Investment Viewpoint

January, 2016

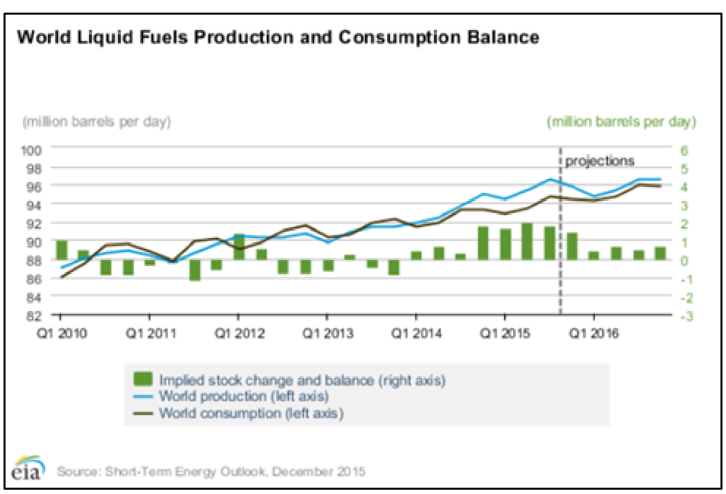
Overview

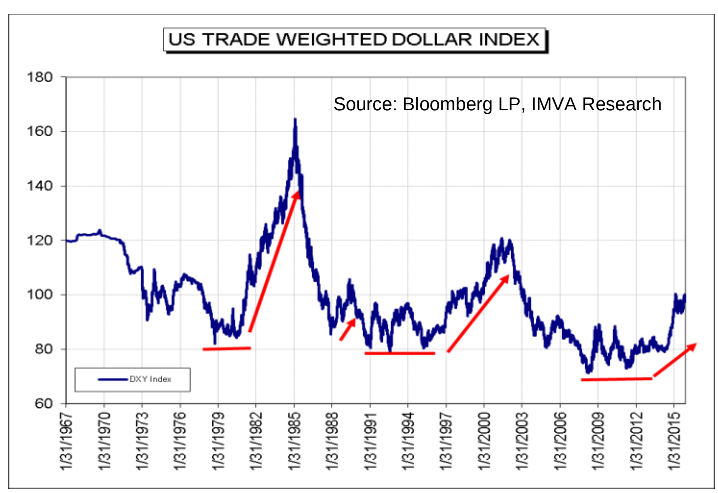
Following the third quarter correction that guided U.S. stock market indices down more than 12% from May highs, equity markets roared back in October and November. In December, however, weakening global economic data, rising U.S. interest rates, and sinking commodity markets prompted the markets to return some of the gains. For the fourth quarter of 2015, the S&P 500 Index, S&P Mid Cap 400 Index, and Small Cap 600 Index gained 7.0%, 2.6%, and 3.7%, respectively, on a total return basis. For the full year, the S&P 500 Index eked out a total return of 1.4%. The S&P Mid Cap 400 and Small Cap 600 slid 2.2% and 2.0%, respectively, on the year. Generally, larger capitalization stocks tended to perform better in the second half of 2015, having lagged during the first half.

Among the major sectors of the S&P 500 Index, performance was mixed. Consumer Discretion (+10.1%), Heath Care (+6.9%), Consumer Staples (+6.6%), Information Technology (+5.9%) and Telecommunication Services (+3.4%) led the way. Financials (-1.53%), Industrials (-2.53%), Utilities (-4.85%) and Materials (-8.38%) lagged. Pronounced weakness in Energy (-21.1%) weighed heavily on the markets and investor psyche. Even though global oil demand increased, world oil production accelerated at a greater clip, widening the supply/demand imbalance and forcing oil prices down. Lower oil prices and weakness in overall industrial commodities (copper, iron ore, etc.) proved deflationary and pressured S&P Index earnings. Excluding the Energy sector, S&P 500 Index companies (unweighted) likely reflected 6%-7% earnings growth for 2015; 9%-10% earnings growth is expected in 2016 on the same basis, according to Thomson Baseline data.

