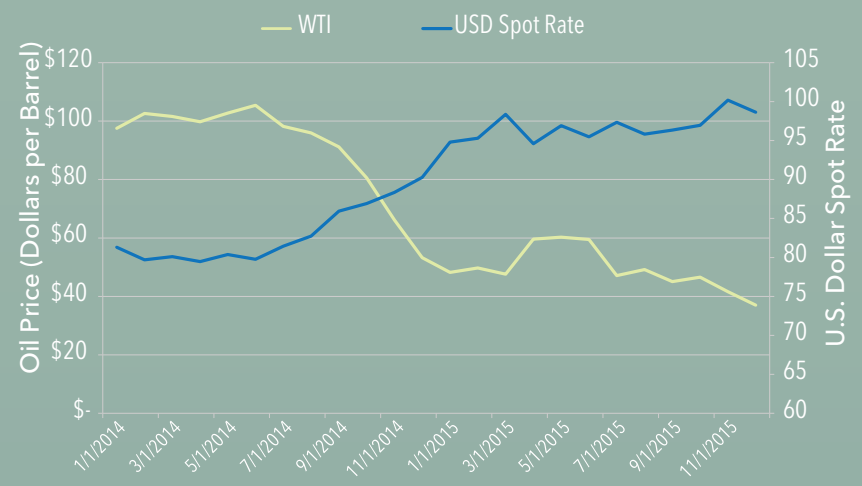
Yes. Our base case scenario calls for the economy to expand at a moderate pace of around 2.5%.[2]

- Since the last recession, we have been impressed with the economy's durability and resilience. The level of growth, however, has been less impressive, as shown in the chart. The average annualized GDP growth rate during this cycle has averaged just above 2%. This is lower than the 3% historical average since the end of WWII.[1]

Does slower growth equal more sustained growth?

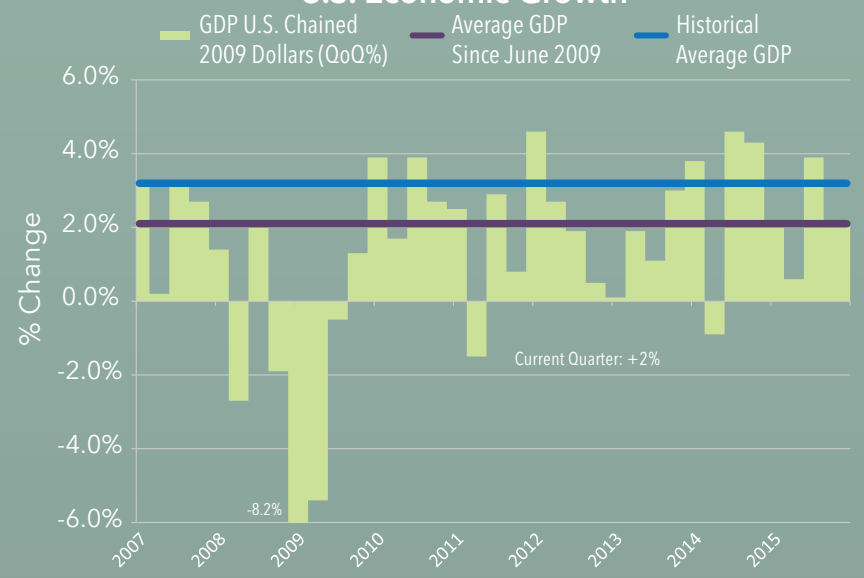
- We believe these two factors are linked. The U.S. economy has grown for 78 months. This is substantially longer than the post-WWII average expansionary cycle of 58 months.[3] Slower growth has likely prevented recession-causing imbalances from developing in the economy. Growth will be mostly driven by personal consumption, but headwinds and structural impediments will be a limiting factor.

Oil and U.S. Dollar Price Change



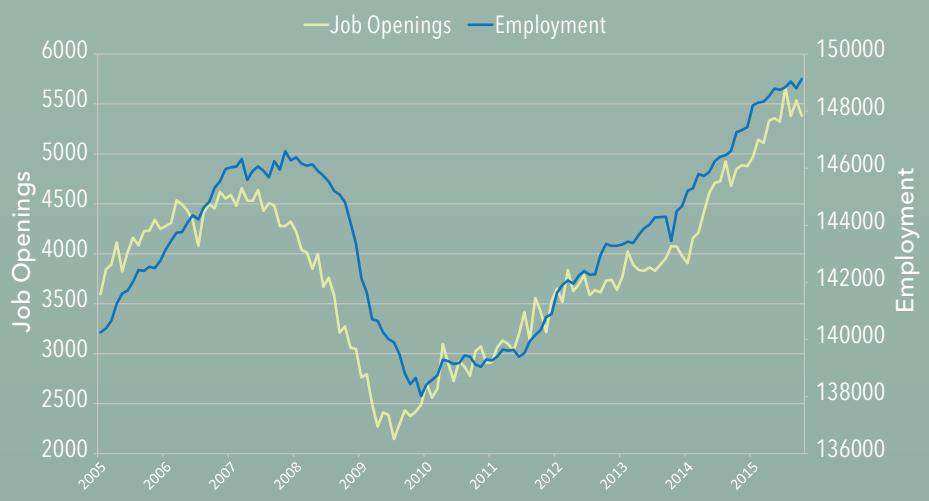
Source: Bloomberg as of 12/31/2015

U.S. Economic Growth



Source: Bloomberg as of 12/31/2015

Total U.S. Employment



Source: Bloomberg as of 12/31/2015

China Economic Growth

Source: China GDP, Bloomberg as of 12/31/2015

What is the most important variable for the economy?

Sustained employment gains should provide a solid tailwind for the economy. During 2015, the economy added 2.65 million jobs.[4] Strengthening labor markets have led to rising wages with average hourly earnings up 2.5%.[4]

The Bureau of Labor Statistics releases the Job Openings and Labor Turnover Survey (the "JOLTS report"). In the most recent report, the number of job openings hit a record high and the ratio of unemployed persons to job openings is 1.5.[4] This is a positive indicator for future labor market conditions. The combination of higher employment and rising wages should be a strong propellant for the economy in 2016.

The expanding labor market is making consumers more confident. The recent Conference Board Consumer Confidence Index report stands at 96.5.[5] The housing and auto sectors have benefited and we expect these industries to contribute to economic growth.

What headwinds may weigh on growth?

We expect non-residential investment spending to remain constrained in 2016. Sluggish global growth, low commodity prices and the strong dollar have contributed to spending cuts on new plants, equipment and machinery. Industrial production has declined year over year and capacity utilization rates have fallen over recent months. Therefore, we do not anticipate companies will increase their investment in capital stock.

The challenges facing developing economies will likely continue during 2016. China is the world's second largest economy and a major driver of global economic growth. As the Chinese economy transitions from investment-oriented to one more focused on consumption, growth has slowed. The deceleration in China's economy has negatively impacted trade partners and commodity-oriented countries. Strained emerging market economies will hinder U.S. economic growth.

