Economic & Market Commentary

2015 was an uninspiring year for investors, with financial assets, almost across the board, providing lackluster returns. Domestic stocks were barely up, with only dividends providing the S&P 500 with a positive return, and bonds up even less. Over the past 20 years, only in 2008 did stocks and bonds together have a worse year. Outside the U.S., only a few countries exceeded U.S. returns in local currency and, because of the strong dollar, only Japan did better in dollar terms. In the U.S., large capitalization stocks did better than small, and growth did better than value.

It was a very difficult year for actively managed money to produce a positive return. The median S&P 500 stock was down more than 20%, and the average actively managed U.S. equity fund tracked by Morningstar was down close to 3%. In fact, if an investor didn't own what are referred to as the FANGS (Facebook, Amazon, Netflix and Google), they most likely had a down year. Collectively, this group has a market value of $1.2 trillion with just $18 billion in earnings, or a valuation of 66 times earnings - four times more expensive than the average S&P 500 stock. We have referred to the narrowness of stock performance in the past, but the degree of distortion in the past year has taken the issue to a new level. Compounding this distortion, volatility returned with a vengeance during the second half of the year. The Chinese stock market collapse, the decline of the yuan, and falling oil prices rekindled fears about global growth, which provided the impetus for the long awaited "correction" during August, with its attendant increase in volatility.

The fact is actively managed money has had a difficult time for several years. Barron's points out that some 80% of active managers underperformed the S&P 500 over the past 5 years. It's no wonder that active money managers are fighting a battle to stave off the flow to index funds. Morningstar notes that last year was the largest ever outflow of funds from active managers, and the last 2 years were record years for the inflow of funds into passive management. We have been through periods like this before, when the case for passive management seemed crystal clear. The narrowness of stock performance, and the distortion it creates is not unique to this period. For instance in the 1970s, when the so called "Nifty Fifty" stocks soared while everything else languished, an investor had to own Kodak, Polaroid, and Avon at unjustified valuations or their relative investment results suffered. In the 1980s, the oil embargo caused oil prices to skyrocket and the energy sector rose to 25-30% of the S&P composite. In the late 1990s, a large cap growth stock bubble developed (led by technology stocks), with those stocks trading at high valuations. Our valuation discipline would not let us own the many growth stock darlings selling at extremely rich prices, and our performance suffered. We were chastised for being "old fashion", but stuck to our principles and were eventually proven right. In the early 2000s, our performance easily caught up when the growth stocks failed to meet unrealistically high expectations. It is worth noting that many of the richly valued stocks, such as Cisco

Systems, General Electric and Intel are still selling well below their prices at that time, despite 15 years of intervening economic and earnings growth. Finally, we have the current period which has similar distortions, and we find ourselves in a similar position required to defend our views. These experiences have provided us with the following lessons:

- When we go through periods like this they tend to last 2-3 years and then turn
- Relative performance during this period is generally below par and painful
- If we stick to our disciplines, doing what we always have, we will eventually resume a superior path

As we read the current situation, we are about 2 years into the latest distortions, so we are optimistic about a return to more normal market environment going forward.

As we start 2016, we're having a déjà vu moment. In the first week of January, the Chinese stock market collapsed, the yuan wobbled, oil continued its decline and North Korea exploded a nuclear device. The U.S. market reacted and the S&P 500 ended the first 2 weeks of the year down 8% (to 1880 from 2045) with other indices down more. Wilshire Associates calculates that the U.S. equity market lost $2.1 trillion since the beginning of the year. It has been the worse start of a year on record. Other global markets have experienced similar declines, with China about twice as severe. So, like late August, we are in a "corrective" mode once again. And, once again, the catalyst for this correction appears to be China. The fear is that the country's economy is in worse shape than thought and that Chinese central policy makers can no longer control the situation. We have discussed this at length in previous memorandum, but it is worth repeating given current circumstances.

An outsider's view of China is through a very clouded window. There is little transparency when it comes to knowing what is happening in the Chinese economy. What Churchill said about Russia "The riddle wrapped in a mystery, inside an enigma" can also be said about China. Virtually all professional China watchers agree that economic prognostications about China are, at best, a shot in the dark. Even the renowned China watcher, and crisis expert, Harvard economics professor Kenneth Rogoff admits to clouded knowledge. How interconnected China is to the rest of the global economy is difficult to assess. However, as the second largest economy globally, it was responsible for 35% of global growth over the last 5 years. We know the Chinese economy is slowing; this is not new news. The hope is that a slowdown will result in a soft landing (growth decelerating from 7-8% to 4-6%) rather than hard. The anecdotal evidence so far supports this estimate. While investment sector growth has slowed dramatically, the consumer and service sectors have picked up. In fact, that is what happened in the past year. Recently released data indicate the economy moderated in 2015 to 6.9% growth, with the bulk of the deceleration coming from the investment sector. This is a transition that the Chinese economy must make to sustain growth in the future. We also know that China has a huge debt load, which has risen from $7 trillion in 2007 to an estimated $28 trillion in 2014. This is about

