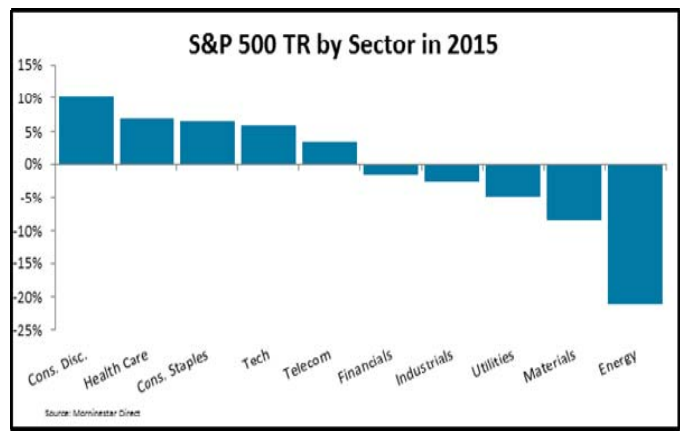
# Quarterly Update & Economic Commentary—December 31, 2015

## Quarter in Review

The fourth quarter was the best quarterly return for the S&P 500 since the fourth quarter of 2013. The quarterly return was 7.04 percent, and for 2015 the broad index returned 1.38 percent if you include the dividends paid. The S&P 500's annual return was the worst since 2008. For the second consecutive year large cap domestic stocks, as represented by the S&P 500 TR, outperformed smaller capitalization domestic stocks, as represented by the S&P SmallCap 600 TR. The S&P SmallCap 600 TR returned 3.72 percent for the quarter but lost 1.97 percent in 2015. International stocks, as defined by the MSCI EAFE NR (net return), finished the year in negative territory for the second consecutive year. The MSCI EAFE NR lost 0.81 percent. The struggles continued in the once dominant emerging market category. The MSCI Emerging Markets (EM) NR was negative for the third consecutive year, losing 14.92 percent. In the U.S. markets, growth outperformed value by almost nine percent in large cap; this is the largest outperformance since 2009. The top performing S&P 500 sectors were consumer discretionary (10.11 percent), health care (6.89 percent) and information technology (5.92 percent). The worst performing sectors were the energy sector (-21.12 percent) and the materials sector (-8.38 percent).

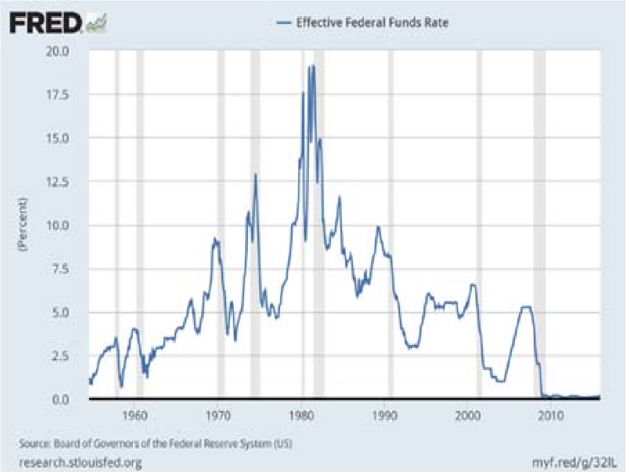
Investment-grade corporate and government bonds had a modest year as a tick-up in rates resulted in a price drop; however, in many cases the yield component made up for the price drop and investors earned a positive total return. The Barclays US Aggregate Bond index returned 0.55 percent for the year and the Barclays US Government Intermediate Index returned 1.18 percent. The high-yield sector of the bond universe posted its worst calendar year return since



2008, losing 4.47 percent. The high-yield fixed income sector was impacted by its exposure to energy and metals, even though the exposure to the sector is relatively low, below 20 percent. Credit investors were spooked when mutual fund company Third Avenue announced that they would limit redemptions and liquidate a high yield mutual fund. What was misunderstood initially was that the fund was invested in distressed securities which carry more risk and a lower credit rating than traditional high yield mutual funds.