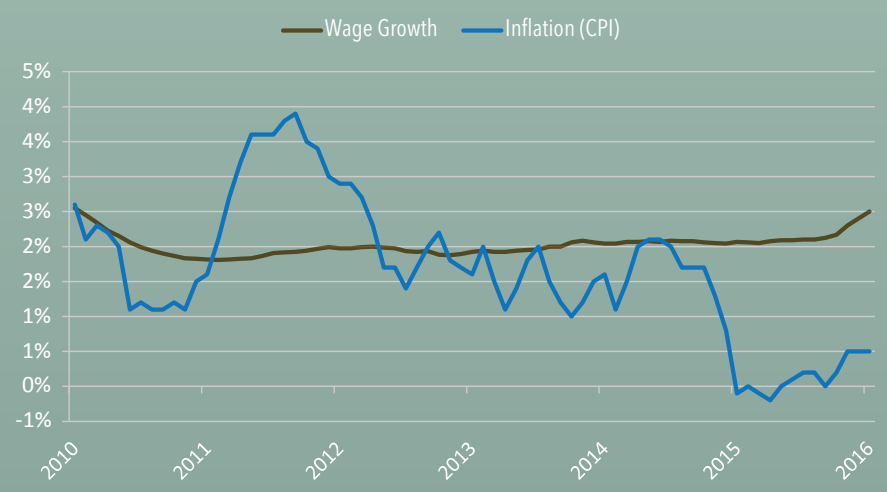
Is inflation a threat?

Stable inflation is an important ingredient to long-term economic vitality and a critical mandate of the Federal Reserve Bank. The Fed's outlook for inflation will be key to the pace of interest rate increases throughout the year.

We expect inflation to remain moderate during the coming year. The strong dollar, low oil and commodity prices, and globalization should help keep inflationary pressures contained.

Wages have been increasing at a moderate pace, which has limited its contribution to inflation. If tighter labor markets cause wages to accelerate, it would likely increase the inflation rate and trigger a policy response from the Federal Reserve. The resulting change in monetary policy and interest rates could be disorderly and destabilizing. Inflation is an important economic factor that the investment team is monitoring closely.

Inflation and Wage Growth



Source: Bloomberg as of 01/08/2016

What is your assessment of the stock market?

- Volatility returned with a vengeance as equities corrected (>10%) for the first time since 2012. There were 72 days during 2015 on which the S&P 500 moved up or down by 1% or more. This nearly doubled the 38 days of 1% or more moves in 2014. [1] The most dramatic instance was when equities dropped 11% in six days in August.
- Growth stocks significantly outperformed value with Facebook, Amazon, Netflix and Google (often called the "FANG" stocks) leading the market.
- For the third consecutive year, a diversified portfolio failed to keep pace with the relatively strong returns in U.S. large caps. Emerging market and commodity returns significantly lagged blue chips as shown in the table.

Will 2016 stock market returns surpass 2015 levels?

Yes. As illustrated, we believe the S&P 500 total return will be around 5% based on a resumption of earnings per share ("EPS") growth, dividend yield and slight compression in valuations (P/E contraction).[2] The estimated return is lower than the historical average and reflects continued global economic risk. Of the return factors, variability in results typically occurs in the valuation component as investor sentiment is difficult to predict.

What is the key to positive returns?

Positive sales and earnings growth. Earnings growth is expected to be positive for the full year in 2015 (Q4 has yet to be reported). However, overall growth was negatively impacted by the massive profit compression in energy. U.S. dollar strength also hindered earnings in basic materials, consumer staples and industrials. The lack of substantial profit growth for S&P 500 companies contributed to market volatility.

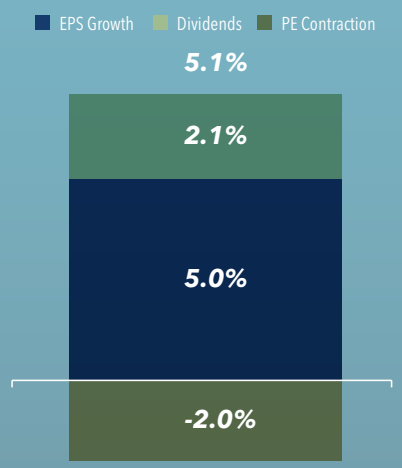
We expect earnings growth to be 4.0 - 5.0%[2] in 2016, which is less than analyst forecasts of 7.6%[6] growth in the S&P 500. We believe consumer discretionary and health care sectors will drive growth with basic materials and energy below expectations. The resumption of sales and earnings growth is essential to the continuation of the bull market.

2015 Returns by Asset Class

	1 Year	5 Year	10 Year
S&P 500 Large-Cap	1.4%	12.6%	7.3%
S&P 400 Mid-Cap	-2.2%	10.7%	8.2%
S&P 600 Small-Cap	-2.0%	11.5%	8.0%
International Developed	-0.8%	3.6%	3.0%
Emerging Markets	-14.9%	-4.8%	3.6%
U.S. REIT	-1.2%	6.1%	N/A
Commodities	-24.7%	-13.5%	-6.4%

Source: Standard & Poors (Large, Mid & Small), MSCI EAFE & EM (Int'l Developed, Emerging), FTSE NAREIT (REIT), Bloomberg Commodity Index (Commodities) Annualized Total Returns from Factset. As of 12/31/2015.

S&P 500 Sources of Return



2016 Estimated Returns
Source: Internal Calculation as of 12/31/2015

Sector Estimated EPS Growth

	2015	2016
Consumer Discretionary	11.1%	14.5%
Materials	-4.9%	10.7%
Health Care	11.5%	9.9%
Financials	13.5%	8.5%
Information Technology	8.3%	7.6%
Consumer Staples	-0.2%	6.4%
Industrials	4.2%	4.5%
Telecommunications	12.1%	2.4%
Energy	-59.3%	-7.6%
S&P 500	1.2%	7.6%

Source: FactSet Research Systems as of 12/31/2015

What would change your view of a low return market?

As illustrated, stock prices and expected earnings are highly correlated. On the positive side, an acceleration of the global economy and stronger company fundamentals would likely lead to >10% stock market returns. The International Monetary Fund (IMF) expects a rebound in global growth the next two years. Global central banks, especially in Europe and Japan, are embarking on unprecedented monetary stimulus. The impact of these government policies and stability in the Chinese economy could lead to a stronger market (yellow arrows).