280% of their GDP, larger than the U.S. or Germany. History tells us that extreme debt levels are the cause of most financial crises. The moves to devalue the yuan, shifting monetary policy by the People's Bank of China (PBOC), coupled with the massive sell-off in Chinese stock markets, all convey an unsettling impression. To date capital flight from China, away from the devalued yuan, has been manageable. To counter that possibility, we know that China has massive hard currency reserves (estimated at $3-4 trillion), which can go a long way toward preventing calamity.

We also know that China is a large consumer of commodities. Their economy consumes 40-50% of the world's output of most industrial commodities and 20-30% of many of the soft commodities. Clearly, this will negatively impact countries that produce those goods (mostly emerging markets). On balance we think China can muddle through this rough period, without a drastic decline in economic activity and without major impact on other economies. If properly used, the Chinese authorities have the tools to prevent a calamitous event that spreads. After all, their leaders know full well that economic crisis can lead to social crisis which can lead to political crisis. We wrote in July that, based on data available, we did not believe China and other emerging markets problem would have a major negative impact on the U.S. The export/import balance of China and the emerging markets (EM) is significant to them, but much less so to the U.S. and much of the developed economies. Exports represent an estimated 23% of China's GDP, compared to 9% of U.S. and 18% of the Eurozone. We concluded then, and do now, that China and their EM partners are important to world trade, more so than the U.S. and the EU. A slowing China will have a dampening impact on world trade, which should affect others more than the U.S. However, we do think a resultant trade slowdown will ensure that global growth will continue to be subdued for some time. In keeping with this, as they did in July, the International Monetary Fund has again reduced their estimate of global growth for the coming year to close to 3.0%.

The U.S. economy continues to be the best house in a poor neighborhood. The consumer sector has been the strength, while other sectors remain sluggish. Housing is still below trend and has room to expand. Job creation has averaged close to 200,000 per month, but wage growth remains stagnant. With capacity utilization stuck below 80%, capital spending is disappointing. Exports are weak, largely because of the strong dollar. GDP estimates for the final quarter center around 1% growth, which would bring the year in at about 2%. This has been our working supposition for some time, and we see no reason to change that going forward. The fear that some of these global dislocations will cascade on the U.S., resulting in a recession is certainly on the minds of many observers currently. We give this a low probability, at this time. The current economic cycle which started in 2009, is now 78 months old. Granted this cycle is long, but there have been three that have been longer: '91-'01 lasting 120 months, '82-'90 lasting 92 months, and '61-'69 lasting 106 months. Besides, economic cycles don't die of old age, they die because of distortions (interest rates, inflation, policy mistakes). At this stage, we do not see any of these looming. So our working assumption for economic activity in the current year is more of the same: slow growth, low inflation, and upwardly biased interest rates.

The risks to our base case are those that we have enumerated before, except it is later in the game and most are no closer to resolution: slowing growth in China and the EM, North Korea saber rattling, Mid-East turmoil and terrorism, are all capable of creating enough fear to rattle the psychology of consumers and investors. These risks exist with a stock market that started the year on the expensive side, close to 18x expected earnings. Granted the past two weeks have taken about 2 multiples of earnings off the valuation, but we are still not in cheap territory. Earnings for the fourth quarter of 2015 (being reported now) will probably be down. Guidance being given by company managements has been weak, and aggregate earnings estimates for 2016 are being reduced. This should be no surprise, as profit margins appear to have peaked. U.S. equity returns over the past few years have been driven by expanding price/earnings ratios (a decline in the equity risk premium), as earnings have not kept pace with stock prices. We do not expect this to be the case in the coming year. Earnings are suspect, volatility is higher, and risks in general are more pronounced, which should be reflected in a diminished equity risk premium. This is not to say we expect a bear market. Bear markets are usually accompanied or caused by a recession, and as we said earlier we see no signs of that as yet. In the past 30 years, however, there have been 3 declines worthy of the term bear market, without an accompanying recession. So, we could have further downside to equities over the near term, as risk is elevated and volatility remains high. Perhaps more than ever, this is an environment that we think calls for superior stock selection and risk control.

