

4Q-2015 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- US Federal Reserve raised interest rates, +0.25%
- Stock markets were up in 4Q, bonds were down
- Global economic growth remains slow

Economy

Real gross domestic product (GDP) gained 2.0% in the 3rd quarter, a drop from the 3.9% gain through mid-year. But that didn't stop the Federal Reserve from raising rates by 0.25% in December for the first time in nine-years.

The Fed was running out of time to meet its promise; not only was the year about to end, but the recovery stage of the business cycle is in the late innings. The "data dependent" Fed was bailed out by stronger than expected employment data for November, allowing them to pull the lever on rates. This took some courage as inflation is hard to find and far from the fed's target of 2%. Commodity prices are still falling, and corporate profit growth has declined for the last two quarters.

That's ok. The move reinstated the Fed's credibility. If the jobs data really is improving, this is the time for the Fed to get out in front of the trend for a change. Moving to a tightening policy signals a belief in continued economic growth and we believe it's there.

But we are at a stage in the economic cycle where perceptions can change. The US economy has substantially recovered, earnings for a number of prominent companies and industries seem to have peaked, and global unrest dominates the news. Aggregate earnings data reflects sharp declines in commodity-related business results which will eventually stabilize.

We think economic growth is on solid footings. While energy and industrials have peaked, housing, banking and consumer sectors are still recovering. The recovery in Europe is gaining steam, but China will have to stabilize.

The benefits of lower commodities and an improved employment picture have bolstered the US consumer. As the massive deleveraging phase comes to an end, consumer spending should pick-up in 2016, sustaining growth in the economy.

Capital Markets

Stocks and bonds took the interest rate hike in stride, at first – it was clearly priced in. Nevertheless, continued geo-political events and a host of corporate earnings warnings kept volatility high through year-end.

Stocks rallied off September lows, gaining over 7% for the quarter. This lifted full-year returns from negative territory to +1.4% for the S&P 500 and +7.0% for the tech-heavy NASDAQ.

Major Index Returns	4Q-2015	YTD
Barclays 1-3 Yr. Tsy.	-0.4%	0.6%
Barclays Agg. Bond	-0.6%	0.6%
London Gold Fix	-5.0%	-10.9%
S&P 500	7.0%	1.4%
MSCI EAFE (Int'l.)	4.7%	-0.8%

The bond market was different. Short-term rates rose throughout the quarter, right into the Fed's move, while longer-term bonds held steady until later, when corporate and high yield bond prices dropped (yields rose) on concerns over default rates and an exodus of investors from mutual funds. Municipal bonds were the leaders, gaining 1.5% for the quarter and 3.3% for

the year. It's going to remain tough to make any money in bonds for a while as the Fed is on a path for 2-4 rate hikes over the next 12-months.

Small cap stocks got back some of their earlier losses to end the year down 4.4%. International markets were mostly positive despite the headline noise, but emerging markets remained generally weak.

The big stories in the 4th quarter and for the year were the strong performance of internet-related stocks and weakness in energy stocks. A few large, growth tech stocks were responsible for keeping the major US indexes in positive territory while the entire energy sector was a very big drag. This enabled the growth stock trend to extend its lead over the value stock category through year-end. In fact, our research that goes back to 1995, reveals that the current 16-month trend of growth outperforming value is the longest on record, eclipsing the 15-month "dot.com" bubble of 1998-99. However, the relative performance, of growth over value, ranks only 5th on the list at 11.6%, still more than 2-percentage points above the average trend gain.

We can't conclude that the growth trend is nearing an end, particularly if we believe consumer spending is poised to kick in. A change in trend from growth to value will be accompanied by a peak in earnings, which many are predicting, at which time investors will exit the past leaders and value will lead just by standing still.

Strategy

Our strategy for 2016 is influenced by our current market views:

- *China growth continues to decelerate*
- *Commodities remain correlated to China*
- *Oil prices should stabilize as supply comes off*
- *Some industries have seen peak profits this cycle*
- *US consumer is stronger than perceived*
- *Conditions are not present for a recession*
- *Europe's recovery is 2-years behind the US*

Concerns over China, the Middle East, and peak earnings in the US will lead to higher volatility in stock prices, but we think stocks will gain in 2016. Consumer spending will improve and borrowing will tick-up. As energy and agriculture prices settle, and start to go up, earnings in those industries will improve.

Developed international markets "feel" cheap but actually P/E ratios are close to those in the US as earnings have not been as strong. That should change as many foreign companies begin to benefit from lower energy prices and improved export competitiveness vs. the stronger US dollar.

Corporate bond yields rose in the wake of the junk bond market sell-off, leading to higher borrowing costs and fears over higher default rates. Concerns should peak in the first quarter.

Real estate appears investable following the recent budget agreement and tax law extensions, and prices will be supported by rising inflation.

G. Foley – January, 2016

Postscript- Prior to releasing our assessment and strategy piece, stock markets around the world dropped precipitously in the early days of 2016. No one really knows the cause but we offer the following: new year selling in the market seems caused by concerns over peak earnings, lower oil prices (lower energy stock prices have hurt the broad indexes, investors then sell the indexes which reduces all stock prices), and profit taking in the big winners of 2015 (investors postponed short-term gains until 2016). China plays a role, but that economy too, will stabilize, if not its stock market. Not every business in the world is affected by China. Our long-term investment strategy is not affected by these early days of the new year.