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INSIGHTS

A QUARTERLY NEWSLETTER BRINGING YOU FINANCIAL INSIGHTS

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2015 Q4 Insights: "Long or Late?"

2015 INDEX RETURNS

2015 YEAR-END WRAP: Happy New Year! And this year I truly mean it, as we turn the page on what can only be summarized as a *deeply frustrating* 2015. Even after a strong bounce in Q4, the past year proved to be an exasperating one for investors. Not only did the S&P 500 end the year essentially flat (closing down 14 points to 2043 but positive 1.38% after including dividends), it seems as though any and every potential market trend quickly reversed itself—case in point, the Index crossed the flat line a record 30 times over the course of the year as it repeatedly sought and then lost traction.

Whatever positive performance did exist was confined to a very small, select list of stocks. In fact, if you remove the 10 largest stocks from the S&P 500, the resulting hypothetical S&P 490 would have lost 4.60% in 2015. And overseas, markets lost ground as well, with Developed Markets (Europe, Japan, etc.) losing 0.81% and Emerging Markets once again suffering (down 14.92%) due in large part to China's continued economic slowdown and resulting currency devaluation in August.

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	NOTABLE SECTORS	Q4	TTM*
STOCKS	***GLOBAL EQUITY***	***5.03***	***-2.36***
	U.S. Large Cap (S&P 500)	*7.04*	*1.38*
	U.S. Small Cap (Russell 2000)	*3.59*	*-4.41*
	International Developed Markets	*4.71*	*-0.81*
	International Emerging Markets	*0.66*	*-14.92*
BONDS	***GLOBAL BONDS***	***-0.92***	***-3.15***
	U.S. Aggregate (High Quality)	*-0.57*	*0.55*
	U.S. High Yield (Low Quality)	*-2.07*	*-4.47*
	International Aggregate	*-1.26*	*-6.02*
	Emerging Market Debt (USD)	*0.98*	*1.29*
ALTS	*Gold*	*-4.93*	*-10.46*
	Commodities	*-10.52*	*-24.66*
	Master Limited Partnerships	*-2.76*	*-32.59*
	Real Estate	*7.08*	*2.52*
CASH	*Inflation*	*-0.15*	*1.18*
	Cash (3-month T-bills)	*0.02*	*0.03*
	U.S. Dollar Index	*2.30*	*7.80*
	**Trailing Twelve Months*		

Losses were not confined to stocks. Global bonds (-3.15%) and higher yielding "junk bonds" (-4.47%) all retreated in 2015. Alternative assets such as gold (-10.46%), copper (-25.54%) and energy infrastructure assets (-32.59%) all posted losses for the year. The takeaway? Genuinely responsible (a.k.a. "diversified") investors most likely lost ground in 2015, even as the bellwether U.S. benchmark we all know, the S&P 500, eked out a minimal gain after dividends. Very frustrating indeed!

No one likes losses; and the current economic malaise — which we termed "*Flying at Low Altitude*" in last quarter's Insights—simply adds fuel to the frustration fire. Recent investment debates center on whether U.S. economic growth will continue along it's already longer than average cycle, or whether we are actually late in the cycle and on the cusp of Recession. That debate could be essentially summed up in the title of this quarterly review…*"Long or Late?"* Traditional indicators (Leading Economic Indicators, service sector profits, consumer strength in autos & housing) all point to continued growth. However, other historically reliable signals (copper, oil, high yield, and corporate manufacturing profits) combined with a Chinese slowdown all hint at further weakness.

Thus, we have investor frustration over a trendless market seemingly exacerbated by a mixed economic outlook. But consider that the bulk of the weak economic data (oil, corporate profits, high yield, etc.) has been caused by one single factor—namely falling energy prices. In analyzing prior historical periods of economic weakness, falling energy prices typically don't lead the U.S. into recession. Conversely, just the opposite is generally true! Recessions are often actually caused by spiking energy prices—hardly an accurate portrayal of the current market situation. Furthermore, U.S. recessions generally occur in advance of recession overseas—which intuitively makes sense if we remember that the U.S. consumer is a key source of global end demand.