Effectively, the global economy relies upon five key engines/economies to drive world growth: the U.S., Europe, Japan, China, and the remaining developing economies. U.S. GDP growth expanded 2.1% over the last year, as of September 2015, a moderate advance by historical standards, yet up from recent years. China decelerated in 2015, as consumption-led growth was emphasized over manufacturing. These trends negatively impacted trade volumes and pricing with other economies, weighing somewhat on the budding recoveries in Europe and Japan and hammering the export-driven, resource and manufacturing-based economies of emerging markets. A strong U.S. dollar, weak commodity prices, and expectations of rising U.S. interest rates added additional uncertainty and potential imbalances among global economies. Nevertheless, the International Monetary Fund's latest forecast is for the world economy to grow by 3.6% in 2016. Many expect mid-2% growth for U.S. GDP in 2016, driven largely by strong domestic consumption and service trends and supported by high job availability, rising incomes, and recent improvements in consumer confidence.

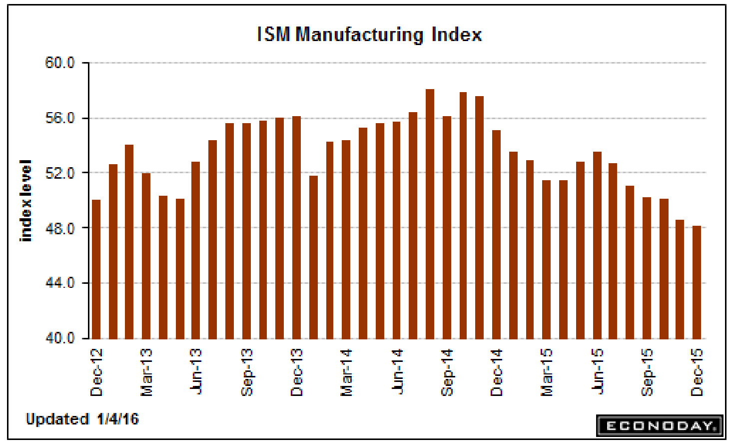
As we enter 2016, many of the impediments to earnings growth in 2015 remain in place. On the other hand, markets tend to do well the year following a year of flat performance and in election years. Ultimately, we believe that a bottoming of commodity prices (especially oil prices), a firming of demand both at home and abroad (especially for capital goods), and stabilization of the U.S. dollar versus other currencies could be factors that stimulate better earnings and sentiment among investors on a long-term basis.