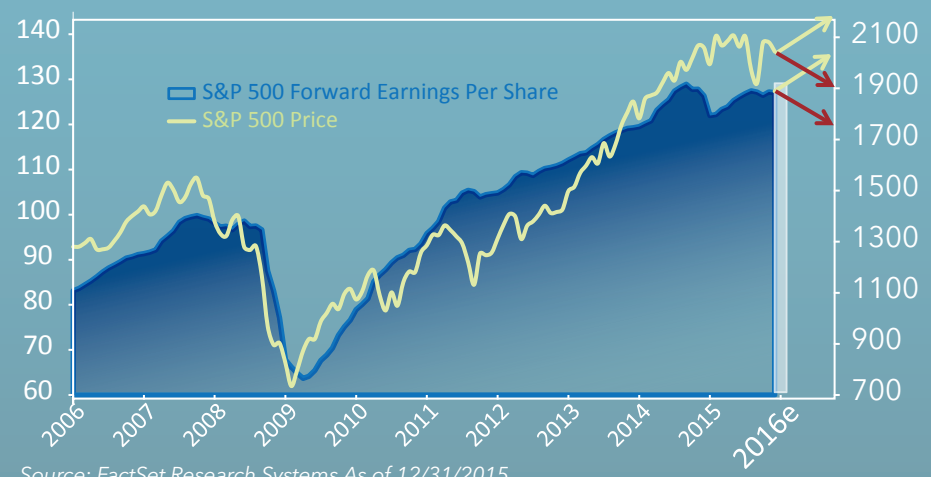
On the negative side, bear markets, or declines of greater than 20%, typically occur in recessions. This is due to the large decline in company earnings and corresponding price correction as depicted in the chart. Although a U.S. recession is not expected, an environment in which the U.S. economy decelerates and international economies struggle could lead to lower prices and a market downturn (red arrows).

How is the stock market valued? Why do you expect a slight compression in valuations?

On various valuation measures, the U.S. stock market appears slightly overvalued. One statistic we evaluate is the next twelve months ("NTM") price-to-earnings ("P/E") ratio. As shown, the current P/E ratio is 16.1x, which is above average as compared to the last 10 years. We believe this valuation is reasonable based on the low global interest rate environment.

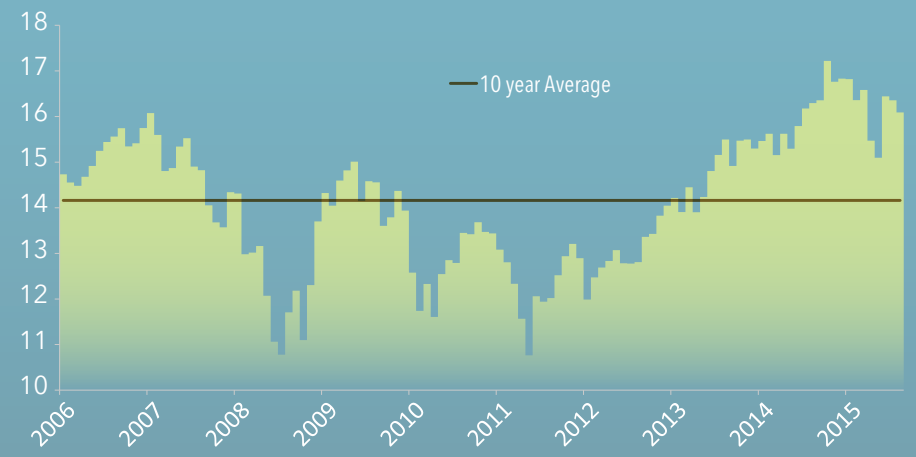
History indicates that on average market valuations compress when the Federal Reserve tightens monetary policy. We believe the Fed will embark on a slow and gradual pace of interest rate increases, which may lead to a small contraction in valuation.

Stock Price and Earnings Outlook



Source: FactSet Research Systems As of 12/31/2015

S&P 500 Forward Price/Earnings Ratio



Source: FactSet Research Systems As of 12/31/2015

Will diversification finally work in 2016?

Yes. We believe U.S. large cap returns will be limited by relatively high valuations. As illustrated in the table, U.S. large cap stocks are trading at a 14% premium to their 10-year average. Certain companies are trading at much higher valuations. For example, the NTM P/E of FANG stocks as of 12/31/2015 are as follows:[1]

- Facebook (ticker FB) NTM P/E 36.5x
- Amazon (ticker AMZN) NTM P/E 122.4x
- Netflix (ticker NFLX) NTM P/E 402.7x
- Google (ticker GOOG) NTM P/E 22.1x

We expect other asset classes to outperform including U.S. small and mid cap equities. International developed markets are trading at a higher premium than its 10-year average. However, we believe this P/E is overstated as earnings remain low in the wake of the 2013 recession in Europe and 2014 economic downturn in Japan. The cheapest area on an absolute and relative basis is emerging markets.

Will commodity prices and oil in particular recover this year?

The volatility and potential recovery in commodity prices is an unknown factor as we enter 2016. Equities are selling off in response to lower oil prices. Economists expect a recovery in West Texas Intermediate (WTI) from $37.0 per barrel as of 12/31/2015 to an average price of $51.25 this year.[6]

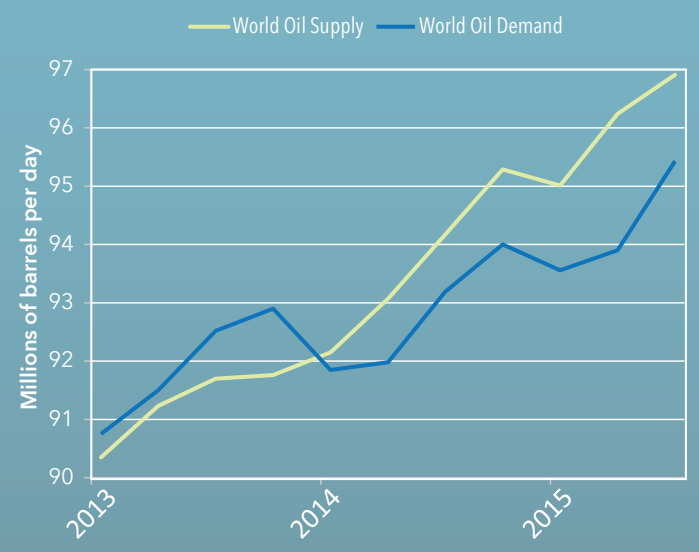
We remain skeptical of the forecast due to high inventories and limited production cuts. As shown, oil supply continues to grow at high levels as OPEC exceeds target production. If oil prices stay lower than the projections, commodity exporting countries will be negatively impacted. Continued lower oil prices also have implications for a possible increase in geopolitical risk in the Middle East. If production cuts finally occur, we believe oil will recover and equities will respond positively.

Valuation by Asset Class

	NTM P/E 12/31/15	10 Yr Average	2015 Premium
S&P 500 Large Cap	16.1x	14.2x	13.6%
S&P 400 Mid Cap	16.4x	15.4x	7.0%
S&P 600 Small Cap	17.3x	15.7x	10.5%
International Developed	14.7x	12.9x	14.2%
International Emerging	10.9x	11.2x	-2.6%

Source: Standard & Poors (Large, Mid & Small), MSCI (International, Emerging), FactSet (calculation); as of 12/31/2015

Oil Supply and Demand



Source: OECD/IEA as of December 11, 2015

What is your assessment of the bond market?

- A strong U.S. dollar and low interest rates globally anchored long-term rates in 2015. At the same time, the anticipation of a Federal Reserve hike put upward pressure on short-term rates. The result was a flatter yield curve by the end of the year.
- Credit spreads widened, particularly in high yield, on weak energy and commodity prices. Returns for various bond sectors are shown in the chart.
- After six years of a zero interest rate policy, the Fed took a step towards normalization by raising overnight lending rates to a range of 0.25 - 0.50% in December.[7]

What signals is the bond market sending about the economy?