Therefore, at the present time it appears as though we are in the midst of a "*Long*" cycle, as both falling energy prices and overseas weakness are not typical harbingers of a pending U.S. recession.

A CLOSER LOOK AT Q4: While most of the attention was focused on Janet Yellen and the Fed's first interest rate hike in nearly ten years (more details below), it was actually the continued selloff in commodities that took the biggest toll on global capital markets, permeating all asset classes:

> **Alternatives**: The brutal bear market in commodities continued in Q4. The pain was widespread with gold (-4.93%), copper (-8.92%), oil (-17.85%), and agriculture (-3.63%) all reaching lows that haven't been seen since 2009 (Gold's total correction from its 2011 high is now approaching 45%). Assets tied to these commodities, such as Master Limited Partnerships (-2.76%), were also down with MLPs posting their worst annual return since 2008.
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> **Equity**: Global stocks rebounded (5.03%) in Q4 after suffering steep losses during the "Summer Squall." Large caps (7.04%) outperformed small caps (3.59%) for the second consecutive quarter, and growth (7.09%) outperformed value (5.41%) for the 5th quarter in a row. Needless to say, large cap growth was the best performing investment style, with non-commodity related healthcare (9.22%) and technology (9.17%) doing the heavy lifting. With the stronger dollar, U.S. stocks bested their unhedged overseas counterparts (3.24%), as developed markets (4.71%) outpaced emerging markets (0.66%).
>
> **Fixed Income**: Interest rates headed north in Q4 with the yield on the 10-Year Treasury Bond moving up 21 basis points, finishing the quarter at 2.27%. The move up in yields pushed down prices in high-quality bonds with Treasuries (-0.94%), TIPs (-0.64%), and the Aggregate Bond Index (-0.57%) all in negative territory. However, the real pain was not in bonds with duration risk but rather bonds tied to credit risk, and again, commodities were the culprit. With oil now near $36 a barrel, the balance sheets of highly leveraged speculative energy companies are still under stress, with some debt subject to bankruptcy risk. The duress in the junk bond energy sector affected the broader high yield bond market, driving the sector lower (-2.07%). Interestingly, 2015 was the first year since 1994 that high yield lost ground while the S&P 500 was positive.

OUTLOOK: We would be remiss if we didn't provide additional analysis on the biggest news event of Q4. After seven long years of zero interest rates, the Federal Reserve finally raised rates a quarter of a point at their December meeting. However, the highly-telegraphed move had little effect on global capital markets. The real market moving news is in what lies ahead.

While the lift-off was a long time coming, the year ahead promises even more Fed drama as the central bank looks to normalize interest rates in our (long or late?) maturing business cycle. We have opined here in the past that current investment decisions should not focus on when the Fed *starts* to raise interest rates but rather on when they will *stop*. Small moves in interest rates, in line with our "*Flying at Low Altitude*" thesis, should not be

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difficult for our economy to absorb. But, if the central bank moves rates too far too fast, the results certainly can be detrimental. The subsequent undesirable effects of a stronger U.S. Dollar (which adversely affects multinational corporate profits, etc.) and a flatter yield curve (which negatively impacts financial corporate profits) will inevitably depress corporate earnings. And if short-term rates get too high, the yield curve could invert (with short-term rates higher than longer-term rates), not only curtailing growth but serving as a highly reliable indicator of recession (correctly predicting the last five recessions dating back forty years).

What to watch for in 2016? Equity investors need to keep a close eye on the bond market to make sure the Fed doesn't engineer a policy mistake and flatten or invert the yield curve—but that's not exactly exciting as the media well knows. Thus, the airwaves will undoubtedly be dominated by the upcoming presidential election. Clinton? Trump? Rubio? Cruz? Or a Bush comeback? Stay tuned…

Deron T. McCoy, CFA, CAIA, CFP®, AIF®
Chief Investment Officer

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