The Investment Letter

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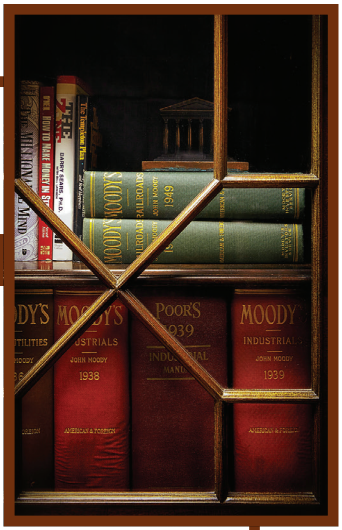

2015 Review / 2016 Preview

As we look at the year ahead we consider some of the possibilities that await us over the next twelve months. Without perfect foresight we can only ascribe different likelihoods to certain events occurring or not but even that is best done with caution. Even with such hedges the markets move quickly and they can be fickle. Therefore, everything that seems reasonable, rational and even highly likely today can quickly change and be replaced by a much different reality.

There are two main issues that are at the forefront of most Economists minds. The first is the condition and growth prospects of the U.S. economy. The second is interest rates. The two are obviously intertwined and each one affects the other – how and to what degree is not always clear, however. These are the two underlying themes that ultimately will dictate the direction and magnitude of the change in both the stock and bond markets in the coming year and beyond.

Interest Rates

The Federal Reserve has long (perhaps too long) maintained record low interest rates. While this was a boon to borrowers; savers and investors were left wanting for more with regard to interest income. Often times that desire for current income sent them in the direction of dividend paying stocks, helping to further stimulate equity market performance.

Record low interest rates are not sustainable, nor are they healthy for long periods of time. The Federal Reserve knows this and finally decided to take action at their December FOMC meeting where they raised rates by a quarter percent. The downside to their very delayed action is that the economic recovery from the Great Recession is now long in the tooth. So long in fact that there are pockets of the economy that are starting to show signs of slowdown and in some cases outright weakness. The one action you don't want central bankers taking is raising rates in the face of economic slowdown!

Energy companies, particularly those in the oil industry are one such area that is drastically under performing the market as a whole due to a glut of supply. Other commodity prices are also down significantly - impacting producers and related firms but ultimately a net positive for buyers and users of their products. In these cases there are larger underlying issues than what the Fed Funds Rate is. It is important to consider the cascading effect a weak industry can have on other seemingly healthy parts of the economy. The way industries interact is often complex and the spread of problems from one area to another can be unpredictable.

Depending on whether the economy can continue to grow or whether it will stall due to above mentioned pressures (or other factors) will determine the near term fate of equity markets. In a worst-case scenario we have rising interest rates coupled with a sluggish, or worse, shrinking economy. At that point the levers at the disposal of the Federal Reserve will eliminate their main weapon, the Fed Funds Rate. Any changes downward would be minor and ultimately have a minimal impact on the economy not to mention they would plunge us immediately back to essentially zero.

The Economy

The U.S. Dollar is currently strong relative to other currencies - while this is a huge positive for overseas travelers and importers it makes it difficult for downtrodden commodities prices (usually denominated in USD) to recover. Additionally, a strong USD makes it less profitable for U.S. companies doing business overseas, which is a majority of the S&P 500 constituents, and large, multi-national companies in particular.

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Because of the drag on non-U.S. income in some of our largest companies, we are seeing a slowing of growth in some firms depending on the magnitude of their overseas exposure. Luckily exports, as a whole, comprise less than 15% of GDP so thankfully this should still be a net positive for the market.

As of the writing of this article, final holiday shopping numbers are not yet available. How the holiday shopping season plays out for retailers is a major sign of the direction of the economy as it gives insight into consumer spending, consumer confidence and overall levels of discretionary spending. Since the U.S. economy is so heavily consumer driven there is a lot to be gleaned from these results. Not only will these results dictate the direction of the economy they will also signal to the Fed how aggressive they should be with their rate rising campaign.

Ultimately, what we really care about is how all these seemingly disparate issues impact stock and bond markets. This is where the rubber meets the road, so to speak, for investors. Please keep in mind that these outlooks are merely a snapshot in time based on current information available – actual results will almost certainly be different.

Outlook for Stocks

When it comes to equities we are cautiously optimistic - slightly less optimistic than the year prior and slightly more cautious than in 2015. The recovery has already far exceeded (in length) the standard post-recession recovery. We even had a dip mid-year of 10%, technically considered a proper correction, as investors got skittish over whether broad based growth could continue or if we're seeing the beginning of the end.

Regardless of when the economy starts to officially contract – and contract it will as it always does - it is safe to say we are likely closer to the end of this post recession bull market than we are the beginning of it.

Given the pace of recovery and ultimately growth, our expectations for stock returns this year are modest. Depending on sector, mid-single digit returns are probably as attractive as we can hope for unless something surprising happens.

The driving factors of stock prices are two-fold. Stocks can increase in value for one or both of the following reasons 1) because growth is positive or 2) because valuations expand (as an investor you pay more per dollar of growth). Given that valuations are fair to rich already and growth is slowing, we feel there is still opportunity in stocks, but it is much more limited than in years past.

How the markets react to the Federal Reserve's interest rate changes (or non-changes) will also dictate the pace and direction of movement. We also can't forget about external factors like overseas growth, the strength of the dollar and even the presidential election.

Outlook for Bonds

Barring unforeseen and massive dislocation in the economy (or a complete lack of backbone on the part of the Federal Reserve) it's safe to assume that the Fed will continue its campaign of cautious interest rate hikes throughout 2016. This will cause downward pressure on bond prices as interest rates slowly creep upwards.

Rising rates will impact longer-term bonds more so than shorter-term bonds. Ultimately, this is a positive for investors as bonds will once again become a much more reasonable alternative and complement to stocks with interest rates that more closely resemble historical norms than a last ditch effort to keep the economy afloat. In the interim, however, as these price changes occur there could be some pain, particularly for investors in longer duration bonds.

Our outlook for bonds is to continue collecting interest payments and try not to focus on price changes too much. This is easier when the Fed moves slowly and you own shorter bonds that move less. Holding bonds for the long-term or to maturity also helps keep the focus off price fluctuations.

There are some occurrences that seem much more likely than others to occur than others in 2016. Simultaneously, we can say with a large degree of confidence that some things will happen that few, if any of us, saw coming. The markets are a mix of obvious occurrences, unforeseen consequences and flat out surprises. This year things will be made all the more complicated by the presidential election and how Wall Street reacts to the leading candidates (once they are decided).

As with any predictions regarding financial markets, all of the above is subject to change.

Investment Counsel wishes you a happy and prosperous New Year!