Fixed Income Review and Outlook

The bond market posted returns in 2015 that can best be described as mediocre. The Barclays U.S. Aggregate Bond Index generated a -0.57% return for the fourth quarter and a 0.55% return for the year. The event in the bond market that had everyone talking didn't come until December 16. We refer, of course, to the Federal Reserve's decision to raise the Fed Funds target for the first time since 2006. To put that into historical perspective, the last time the Fed raised interest rates, there were no iPhones.

Treasuries trailed the overall market during the fourth quarter with a -0.94% return and produced a 0.84% return for the year. Despite a strong start to 2015, which saw the thirty year Treasury yield fall to modern era lows in January, the general trend was for higher yields. The changes were greatest at the extreme ends of the Treasury curve as the curve flattened moderately. This movement is typical when the Fed starts to or is expected to start raising interest rates. Short term rates, which are directly affected by Fed decisions, rise faster than longer term rates, which are influenced more by inflation and growth expectations.

Our opinion of Treasury Inflation Protected Securities (TIPS) as an attractive alternative to nominal Treasuries has not changed. We like TIPS because the breakeven rates (the point at which you are indifferent to owning TIPS, whose principal resets with the CPI or a nominal Treasury security that is completely exposed to inflationary pressures) are low by historic standards. If breakevens move back toward their historic norms or deflationary pressures return, we would look to reduce positions.

Agencies underperformed for the quarter and the year. Agencies in some sense were victims of their success over the last several years. The spread over Treasuries that Agencies offered yield-hungry investors has fallen so much over the last several years that even a small widening of spreads would cause underperformance. That's what happened in 2015. In spite of this, Agencies remain instrumental to our strategy. We prefer to use bullet Agencies with less than one year to maturity as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries. We will continue to add callable Agencies opportunistically.

Investment grade corporate bond returns were in line with the index for the quarter, but were disappointingly negative for the year. We maintained our overweight allocation to credit that we established earlier in the year, as we see value in corporates and expect to add incrementally during the first quarter. Spreads are at levels usually associated with recessions, with much of the movement in energy company paper. Many energy companies are being adversely affected by the drop in oil and natural gas prices. Some may not survive. However, we see opportunity as strong credits are treated like their weaker brethren and their spreads move toward post-crisis highs. We plan to add to those names we like at attractive levels. In terms of curve positioning, we like the 7 to 10 year part of the curve, as we see it representing the best value and have several holdings in long corporate bonds in credits we expect to benefit from M&A activity. We continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair. And, as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgages bested the performance of the Barclays Aggregate during the fourth quarter and the year. Mortgages delivered a positive return, in large part, because of the short duration or interest rate sensitivity of the product. While mortgage spreads, like credit spreads, have widened relative to Treasuries for most of the year, the move was muted. Much of the return of mortgages has been income, with negative price action and paydowns subtracting from the total.

We held our mortgages position constant over the quarter and would look at additional spread widening as an opportunity to add to mortgages. We think that Federal Reserve could cease reinvesting the coupons, paydowns and maturities of its $1.7 trillion mortgage holdings at some point this year. This action would remove a large buyer of mortgage securities and could put some upward pressure on spreads. We expect to use Collateralized Mortgage Obligations

(CMOs) carved from high quality Fannie Mae and Ginnie Mae mortgages with yields comparable to corporate debt. We like structured paper priced below par ($100) designed to be less interest rate sensitive in the face of rising interest rates.

Municipal returns were the strongest bond category for both the quarter and the year. Low Treasury yields, declining net issuance of new municipal debt and strong inflows into municipal mutual funds combined for a good year for municipals. For our clients for whom munis are a natural investment or for those looking for some diversification, we favor AAA and AA-rated municipal securities specifically in those states and municipalities not dependent on oil revenues. We also like revenue bonds where the coupon and principal are backed by a lien against a payment stream.

As noted above, at the December FOMC meeting, the Fed ended its ZIRP (zero interest rate policy) in favor a range of 0.25% - 0.50% for the Fed Funds rate. The market's attention has now turned to the expected path of future monetary policy tightening decisions. Some Fed governors have voiced a need for three or four more rate increases in 2016. The market, as defined by the Fed funds futures contract, is far more cautious. At year end, expectations for a rate no higher than 1%, or two tightening decisions, stood at greater than 75% with a 6% chance of an easing at the January meeting.

In order not to expose client portfolios to more interest rate risk than we feel is warranted, we are maintaining a defensive strategy with durations of about 90% - 95% of our target. We are positioned with most of our interest rate exposure using the five to ten year part of the curve at the long end and have moved to a more pronounced barbell strategy. A barbell strategy involves holding a mix of securities at both the short and long end of the maturity spectrum.