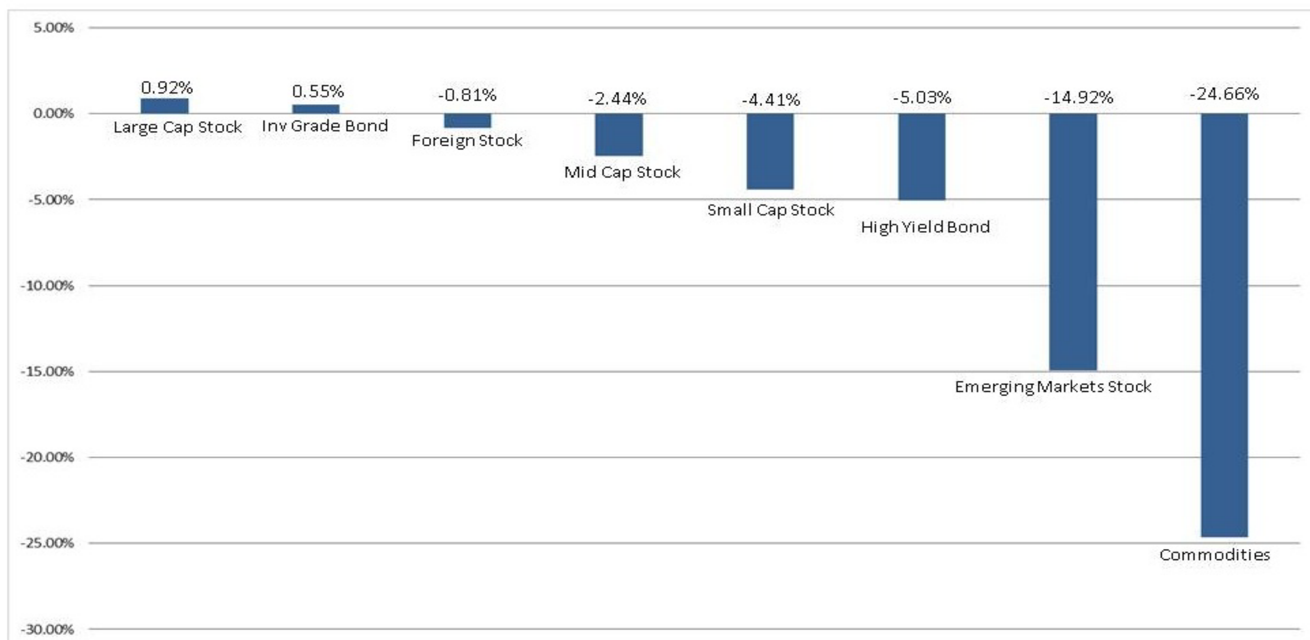
Happy New Year?

Calendar year 2015 delivered a somewhat negative result to most investors, but after the dramatic beginning to 2016, last year seems like very old news. As a consequence, it's tempting to jump right into current events, but let's first take a look back at the year just ended.

Despite surface appearances, it proved exceedingly difficult for most investors to escape red ink for their portfolio performance in calendar year 2015. In many respects, 2015 was a reprise of 2011: though the more visible U.S. large caps were essentially flat for the year, most other asset classes – including mid caps and small caps - were down, some dramatically. At least in 2011, bonds provided gains for those willing to assume the interest rate risk; in 2015, even investment grade bond funds struggled to break even, and most categories of bonds were losers.

Not even the large caps were a safe bet. The stock market was like an iceberg in 2015, with a relatively small tip above the surface, and the much larger body of stocks submerged well underneath. Trying to take a defensive approach was of little help, as the more conservative large cap value stocks were down significantly. Generally speaking, only a limited subset of growth stocks were significant winners in this challenging environment.



It seemed that practically the only way for most investors to have made any meaningful money in 2015 was to:

- Concentrate their portfolios in large cap U.S. growth stocks, or
- Invest very narrowly in only a handful of companies - and make sure to choose the right ones - during a period when the overwhelming majority of the equity universe was well underwater.

Unfortunately, neither of those approaches would have been prudent for the average investor.

