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Market Commentary
Winter 2016

Q4 Key Takeaways

- As we look back more broadly on the financial markets in 2015, what really stands out is how poor the returns were *across the globe and across asset classes.* Among the major global stock markets, the U.S. market was the best performer, driven by just a handful of large technology names.

- One striking feature of last year's investment environment was the difference in the direction of the U.S. economy and U.S. monetary policy versus other major global economies. In December, the U.S. Federal Reserve was sufficiently comfortable with the outlook for economic growth and the potential for inflation to eventually normalize that it made its first increase in rates in nearly a decade.

- Outside the United States, regaining more normal economic growth and inflation has remained more challenging. Sharply lower commodity prices (most notably oil), Middle East tensions, and China's slower economic growth all weighed on foreign stock market returns. Developed international stocks ended the year down 0.4% while emerging markets fared worse, falling 15.8%.

- The worst-performing areas of the markets were commodity-related asset classes.

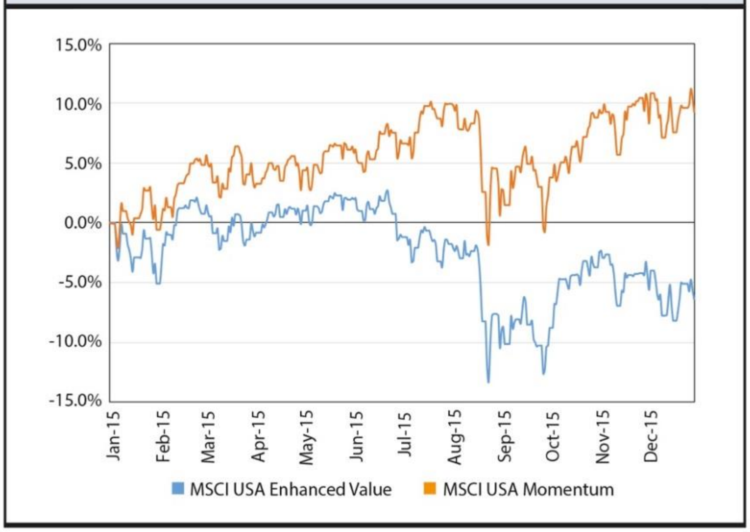
- Fixed-income offered little respite, with the core bond index gaining just 0.3%. High-yield bonds fared worse, down close to 5%, while floating-rate loans lost 0.7%. Investment-grade municipal bonds were a *relative* bright spot, with the national muni bond index up nearly 3% on the year.

Q4 Investment Commentary

2015 was a poor year for financial markets across the globe and across asset classes (stocks, bonds, commodities, etc.). Among the major global stock markets, the United States was the best performer, but that's faint praise given the S&P 500's 1.4% return. What's more, it was a market in which a handful of large tech/internet companies (e.g., Facebook, Amazon.com, Netflix, and Google) generated huge gains and helped propel the index into positive territory, while the equal-weighted S&P 500 index actually *fell* 2.2% for the year.

This lack of breadth in the market was also reflected in the performance of the large-cap value stock index (down 4%) versus the large-cap growth index (up 5.5%). The growth index benefited from its large weighting in the strongest-performing market sectors—technology, health care, and consumer stocks—as well as from its minimal allocation to the bottom-dwelling energy sector, which plunged nearly 25% on the year. Over the long term, value has outperformed growth by a meaningful margin, but the opposite has been true over the past several years (and actually going back to mid-2006). Smaller-cap U.S. stocks were down 4.5%, their second consecutive year trailing larger caps.

Momentum Outperformed Value by a Wide Margin in 2015



Source: Morningstar Direct. Data as of 12/31/2015.

