Wealth Management Group Newsletter

Secure Your Future With Confidence | Spring 2016 Edition

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2015 AND JANUARY 2016 FINANCIAL MARKET OVERVIEW

The challenging economic and equity market environment experienced in 2015 carried over into the new year and accelerated in January. The best performing stock index on our list at right for 2015 and early 2016 is the S&P 500, returning 1.38% and -4.96% respectively. Large-cap U.S. stocks provided the best relative returns as investors worldwide sought quality and marketability in an effort to reduce risk in portfolios.

Why? For starters, here's a list that certainly can be added to:

- Global weak economic growth in developed nations.
- A slowing Chinese economy with uncertainty surrounding a weakening currency.
- A very weak global commodity

Financial Market Total Returns

As of January 31, 2016

Equity	4th Qtr 2015	Year 2015	January 2016
S&P 500 Index	7.04	1.38	–4.96
S&P Mid-Cap 400 Index	2.60	–2.18	–5.69
S&P Small-Cap 600 Index	3.72	–1.97	–6.17
MSCI EAFE Index	4.71	–0.81	–7.23
MSCI Emerging Mkt Index	0.66	–14.92	–6.49
Fixed Income			
Barclays Capital Intermediate Govt/Credit Index	–0.69	1.07	1.22
iBoxx High Yld Index	–1.48	–5.03	–1.24
Real Estate			
Dow Jones US Real Estate Index	7.23	2.14	–4.03
Commodities			
Bloomberg Commodity Index	–10.52	–24.67	–1.68

All returns shown as percentage

sector, highlighted by a jaw-dropping plunge in the price of oil.

- Uncomfortably low global inflation in developed economies.
- The prospect of a third quarter of negative U.S. corporate earnings growth compounded by a stronger dollar.
- And last but not least, a U.S. Fed embarking on a divergent monetary path relative to the rest of world's major central banks, with their December rate hike.

THE FED: ONE SMALL STEP FOR RATES, ONE GIANT LEAP FOR MARKET VOLATILITY

Leaving its zero interest rate policy (ZIRP) behind, the Federal Reserve increased its overnight Fed Funds rate target to 0.25% last December. With that action, the Fed put U.S. monetary policy on a divergent path from that of other major central banks around the world. In addition, and perhaps more impactful, with its description of the path forward along with Committee member forecasts it gave an impression of the likelihood of as many as four additional rate hikes in 2016 of similar magnitude. In contrast, the Bank of Japan recently instituted a negative interest rate policy on bank reserves. In doing so, they have joined a club of nations with negative rates which already counts as members, the Euro area, Denmark, Switzerland, and Sweden. To put that in perspective, according to the Economist, almost a quarter of the world's GDP now comes from countries with negative interest rates. At present, approximately 29% of the Bloomberg Global Developed Sovereign Bond Index holds bonds offering yields below 0%, which equates to approximately $7 trillion of bonds. This number does not include the full impact of Japan's recent policy which has caused Japan's 10-year bond rate to move into negative yield territory. Yes, the result is as bizarre as it sounds...investors who buy the bonds and hold to maturity will receive back less than they paid at purchase. The jury is still out as to whether or not this approach can actually spur economic growth and some amount of healthy inflation. One likely impact however, is on currency values. While a number of variables can impact currency strength at any point in time, it is a fundamental belief in economics that if a country has higher interest rates relative to other countries, (along with a stable and growing economy), foreign capital will be attracted for investment in securities denominated in that country's currency, thereby driving up demand and the value of its currency relative to others. Last year, growing expectations for a Fed rate hike, along with the event itself, and then compounded further by expectations for additional hikes in the near future, served to drive the U.S. dollar higher. The negative impact on economic growth can be significant especially in a low growth environment. According to the U.S. Bureau of Economic Analysis (BEA), declining net exports subtracted approximately 0.5% from 4th quarter 2015 GDP growth, causing U.S. economic growth to end 2015 on a low note with the GDP growth number for the quarter coming in at 0.7%. Adding to the list of concerns, the future path of U.S. economic growth was brought into question when the services component of the Institute of Supply Management's (ISM) survey revealed slowing expansion. The service sector now accounts for approximately 80% of the U.S. economy. The other 20%, the manufacturing sector, has been in contraction for four consecutive months. As for the labor market, the recent U.S. Department of Labor jobs report, while unimpressive with the number of jobs added (151,000 vs. an expected 195,000), had some positive data below the surface. Namely, the headline unemployment rate fell below 5% without labor force participation moving lower, and perhaps most important to the Fed, average hourly earnings increased 0.5% and hours worked were at a post-recession high. Since that time, Reuters has reported that U.S. job openings in the JOLTS survey (the U.S. Labor Department's Job Openings and Labor Turnover