As we headed into 2016, the “consensus” forecast – rarely correct - was that the market would likely produce only modest growth for the year, probably with some very volatile stretches along the way. The market wasted no time in confirming the last part of that prediction, at least. It is news to no one that we woke up on the first trading day of the new year to reports of Chinese markets in free fall. This appeared to spook U.S. markets into what one might judge to have been a significant overreaction, which, rational or not, gained fuel a couple of nights later when North Korea announced the testing of a hydrogen bomb. However, what quickly became most important was what was happening to the price of oil. Oil, which had begun to trend sharply lower again in November, suddenly plummeted to levels many had no longer believed possible, dropping relentlessly day after day, and apparently taking the equity markets with it, making the analysis of most other factors seem moot until the price of oil could stabilize.

When markets panic, it is important to mentally “slow the game down”. What created the environment in which these sparks were able to ignite, and more importantly, what do conditions suggest about where we go from here?

To begin, one can reasonably say that:

- Equity valuations had become stretched.
- After reaching record levels, corporate earnings have been declining.
- Without an expectation of renewed growth in corporate earnings, generous valuations cannot continue to be logically justified.

In this uneasy environment, the series of negative catalysts as the year began seems to have triggered a swift recalibration of equity prices by investors. That is a gross oversimplification of very complex market dynamics – which likely include no small amount of selling by large entities suddenly caught holding the wrong leveraged bets, among other things - but it probably captures to some extent the sudden desire of many investors to reduce their risk.

A “reset” of this nature – if that is what it ultimately proves to be - can be healthy in the long run, but it doesn’t feel that way as it is happening. So as equity prices have dropped, a general air of pessimism has ramped up very quickly. As has been true throughout the years following the financial crisis, there are ample negatives with which to make a more ominous case, but the economic picture has not to date deteriorated nearly so much as some seem to suggest. Certain data points have ticked down; others have ticked up. We have been carefully monitoring changes to the composite data on a day to day basis.

As of the end of the third week in January, the most we can objectively say is that the economy appeared to slow as we moved through the close of the year and into January. Global growth has also slowed somewhat overall, but has been reasonably stable on a composite basis and is showing no signs of any sharp downturn. Most of the suddenly headline-grabbing projections of a potential U.S. recession in the near future appear to rely upon at least a certain amount of speculation. It can certainly happen, but the much stronger probability based on quantifiable current conditions is that the economy continues to plod along at a modest pace during 2016.

From a market perspective, we find that the three big issues addressed in our last quarterly commentary remain primary in the minds of investors:

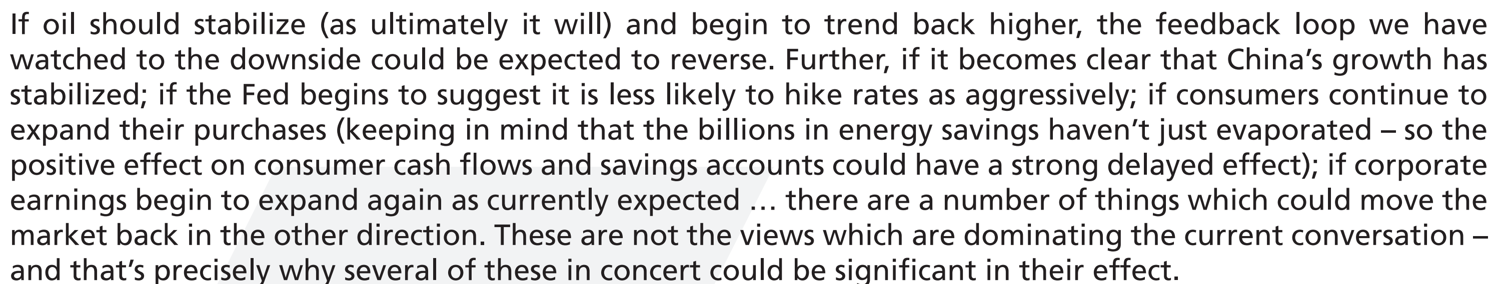
- As already noted, ***oil*** is a very big concern in the immediate sense, because its price appears to have been the primary factor driving markets of late. The relentless drive lower will end – unfortunately we do not know where or when, making near-term market predictions dicey at best. The direct effect of lower oil has a negative side and a positive side. It is immediately negative for energy companies and the jobs they provide; it is a positive for individual consumers and for companies which consume energy. With the savings from lower energy costs slow to show up in consumer spending, lower oil prices have been viewed by markets as a negative. The indirect effect of lower oil is on credit, as many energy producers which have incurred debt for their expansion will not be able to generate sufficient revenue at current prices to meet debt obligations. Following the experience with subprime lending leading to the financial crisis, investors are very sensitive to credit concerns. Thus, unlike 2008, it would be hard to say this is sneaking up on anyone. At the same time, the dynamic nature of the price of oil makes this a moving target, and we are monitoring closely.

