First Quarter 2016 Financial Market Commentary

April, 2016

The Very Unloved Bull Market Rolls On

After falling precipitously over the first six weeks of 2016 on concerns the U.S. economy could be moving towards a recession, stocks rebounded sharply during the second half of the quarter as economic data proved the U.S. economy's resilience despite slowdowns in China, Japan, and Europe. The S&P 500 Index fell 10.5% through February 11th and then rose nearly 13% to close the quarter with a positive total return of 1.31% **(See Table #1)**.

Real Estate Investment Trusts (REITs) and Emerging Market stocks were the top performers during the quarter while International stocks, Commodities, and U.S. Small Cap stocks all declined. All primary bond sectors were higher for the quarter led by High Yield and Investment Grade Corporate bonds. **(See Tables #1 & #2)**.

The rebound in risk-based assets occurred as oil prices surged 25%, concerns over mass defaults among energy producers eased, the European Central Bank (ECB) and Bank of Japan (BOJ) both promised more easing measures, and the Fed signaled a slower pace of interest rate increases. The People's Bank of China (PBOC) enacted more monetary policy measures aimed at stimulating growth. In the U.S., manufacturing data started to improve while consumer spending has been increasing at a moderate pace.

TABLE #1: 2016 1st Quarter and 1 Year Ending March 31st - Asset Class Index Total Returns*

	Large Cap Stocks	Mid-Cap Stocks	Small Cap Stocks	Int'l Stocks	Emerging Stocks	Intermediate Bonds	High Yield Bonds	Real Estate (REITs)	Preferred Stocks	Commodities	Cash
1Q 2016	1.31%	3.75%	-1.55%	-2.89%	5.67%	2.44%	3.00%	5.84%	1.60%	-2.50%	0.07%
1YR 3/31/16	1.77%	-3.60%	-9.77%	-7.76%	-11.71%	2.10%	-4.01%	4.66%	5.72%	-28.67%	0.12%

TABLE #2: 2016 1st Quarter and 1 Year Ending March 31st – Bond Sector Index Total Returns*

	U.S. Treasuries 1-10yr	U.S. Agencies 1-10yr	Corporate Bonds 1-10yr	Mortgage-Backed Securities (MBS) 0-10yr	Municipal Bonds 1-10yr
1Q 2016	2.31%	1.53%	2.82%	1.95%	1.12%
1 YR 3/31/16	2.22%	1.70%	1.94%	2.41%	2.60%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

March 9th of last month marked the 7 year anniversary of the bull market in U.S. stocks. Although this rally in stock prices holds the distinction of being one of the longest in the history of stock markets, it is also one of the most unloved. Investors who have long worried about the bull market's sustainability have found little reason to cheer up following the intense volatility that occurred during the first six weeks of 2016. Despite the fact that 28 of the world's 63 major stock indexes are currently in bull markets with another 10 indexes close to joining them, investors are pulling money out of stocks at an unprecedented rate. Individuals have taken a net $130 billion from mutual and

exchange-traded equity funds in the past year. Investors continue to question the strength of the rally in stock prices because of lower expectations for corporate earnings. Many analysts are waiting to see stronger proof of improving economic activity before raising their projections.

During the month of March, stocks benefited from seller's exhaustion and stabilization in the price of oil. Stocks appear to be building a base after several weeks of volatility. The S&P 500 Index may have entered a temporary trading range, with the floor set by hopes for profit improvement encouraged by a weaker U.S. dollar, stabilization in the price of oil, and easier monetary conditions in the upcoming quarters. In general, **recent economic data including strength in the February and March employment reports and the ISM Manufacturing Index point to a U.S. economy that remains in solid shape and suggests that recession risks have eased considerably. We believe the preconditions for a sharp economic downturn in the U.S. economy are not in place.**

