Navigating Unprecedented Markets

2015 review

2015 was a tough year. After peaking in May, the S&P 500 Index finished the year up just 1.4%. This was the best return for the four major asset classes, stocks, bonds, cash and commodities[1]. Bonds were down about -1.5%, cash was flat and commodities were down almost -25%. What made the year tough was that nothing really worked. The highest return of these four major asset classes came from stocks (+1.4%). This was the lowest "best" return since 1937[2]. Generally speaking, one of these asset classes is usually working. For instance, in a year where stock returns are negative, bond returns are usually positive, as in 2008 when 10-Year US Treasury bonds were up +20%. While the "best" return is not always as strong as 10-Year US Treasuries in 2008, during the last 20 years one of these asset classes has been up at least 8%[2].

Given how market conditions changed in 2015, it's understandable that investors are concerned. First, corporate earnings[3] fell. From 2009 to 2014 earnings had risen 145%. Last year they fell -7%[4] marking the first decline since the financial crisis of 2008. While this decline was largely a result of a collapse in commodity prices, specifically energy prices, the fact remains that earnings declined. Further clouding the earnings picture was slowing growth in China. A currency devaluation in August by the Chinese Central Bank surprised investors and created uncertainty over China's future economic growth rate.

The S&P 500 Index, which was historically cheap at less than 10x in 2009, rose to over 17x in May of 2015[5]. Valuations typically rise when investors become more comfortable about the future of earnings growth. While a multiple of 17x isn't extreme, it is at the high end of fair value. This valuation coupled with an earnings decline hurt the stock market during the second half of 2015.

Lastly, the Federal Reserve continued its policy of zero percent short-term interest rates until December when they raised short-term rates 0.25%. The change in policy was widely expected but marked the end of the historic and unprecedented policy that began in 2008. Economists expect the Fed will continue to raise rates in 2016. The change in policy is important. When the Federal Reserve is raising interest rates, financial markets tend to be more volatile.

Portfolio construction

In this low return environment, our portfolio construction philosophy has centered on generating income. This income focus allows portfolios to be less dependent on capital appreciation to achieve client goals. We allocate the majority of our portfolios to a core group of stock and bond asset classes. Stock asset classes include: US large cap, mid cap, small cap and international developed country large cap stocks. Bond asset classes include: US investment grade bonds and/or municipal bonds. We will allocate to non-core asset classes when they can provide better returns than core asset classes.

2016 outlook: A resumption of growth with slowly rising interest rates

Markets focus on the future. For 2016, consensus is that corporate earnings will grow +18%[6]. This would be a welcomed resumption of the earnings trend begun in 2009. Much of that growth is slated to happen in the second half of 2016. We expect the S&P 500 Index to be volatile in the first half of 2016 before regaining its footing to finish the year with a positive mid to upper single digit return. The US is expected to be the best performing region for stocks in 2016, just as it was last year. US stocks make up roughly 83% of our equity allocation. This increased from 75% in August last year.

Internationally, the recovery continues in Europe. 2015 and 2016 European GDP growth is expected to be 1.5% and 1.6% respectively. The European Central Bank is continuing to stimulate the economy much like the Federal Reserve has done. Valuations are significantly lower than US stocks. If the recovery gains traction and growth begins to accelerate, European stock markets would respond favorably.

China will continue to be a wild card in 2016. While China is now the second largest economy in the world, its impact on the US economy is fairly limited. Estimates indicate that a 1% reduction in Chinese GDP growth, results in a -0.03% reduction in US GDP growth[7]. Additionally, currency exchange rate changes can also impact US GDP growth. A 3% change in the value of the Renminbi vs. the Dollar could further reduce US GDP growth by -0.08%[7].

Chinese growth and currency exchange rate moves can get worse but it would take a big change to really hurt the US economy. After the Chinese currency devaluation in August of 2015, we removed our exposure to emerging markets. This exposure was between 7% - 8% of our equity allocation. We invested those assets in short-term bonds.

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Now that the Federal Reserve has begun to raise short-term interest rates, the question is how fast and how high will rates go. Expectations are that short-term rates will rise very slowly to 1.43% by December 2017[8]. That level is very important. 10-Year Treasury note interest rates need to rise above 5% before they start negatively impacting stock returns[8]. For the 10-Year Treasury note to be above 5%, short-term rates would need to be close to 3%.