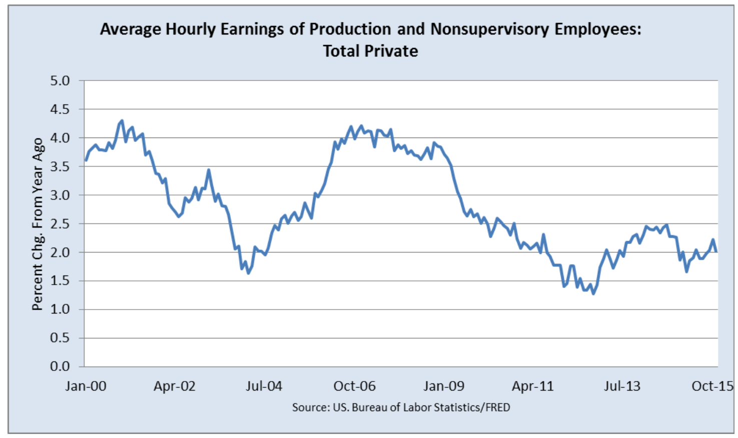




Economic Trends

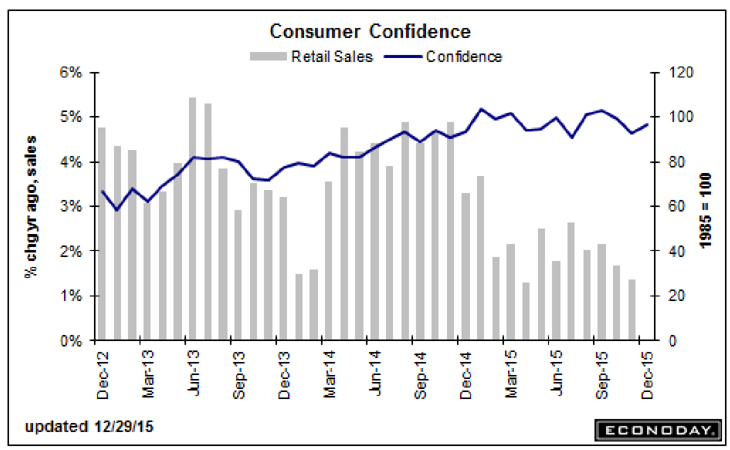
- December's ISM Manufacturing Index report generally reflected the weakest conditions since 2009. Headwinds included elevated channel inventories, weak raw material pricing power, and a strong U.S. dollar, with the latter making U.S. exports more expensive to foreign purchasers. Nevertheless, the new export orders component of the report rose, providing a much needed silver lining.
- Average hourly earnings in November showed a 2% gain from the year ago period. While income growth has come slowly and unevenly during this recovery, average hourly earnings have improved markedly since late 2012.
- Jobless claims dropped to a forty-two year low in 2015, and job openings climbed to new highs, well above 2007's peak. Net layoffs continued to decline even as the energy and manufacturing sectors shed workers. Generally, jobs availablity and rising incomes helped fuel domestic growth in 2015, offsetting manufacturing weakness.
- Together these employment and income trends, along with the benefits of low fuel prices, supported favorable consumer confidence levels. This confidence translated into improvements in retail, auto, and housing sales. Overall construction trends, both public and private, improved as well. Concurrently, the personal savings rate rose, and debt reduction continued.
- Real gross domestic purchases, purchases by U.S. residents of goods and services wherever produced, increased 2.2% in the third quarter, following a strong increase in the second quarter.

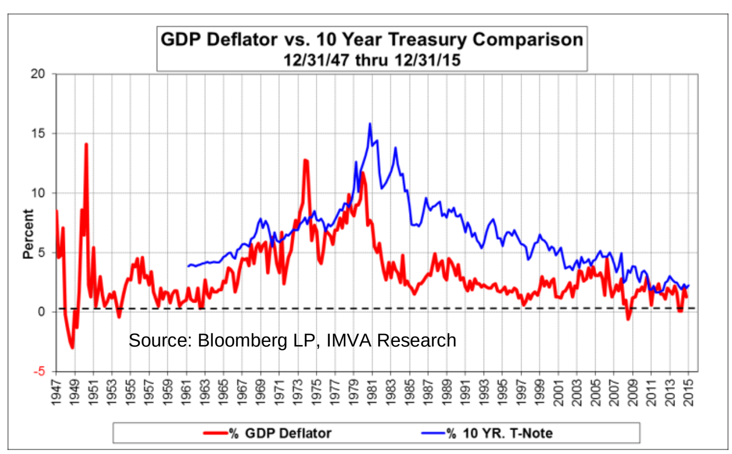




Financial Conditions/Monetary Trends

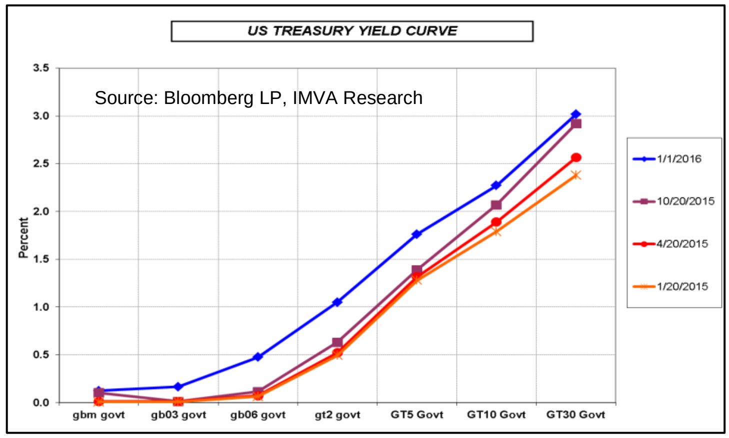
- On December 16, 2015, the Federal Reserve raised the federal funds interest rate for the first time since 2006, having held the rate near zero for nearly a decade. The new target range is 0.25% to 0.50%, up 25 bps; policy makers now forecast a target rate of 1.375% by the end of 2016, implying four additional quarter-point increases. The Fed said it raised rates "given the economic outlook, and recognizing the time it takes for policy actions to affect future economic outcomes."
- On the one hand, this tightening reflected the Fed's traditional desire to get ahead of the potential for an inflation rate above 2%, fueled by rising wage and employment trends (which have come to pass). On the other hand – and amidst the slump in manufacturing, low commodity prices, and weakness among our trading partners – aggregate U.S. inflation rates are presently modest, perhaps closer to 1.0-1.5%, a range last seen in the deflationary years of the 1950s. We believe that this action by the Central Bank also reflected its strong desire to begin normalizing monetary policy
- The Fed emphasized that the pace of subsequent interest rate increases will be "gradual", that "the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data", and that monetary policy would remain accomodative. In fact, the money supply (MZM), which historically has contracted when the Fed tightens, has recently grown at a healthy 4%-6%





