Investment Viewpoint

April, 2016

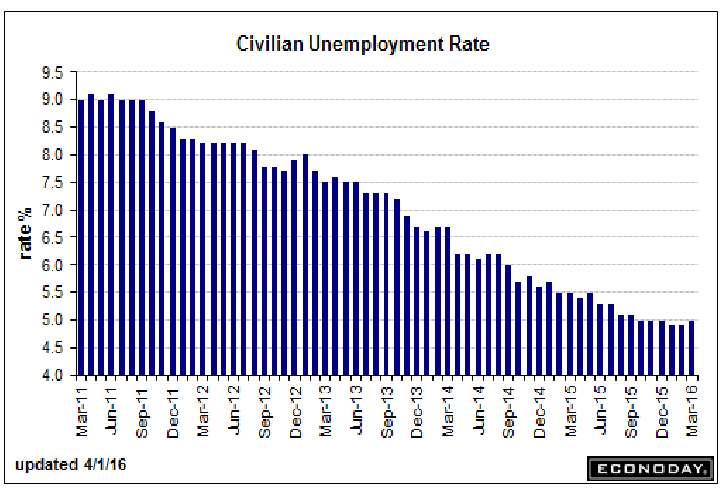
Overview

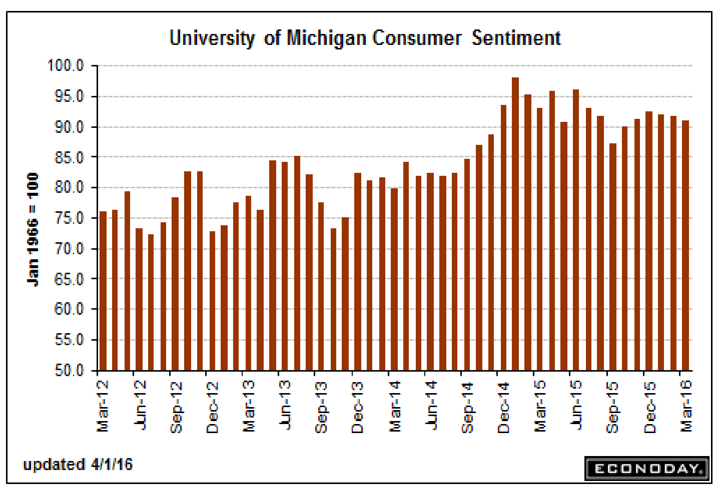
Between the opening bell of the New Year and February 11th, the major U.S. stock indexes plummeted more than 10%, reaching levels that were approximately 14% below the May 2015 equity market top. The litany of worries that drove this weakness included: decelerating economic growth and devaluation of the renminbi in China, which threatened to hamper trade in other economies, both developed and emerging; weakening crude oil prices, which touched $26 per barrel in February, a level well below breakeven for most energy companies and resource-dependent countries; the strong dollar, which made U.S. goods less competitive in foreign markets; and the hawkish tone of the U.S. Federal Reserve, which seemed determined to raise rates/"normalize" even as 2016 earnings and GDP forecasts were being revised lower – and as many foreign central banks were cutting their rates (into negative territory in some cases). Additionally, credit markets tightened on fears that defaults in the energy complex would weaken the financial system. As perceived risks appeared to be mounting to the downside, the seeds for relief were already being sewn.

On January 27th, the U.S. Federal Reserve opted not to raise the Federal Funds rate. In the weeks that followed, the European Central Bank announced an expansion of its stimulus package, and China took steps to steady its economy and allay fears of further, massive currency devaluations. Then, in late March, U.S. Federal Reserve Chair Yellen acknowledged, in prepared remarks before Congress, that global economic conditions had weakened, and she specifically emphasized the need to "proceed cautiously". Soon thereafter, expectations for rate increases during 2016 fell from four times to two, and the U.S. dollar weakened, dialing back the pressure on foreign currencies, especially those of struggling, emerging markets.