Survey) was the second highest reading since 2001. And, the number of American workers voluntarily quitting hit a nine-year high. The quit number is a positive sign because workers only voluntarily leave their job when confidence is high they'll get another. On the inflation front, there has been no evidence of upward movement toward the Fed target of 2%, however the Fed has stated that factors such as plunging oil and commodity prices should be "transitory." In the end, we believe the Fed should be trusted in stating that incoming economic data will determine the future course of monetary policy. We expect the Fed to filter all incoming economic data through the prism of their dual mandate of maximum employment within a stable price environment. Financial markets are currently in disagreement (or doubting mode) regarding any plan the Fed might have to implement further rate increases in 2016. Since the start of this year, longer term U.S. interest rates have fallen, indicating anticipated economic slowdown. The 10-year U.S. Treasury bond yield has dropped 0.50% year-to-date, and the spread between the 2-year Treasury bond yield and the 10-year is the lowest it has been since 2007. The Fed Funds futures market is now pricing in a 0% probability of additional Fed rate increases this year.

U.S. CORPORATE EARNINGS

A weak global economy, a dramatic drop in oil, and a strong U.S. dollar have adversely affected corporate earnings. As these challenges have grown, earnings expectations and guidance by analysts and companies have moved lower. As this newsletter is written, approximately 74% of the companies in the S&P 500 have reported for the 4th quarter. Of that number, 76% have reported earnings above the mean estimate and 47% have reported sales revenues above the mean estimate. When concluded, it is expected that for the quarter, earnings growth for the S&P 500 in aggregate, will be negative. If so, it will mark the third consecutive quarter of year-over-year earnings decline since 2009. The estimate of the final number at present is for 4th quarter earnings growth of -5.6%. The decline is led by a 74% drop in energy sector earnings growth and an 18% drop in the materials sector. As for earnings guidance for the current quarter, 57 companies have issued negative earnings/share guidance and 14 companies have issued positive earnings growth guidance. Aggregate revenue growth is badly needed to move the stock market higher.

OUR OUTLOOK

Liquidity, corporate earnings, and current valuation measures all play an important role in developing expectations for the market. Our discussion thus far has made note of the challenges now being experienced by the first two items: liquidity and corporate earnings. The Fed, at least for the time being, is on a divergent path from other central banks in regards to monetary policy; and a U.S. corporate earnings slowdown which now appears to have run for at least three quarters. On the last item, current market valuation, the S&P 500 is currently at a Price/Earnings (P/E) multiple of 16.5 times using the prior 12 month's earnings figure. The historical median P/E of the market for the last 60 years has been 16.7 times. So, we do see the S&P 500 as being reasonably priced within that framework, however we also believe the market is likely to exhibit greater levels of volatility in the near term given the factors discussed earlier. With that in mind, our Investment Policy Committee has recently voted to be tactically defensive (to a degree) for the near term with the implementation of a 10% equity cash reserve during this period in equity portfolios. The establishment of this equity cash reserve results in a total portfolio cash weighting ranging from 3% to 10% based on individual account objectives and strategic asset allocation at the account level. This reserve is to be established and re-invested as near term market volatility presents opportunities to do so.

We believe it is within the spirit of a long term investment strategy to implement a tactically defensive posture to take advantage of near term opportunities a volatile market may provide. That said, we also believe it to be vitally important that investors "stay the course" with strategic asset allocation ranges during all market conditions. Market timing driven by emotional response to challenging economic conditions is bound to fail. Fear and doubt can lead some investors to question whether or not the stock market will be as resilient as it has been in decades past. A difficult economic environment and challenging financial markets can cause investors to assume current conditions will persist. The odds of success however, are with investors who maintain a long term perspective and who do not deviate from it. According to Ibbotson Associates data, there have been 81 rolling 10-year periods since 1926. The S&P 500 produced gains in 77 of them and losses in only 4, which means stocks increased in 97% of those 10-year rolling time frames. And if one believes they have a special gift of being able to predict the future, historical S&P data shows if an investment of $10,000 had been made in stocks 20 years ago, and remained invested, it would have grown to approximately $65,000. The same $10,000 invested in stocks for the same 20 years, but missing only the top 10 return days, which invariably come during the depths of bear markets, would have grown to approximately $32,000 or about half of the prior amount.

OUR CORE PHILOSOPHICAL BELIEFS

As we have stated many times in past editions, our core philosophical beliefs rest on a foundation of discipline and diversification and our message to our clients is:

- Stay fully invested in line with appropriate client specific asset allocation weightings. There is no evidence that market timing works.
- Stay fully diversified across all recommended asset class and sub-asset class category weightings.
- Monitor and control risk through periodic portfolio rebalancing back to strategic asset class and sub-asset class weighting targets.