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2016 Outlook

January 8, 2016

As we begin a new year, I wanted to share some thoughts about the year just completed and provide some insight as to possible market influences going forward.

Looking Back

2015 was really a year to forget in the equity and bond markets. Even though the S&P 500 eked out a fractional gain for the year, that was largely due to a relatively small number of mega-cap stocks. Looking at the broader picture, most markets showed losses for the year. The Russell 3000 Value Index returned a loss of 5.83% while the Russell 2000 Index of small-cap stocks was down over 6%. Overseas, the International Developed Markets Index (MSCI EAFE) was down 3.4% and the MSCI Emerging Markets Index declined by 17.3%.

In the fixed income category, the year-long threat of the Fed raising short-term interest rates proved to be negative for bonds. Bond fund values declined marginally throughout the year although interest income generally more than offset those losses. Still, 2015 would have to be considered an off year for bonds.

What Lies Ahead

At the time of this writing, 2016 has started out on a sour note as equity markets have fallen about 5% in the first 4 trading days of the year. This has largely been a reaction to continuing reports of a slowing growth rate of the Chinese economy as well as another surprise devaluation of that country's currency. Also contributing to the stock market's volatility has been the ongoing decline in the price of oil.

There are reasons to argue that equity markets could see better times ahead regardless of the recent volatility. On the topic of oil prices, we have seen a huge price decline since the beginning of last summer. Oil fell from the mid $60s per barrel in June to the recent low near $33. That kind of decline simply cannot continue indefinitely. There certainly will be some price point where oil will stabilize. With inventories at record levels, storage facilities are nearing capacity and once that happens, production will have to level off. Already, the

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number of producing well in the US has declined significantly over the past year. At some point in the future after the price of oil has bottomed out, demand will eventually catch up with output and we will see prices begin to rise. The timing and the rate of increase, of course, remain to be seen.

There is also reason for optimism in the overall economy. According to data compiled by Standards and Poor's, operating earnings of companies in the S&P 500 (excluding the energy sector) are estimated to have increased by 6% in 2015 over the previous year. However, for 2016, S&P analysts project operating earnings in the S&P 500 will increase by 18% over 2015. Certainly there is no guarantee that stock prices will rise in proportion to earnings. In fact, stock prices in the short-term sometimes seem to be completely non-correlated to business profits. However, over longer time periods, US stocks do tend to mirror the financial health of US businesses. Globally, the International Monetary Fund (IMF) expects the global economy to grow at a rate of 3.6% in 2016 compared to a projected 3.1% for 2015.

In addition to an improving overall economy, certain sectors continue to lead. The US housing sector continues to be a bright spot along with the auto industry which has had a solid recovery since the end of the Great Recession. Historically low interest rates have undoubtedly contributed to this growth. The labor market has slowly but surely continued to improve although wage growth is only just beginning to show gains.

After the Federal Reserve increased short-term interest rates by a quarter of a point in December, expectations are that the committee will take a very gradual approach to further tightening over the next few years. Historically, stocks have tended to perform well during periods of slowly rising rates. Although not expected, a faster pace of interest rate hikes might tend to derail the ongoing economic expansion. On the other hand, the negative effects of gradual interest rate increases on US companies is likely to be offset by the anticipated ongoing environment of low commodity prices.

Continued Risk of Volatility

The current bull market is approaching seven years which is quite long by historical standards. This fact combined with fears about the global economy, particularly the effect that China will have on the rest of the world, naturally raises concern about the possibility of a significant market correction. Certainly, even without such a correction, there are still expectations of periods of market volatility. Volatility is quite challenging to investors as every time markets drop suddenly by a few percentage points, one tends to expect the worst. However, selling after short-term declines out of fear is never the appropriate action for long-term investors.

As always, I continue to monitor your investments and watch markets closely. I greatly appreciate your trust and patience, especially during times when markets are as challenging as they have been lately. Don't hesitate to call or email if you have questions or concerns.

Sincerely,

Steven L. Holmes

The views are those of Steven L. Holmes and should not be construed as investment advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. Past performance does not guarantee future results. Investors cannot directly invest in indices.

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