While the world obsessed about what might happen, various U.S. economic data revealed that what was actually happening might not be so bad. In fact, by the end of the first quarter, the data showed that unemployment had declined to a cycle low; wages had started to rise; consumers were judiciously spending even as savings had increased; auto sales had remained near record highs; construction and housing trends had strengthened; new household formations had risen; and some manufacturing data had improved. According to Evercore ISI research, company surveys near the end of the quarter were consistent with 2% Real GDP growth. One of the Federal Reserve Bank Presidents, John Williams, recently asserted that the world's largest economy is doing "quite well."

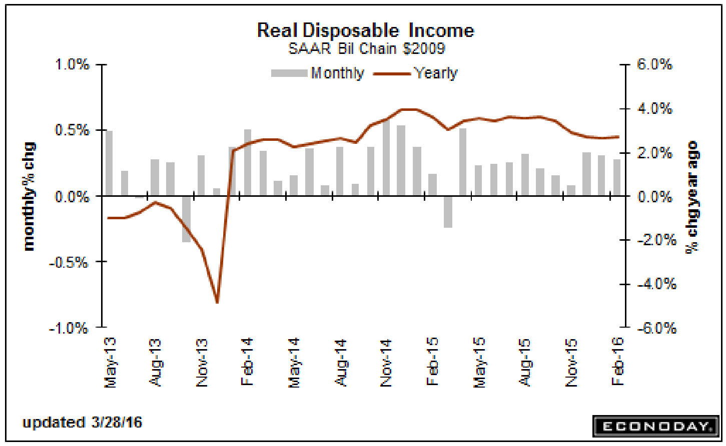
Eventually, investors digested the possibility that all of their worst fears might not be realized imminently, and the markets recovered. Despite a rocky start, the S&P 500 Index, the S&P MidCap 400 Index, and S&P SmallCap 600 Index delivered total returns of 1.4%, 3.8%, and 2.7%, respectively, in the first quarter. The Dow Jones Industrial Average advanced 2.2%. Equity leadership rotated/broadened from a narrow set of "growth" stocks, which had dominated in 2015, to "value." Stocks with defensive characteristics and/or high quality dividends led the breakout.