Mixed. The yield curve remains upward sloping, which indicates economic expansion. Wider credit spreads, however, point to lower liquidity and higher underlying risks.[8] Overall, we expect bond market volatility to continue and have modest return expectations of 1.5 - 2.5% for diversified bond portfolios.[2] We see lower levels of interest rate risk compared to prior years, but credit risk is growing due to increased leverage and global economic turmoil.

Will the federal funds rate be closer to the Fed's median forecast of 1.4% or the market's 0.8% at the end of 2016?

The market's forecast seems more likely in our view.

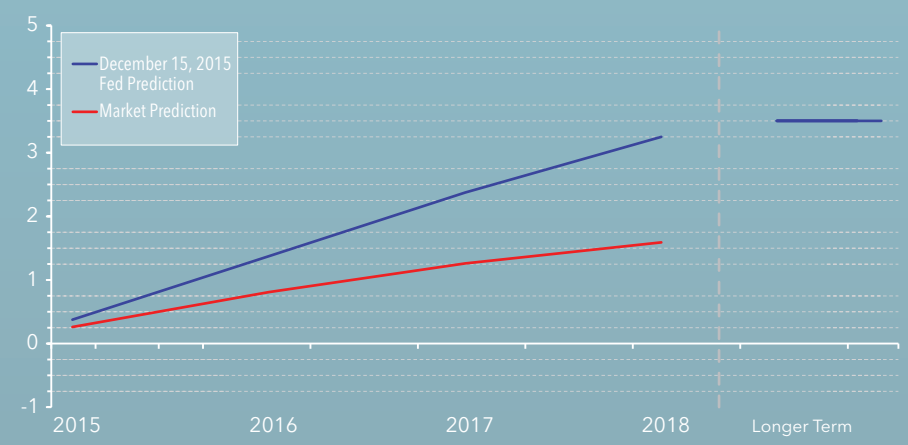
- Although the rate hikes could follow any number of paths, a base case would be to raise rates 0.25% at a time. This pace would require rate hikes at four of the eight FOMC meetings in 2016, which seems ambitious, especially since first quarter growth tends to be tepid.[7]
- Global output growth is slower than it was a decade ago. This means market rates should be lower now, even without central bank intervention.[7] If the Fed reached its forecast by year-end, it would be a tightening, not easy monetary policy.

2015 Bond Returns by Sector

	1 Year	3 Year	5 Year	10 Year
Government	1.2%	0.8%	2.0%	3.7%
Credit	1.1%	1.6%	3.6%	4.8%
International Managed	-4.0%	0.0%	2.6%	7.5%
U.S. High Yield	-4.5%	1.5%	4.8%	6.7%
Managed Municipal	2.8%	2.1%	3.5%	4.2%

Source: Barclay's Capital Intermediate Indices, Templeton Global Bond Annualized Total Return from FactSet. As of 12/31/2015.

Federal Funds Rate Predictions



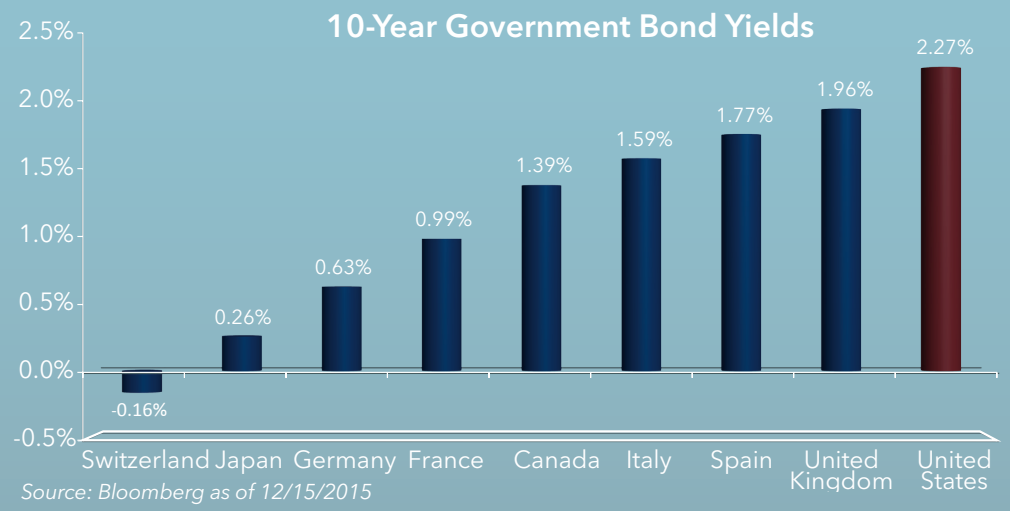
Source: Bloomberg as of 12/15/2015

Is the year-end consensus 10-Year Treasury yield forecast of 2.8% realistic?

No. We believe economic data points to a lower range of 2.1 - 2.6%.[2] Rates could drift in either direction but we don't expect them to significantly change from current levels.

- While U.S. rates seem low, they are quite high relative to the other G-7 countries as depicted in the chart. While the Federal Reserve has started raising short-term interest rates, the ECB lowered its overnight lending rate to below 0%. Switzerland, a euro-zone neighbor, even has negative rates on 10-year bonds.[1] The attractive safe haven yield should continue to attract investors, keeping demand for U.S. Treasuries strong and rates low for longer.

- There is a strong relationship between global GDP and U.S. Treasury yields. A downward revision to global growth predictions reduced inflation expectations, which takes some pressure off bond yields.[9] Negative revisions also lead to a flight to quality, adding demand to Treasuries. Barring a positive economic surprise from multiple countries, we see few catalysts for inflation or significantly higher long-term rates.



Source: Bloomberg as of 12/15/2015

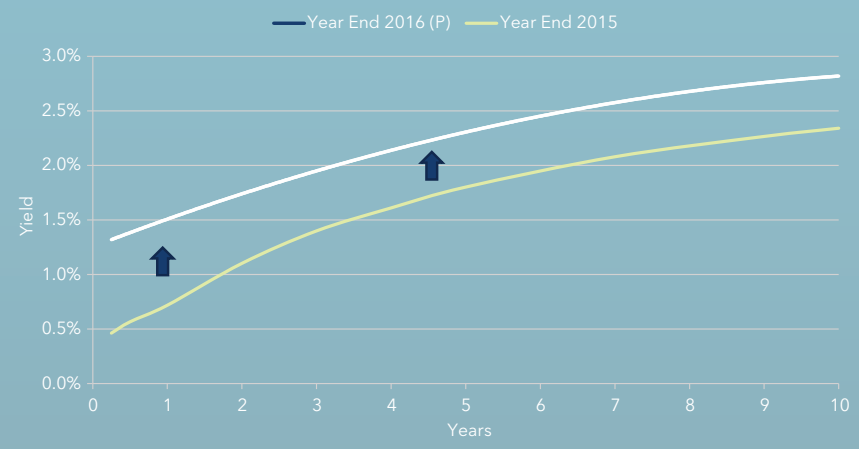
What implications does a flattening yield curve have?