For a bull market to be healthy there needs to be a series of corrections along the way so that there is not too much speculative excess built up in the market. Although the S&P 500 Index hasn't seen a new high in 10 months, we expect corporate profits to bottom in the first half of this year and then begin to improve in the second half of the year as the U.S. economy strengthens and the drag from a stronger dollar and lower oil prices diminishes.
Stocks should break out of this trading range as earnings growth returns. While many investors have remained on the sidelines, they may feel compelled to jump back in once the market reaches new highs. **An improvement in corporate earnings will be the key to pushing stock prices higher.**

During the quarter we completed a few tactical moves across asset allocation strategy accounts. First, we reduced exposure to International Developed Market (Europe and Japan) stocks from overweight to equal weight to strategic target allocations across all strategies. We accomplished this by selling a portion of our holding in the Vanguard FTSE Developed Markets ETF (ticker symbol VEA). Sales proceeds were invested in cash.

We removed the overweight position to international developed market stocks because the strength of the sell signal generated by our technical analysis model warranted such a move. In addition, the East Asian countries of Japan, South Korea, and Hong Kong make up 30% of VEA. Struggling growth led the Bank of Japan to announce that it is adopting a negative interest rate policy in its ongoing quest to fight deflation.

Japan's leading economic indicators rolled over while inflation expectations have been falling. Moreover, Japan's currency, the yen, has been rallying, with the trade-weighted currency rising nearly 9% over the span of six weeks ending 3/31/16. A weakening economy combined with a strengthening currency is not supportive of stock prices.

Secondly, we added a small position in VWO (Vanguard FTSE Emerging Markets ETF). Having eliminated all direct exposure to Emerging Markets stocks last year and recognizing that VWO was trading 32% below its 52 week high, we felt it was prudent to begin to add back exposure to this asset class. Funding for the purchase came from cash.

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With all 3 of our tactical indicators (fundamental, valuation, and technical analysis) directing us to increase exposure to U.S. Mid Cap stocks, we raised exposure to this asset class across all asset allocation strategies from underweight to equal-weight to the strategic target. We accomplished this by buying more IJH (IShares Core S&P Mid-Cap ETF).

Lastly, we increased exposure to the real estate sector by purchasing more ICF (IShares Cohen & Steers REIT ETF) in Conservative, Moderate, and Aggressive asset allocation strategies. We still have a slight underweight to the strategic target for the real estate sector. The purchase was funded by cash. ICF's current dividend yield is 4.20%.

The pace and magnitude of Fed interest rate increases will be extremely slow and low due to low inflation, economic weakness in Europe, Japan, and China, reduced investment demand relative to desired savings, and our belief that the U.S. and global economy can't withstand successive series of interest rate increases over the next year or two.

At its March 16th Federal Open Market Committee meeting, the Fed helped to validate our thinking. They did not raise borrowing costs and scaled back forecasts for how high interest rates will rise this year, citing the potential impact from weaker global growth and financial market turmoil on the U.S. economy. In their released statement they said ***"the committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen. However, global economic and financial developments continue to pose risks."*** Fed policy makers' updated quarterly projections saw the fed funds rate at 0.875% at the end of 2016. This implies two 0.25% increases for this year, down from four increases forecast back in December of last year.

The key to future financial markets' performance will be the Fed's ability to communicate a very complex monetary policy shift from an unprecedented level of easing to the early stages of policy tightening. This situation is made more difficult by the fact that the ECB, BOJ, and PBOC are all still focused on easing monetary policy to promote economic growth. Low inflation, a strong U.S. dollar, and economic weakness abroad argue against the need for any significant interest rate increases. Inflation should be held in check by low oil prices and such structural global deflationary forces as excess savings, aging demographics, declining birth rates, and rising life expectancies.

We continue to believe that stocks will outperform bonds and cash this year. However, bouts of volatility will likely continue until global economic conditions and corporate earnings improve. Until such time, we will remain defensively positioned and wait for further strengthening in global economic fundamentals and confirmation from our proprietary technical analysis model before moving to an overweight position in risk-based assets.

Andrew Zimmerman – Chief Investment Strategist

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