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Developed international stocks were down 0.4% (in U.S.-dollar terms), marking their third year in a row trailing U.S. stocks and five out of the last six calendar years. Emerging-markets stocks had a terrible year, falling 15.8%. This was also their third consecutive year trailing the S&P 500 and fourth out of the last five years. As in 2014, currency movements (dollar strength) exacerbated foreign markets' underperformance for dollar-based investors, detracting 9% from emerging-markets stocks and 6% from developed international stocks compared to their local-currency returns. As in 2014, the strength of the dollar exacerbated foreign markets' underperformance for dollar-based investors. Currency effects will always be a shorter-term wild card when investing in non-U.S. assets, but on a fundamental, longer-term basis we believe currency movements may be a tailwind to dollar-based returns going forward after having been a drag on returns the past few years. Putting it all together, the MSCI All Country World Index, a market-cap weighted index of U.S., international, and emerging-markets stocks, was down 2.4% for the year.

The worst-performing areas of the markets were commodity-related asset classes, which are often held as an inflation hedge or for broader portfolio diversification. Commodity indexes were crushed, down on the order of 25%–30% (e.g., Bloomberg Commodity Index, Dow Jones-UBS Commodity Index, S&P GSCI). Oil prices hit an 11-year low in December and fell 30% for the year, after plunging 50% in 2014.

It wasn't much better on the fixed-income side. The core bond index gained just 0.3%. Aside from 2013, when the Fed's "taper tantrum" led to a 2% decline, this was the worst performance for core bonds since 1999 (down 0.8%) and the fourth worst year since the index's inception 40 years ago. High-yield bonds fared worse, down close to 5%, only the fifth negative year in the asset class's 30-year history. Floating-rate loans were down 0.7%. Investment-grade municipal bonds were a relative bright spot, with the national muni bond index up 2.9% on the year.

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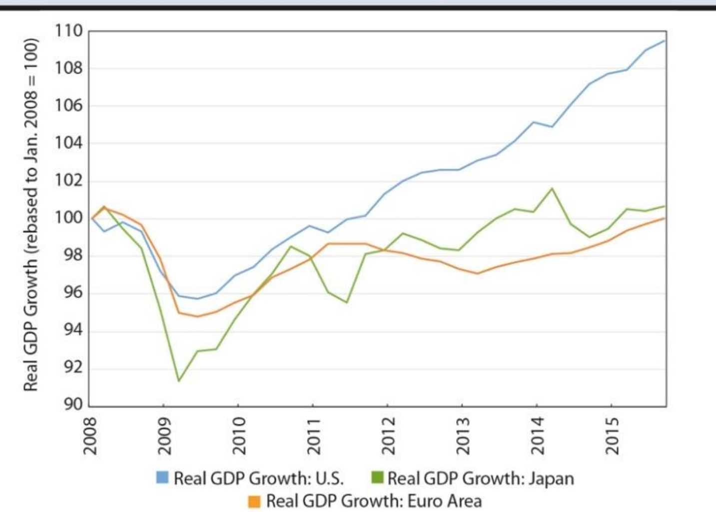
For the U.S. economy, 2015 was a decent year. Real GDP (inflation-adjusted) grew at a 2.2% annual rate (year over year through the third quarter)—nothing to write home about but still better than most other major economies, which continue to struggle to recover from the financial crisis. Both the eurozone and Japan grew by less than 2%. Emerging-market economies grew at around a 4% rate, but that has come down from closer to 8% prior to the financial crisis. Overall global GDP growth last year was about 3%, below the 3.5% average global growth rate of the past 35 years, according to Ned Davis Research.

The U.S. labor market continued to strengthen during the year—the unemployment rate fell from 5.8% to 5%, new job growth creation averaged a healthy 210,000 per month (nonfarm payrolls), and wage growth ticked higher to 2.3% (average hourly worker earnings, year over year through November). Meanwhile, inflation remained subdued. The core CPI rate did rise to 2% in November, its highest since July 2012. However, the Federal Reserve's preferred inflation measure, the core PCE rate, remained stuck at around 1.3%, well below the Fed's 2% inflation objective.

U.S. Economic Growth Has Outpaced Other Developed Economies since the Financial Crisis



Source: OECD. Data as of 9/30/2015.