Rising short-term rates combined with neutral long-term rates results in a flatter yield curve. As illustrated, this is expected to happen over the next year and indicates an economy that is growing, but at a slowing pace. Higher rates on the long end of the curve make taking some interest rate risk worthwhile. We view credit investments as attractive based on positive economic growth.

In what ways do you foresee the bond market changing?

- An estimated 4 million baby boomers are retiring each year.[10] The changing needs of this key demographic will potentially lead to bond inflows. Further stock market volatility would likely contribute to the increase in demand for bonds as well.
- New industry regulations reduce the ability of banks to trade and hold bonds in inventory.[11] Part of the spread widening for corporate bonds last year was likely due to a higher liquidity premium.
- In contrast, higher yielding sectors of the bond market could see outflows in coming years. As interest rates rise, safer bonds become more attractive and investors may not reach for yield.

US Yield Curve and Predicted Yield Curve



Source: Bloomberg as of 12/15/2015

What changes are you making in asset allocation?

For the second consecutive year, we have adjusted the stock allocation target. For illustration purposes, the balanced objective is highlighted. It has a midpoint allocation of 45% to both equities and fixed income and an allowable range for each asset class of 30 – 60%. Since late 2009, we have advocated a stock allocation between 51 – 55%. Based on the expected low return environment and higher level of risk, our current stock allocation target is 49%.[2]

We increased exposure in fixed income and cash.

- *Fixed Income:* The higher bond allocation reflects the belief that interest rates are likely to remain low, in addition to our emphasis on reducing portfolio risk.

- *Cash:* The increase is due to our desire to have more flexibility to take advantage of market volatility.[2]

We are maintaining our alternative investment (alts) allocation at 8%. In 2015, alts were effective in reducing portfolio risk, but their returns disappointed. We recently increased our exposure in our lowest risk alt mutual fund to further reduce stock market sensitivity of the asset class.[2]

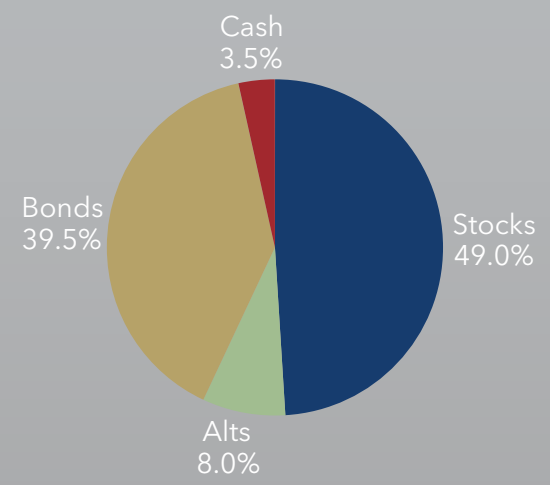
Why continue to overweight equities relative to fixed income?

Our asset allocation model is based on the following factors:

- Economic and profit outlook: We believe U.S. economic growth will exceed 2%, which will lead to company earnings growth of 4 - 5% for U.S. large caps and 5 - 7% for U.S. small and mid caps.[2]

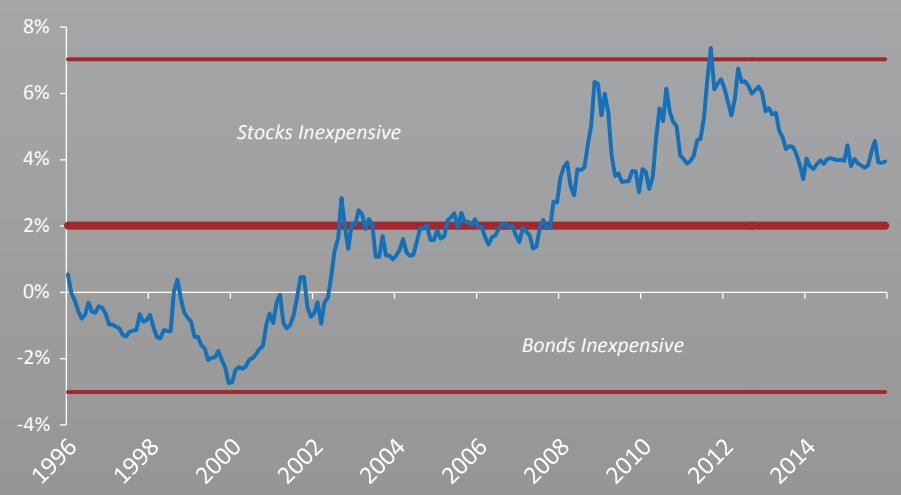
- Relative valuation discount: From a valuation standpoint, both stock and bond markets are trading at above average valuations. On a comparison basis, equities remain cheap relative to fixed income as illustrated by the equity risk premium ("ERP"). The current 3.9% level is above the 20-year average and indicates that equities remain inexpensive relative to bonds. The move from incredibly cheap in 2012 on a relative basis to a modest discount in 2015 is part of our lower stock allocation decision.

Balanced Objective Target Allocation



Source: Internal Calculation as of 12/31/2015

S&P 500 Equity Risk Premium

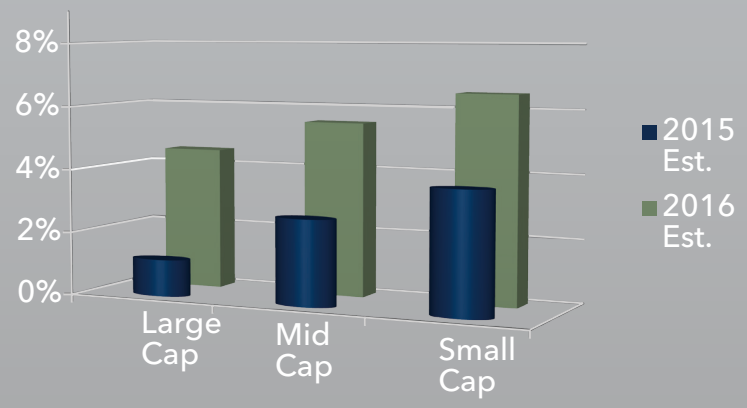


Source: Bloomberg as of 12/15/2015

How do you plan to add value in a low return environment?

One key to generating returns in a volatile, low return environment is focusing on long-term horizons and successfully implementing tactical asset allocation decisions. We plan to take advantage of stock market volatility by adding equity exposure during corrections and reducing portfolio risk as markets move higher. We also see opportunities to enhance returns within equity and fixed income sub-asset classes. Active management will be critical in generating excess returns, both in mutual fund and individual security selection.

U.S. EPS Growth by Market Cap



Source: Factset Research Systems for 2015. As of 12/31/2015
First National Bank Estimates for 2016

GDP Growth

	2011	2012	2013	2014	2015E	2016E
Developed Markets	1.8%	1.3%	1.2%	1.8%	2.0%	2.2%
U.S.	1.6%	2.2%	1.5%	2.4%	2.5%	2.5%
Japan	-0.4%	1.8%	1.4%	0.0%	0.6%	1.1%
U.K.	2.0%	1.2%	2.2%	2.9%	2.4%	2.3%
Euro ex U.K.	1.6%	-0.9%	-0.3%	0.9%	1.5%	1.7%

Source: International Monetary Fund as of 12/31/2015

What asset classes do you like in equities?