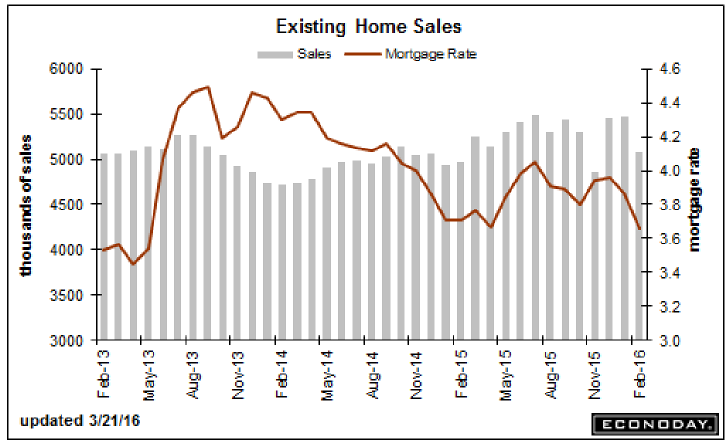


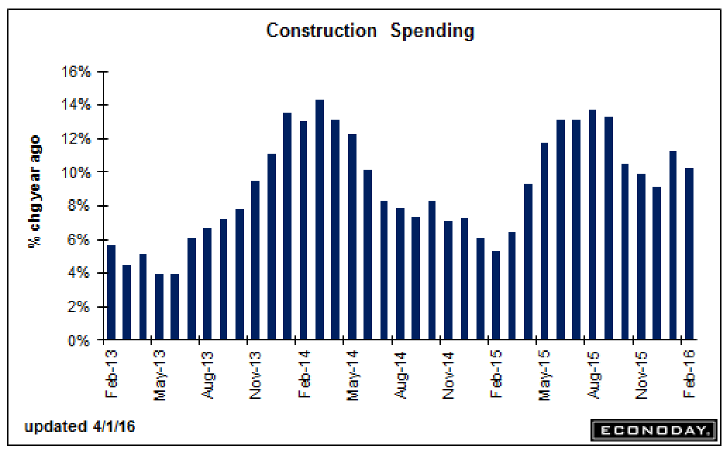


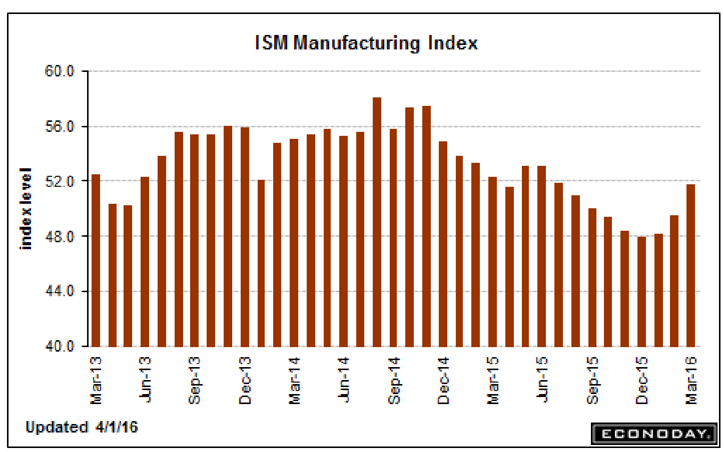
Economic Trends

- Nonfarm payrolls increased a higher than expected 215,000 in March. The labor market has steadily averaged monthly job gains of more than 200,000 for at least two years now. Strength can be seen in transportation, construction, retail, and business services. The unemployment rate recently registered the best level of the recovery and the lowest rate since 2007.
- Average hourly earnings have grown as well, rising 0.3% in March (2.3% year-over-year).
- As can be seen in the chart to the right, strength in payroll and earnings has translated into growth in disposable income (averaging roughly 2% for several years) and stability in consumer confidence (see page 1).
- Retail, auto, and home sales, along with construction spending, have been the primary drivers of domestic growth. Fourth quarter Real GDP growth was reported at 1.4%; first quarter growth is expected to be light; but expectations call for improvements later in the year, with full-year 2016 GDP growth averaging 2.0% or higher.
- Manufacturing has been the weak link in the last 12-18 months but may be turning; an April 1st ISM Manufacturing Index report showed improvements in orders (including exports) and backlogs.









