Q4|2015 Commentary

Overview

As another eventful year has come to an end, the global markets remain volatile and face many headwinds. During the quarter, developed market stocks rebounded sharply (from an awful 3rd quarter), bonds were mixed, and commodities struggled. For the first time in over a decade, the U.S. Federal Reserve (Fed) raised short-term rates.

After correcting by more than 10% during Q3, the bellwether S&P 500 index rallied hard during the 4th quarter and just managed to finish in the green for the year, with dividends included. Without dividends, the S&P was slightly negative for the year, a headline you may see to start the New Year.

For 2015, there were no asset class stand-outs. International stocks finished strong but gave up their gains and ended in the red. Small cap stocks, emerging markets, and commodities did poorly. Core bonds added very little and high yield bonds struggled. 2016 stands to be another interesting year as many enduring issues remain.

U.S. Economy

The U.S. economy continues to grow at a modest pace and expanded at an annualized real rate of **2.0%** in Q3.[1] The U.S. consumer continues to drive growth; however, increasing business inventories and a strong U.S. dollar point towards the potential for future economic weakness.

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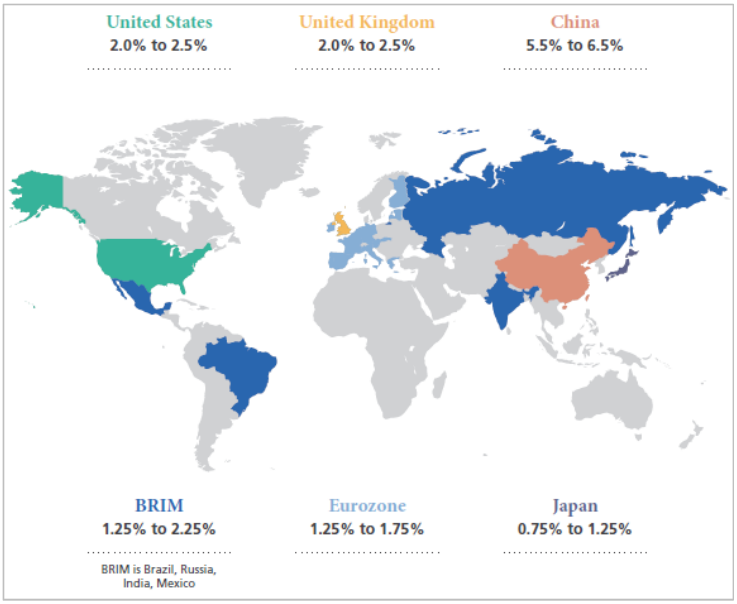
The labor and housing markets remain strong and have been consistent bright spots within the domestic landscape. Jobless claims continue to trend downward and the unemployment rate stands at **5.0%** with a **62.5%** labor participation rate.[2] Additionally, housing starts continue to trend positively and existing home sales remain firm.

Looking into 2016, the U.S. economy remains relatively healthy which was the catalyst for the Fed to raise short-term rates in December. Although many pundits are concerned that the global economy can't withstand a rate hike, we think it was good decision and could have a positive impact. In fact, it may actually spur growth as first-time home buyers and other consumers move to make previously delayed purchases. In addition, savers may start to once again earn interest on their cash - potentially increasing consumer confidence. Overall, the Fed is unlikely to raise rates too quickly, and although economic headwinds exist - the odds of a near-term recession remain very low.

Chart 1



Source: PIMCO.

Global Economy

Looking abroad, the global outlook remains diverse (see Chart 1). The Eurozone continues to muddle along but is slowly making headway. Their central bank, the European Central Bank (ECB), remains determined to spawn economic growth and is

committed to doing whatever it takes. They continue to use quantitative easing programs and have even introduced negative interest rates to encourage bank lending. As of now, it appears to be working as the Eurozone economy is expected to grow bewtween 1.25 - 1.75% over the next 12 months.[3]

Asia remains weak as Japan and China struggle with falling global demand. However, both the Bank of Japan (BOJ) and Peoples Bank of China (PBOC) remain steadfast in their desire to encourage growth through monetary easing. Each central bank has continued using large scale programs in an attempt to boost productivity and stimulate demand.

Lastly, the emerging markets and frontier markets continue to show little signs of recovery. As we noted last quarter, weak foreign demand, persistently low commodity prices, and capital outflows have all created headwinds for countries in these areas. These issues, coupled with a strong U.S. dollar and rising rates, are likely to persist.

U.S. Equities

U.S. stocks rallied hard during the quarter and made up a lot of the ground lost during Q3. The S&P 500 index (large caps) and Russell 2000 index (small caps) finished the quarter up **7.04%** and **3.59%**, respectively.[4] However, only the S&P 500 produced gains strong enough to finish the year positive as each finished 2015 up **1.38%** and down **-4.41%**, respectively.[5]