- ***China*** does appear to be economically stabilizing, albeit at a materially slower pace of growth, and likely well below official Chinese government figures. China is a big economy with big issues, positive and negative. In context, however, their direct effect on the U.S. economy is very small. There are genuine credit and currency related concerns which could be more impactful to U.S. interests, but in general these are (a) not new and (b) subject to such significant speculation, misinformation, and misinterpretation as to call into question much of the value of the headline news for short term investment purposes.

- After vacillating for much of 2015 over whether to raise rates, the ***Federal Reserve*** finally acted in December, raising rates for the first time since before the financial crisis. There is no clear indication that this initial quarter point hike has had any material effect on either markets or economic activity. The big concern for financial markets is the pace of intended increases going forward. Suggestions by some Fed governors that they might be entering a more aggressive and sustained round of tightening has been a concern to financial markets, as material rate increases without commensurate expansion in U.S. economic activity could definitely stall the economy. As cautious as this Fed has been regarding rate increases, it seems unlikely they will materially tighten should the economy fail to show solid expansion moving forward, but this also bears close scrutiny.

So long as these and other factors are viewed with such uncertainty, markets can be expected to remain quite volatile. And markets gripped by either fear or euphoria can trend far in one direction or the other before the realities of valuation and economics restore equilibrium.

At present, markets have moved down quickly and dramatically. Valuations in general are still not low, but they are materially improved, and some things are indeed cheap. If this proves to be simply a material market correction - or even if it turns into a garden variety bear market - much of the decline has happened already.



If oil should stabilize (as ultimately it will) and begin to trend back higher, the feedback loop we have watched to the downside could be expected to reverse. Further, if it becomes clear that China's growth has stabilized; if the Fed begins to suggest it is less likely to hike rates as aggressively; if consumers continue to expand their purchases (keeping in mind that the billions in energy savings haven't just evaporated – so the positive effect on consumer cash flows and savings accounts could have a strong delayed effect); if corporate earnings begin to expand again as currently expected … there are a number of things which could move the market back in the other direction. These are not the views which are dominating the current conversation – and that's precisely why several of these in concert could be significant in their effect.

If, alternatively, negative conditions cascade much more seriously as a consequence of something like a meltdown in the European banking system, to name but one of multiple possibilities, the potential for a more severe and damaging bear market remains very real.

From our perspective, the more likely near-term scenario for equities – absent an additional "shock" - is to complete the current "reset" and then work their way higher again. However, oil remains a wild card, making current predictions of any kind even more speculative than usual. We continue to make carefully considered adjustments to allocations in a manner consistent with the discipline and objectives of each of our investment strategies, further tempering risk where it seems prudent while staying alert for reasonable opportunities created within the storm.

As we suggested last quarter, it is as important as ever for investors to position themselves appropriately with consideration for their investment time frames and their appetite for weathering sometimes significant turmoil. Investors who, in consultation with their advisor, seek to err on the side of caution have plenty of reason to take that approach in the increasingly unpredictable environment with which we have all been faced since the financial crisis. At the same time, there is room for optimism within an appropriately defined strategy and time frame, so long as there is clear-eyed recognition of risks and consistent execution of the strategy selected.

Illustrated returns come from the following indices:
Large Cap Stock – Russell 1000 Index – Designed to represent the universe of U.S. large company stocks.
Investment Grade Bond - Barclays U.S. Aggregate Bond Index – Used to represent intermediate term U.S. investment-grade bonds.
Foreign Stock - MSCI EAFE Index – Designed to represent the stocks of developed foreign countries in Europe, Australia, and the Far East.
Mid Cap Stock – Russell Mid Cap Index – Designed to represent the universe of U.S. mid cap stocks.
Small Cap Stock – Russell 2000 Index – Designed to represent the universe of U.S. small company stocks.
High Yield Bonds – Markit iBox USD Liquid High Yield – Designed to represent the universe of U.S. high yield bonds.
Emerging Markets Stock - MSCI Emerging Markets Index – Designed to represent the stocks of developing countries worldwide.
Commodities - Dow Jones-UBS Commodity Index – Aims to provide broadly diversified representation of commodity markets.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.