Our bond allocations are dominated by short to intermediate term investment grade corporate and/or municipal bonds depending on the tax status of the account. Our managers are focusing on maximizing current income while maintaining a short duration[9]. Liquidity in the bond market has declined dramatically since the financial crisis. Liquidity refers to the ability to buy and sell without negatively impacting the current bond price. If bond mutual funds were to face severe redemption pressure, they could be forced to sell more illiquid holdings at unreasonably low prices. All shareholders of that bond mutual fund would be impacted. If an investor holds individual bonds instead, they are not impacted by the redemption pressure. For this reason we invest the majority of our bond allocations in individual bonds.

We use active and passive managers in our portfolios depending on asset class and market conditions. With the expectation of higher volatility, we are using more active managers. When volatility is high, active managers outperform their benchmarks[10].

"2016 will present challenges for investment portfolios. It is important to continue to focus on the long-term."

2016 will present challenges for investment portfolios. It is important to continue to focus on the long-term. While the first half of the year may be volatile and tempt investors to time the market, missing some of the S&P 500 Index's best days can hurt performance. Over the last 20 years ending 12/31/2014, the S&P 500 Index average annual total return was 9.85%. If you were not invested during the 10 best days in the market of that 20 year period, your return fell to 6.11%. If you missed the best 20 days, the return becomes 3.63%. By missing the best 40 days in that same 20 year period, the return dropped to negative at -0.45%[11].

Reaching your financial goals requires discipline and courage; the discipline to build a diversified investment portfolio based on your risk tolerance, and the courage to stick with it.

Brian L. Thorkelson • Chief Investment Officer

Inventive. Intelligent. Invested.

[1] The asset classes are represented by indexes; stocks (S&P 500 Index), bonds (30-year US Treasury bond), cash (3-Month Treasury bill), commodities (Bloomberg Commodity Index). The Standard & Poor's 500 (S&P 500 Index) is an unmanaged group of securities considered to be representative of the stock market in general. The 30-year Treasury bond represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 30-year Treasury bond as a benchmark for the long-term bond market. 3-Month Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. The Bloomberg Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998. You cannot invest directly in these indexes.

[2] “The year nothing worked: Stocks, Bonds, Cash Go Nowhere”, Bloomberg Business 12/28/2015

[3] Corporate earnings are represented by the S&P 500 aggregate company earnings.

[4] “US Weekly Kickstart”, David J. Kostin, Goldman Sachs 12/18/2015; Company earnings reports for Q4 2015 will be released during January and February. Expectations are for a -7% decline.

[5] Most investors value the stock market by comparing the current price level of the S&P 500 Index to the aggregate next four quarters earnings per share of all 500 companies in the index. This is expressed as a multiple. “x” means “times”. The higher the multiple, the more investors are paying for those aggregate earnings.

[6] “US Weekly Kickstart”, David J. Kostin, Goldman Sachs 12/18/2015.

[7] “The Drag from China: Many Channels, Limited Impact”, US Economics Analyst, Jan Hatzius, Goldman Sachs 9/4/2015

[8] “Guide to the Markets”, Market Insights, Dr. David P. Kelly, CFA, JPMorgan Asset Management 12/31/2015

[9] Duration measures how much a bond price will go up or down when interest rates change. The higher the number, the more the bond price will change when interest rates change. Since bond prices fall when interest rates rise, we want the price rise to be as small as possible.

[10] “Is Your Portfolio Built for 2016?” BlackRock, January 2016. 74% of the time active managers have beaten their benchmark when volatility is high.

[11] “5 Things You Need to Know to Ride Out a Volatile Stock Market”, Franklin Templeton Investments, 2014

The return assumptions are not reflective of any specific product, and do not include all fees or expenses that may be incurred by investing in specific products. The actual returns of a specific product may be more or less than the returns used. It is not possible to directly invest in an index. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. The return and principal value of the investments will fluctuate so that, when redeemed, they may be worth more or less than their original cost. Past performance is not a guarantee or a predictor of future results of either the indices or any particular investment.

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