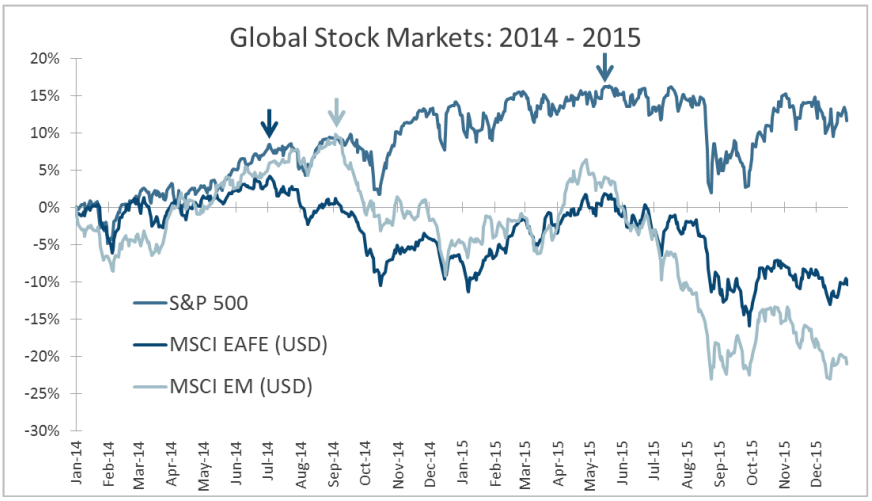
Looking ahead to 2016, the outlook for the U.S. markets remains questionable. The current bull market is now over 7 years old and appears to be growing tired. More specifically, fewer and fewer large stocks are driving the market's returns. This is known as narrowing breadth and suggests that the market may be weakening. Furthermore, the S&P 500 has not made new highs since May of 2015 and it has been even longer for many other indexes (see corresponding arrows on chart 2). Lastly, current fundamental valuations such as price-to-earnings are not conducive of strong future returns. Even so, the market is still within a stones throw of new all-time-highs and could easily move higher from here. We remain optimistic but realize that bull markets don't last forever.

International Equities

The international developed markets, represented by the MSCI EAFE index, ended the quarter and year up **4.71%** and down **0.81%**, respectively.[6] Generally speaking, the international developed indexes tend to trade in line with the U.S. markets and this is likely to remain true going forward. Similar to the S&P 500, the MSCI EAFE has not made new recent highs (see corresponding arrows on chart 2) and appears vulnerable.

Emerging Market (EM) and Frontier Market (FM) equities, as represented by the MSCI EM index and MSCI FM Index, finished Q4 up **0.66%** and down **0.45%**, respectively, and down **14.92%** and **13.80%** for 2015.[7] Investor sentiment towards these

Chart 2



Source: St. Louis Federal Reserve, MSCI, Wealth & Pension Services Group.

markets remains very negative; however, valuations are starting to become more attractive and technically they are somewhat oversold. Looking ahead, these markets have the potential to bottom during the next 12 months.

Fixed Income

Bonds and interest rates continued to garner attention during the quarter as the Fed embarked on its first rate hike in over 10 years. The U.S. 10-year Treasury index (10-yr) finished the quarter higher at **2.27%** as U.S. stocks rallied and treasuries were sold.[8] This led the Barclays US Aggregate Bond Index to finish the quarter down a modest **0.57%** and up **0.55%** for the year.[9]

Riskier areas of the bond market struggled during the quarter and 2015 as a whole. The Barclays Corporate High Yield Bond Index ended Q4 down **2.07%** and down **4.47%** for the year.[10] This weakness has led many experts to predict that stocks will follow high yield bonds lower and underperform in 2016 (credit related bonds such as high yield have historically led stocks). Lastly, the Barclays Global Aggregate ex-USD Bond Index finished Q4 and 2015 down **1.26%** and **6.02%**, mainly due to U.S. dollar strength.[11]

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The outlook for bonds is mixed but much clearer than last quarter. From here, we expect to see short-term rates continue to rise as the Fed hikes rates over the next few quarters. On the longer end, we see long-term rates remaining stable or even coming down as global demand for U.S. bonds remains strong. High yield bonds no longer look attractive and contain significant headline risk. Finally, international developed interest rates are at historic lows and EM growth remains relatively weak - making these bond markets appear unattractive at their current levels.

Commodities

Commodities, as represented by the Bloomberg Commodity Index, continued to underperform and finished the quarter and year down **10.52%** and **24.66%**, respectively.[12] During the quarter, the index actually made a new 16-year low going back to 1999.[13] Experts speculate that decreased demand from China, a global supply glut, improved technology, and a stronger U.S. dollar have all played their part in pushing prices lower. During the quarter and year, the U.S. dollar rose **2.30%** and **7.80%**, respectively.[14] These lingering issues have been a headwind for the commodity market over the last few years and are not likely to abate anytime soon. However, areas such as energy and precious metals are starting to look interesting and may prove to be good places to invest in 2016.

Outlook

As we look into 2016, many ongoing issues have yet to be resolved and new concerns have emerged. The current bull market in stocks is over seven years old and growing tired, market jitters may increase due to the Federal Reserve starting a new rate hiking cycle, and the global economy remains fragile. Even so, opportunities exist within this highly volatile landscape. We remain long-term bulls but with a cautiously optimistic view of the markets. Going forward, we plan to continue focusing on effective risk-management and attempting to reduce volatility to the downside.

As always, please feel free to contact us with any questions you may have.

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Source:

1. bloomberg.com/markets/economic-calendar
2. Ibid
3. PIMCO
4. Morningstar
5. Ibid
6. Ibid
7. Ibid
8. Ibid
9. Ibid
10. Ibid
11. Ibid
12. Ibid
13. Zerohedge.com
14. Morningstar

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