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Economic Update – 4th Quarter 2015

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Economic Update

The first few weeks of 2016 has been difficult for most investors. The Markets began 2016 by cratering after a volatile second half of 2015. January first through January 13th has been horrible with market declines of (-7.25%) in the Dow, (-9.61%) in the NASDAQ Composite and (-11.4%) in the Russell 1000. We think the Markets will finish 2016 in positive territory but volatility will be dramatic and be caused by economic uncertainty globally. In addition, we are looking for additional very small Federal Reserve driven interest rate hikes this year. These hikes, well broadcasted, are the first rate hikes since June 2006. Finally, we believe that the presidential election cycle contribute to market volatility. Therefore, we expect security selection to drive positive returns in 2016.

Historically, investors who have not dropped out of the market during distressed times, have tended to outperform those investors who have dropped out and attempted market timing. We are advising our clients to stay in the market and not panic. We have attached a Schwab graphic at the end of this blog which clearly illustrates the difference between reactive investing verses consistent investment strategies. We advocate a steady investment strategy to ride through the market downdrafts.

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We believe that growing fears over a global slowdown will likely lead to ongoing volatility in 2016. The US economy continued to grow in the third quarter rising 2.0% (third estimate), which was down 0.1% from the previous estimate of 2.1%. The weaker economic growth followed a strong second quarter GDP estimate of 3.9%. The deceleration in GDP in the third quarter was primarily caused by a decrease in private inventory investment and decelerations in exports, in personal consumption expenditures and in

nonresidential fixed investment. State and local government spending also slowed. Weaker US activity was partially offset by a deceleration in imports. The Atlanta Federal Reserve cut its Fourth Quarter GDP estimate to 0.8% on January 8, 2016 from the prior estimate of 1.0%. The decrease in the estimate was attributed to declining inventory investment.

The fourth quarter of 2015 ended with a December unemployment rate of 5.0%. The unemployment rate remained flat from the prior month but saw a decrease of 0.7% from the January 2015 rate of 5.7%. Total nonfarm payroll employment figures were strong, increasing by 292,000 in December. Employment gains occurred in several industries including professional and business services, construction, health care, and food services and drinking places. Mining continued to experience declines. Employment gains in October and November saw strong revisions upward with combined gains totaling 50,000 higher than previously reported. The 3-month moving average for job gains was 284,000 per month. The participation rate increased to 62.6% in December from the September rate of 62.4%.

Housing starts in November 2015 increased by 10.5% to an annual rate of 1,173,000 from a revised October estimate of 1,062,000. November's rate represents 16.5% increase from a November 2014 rate of 1,007,000. November's single-family housing starts were at a rate of 768,000; this is 7.6% above the revised October rate of 714,000. The November rate for multi-unit dwelling was 398,000. Sales of new single-family homes rose 4.3% to a seasonally adjusted annual rate of 490,000 units in November 2015, according to the Department of Housing and Urban Development and the U.S. Census Bureau. According to the National Association of Home Builders (NAHB) a primary reason for the continued increase is that home builders are increasing inventory despite lot and labor shortages. However, "Limited gains in new-home sales can be attributed to a weak existing sales report," said NAHB Chief Economist David Crowe. "People who already own a house comprise most of the new residential construction market, and they often must sell their existing home before making another purchase." The Western and Southern regions experienced increases in new home sales of 20.5% and 4.5%, respectively while sales fell 28.6% in the Northeast and 8.6% in the Midwest. The inventory of new homes for sale was 232,000 units in November. This is a 5.7-month supply at the current sales pace. Existing-home sales dropped off dramatically in November 2015 to the slowest pace in 19 months. Existing-home sales fell 10.5% to a seasonally adjusted annual rate of 4.76 million in November from a downwardly revised 5.32 million in October. November's rate is the lowest since April 2014 which was 4.75 million. "After last month's decline (largest since July 2010 at 22.5%), sales are now 3.8% below a year ago — the first year-over-year decrease since September 2014." Some of the decrease was attributed to an apparent rise in closing timeframes due to the introduction of new closing documentation required by the government that may have pushed some transactions into December, according to the National Association of Realtors. All four major regions saw declines in November. According to Freddie Mac, the average 30-year mortgage rate for December was 3.96%. The rate experienced saw a 2bps increase from the prior month and a 0.10% increase from December a year ago.