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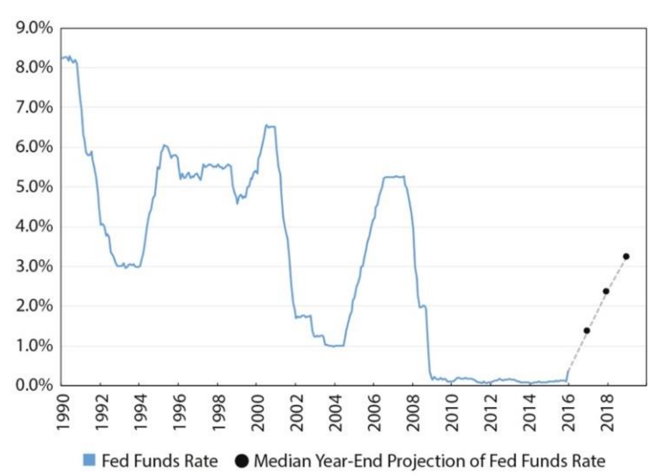
Nonetheless, the economic tea leaves were strong enough in December for the Fed to initiate their long-anticipated first interest rate increase since 2006, after having cut the federal funds rate to near 0% in late 2008. On December 16, it raised the fed funds rate by 0.25%, to a target range of 0.25%–0.5%. Investors had been expecting this, and global stock markets signaled their immediate approval by moving higher on the day. However, stocks fell back sharply over the following days, ending slightly up for the year.

First Fed Funds Rate Increase in Nearly a Decade



Source: Board of Governors of the Federal Reserve System. Data as of 12/31/2015.

More important than the impact of a 25-basis-point increase, the Fed emphasized they expect the pace of future rate increases to likely be very gradual, given their expectation of continued restrained inflation. Specifically, the median Federal Open Market Committee participant forecast is for the fed funds rate to rise one percentage point, to 1.375% by the end of 2016, and then to 2.375% by the end of 2017. This implies four quarter-point rate increases each year, a much shallower path than has historically been the case once the Fed embarks on a tightening of monetary policy. Meanwhile, the bond markets are discounting an even slower and shallower path, along the lines of just two 25-bps rate hikes next year. It will be interesting to see how that expectations gap between the Fed and the market adjusts. If the Fed actually ends up raising rates four times next year, financial markets may not respond positively.

Meanwhile, despite the improvements on the macroeconomic front, the U.S. stock market was slightly positive, posting its worst return since 2008. This is not necessarily surprising, as the economic cycle and the stock market cycle do not move in lockstep. At this point in the market cycle, good news for Main Street (e.g., stronger wage growth due to a tighter labor market) is not necessarily good news for Wall Street (corporate profit margins are hurt when wages rise), at least over the shorter term.

S&P 500 earnings growth was disappointing in 2015. Expectations of 6-8% growth at the start of the year were wiped out due to the collapse of earnings in the energy space and a stronger dollar. That the S&P 500 held up as well as it did in the face of this sharp and unexpected earnings drop suggests investors are expecting a strong rebound in earnings next year.

Outlook

Expectations for earnings growth at the start of 2016 are much the same as 2015 – mid to upper single digit growth. Over time, the market will follow the growth trajectory in earnings. However, as we just cited during 2015, that growth was eroded during the course of the year due to the fallout in the energy sector and a stronger dollar impacting the bottom lines of U.S. multinationals. Since companies in the energy space have cut costs back in a material way and the price of oil has fallen 70% over the past two years, it is hard to believe that the sector's earnings would have a material collapse in 2016, at least not to the extent in 2015. Even if that happened, energy accounts for half of its S&P weighting that it had at the start of 2015, so the impact would be less. The dollar, which strengthened against most currencies in 2015, is unlikely to see a similar rise in 2016, in our opinion. Imagine if the dollar weakened! If earnings expectations were to fall in 2016, we believe it has to come from different influences compared to what we experienced in 2015.

