Fourth Quarter 2015 Financial Market Commentary

January, 2016

How Gradual is Gradual

Despite rallying in the fourth quarter, global stocks ended the year in negative territory on a price return basis. When adding back dividend income, the S&P 500 Index closed the year with a total return of 1.37% while most other risk-based assets were down for 2015 **(See Table #1)**. The exceptions were REITs and preferred stocks which both offer attractive dividend yields compared to other risk-based assets and bonds.

Emerging markets stocks and commodities led the decliners as the U.S. dollar rose sharply for a second straight year while the trade-weighted price of oil dropped 30%. Since the beginning of 2014, the U.S. dollar has risen over 22% and the price of oil has dropped 57%. Both events negatively impacted corporate earnings during the year. Investor uncertainty regarding the prospects for Fed tightening didn't help matters as market sentiment and breadth (# of stocks advancing vs. declining) were very poor. Concerns that an economic slowdown in the world's second largest economy (China) will spread to weaken global growth were also reflected in risk-based asset performance.

The U.S. bond market didn't move much in 2015 despite the fact that the labor market strengthened and the Fed raised interest rates for the first time since June 2006. The yield on the 10 year maturity U.S. Treasury Note rose only 0.10% in 2015 to close the year at 2.27%. All investment grade fixed income asset classes finished the year with very low single digit total returns led by municipal bonds and mortgage-backed securities **(See Table #2)**. The municipal market enjoyed a very good year on a risk-adjusted basis versus almost every other asset class due to decreased supply and a continued increase in demand by investors searching for a solution to a continual and seemingly unending growth in taxes. Credit fundamentals for many cities and states strengthened in 2015 given increased tax receipts and defaults were extremely low.

TABLE #1: 2015 4th Quarter and 1 Year Ending December 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
4Q 2015	7.03%	2.61%	3.60%	4.81%	-18.23%	-0.66%	-2.09%	7.68%	3.46%	-16.63%	0.03%
1YR 12/31/15	1.37%	-2.18%	-4.41%	-0.65%	-15.09%	1.17%	-4.62%	2.83%	7.58%	-32.86%	0.05%

TABLE #2: 2015 4th Quarter and 1 Year Ending December 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
4Q 2015	-0.86%	-0.53%	-0.35%	-0.06%	0.68%
1 YR 12/31/15	1.24%	1.19%	1.06%	1.46%	2.12%

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

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As was widely expected, the Fed raised the overnight Fed Funds rate by (25 bps) on 12/16/15. It was the first rate increase since 6/29/06. ***Chair Yellen stated that this initial rate increase will be followed by "gradual" tightening as officials watch for evidence of higher inflation. The FOMC committee "currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen."***

The Fed expects to raise the Fed Funds rate 4 times in 25 basis point increments in 2016 bringing the rate to 1.375%. ***Market participants, including ourselves, think the Fed with raise rates only 2 times in 25 basis point increments in 2016 bringing the rate to 1%. We don't believe the U.S. or global economy can withstand a successive series of interest rate increases over the next year or two.*** Low inflation, a strong U.S. dollar, and economic weakness in Europe, Japan, and China (our largest trading partners) argue against the need for any significant interest rate increases. Low oil prices will help hold inflation down along with such structural global deflationary forces as excess savings, aging demographics, declining birth rates, rising life expectancies, and restrictive fiscal policies.

Global economic growth has been slow and uneven since the end of the Great Recession in 2008 primarily because of the large global savings glut. Today's low interest rates are primarily the result of this savings glut. Going forward, global savings may not decline very much because households in the U.S., Europe, and Japan remain averse to taking on new debt. Emerging Markets are beginning to hit a borrowing wall. China's government is trying to discourage/reduce household and business borrowing.

In the 7 years following the Great Recession of 2008, savings has been primarily invested in financial assets (stocks, bonds, money markets) and not back into the economy via capital expenditures (capex) by businesses, businesses hiring more workers, and consumers consuming. What the global economy needs is an increase in investment spending from savings to drive economic growth. However, investment spending has been on the decline in the Developed World. It is beginning to decline in Emerging Markets. Interest rates should remain low for a long time due to reduced investment demand relative to desired savings.

During the quarter we completed a few tactical moves across asset allocation strategy accounts. We sold our entire position in **VWO** (Vanguard FTSE Emerging Markets ETF). Emerging market stocks may continue to underperform developed market stocks, given the stressed macro environment in China, weakness in commodity prices, and U.S. dollar strength. **VWO** was one of a few positions held in portfolios that had a long-term capital loss. Therefore, by eliminating all exposure, most taxable accounts will be able to use this long-term capital loss to offset long-term capital gains taken earlier this year.

Next, we sold all exposure to **JSOSX** (JP Morgan Strategic Income Opportunities Fund). We believe that interest rates will remain low for a very long time. In a very slow growth global economic environment, this fund will struggle to find good opportunities in the bond sector and its hedge against higher interest rates will not be needed.

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Proceeds from this sale were invested in 3 different securities. First, we raised our exposure in High Yield debt to equal weight to the strategic target by adding to our current position in **JNK** (SPDR Barclays High Yield Bond ETF). The fourth quarter turmoil in the high yield bond markets was primarily the result of forced selling in distressed debt, privately-held, illiquid funds and not publicly-issued corporate debt from non-investment grade publicly-traded companies – the type of bonds owned by **JNK**. This recent stress in high yield bonds will not lead to a credit-induced economic slowdown. Therefore, we viewed this dislocation as a great opportunity to add to our High Yield bond allocation. We also increased existing allocations to **DBLTX** (Double Total Return Bond Fund), **AGG** (IShares Core U.S. Aggregate Bond ETF) and individual corporate and municipal bonds.

We then sold all exposure to **IAU** (IShares Gold Trust ETF). The combination of a strong U.S. dollar and deflationary global forces is providing a very powerful headwind for gold prices. **IAU** was one of few positions held in portfolios that had a long-term capital loss. Therefore, by eliminating all exposure at this time, most taxable accounts will be able to use this long-term capital loss to offset long-term capital gains taken earlier this year. Proceeds of the sale were used to initiate a position in **ICF** (IShares Cohen & Steers REIT ETF). **ICF** holds only the 30 largest REITs. It is constructed to capitalize on further securitization of the U.S. real estate market, with the belief that the largest firms will be the best positioned to grow as the market consolidates.

Uncertainty, volatility, and skittish markets may become the norm over the next few months as investors wait to see how the Fed manages U.S. monetary policy. 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. The price of oil, after declining over the past 2 years, will begin to bottom and stabilize as U.S. and non-OPEC countries are planning supply cuts for 2016. The pace of U.S. dollar appreciation should begin to slow as global investors come to the realization that the Fed will not be able to raise interest rates very much. The Chinese economy should continue to avoid a hard landing.

We look for stocks, particularly U.S. and European markets, to outperform bonds and cash in the coming months. The global economy will continue to slowly recover, earnings yields on stocks are much higher (more attractive) than bond yields, and stock market sentiment is very negative, which is usually, a very good contrarian indicator for the future direction of prices. However, stock price appreciation could be slow and volatile, warranting a defensive position. Income may become a larger portion of total return than principal growth in the coming year as financial assets with relatively higher yields/dividends outperform more aggressive growth-oriented assets.

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