WealthHealth
Personal Wealth Management

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Market Review

Overall, 2015 was a challenging year, with poor returns from 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, 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.

Outside the United States, regaining more normal economic growth and inflation has remained 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 0.81% while emerging markets fared worse, falling 14.92%.

The worst-performing areas of the markets were commodity-related asset classes. Commodity indexes were crushed, down 25%, as oil prices hit an 11-year low in December and fell 30% for the year, after plunging 50% in 2014. Energy MLPs, an increasingly popular vehicle for yield seekers (and yield chasers), dropped 35%–40%, wiping out the previous four years' worth of gains.

Fixed-income offered little respite, with the core bond index gaining just 0.55%. 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 3.30% on the year.

Index Returns *Through 12/31/2015*

			Annualized Returns		
Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	7.04%	1.38%	1.38%	15.13%	12.57%
Russell 2000	3.59%	-4.41%	-4.41%	11.65%	9.19%
MSCI EAFE	4.71%	-0.81%	-0.81%	5.01%	3.60%
MSCI All Country World Index	4.90%	-2.16%	-2.16%	7.87%	6.10%
MSCI Emerging Markets Index	0.66%	-14.92%	-14.92%	-6.76%	-4.81%
Barclay Capital US Aggregate Bond	-0.57%	0.55%	0.55%	1.44%	3.25%
Barclay Capital Municipals	1.50%	3.30%	3.30%	3.16%	5.35%
Bloomberg Commodity Index	-10.52%	-24.66%	-24.66%	-17.29%	-13.47%
HFRI Fund of Funds Composite Index	0.62%	-0.36%	-0.36%	3.92%	2.08%

As we write this newsletter, the challenges have continued at an even greater pace to start 2016, due in large part to several key macroeconomic issues – uncertainty regarding the Fed's decision to raise interest rates, the impact on corporate profits from a 30% decline in oil prices and a rising US dollar, and questions about China's economic growth.

While these concerns are realities, we believe there exists a disconnect between the economy and the financial markets. For the US economy, 2015 was not all bad. Although slower than historical averages, Real GDP (inflation adjusted) grew at a 2.2% annual rate (year over year through the 3rd quarter), better than most other developed economies which continue to struggle

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to recover from the financial crisis. Both the Eurozone and Japan grew by less than 2%, while Emerging market economies grew at approximately 4%, down from closer to 8% prior to the crisis. Overall Global GDP growth last year was about 3%, well below the 3.5% average global growth rate of the past 35 years.

The US labor market continued to strengthen during the year, with almost 3 million new jobs created during 2015 and the unemployment rate falling to 5%. The US Dollar remained strong as the Fiscal Deficit decreased to 2.5% of GDP, close to its historical average. All the while inflation, a key factor in the Fed's rate hike decision making, remained subdued.

Although this disconnect seems to have continued into 2016, we believe there are some reasons for optimism. In line with the positive US data mentioned above, 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. The Fed has indicated that four .25% rate hikes (for a total of 1%) were likely in 2016, a much slower pace of increase compared to historical tightening periods (average of 2.20% increase per year).

While the current level of oil prices has had a negative impact on corporate earnings, we feel that the oil imbalance will correct itself, with prices stabilizing between $40 - $50 per barrel. This price will still help to fuel consumer spending in the US and globally, especially in countries in Europe, Asia, and South America that are oil importers.

With respect to corporate earnings, we believe the impact of a stronger dollar and low oil prices is already reflected. Unless we see further declines in oil or dollar appreciation, we feel the impact is behind us. Current forecasts are for earnings increases in the US of over 7% in 2016.

With 2016 estimates of operating earnings per share on the S&P 500 from $125-$130, current Price-Earnings ratios for the S&P 500 are around 15x (below its long-term historical average). Given today's low yields and inflation, we see room for multiple expansion of P/E ratios, as investors should be more willing to pay more for these earnings.

Lastly, while we may be in the later innings of a bull market, we feel there is still some growth left and don't believe that we are on the verge of a recession. It is said that most economic recoveries are "killed by the Fed" by interest rate increases. However, as mentioned above, the Fed has indicated that it plans to gradually raise rates over a long period of time and that these rate increases will remain data dependent. Every post WWII recession was preceded by a rise in the Federal Funds rate to 2% or higher. With a current rate of .25% and the Fed's plans for slow hikes, we don't see the Feds actions as recovery killing.

Most recessions occur after periods of tight labor markets, high wage growth, high inflation, and high interest rates. Despite significant improvements in labor markets, slack still remains while inflation and interest rates remain historically low. In addition, flat or inverted yield curves often signal recessions, a risk which remains low as the spread between the 2 and 10-year treasury is over 1%.

Of the last 9 historical periods of interest rate increases, the median time from the first rate hike to the start of a recession has been 31 months. In addition, the time period from the first rate hike to the peak of the S&P 500 has been 16 months. Given the evidence above and reasonable stock valuations, we believe there is an opportunity for markets to get better before they get worse.

While quantitative easing has played a role in hurting currencies like the Euro and the Yen, we feel the monetary policy of the ECB and the Bank of Japan should continue to be a positive catalyst for these markets. Increases in exports due to depressed currencies should translate into greater earnings. As such, with reasonable valuations and increased earnings, returns from Europe and Japan should add value to portfolio returns in 2016.

Despite our optimism and belief that this bull market still has legs, we recognize that it will eventually end. With economic growth still slower than historical averages and rates increasing, the returns from US stocks seen in 2014 and earlier aren't likely to repeat. And while these returns may be less and markets may experience more volatility than recent years, we recommend staying invested in equites, as we find the alternatives (cash and bonds) to be less compelling investments at this time.

One overreaching theme we believe should continue is the strength of the consumer. With oil and gas prices at historically low levels and the dollar's rise, consumers should drive economic growth. In addition, with inflation at such low levels, we would favor stocks over bonds but recognize the value bonds add to a diversified portfolio. Although most sectors of the fixed income markets provided little relief in 2015, as core bonds, high yield, and floating rate bonds all fared poorly, bonds mitigate the risk of short term uncertainty and volatility that comes from owning stocks. Bonds have historically performed well relative to riskier assets like stocks in the event of a bear market. As such, bonds play a very important risk management role within the portfolio even though yields may not be very attractive.

Managing through periods of disruptions has historically caused market volatility. Such volatility can cause investors to make poor decisions, often reacting to short term events. To put this into perspective, if you were to remove the best 60 months of performance from the S&P 500 index since 1926, the average return for the remaining months is barely positive. Even being out of the market a matter of days can drastically impact your returns. We expect the potential for more disruptions and greater volatility as we move into this late stage recovery and strongly favor a well diversified investment portfolio and sticking to your strategy now more than ever. We caution clients to resist becoming impatient in a low return environment with increased volatility but rather emphasize revisiting your risk tolerance.

As always we are here to discuss you individual circumstances and thank you for your trust and patience during these tough times.

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