2015 was not a good year for commodities. The move lower was broad based but the notable drops were seen in the energy and metals sectors. The spot price of Brent Crude fell by over 35 percent. The decline in energy prices had a negative impact on energy MLPs as the Alerian MLP index lost 32.59 percent. The decline in metals was led by the 41 percent drop in the price of Nickel, a 25 percent drop in Copper, an 11 percent drop in Silver and a 10 percent drop in Gold prices.

Central banks around the world continued to have a big impact on financial markets. In December, the U.S. Federal Reserve decided to hike interest rates by 0.25 percent; this was the first interest rate increase since 2006. Other than the Fed, just about every relevant central bank cut rates in 2015. This divergence in policy has resulted in a stronger dollar, which has hurt the earnings of many multi-national companies. Almost half of the revenue in the S&P 500 comes from outside the U.S., and when these companies repatriate their financials back to the U.S., it has a negative impact when the dollar increases in value. This currency race to the bottom is an attempt to increase demand for a country's goods by making them cheaper.




In addition to the stronger dollar, the significant decline in energy prices has hurt the earnings of companies in the energy sector. Both S&P earnings and revenues have been on the decline through most of 2015.

As is consistent with the Fed's decision to raise rates, the U.S. economy is well ahead of other foreign economies. GDP grew at a rate of 2.0 percent in the third quarter. The employment picture in the U.S. has steadily improved, with the unemployment rate finishing the year at 5 percent. The housing sector had a great 2015. Housing starts continue to grow and the demand of homebuyers, coupled with a lack of supply, have pushed home prices steadily higher. Light vehicle auto sales also had a strong year; annualized sales are expected to top 18 million— a measure not seen in over a decade. Despite all the rhetoric around a lack of wage growth and the quality of jobs, the U.S. consumer is doing well and spending money. The U.S. Consumer Sentiment Index is above historical averages.

One area of the U.S. economy that is beginning to show signs of distress is the manufacturing sector. American industrial production suffered its largest drop since March of 2012. The ISM's PMI survey indicated that the manufacturing sector is contracting. The sluggish manufacturing sector is being impacted by slower global growth and a stronger U.S. dollar, which makes domestic goods more expensive to foreign buyers. On the positive side, the ISM Non-manufacturing (Services) Survey continues to show expansion.

Inflation in the U.S. is stronger than many people realize. While headline inflation is essentially flat, core inflation, (which excludes the prices of food and energy because of their volatility) is at 2.02 percent as of November; in fact, this is slightly above the Fed's target rate of 2%.

As evidenced by the decisions of other central banks, the economic conditions abroad are not as positive as they are here at home. However, since starting QE, Europe's economy has slightly improved. There has been a steady increase in loan demand, the unemployment rate has fallen and GDP grew by 1.6% in the third quarter. They are far from economic stability but recent economic activity has been positive.

China's economy and stock market had a bad year. The country decided to remove the currency peg and let its currency trade more freely, but not without some government intervention. This caused the currency to fall as they desired. The Chinese economy weakened through the year and the stock market was extremely volatile. The Chinese economy continues to grow but a hard landing is becoming more of a possibility.

## A Look at the Numbers

| Name | 4th Quarter Performance (%) | YTD Performance (%) |
|---|---|---|
| DJ Industrial Average TR USD | 7.70 | 0.21 |
| S&P 500 TR USD | 7.04 | 1.38 |
| S&P MidCap 400 TR | 2.60 | -2.18 |
| S&P SmallCap 600 TR USD | 3.72 | -1.97 |
| NASDAQ Composite TR USD | 8.71 | 6.96 |
| MSCI EAFE NR USD | 4.71 | -0.81 |
| Barclays US Agg Bond TR USD | -0.57 | 0.55 |
| Wilshire US REIT TR USD | 7.47 | 4.23 |
| IA SBBI US 30 Day TBill TR USD | 0.01 | 0.02 |

## Forecast In Brief

As we kick off 2016, we believe many of the same stories that made headlines in 2015 will be prevalent again this year. The Fed's decision to raise rates in 2015 was important, but nowhere near as important as the pace of future rate hikes. There appears to be a disconnect between what the market believes the pace will be and what the Fed officials are forecasting based on the most recently released dot plot. The market expects two rate hikes while the Fed has forecasted four hikes in 2016. Based on how long it took the Fed to come off zero, in addition to the Fed's concern about continued slow growth and tame inflation, we expect the Fed to hike two to three times in 2016. Historically, stocks have gone up during periods of low but increasing interest rates in the U.S. That said, much of the volatility in 2015 was due to uncertainty around what the Fed would do. Because of this, we expect to see increases in volatility around each new Fed meeting.