- U.S. small and mid cap ("SMID")

  U.S. SMID stocks trade at reasonable valuations relative to their 10-year history. As illustrated, we anticipate faster earnings growth due to the following factors: Higher exposure to the U.S. economy; less impact from a strong U.S. dollar; lower allocation to the depressed energy sector.

  Although SMID investors have not been rewarded in price appreciation, we believe positive relative fundamentals will result in stronger equity returns this year.

- International developed markets. This sub-asset class is focused on MSCI Europe, Australia, Far East (EAFE). The largest countries are Japan, U.K. and Germany. Since 2009, we have advocated a low weighting based on sub-par international economic growth. World GDP growth has declined over the last few years with IMF 2015 projected growth of 3.1%.[1]

  As the GDP table depicts, developed markets have reported stronger economic growth since 2013. We expect a modest acceleration in growth this year due to accommodative central bank policies in Europe and Japan and benefits from recent currency weakness.

  Ultimately, GDP growth may lead to stronger earnings growth for international developed markets. We do not anticipate the U.S. dollar being as strong in 2016, which hindered prior equity returns. We increased our developed international exposure due to expected earnings growth and the absolute valuation discount.

What areas are you cautious on in equities?

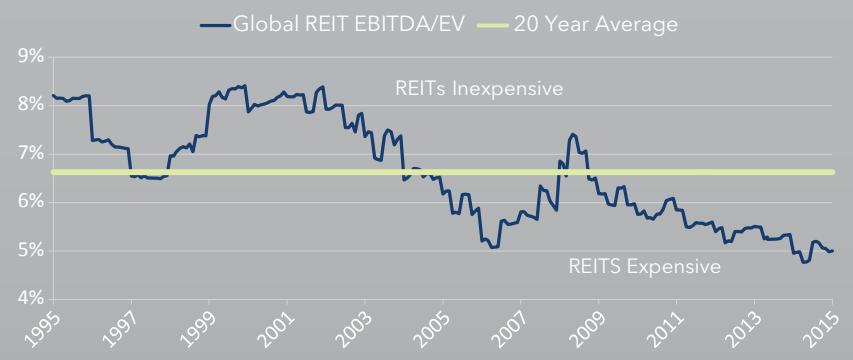
- Global real estate. Fundamentals remain positive in commercial real estate as a result of strong operating cash flow. The primary reason for our low allocation is the relative high valuation. We utilize EBITDA/EV to value real estate investment trusts ("REITs"). As shown in the chart, the current valuation is expensive relative to its 20-year average. We believe the cash yield decline to 5% is due to the low interest rate environment as investors search for income.[2]

  We advocate an allocation to global real estate due to its low risk characteristic. The flexibility to allocate investments in different countries is a positive attribute of global REIT investing.

- International emerging markets. Developing economies are levered to global economic growth and commodity cycles. As we enter 2016, emerging economies face the prospect of additional Federal Reserve rate hikes, headwinds from U.S. dollar strength and the economic slowdown in China. As a result, many emerging markets are suffering from currency weakness as central banks try to stimulate growth by cutting rates. The growth benefit of weaker currencies has been limited by slowing global trade.

  After four years of declining GDP growth, the IMF expects a recovery in 2016 as depicted in the table. We are not convinced and believe that lower Chinese growth and currency pressure in many countries will limit equity returns.

Global REIT Valuation



Source: PREI,UBS estimates as of 12/31/2015

GDP Growth

	2011	2012	2013	2014	2015E	2016E
Emerging Markets	6.7%	5.1%	5.1%	4.8%	4.0%	4.6%
China	9.5%	7.7%	7.7%	7.3%	6.9%	6.5%
Brazil	3.9%	1.9%	3.0%	0.1%	-3.5%	-2.5%
India	7.7%	4.8%	4.7%	6.9%	7.4%	7.4%
Russia	4.3%	3.4%	1.3%	0.6%	-3.8%	-0.2%

Source: International Monetary Fund as of 12/31/2015

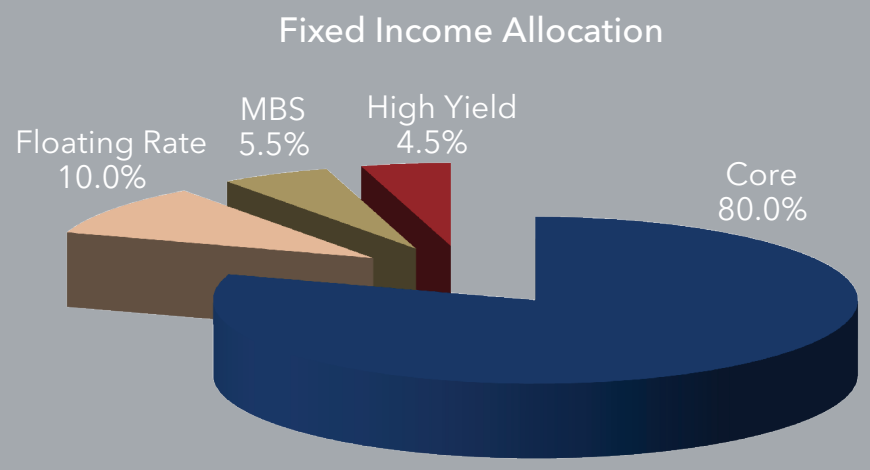
Commodities: We advise a zero allocation to industrial commodities in your portfolio as this asset class adds risk with limited expected returns. In the third quarter, we eliminated the MLP Infrastructure Fund and avoided much of that industry's recent downturn. We also expect precious metals, including gold and silver, to remain under pressure, especially if the U.S. Federal Reserve increases interest rates. The cost of holding commodities increases in an environment of rising interest rates, which limits their attractiveness.

As commodities and emerging markets have dropped significantly in price, we are constantly evaluating both asset classes for potential buying opportunities. One key factor is an improvement in oil inventory levels. Although we believe it's too early to buy today, we expect opportunities from fundamental improvement later in 2016.

Have you increased the core fixed income allocation?

Yes. We have increased our core bond allocation from 75% to 80% as illustrated. The core includes U.S. Treasuries, government agencies, investment grade ("IG") corporate bonds and municipal bonds.

This decision reflects the recent increase in short-term interest rates, making core fixed income more attractive. It also serves to reduce portfolio risk.



Source: Internal Calculation as of 12/31/2015

Will IG corporate bonds outperform U.S. Government securities this year?

Yes, although we expect a low disparity in returns. We believe IG corporate bonds will outperform due to the yield carry and higher interest rates.