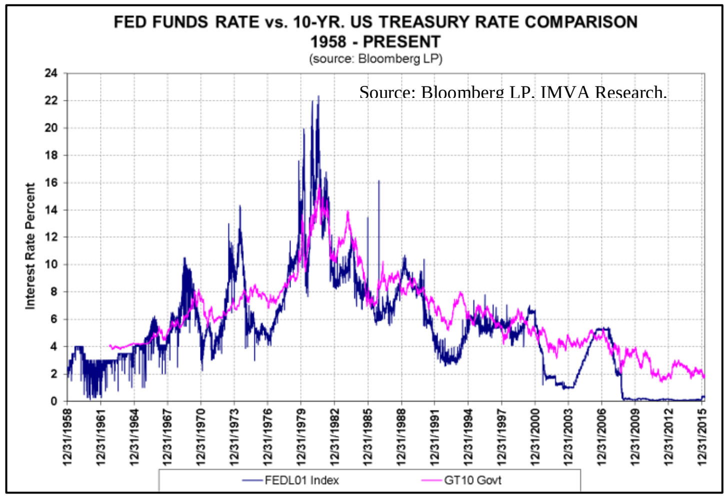
Financial Conditions/Monetary Trends

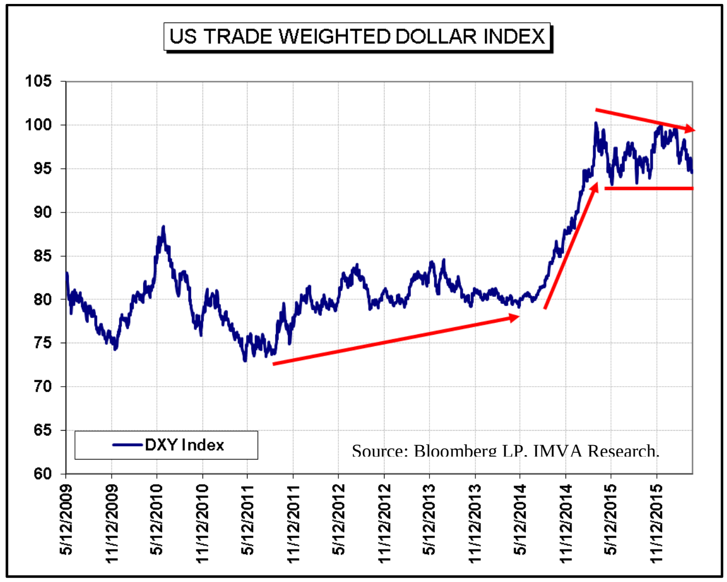
- In March, the Open Market Committee decided to "proceed cautiously" and leave the Fed Funds lending rate unchanged at 0.25%, effectively pushing "normalization" to higher interest rates out into the future. Although its traditional mandates have been limited to domestic employment, growth, and inflation, the Fed expressly acknowledged that mounting global risks could have "adverse" effects on the U.S.
- Chair Yellen did, however, detail conditions that might portend future hikes:
  - Foreign economies and their financial markets need to firm.
  - The dollar cannot appreciate further. That would hurt U.S. manufacturing, depressing exports, and could prove deflationary.
  - Commodity prices need to stabilize to help foreign producers find a better footing for growth.
  - The housing sector needs to make a larger contribution to U.S. output.
  - The recent rise in core inflation, which strips out food and energy, needs to prove itself to be "durable."

Sentiment Indicators/Market Trends

- Elevated market volatility, which has been building over the last year, appeared to take its toll on investors into quarter-end, e.g. "Bullishness" at only 27% according to a recent survey by the American Association of Individual Investors (AAII). In fact, according to Bloomberg, the S&P 500 has posted daily moves of at least one percent 81 times in the last 12 months, a figure representing more than the combined total for 2013 and 2014. Bank of America data show that individuals have taken a net $130 billion from mutual and exchange-traded equity funds in the past year; it also reported that its trading clients have been net sellers of stock for eight straight weeks, the longest stretch since 2011. This type of activity, according to Jim Paulsen, Chief Investment Strategist of Wells Capital Management, often happens as investors pause to asses rising valuations, decelerating earnings growth, or tightening Fed policy. He also reminds us that once markets move higher (as they did into quarter-end), investors who are short or who have been waiting in cash on the sidelines often feel compelled to jump back into the market. We shall see.

- Either way, short-term market measures appeared over-bought as of 3/31, following the recent stock market recovery from February lows.





Equity Market Valuations & Earnings

- S&P 500 earnings growth was flat in 2015, with Energy being the drag. Thus far, estimates for 2016 look only modestly better. Still, we are encouraged by ex-Energy expectations for 7%-8% earnings growth in 2016; also, many are calling for energy sector earnings to trough later this year, setting up easier comparisons for 2017 and beyond.
- Currency exchange rates also handed a devastating blow to U.S. earnings over the last eighteen months. After peaking versus other currencies in March of 2015, the U.S. dollar recently has shown signs of stabilizing. If that trend holds (or improves further), it could be a significant boon to both U.S. multinational corporations and emerging economies. U.S. goods would become more price-competitive around the globe. Income from foreign sales would be repatriated "less badly" (versus 2015) into U.S. dollars. Conditions in developing economies, who owe many of their debts in U.S. dollars, would ease as well.
- As for valuations, price-to earnings ratios generally do not appear as attractive as they did in mid-February. Further sustainable advances in the market likely will depend on improvements in earnings.

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