Oil prices are very difficult to predict, but the expectation is that oil prices will stay low in 2016, though probably not as low as they are now at less than $40 a barrel. Another year of low oil prices may push some companies out of business, increase unemployment in the energy sector and hurt the revenues of many oil producing U.S. states and countries across the globe. Still, lower oil prices should be a net positive to the U.S. economy. The U.S. economy is consumption driven, and lower oil prices result in more discretionary income for consumers to spend. The low energy prices may continue to put pressure on certain parts of the high yield credit markets, but this should be contained to the energy sector.

As a whole S&P earnings are expected to decline again for the fourth quarter but this is mainly driven by energy stocks. Excluding energy, earnings growth is expected to be above five percent in 2016. Like corporate earnings, the U.S. economy is expected to have a low but stable growth rate. Because of all of the uncertainty, earnings multiples are unlikely to expand, which may contain equity returns to the earnings growth rate plus dividends.

The U.S. will have a presidential election in 2016, which should not have a significant impact on the markets; however, some sectors may be impacted by the winner. Unless there is a historic comeback, it appears as if the Democrats will be sending Hillary Clinton while the Republican nomination remains up in the air. The Republican field still has too many candidates but the field should narrow during the first half of the year as the primary elections begin in February. If both parties elect candidates who fail to generate excitement, there is the possibility that a wealthy independent could join the race in the final innings. This may be a long shot but something to keep your eye on.

There are a number of geopolitical concerns to keep the markets on edge. ISIS poses a global threat and has struck Western democracies by carrying out attacks in Paris and likely inspiring an attack in San Bernardino, CA. Though attacks like these have not had a significant impact on financial markets, many politicians have reacted with calls to restrict the flow of people across national borders and even within the Eurozone. The massive flow of refugees from the Middle East and Northern Africa is contributing to fears about national security. Free movement within the Eurozone has been a defining part of its economic growth, and limiting such movement would likely put a drag on the economy. Meanwhile, Iran and North Korea continue to show signs of belligerence, and China is projecting military force with increasing boldness on the world stage. Russia's involvement in Syria—ostensibly for the purpose of defeating ISIS, but in reality for the purpose of propping up the Syrian regime—has served to complicate an already complex situation. In November, NATO ally Turkey shot down a Russian fighter jet that encroached on its borders. These concerns are real and for now the new normal. Many feel that Obama's unwillingness to become entangled in yet another war in the Middle East has softened America's reputation, encouraged its adversaries and left its allies feeling vulnerable.

As was the case in 2015, China's economy will be in focus. We continue to expect its markets to be volatile but also expect its government to intervene at all costs to help the economy and prop up its markets. No one doubts the government's willingness to intervene, but many believe that such intervention is losing its effectiveness. A slowdown in China is bad for countries selling goods to China but should have little impact on countries that purchase goods from China, like the U.S. If anything, these goods should be cheaper for Americans.

We expect more of the same in Europe and Japan. Both economies have structural and demographic issues that can't be fixed by central bank intervention; however, that will not stop the central banks from continuing their activities and masking the problem short-term. We see the potential for Europe and Japan to have good years; however, a strengthening dollar will continue to eat into the international returns of U.S. investors.

As we look at the investment landscape going into 2016, we believe managing risk through diversification will be important. Fixed income remains an important component of a diversified allocation because of its low correlation to equities. The expectations of returns of fixed income are low but the downside risks compared to equities are also much lower. In the previous two years diversifying equity exposure to small and mid-capitalization stocks did not help boost returns, however, we continue to believe small and mid-capitalization stocks add value over a full market cycle.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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