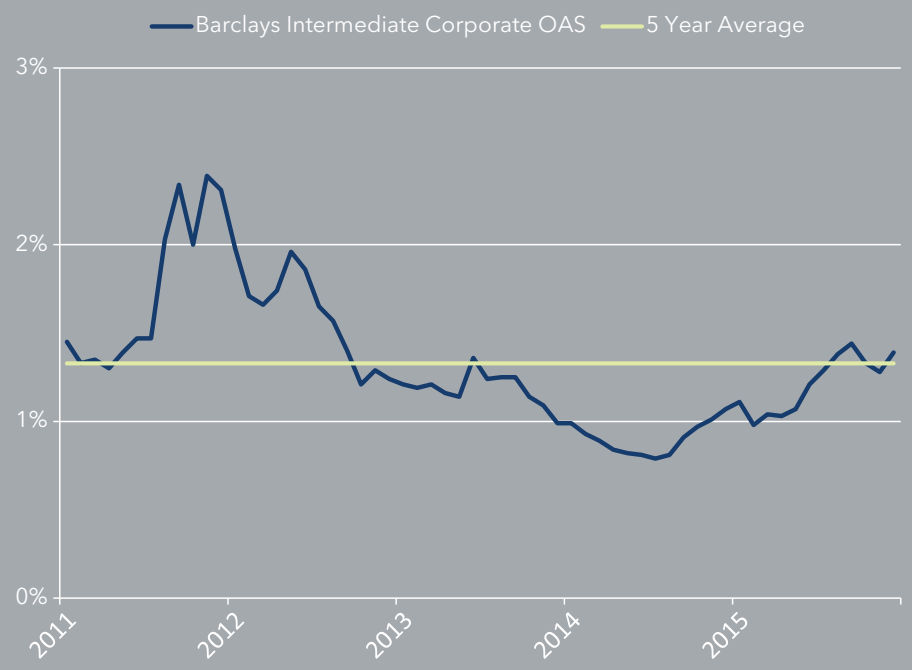
Debt issuance to fund M&A activity, share buy backs and dividends were common in 2015. Higher leverage and lower market liquidity drove spread levels close to the 5-year average as indicated. Given the higher yields, we are holding a significant allocation to corporate bonds.

Meanwhile, we have been moving closer to a neutral position for U.S. Treasuries. They remain the most liquid bond investment and offer a performance advantage in the event of global economic weakness.

Do you find municipal bonds attractive?

Yes. U.S. economic growth and a demand/supply imbalance give the sector a positive outlook. Post-recession, policy makers of local and state governments took a conservative approach to spending. As a result, the $3.6 trillion tax-exempt municipal bond market has shrunk since 2010. The decline in outstanding bonds and increase in demand have led to excess returns in recent years. An estimated net increase of $45 - 50 billion in 2016 will reverse the 5 year trend of supply declines. Although this sector may not lead the bond market again this year, pent up demand should absorb the extra supply and continue to support prices in the coming year.[1]

Investment Grade Spreads vs. 5 Year Average



Source: Bloomberg as of 12/31/2015

What satellite sectors are attractive?

In 2015, our satellite positions included mutual funds focused on the following sectors: Global, collateralized loan obligations (CLO), mortgage backed securities (MBS) and high yield.

- *CLO.* We prefer this sector over traditional floating rate securities as it offers attractive yields that immediately benefit from interest rate hikes. In addition, we invest in a mutual fund that has an average credit rating of BBB, which is higher than floating rate income funds (typically BB). The table shows the relative yield advantage as compared to corporate bonds of similar ratings.
- *MBS.* Reasonable valuations and improving fundamentals for real estate make certain areas in this sector an attractive investment.

We added the CLO fund in mid-2015 and recently increased our allocation to both sectors, with more going to CLO than MBS. Our exposure on a combined basis is somewhat constrained by the inherent liquidity risk in both sectors.

What areas are you cautious on within fixed income?

Global. International developed bond yields are at historically low levels. Emerging market yields are attractive in comparison but have high currency and credit risk. At this point in the global economic cycle, the risk/return trade-off is not favorable. We have moved from a 12% allocation one year ago to 0% allocation.[2]

What do you think of high yield?

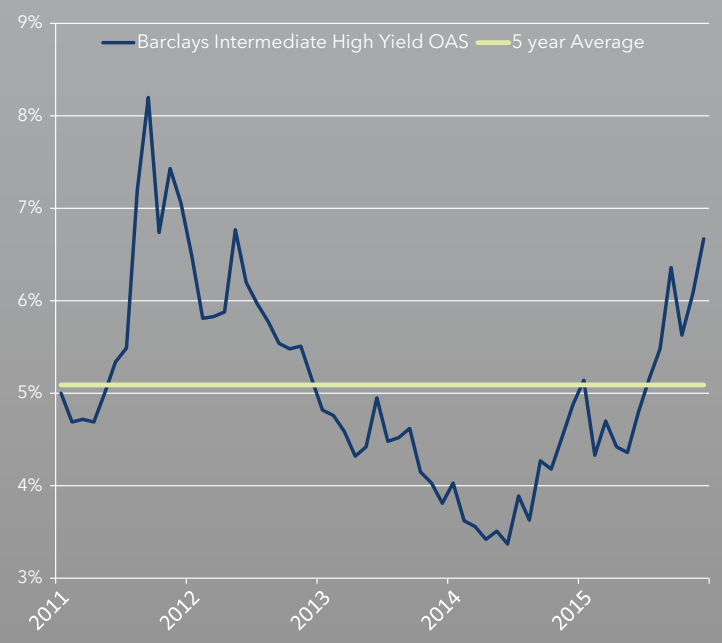
We have maintained exposure to high yield at modest levels. Steep valuation declines took yields and spreads above their 5-year average. The majority of the move is due to issuers in the energy and commodity industries. Since this is mostly industry specific, stabilization in commodities is a prerequisite for a rebound. Additionally, the issuer-weighted speculative default rate is up from 1.4% a year ago to 4.8% in November.[12] Waiting for default expectations to peak would also give us more confidence in the outlook. We are evaluating high yield for an opportunity to increase our allocation.

Credit Spreads

Credit Rating	Collateralized Loan Obligation	Corporate Bond
AAA	160 - 185 bps	51 bps
AA	240 - 260 bps	64 bps
A	330 - 370 bps	89 bps
BBB	475 - 550 bps	155 bps
BB	800 - 950 bps	344 bps

Source: Citi Research, LCD; Bloomberg Fair Value Curves

High Yield Spreads vs. 5 Year Average



Source: Bloomberg as of 12/31/2015

We constantly evaluate asset allocation and investment strategies within equities, fixed income and alternative investments to add value for our clients. As 2016 progresses, we expect to make changes in response to economic conditions and find tactical opportunities as they surface.

Thank you for your interest in this year's Outlook and for the trust you place in the Wealth Management Group at First National Bank. We look forward to working with you closely to meet your investment goals.

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SOURCES:

1. Bloomberg.
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7. The Federal Reserve.
8. Wells Fargo Investment Institute.
9. International Monetary Fund (IMF).
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11. Fidelity.

DEFINITIONS

Research reports often contain terminology and acronyms that are specific to the industry. The following definitions are provided to help navigate the terminology used in this report.

ASSET ALLOCATION: An investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon.

COLLATERALIZED LOAN OBLIGATIONS (CLO): A type of security backed by a pool of debt similar to mortgage backed securities. CLOs are backed by generally low-rated corporate loans.

COMMODITIES: Any good exchanged during commerce, which includes goods traded on a commodity exchange. Examples of commodities include corn, oil, gold, live cattle, and coffee.