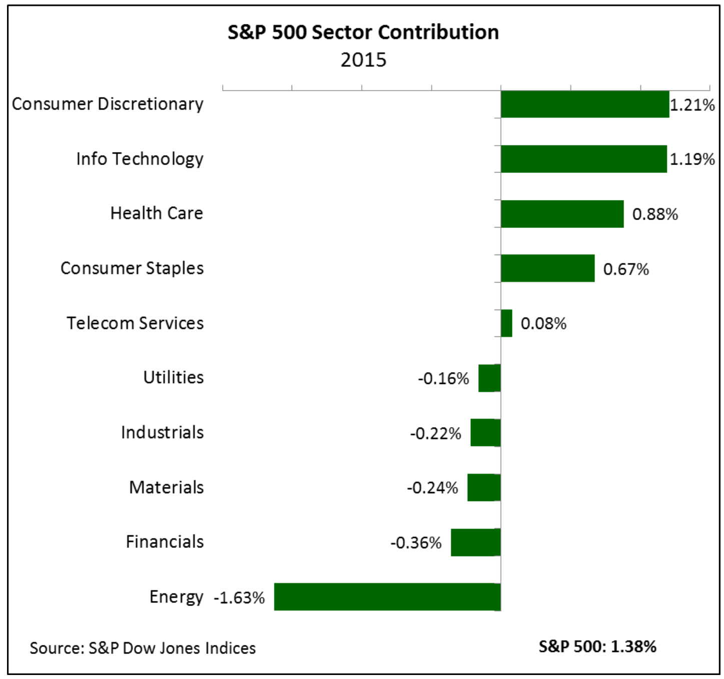
annualized rate.

- Given that the Fed had been telegraphing its intentions to raise interest rates well in advance of the actual decision, credit conditions tightened somewhat ahead of the December rate hike. Over the course of last year, longer maturity interest rates rose, particularly in high yield markets.



Sentiment Indicators/Market Trends

- Both bullish sentiment and bearishness were uncharacteristically low at year-end, implying investor complacency. Other indicators, like the VIX and put-to-call ratio, screened neutrally as well.
- As measured by the NYSE cumulative advance/decline ratio, the market effectively has moved sideways since June of 2014, hopefully consolidating the gains of preceding years and setting the stage for future advances.
- Presently, many of our market measures are approaching "oversold" conditions. These measures are short-term in nature; they are never perfect indicators; and we are hard pressed to identify imminent catalysts that would move the market off center in the near-term.
- Looking ahead, we believe that a bottoming of commodity prices (especially oil prices), a firming of demand both at home and abroad (especially for capital goods), and stabilization of the U.S. dollar versus other currencies could be factors that stimulate better sentiment among investors on a long-term basis.



Equity Market Valuations & Earnings

- Numerous variables contribute to the performance of equity markets and individual stocks over any given period. The relative influence of these factors can shift over time, alternately rewarding "growth" or "value", "large" or "small" capitalization, etc. Over the long run, stocks tend to appreciate as new value is created and/or when investors recognize that prices rest below the underlying/intrinsic value of the business.
- In 2015, individual stock performance was heavily influenced by investor focus on a narrow set of factors – current earnings growth, earnings momentum, and stock price momentum. Additionally, companies that derived their revenues predominantly from domestic sources did relatively better than multinationals, whose foreign revenues were negatively impacted when "translated" into U.S. dollars. Large capitalization stocks generally bested their smaller brethren into year-end.
- Currently, S&P bottoms-up earnings expectations reflect 7% growth for 2016. Given the "full" to "fair" forward market multiple of 16.7x, near-term progress likely will rest on actual earnings growth rather than further multiple expansion.
- As noted by ISI's Ed Hyman, since 1960, after every "flat" year for the S&P, like 2015, the S&P has rallied the following year. There have been seven such instances since 1970. However, S&P earnings increased in all seven "following years".

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