Quarterly Economic Update 4Q 2015

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The quarter in brief. Stocks managed to rebound nicely in Q4 though nearly all of the gain came in October. As the quarter progressed, the prospects of the first Fed rate hike in 10 years and general investor caution pushed markets lower. The S&P 500 still managed to finish the quarter up 7.04 percent and was one of the few indices posting positive returns for the year.

Economic news. The U.S. economy expanded 2.0 percent in Q3, a rate much lower than the 3.9 percent posted in Q2. The report reflected positive contributions from personal consumption and government spending, but once again was offset by a contracting manufacturing sector and weak exports. Personal consumption expenditures grew at a 3.1 percent annual rate, representing the lion's share of GDP growth for the quarter and the year.

Total nonfarm payroll employment increased by 851,000 in the quarter, and the unemployment rate was unchanged at 5.0 percent. All told, the U.S. added 2.65 million jobs in 2015 with Q4 being the strongest quarter. Average hourly earnings grew 2.5 percent and lower energy prices benefited consumers. However, the savings rate reached a high of 5.5 percent in December, a level not seen in three years, indicating consumers remained cautious.

Though the consumer side of the economy is proving resilient, the manufacturing side continues to struggle. Weak global growth and the strong U.S. Dollar continued to hurt manufacturing. The Dollar has risen 25 percent in trade-weighted terms against major currencies since the end of Q2, 2014, helping push the ISM manufacturing index down to a December reading of 48.0, a level that is indicative of a contracting manufacturing sector.

The Federal Reserve raised rates (from 0.00 percent to 0.25 percent, to 0.25 percent to 0.50 percent) in December for the first time since 2006. This move was widely anticipated and expectations, based on the Fed's own forecast, are for the Fed Funds rate to be at 1.4 percent by year-end 2016. In contrast, at least 60 of the world's central banks either cut interest rates or implemented new stimulus measures during the year. Europe and Japan continued their programs and China lowered rates and eased reserve requirements as growth in the region remained sluggish.

Markets. The market rebounded in October to post the best monthly return in four years (S&P 500 +8.44 percent), only to lose ground in November and December, as geopolitical instability, continued commodity pressures, and the concerns over a Fed rate hike paralyzed investors. Nearly all asset classes posted positive returns in Q4, with large-caps (S&P 500 +7.04 percent) showing the strongest recovery. Despite the strong fourth quarter, calendar year returns were mixed, with very few asset classes posting positive returns.

Index Performance	Q4 2015	Q3 2015	YTD
Domestic Equity			
S&P 500	7.04%	-6.44%	1.38%
Russell Mid Cap	3.62%	-8.01%	-2.44%
Russell 2000	3.59%	-11.92%	-4.41%
International Equity			
MSCI EAFE	4.71%	-10.23%	-0.81%
MSCI Emerging Markets	0.73%	-17.78%	-14.60%
Fixed Income			
Barclays Aggregate	-0.57%	1.23%	0.97%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Leadership was narrow for the year, as the 50 largest stocks in the S&P 500 were up an average of 10.3 percent while the bottom 50 declined by more than 22 percent. The last time the divergence was that large was the late-1990s when large-cap technology names dominated the market. In fact, by removing four of the larger stocks in the S&P 500 – Facebook (34 percent), Amazon (118 percent), Netflix (134 percent), and Google (44 percent) – the return of the S&P 500 would have been -5.0 percent for 2015.

Sluggish growth coupled with growing risk aversion led to the underperformance of small- (+3.59 percent) and mid-cap (+3.62 percent) stocks for Q4. The general "risk-off" sentiment kept small- and mid-cap stocks in the red, down 4.41 percent and 2.44 percent respectively for 2015.

International markets, as measured by the MSCI EAFE Index, posted a 4.7 percent return in Q4, but the rally was not enough to push international indices into the black for the year. Broad-based international markets finished the year with positive returns in local currency, but the MSCI EAFE posted a -0.81 percent return when measured in U.S. dollars. Japan (+9.3 percent) was one of the few developed international regions that posted positive returns for 2015. Emerging markets were flat for the quarter but posted double-digit losses (-14.60 percent) for the entire year, trailing developed markets for the third straight year.