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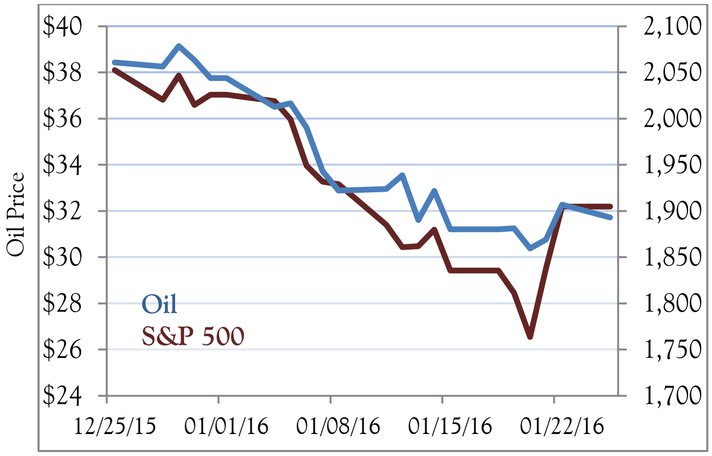
In the short-run, the market is strongly tied to the price of oil. The chart below shows the market moving almost in lockstep with the price of oil for the past month.



Source: FactSet

Why? Well, if oil is falling, some say it is a slowing in demand and a sign that global economies are continuing to slow beyond current expectations. Sure, we agree, that a slowing in the global economies is apparent, but how much? China's real growth fell to 6.9%, down from just 7.3% a year ago. (If one believes the numbers reported by China are real.) How much of the slowdown is already priced in? We believe the *supply* of oil is having a larger impact compared to demand. The shale companies in the U.S. will not stop drilling. It is better to continue to drill, even at a loss, than not to drill and have larger losses. Saudi Arabia has made it clear it will not give up market share and will continue to produce oil and finally, the Iranians have been cleared to supply oil to the global markets. That is a lot of oil being produced regardless of the economics.

If we are right and oil is falling due to supply concerns and less so on demand, then the market is providing an opportunity for investors as recent declines in the market are an overreaction to the decline in oil prices. And, at some point, we believe, investors will start to focus on the benefits of lower oil prices rippling through the economy. Cruise lines, airlines, manufacturers that use oil as an input in their manufacturing process and restaurants (and other industries exposed to consumer spending) will benefit from lower oil prices. Perhaps that accounts for the recent strength in McDonalds' results of late.

U.S. real GDP growth in the U.S. should be around 2.0% for 2015, slightly less than the 2.5% reported in 2013 and 2014. This still represents growth and we believe these expectations will rise during 2016 leading to market returns in line with earnings growth of 6% plus a 2% yield for a total return expectation of 6-10%.

The bond market, as stated earlier, is not pricing rate increases in, to the extent the FOMC participants have forecasted. In other words, the bond market doesn't believe the economy will grow to such an extent that it warrants four rate hikes. We don't either. The economy's growth is not high enough to justify even multiple increases in 2016, in our opinion. We feel the Fed's rate hike in December was done more to placate market participant's expectations and maintain credibility instead of basing the decision on market fundamentals. Bonds, however, remain an important component of most investor's portfolios. Credit spreads (the difference in yield between a corporate bond and a U.S. Treasury of similar maturity) have widened over the past year, allowing bond investors to realize higher interest income in this asset class. Ten year investment grade bonds yield 4.0%, a doubling of rates compared to the 2.1% yield in the Treasury market. We expect higher yields in the bond market to offset any drop in price due to gradual rate increases in 2016, at least for bonds of shorter maturities.

Concluding Comments

We aren't sad to say goodbye to 2015. While the global economy trudged ahead, it was a difficult year for most major asset classes and financial markets. However, as we all know, markets do not go up in a straight line forever. In fact, most market advances have been preceded by a sideways movement, or consolidation period, setting the stage for the next bull market. The market's break, if you will, is a healthy one after strong returns since the bottom in 2009. We rely on the belief that earnings growth will ultimately drive this market higher as it always has.