The Consumer Confidence Index, improved in December after a moderate decrease in November. The Index stood at 96.5 (1985=100), up from 92.6 in November. However, the December Index saw a sharp decrease from the September 2015 reading 103.0 The Present Situation Index increased from 110.9 last month to 115.3 in December, while the Expectations Index improved to 83.9 from 80.4 in November. Lynn Franco, Director of Economic Indicators at The Conference Board said, "As 2015 draws to a close, consumers' assessment of the current state of the economy remains positive, particularly their assessment of the job market. Looking ahead to 2016, consumers are expecting little change in both business conditions

and the labor market. Expectations regarding their financial outlook are mixed, but the optimists continue to outweigh the pessimists."

On December 16, 2015 the Federal Reserve (FED) raised the target range for the federal funds rate by 0.25%, bringing it to a target range of 0.25 to 0.50%. The FED stated, "This action marks the end of an extraordinary seven-year period during which the federal funds rate was held near zero to support the recovery of the economy from the worst financial crisis and recession since the Great Depression. It also recognizes the considerable progress that has been made toward restoring jobs, raising incomes, and easing the economic hardship of millions of Americans. And it reflects the Committee's confidence that the economy will continue to strengthen. Room for further improvement in the labor market remains, and inflation continues to run below our longer-run objective. But with the economy performing well and expected to continue to do so, the Committee judged that a modest increase in the federal funds rate target is now appropriate, recognizing that even after this increase, monetary policy remains accommodative." The FED reiterated that the process of normalizing rates is likely to proceed gradually, although future policy actions will obviously depend on how the economy evolves relative the FED's dual mandate of maximum employment and price stability.

At the end of the Fourth Quarter of 2015, the S&P 500 stood at 2044 down 0.73% for the year but up strongly for the quarter with a 6.45%. Both The DJIA and the NASDAQ Composite out-performed the S&P with quarterly returns of 7.00% and 8.38%, respectively. For the year, the DJIA under-performed the S&P while the NASDAQ out-performed the broader index with returns of -2.23% and 5.72%, respectively. Of the 9 sectors represented in the S&P, all but one sector saw positive performance for the quarter, as measured by the SPDR sector ETFs." The worst performing sector for the quarter was Energy (-0.61%). The best performing sector for the quarter was Materials (9.60%) followed by Healthcare (9.12%) and the Technology (8.89%) sectors. The remaining sectors with positive performance were Consumer Staples (7.70%), Consumer Discretionary (5.74%), Financials (5.89%), Industrials (6.89%) and Utilities (1.01%) For all of 2015 sector performance was much different. Of the 9 sectors represented in the S&P, 5 saw negative performance for the year. The worst performing sector for 2015 remained Energy (-21.46%). Other sectors with negative performance were Materials (-8.58%), Utilities (-4.86%), Industrials (-4.25%), and Financials (-1.60%). The best performing sector for 2015 was Consumer Discretionary (9.94%) followed by the Healthcare (6.86%), Consumer Staples (6.83%) and Technology (5.63%) sectors.

In Fixed Income, the Barclays U.S. Aggregate Bond Index ended the fourth quarter down -0.57% but up 0.55% for 2015. The long end of the yield curve flattened as U.S. Treasury yields rose with the 10-year note and the 30-year bond rising by about 21 and 14 basis points, ending the quarter at 2.27% and 3.01%, respectively. At the beginning of 2015, the 10-year note stood at 2.12% while the 30-year bond was 2.69%.

Inflation pressures continued to be weak in the 4th quarter, reflected in gold futures prices experiencing a loss of about $54.00 with a December 31 closing price of about $1060.00 per ounce. Gold began 2015 at about $1190 per ounce. Oil prices, as measured by the WTI, continued their declines through the quarter, falling more than $7.93/bbl to end the fourth quarter at about $37.13/bbl. WTI oil began 2015 at a price of $52.72 per bbl. The WSJ Dollar Index continued to strengthen in the fourth quarter rising by about 1.39 to 90.17. At the beginning of 2015, WSJ Dollar Index stood at about 83.65.

Conclusion

The Markets began 2016 on a negative note after a volatile second half of 2015. We think the Markets will finish 2016 in positive territory, but volatility will be dramatic caused by global economic uncertainty. The Market tends to anticipate economic conditions. Those economic forecasts can change and often do, rapidly and frequently. Government economic reports generally look back in time and are often revised, but usually don't change in at meaningful way. In addition we are in the middle of a highly contested presidential election cycle where any economic news positive or negative can be blown completely out of proportion. We believe market participants will look for a further slow rise in interest rates following the first Fed Funds increase since June 2006. As a result of these background issues, we expect security selection to drive positive returns in 2016.

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