Most U.S. fixed income benchmarks posted modest losses in Q4, influenced by rate-hike expectations and widening credit spreads. Treasuries performed relatively well but corporate bonds and high yield securities performed poorly. The Barclays Aggregate Index (a mix of mostly government, corporate, and mortgage-backed securities), was down .57 percent for Q4, but managed to post a 1.23 percent return for the year.

All told, 2015 was another difficult year for asset allocation strategies, as it represented the third straight year where two or fewer major asset classes outperformed the S&P 500. This year it was real estate and small cap international equities – all others were flat to negative.

S&P 500 Sector Performance	Q4 2015	Q3 2015	YTD
Consumer Discretionary	5.79%	-2.56%	10.11%
Consumer Staples	7.64%	-0.20%	6.60%
Energy	0.20%	-17.41%	-21.12%
Financials	5.96%	-6.72%	-1.53%
Healthcare	9.22%	-10.67%	6.89%
Industrials	8.00%	-6.90%	-2.53%
Information Technology	9.17%	-3.70%	5.92%
Materials	9.69%	-16.89%	-8.38%
Telecommunications	7.61%	-6.85%	3.40%
Utilities	1.07%	5.40%	-4.85%

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All S&P 500 sectors posted gains in Q4, although the energy and utility sectors were barely higher. Healthcare and technology, which represent 35 percent of the S&P 500, were strong in Q4 and also were among the strongest sectors for the year. While consumer discretionary lagged in Q4, it was the top-performing sector for 2015 at 10.11 percent. Though industrials and materials were among the leaders in Q4, a weak manufacturing sector and plummeting commodity prices caused them to be the worst for the year. Energy was the worst performing sector for the second straight year.

Outlook. The first month of 2016 is now in the books and it wasn't pretty. In fact it was the worst January (-5.07 percent) for the S&P 500 since 2009 – even after a 2.4 percent rally on the last day of the month. The market has essentially given nearly everything back that it gained in Q4. Disappointment with the Fed, soft economic data, and a mixed start to the Q4 earnings season brought about a level of pessimism not seen since Q3 of last year. On January 29 all of this cynicism was seemingly validated when the Bureau of Economic Analysis released the first estimate of Q4 GDP (+.70 percent), a level much softer than the market expected.

Though recent economic data has been mixed, the risk of a recession seems low. While currency appreciation and falling commodity prices are hurting the industrial sector, leading economic indicators are still pointing to reasonable strength in the non-manufacturing areas of the economy. Healthy job growth, higher wages, and the positive impact of lower gasoline prices should keep the consumer side of the economy firm. As such, consensus calls for a year much like the last – somewhere between 2.0 percent and 2.5 percent. Not great, but not recessionary either.

The Fed's year-end forecast for the funds rate is at 1.4 percent, the market however is less convinced, as the futures market is indicating .90 percent. Most other major economies are using monetary policy to stimulate their economies (most notably Europe, Japan, and China), and doing so aggressively. Even as the U.S. begins to tighten, short-term rates are likely to remain well below inflation – in other words – still accommodative. In short, while diverging monetary policies may create more volatility, central banks across the globe remain supportive.

The economy keeps plodding along yet it is troubling that corporate profits have stagnated. Profit projections for Q4 2015 (for the 40 percent of S&P 500 companies that have reported so far) fell by 5.8 percent and represents the third consecutive quarterly decline, a feat not seen since 2009. The declines are primarily coming from two sectors (energy and materials) that make up roughly 10 percent of the S&P 500. Exclude these energy related sectors and S&P 500 earnings growth was still a paltry two percent. Not great, but also not at levels typical of a bear market.

With better employment, stronger wage growth, and lower fuel costs, the consumer should keep the economy afloat. A more stable dollar and consistent energy prices could stabilize the industrial side of the economy and help kick-start anemic earnings-per-share growth. Stock market volatility on a day-to-day basis is more a barometer for investor sentiment and less about market fundamentals. After the sell-off, the U.S. market sells at roughly 15 times earnings, a level much closer to historical norms. As such, recent activity appears to be more of a price adjustment and less a precursor to a prolonged bear market. Admittedly, the margin for error is far less than it has been in recent memory.