CONSUMER AND BUSINESS CONFIDENCE: Consumer confidence is a measure of the level of optimism consumers have about the performance of the economy. Generally consumer confidence is high when the unemployment rate is low and GDP growth is strong.
Business confidence is a measure of the level of optimism businesses have about the performance of the economy. Generally business confidence is high when GDP growth is strong and business leaders feel good about the prospects of their companies.

CONSUMER PRICE INDEX (CPI): A measure that examines the weighted average prices of a basket of consumer goods and services (such as transportation, food and medical care). Changes in CPI are associated with the cost of living.

CORPORATE BONDS: A debt security issued by a company. The backing for the bond is usually the payment ability of the company's earnings from future operations. In some cases, the company's physical assets may be used as collateral for bonds. Corporate bonds are considered higher risk than government bonds, thus interest rates are almost always higher.

CREDIT RISK: The risk of loss of principal stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

DEVELOPED MARKETS: Nations that have met all of the following criteria: They are a high-income economy as defined by the World Bank having a Gross National Income per capita of $12,736; they have a formal market and regulatory environment, a stable & transparent financial system; and a broad depth to their markets.

DIVIDEND YIELD: A financial ratio that shows how much a company pays out in dividends each year relative to its share price. In the absence of any capital gains, the dividend yield is the return on investment for a stock. Dividend yield is calculated as follows: Annual Dividends Per Share divided by Price Per Share.

EARNINGS (EPS) GROWTH: Percentage change in earnings per share (EPS) over an annualized period. EPS is the portion of a company's profit allocated to each outstanding share of common stock calculated as (Net Income – Dividends on Preferred) divided by average number of outstanding shares.

EBITDA/EV: Earnings before interest, taxes, depreciation and amortization/Enterprise value. This is a financial ratio that is used as a valuation metric for return on investment. The ratio is normalized for differences in capital structure which makes it optimal for comparing different companies within an industry.
Emerging Markets: Nations with social or business activity in the process of rapid growth and industrialization. Emerging markets generally do not have the level of market efficiency and strict standards in accounting and securities regulation to be on par

with advanced economies (such as the United States, Europe and Japan), but emerging markets will typically have a physical financial infrastructure including banks, a stock exchange and a unified currency.

EQUITY: A stock or any other security representing an ownership interest. In terms of investment strategies, equity (stocks) is one of the principal asset classes. The other two are fixed-income (bonds) and cash/cash-equivalents. These are used in asset allocation planning to structure a desired risk and return profile for an investor's portfolio.

EQUITY RISK PREMIUM: The excess return that an asset or the overall market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the asset. The size of the premium will vary as the risk in a particular asset, or in the market as a whole, changes; higher-risk investments are compensated with a higher premium.

FIXED INCOME: Any investment paying a fixed interest rate such as a money market account, a certificate of deposit, a bond, a note, or a preferred stock. A fixed investment is the opposite of a variable investment.

GROSS DOMESTIC PRODUCT (GDP): The total of goods and services produced by a nation over a given period, usually one year. Gross Domestic Product measures the total output from all the resources located in a country, wherever the owners of the resources live.

HIGH YIELD: A subset of corporate bonds characterized by having a rating below Investment Grade (below BBB- or Baa3) or no rating at all. High yield bonds typically have a significantly higher interest rate because of their historically higher default rates.

INFLATION: Increase in the overall level of prices over an extended period of time.

INVESTMENT/CAPITAL SPENDING: Money spent on capital goods, or goods used in the production of capital, goods, or services. Investment spending may include purchases such as machinery, land, production inputs, or infrastructure. Investment spending should not be confused with investment, which refers to the purchase of financial instruments such as stocks, bonds, and derivatives.

LIQUIDITY: The degree of how easily an asset or security can be bought or sold in the market without significantly changing the price. Cash is the most liquid asset.

MARKET CAPITALIZATION (LARGE CAP, MID CAP SMALL CAP): Market capitalization is the total value of the tradable shares of a publicly traded company; it is equal to the share price times the number of shares outstanding. As outstanding stock is bought and sold in public markets, capitalization could be used as a proxy for the public opinion of a company's net worth and is a determining factor in some forms of stock valuation.

Large Cap > $14billion
Mid Cap $4 – 14 billion
Small Cap < $4 billion

MONETARY POLICY: The actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as increasing the interest rate, or changing the amount of money banks need to keep in the vault (bank reserves).
Related Fiscal Policy refers to the actions of a government in regards to the budget, spending, taxation, and borrowing.

MORTGAGE BACKED SECURITIES (MBS): A type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of hundreds of mortgages. The structure of the MBS is known as "pass-through", where the interest and principal payments from the borrower or homebuyer pass through it to the MBS holder. Other types of MBS include commercial mortgages (CMBS), collateralized mortgage obligations (CMOs, often structured as real estate mortgage investment conduits) and collateralized debt obligations (CDOs).

DEFINITIONS

MUNICIPAL BONDS: A debt security issued by a state, county, or municipality to finance its capital expenditures. Municipal bonds can be exempt from federal, state, and local taxes, especially if you live in the state in which the bond is issued.

PERSONAL CONSUMPTION: Measure of data pertaining to spending on goods and services targeted toward individuals and consumed by individuals.

PRICE TO EARNINGS (P/E): Price-to-earnings is a ratio calculated by taking the current stock price and dividing it by the earnings per share.
Historical P/E uses actual earnings data for the past 12 months.

- Forward P/E uses earnings estimates (forward earnings per
- share [EPS]) for the next four quarters.

RECESSION: A significant decline in activity across the economy, lasting longer than a few months. It is visible in industrial production, employment, real income and wholesale-retail trade. The technical indicator of a recession is two consecutive quarters of negative economic growth as measured by a country's GDP.

REAL ESTATE INVESTMENT TRUST (REIT): A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

SHARE BUYBACK: A program where a company repurchases its own shares from the market. This reduces the number of outstanding shares, which in turn increases earnings per share.

STANDARD & POOR'S 500 INDEX: An index of 500 stocks chosen for market size, liquidity, and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market value weighted index where each stock's weight is proportionate to its market value.

UNEMPLOYMENT RATE: The percentage of the total labor force that is not working but actively seeking employment and willing to work.

VALUATION: The process of determining the current worth of an asset or company. There are many techniques that can be used to determine value, some are subjective and others are objective. Many types of valuation methods are used, involving several sets of metrics. For equities, the most common valuation metric to use is the P/E ratio, although other valuation metrics include: Price/Earnings, Price/Book Value, Price/Sales, Enterprise Value/EBIDTA, Economic Value Added and Discounted Cash Flow.

YIELD CURVE: A curve that plots interest rates of bonds with equal credit quality but differing maturity dates. These curves are commonly used as predictors for economic output and growth.

ZERO INTEREST RATE POLICY: A method of stimulating economic growth by keeping interest rates close to zero. This policy is primarily used to combat deflation and promote economic recovery. The United States Federal Reserve recently moved away from a zero interest rate policy after several years of economic stimulus.

DEFINITION SOURCES: Investopedia; About.com; Wikipedia, Federal Reserve Bank of Cleveland

Unless otherwise stated, all data are as of December 31, 2015 or most recently available.

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