



The Financial Markets

- The Federal Reserve increased short-term interest rates by 0.25% at its December policy meeting after seven years of keeping the federal funds rate near-zero. The yield on the 10-year Treasury note increased 10 basis points to 2.27% at quarter-end, while the 2-year note yield increased 38 basis points to 1.05%.
- During the fourth quarter, the S&P 500 Index jumped 7.0%. The Russell Mid Cap and Small Cap Indices both rose 3.6%. For the year, the S&P 500 returned 1.4%, while the Russell Mid and Small Cap Indices declined 2.4% and 4.4%, respectively.
- The Materials, Technology and Healthcare sectors were the best performing groups for the fourth quarter, while Energy and Utilities showed the weakest performance.
- The MSCI All Country World ex-U.S. Index rose 3.2% during the quarter. The MSCI Emerging Markets Index managed a gain of just 0.7%, hurt by continued weakness in global commodity markets.
- International markets were hard hit, as the MSCI All Country World ex-U.S. Index dropped 12.2% during the quarter, while the MSCI Emerging Markets index plunged 17.9%.
- Commodities also fell hard during the quarter. Gold was down 5%, while copper dropped nearly 11%. Futures for November delivery of West Texas Intermediate oil were off 25%, and natural gas fell 15%.
- Commodity prices continued to slide during the quarter as the Bloomberg Commodities Index fell 10.6%. Gold and Silver were both down approximately 5%. Copper dropped nearly 9% and steel fell 6%. Futures for February delivery of West Texas Intermediate oil declined 21%.

The Economy

- Real Gross Domestic Product (GDP) increased 2.0% in the third quarter after rising a more robust 3.9% in the second quarter.
- The November real goods trade deficit continued to widen on a 12-month total basis, reaching its highest level since June 2008, implying a headwind for Q4 GDP growth. As a result, the Atlanta Fed cut its Q4 GDP growth rate forecast to just 0.7%.
- Labor markets overall are strong, though some sectors are contracting. Nonfarm payrolls expanded by 292,000 in December, a stronger than expected gain, while the previous two months' payrolls were revised upward by 50,000. However, job cut announcements totaled 598,510 in 2015, up 23.9% from a year ago, and the highest level since 2011. The top downsizing industry was energy, accounting for about 16% of all layoffs last year, reflecting the sharp drop in oil prices. The government sector followed with about 12% of layoffs, due to large-scale cutbacks in the military. Other top job-cutting industries included retail, computer, and industrial goods.
- In October, the Case-Shiller House Price Index increased 0.8% month-over-month. Mortgage rates have remained under 4%. While refi applications have slowed to 3.2% growth year-over-year, purchase applications are up 34.8%, near its fastest pace since October 1998, indicating housing demand remains solid.
- The ISM Non-Manufacturing Index (NMI) fell 0.6 points to 55.3 in December, contrary to the consensus estimate for a slight increase. This marked the fourth decline in the past five months and the lowest level since April 2014.
- December light vehicle sales came in at a 17.2 million unit annual rate, in line with estimates. For all of 2015, sales totaled 17.3 million, the strongest year on record, driven by solid consumer demand, high incentives, low gas prices and favorable credit conditions throughout the year.

Future Prospects and Portfolio Strategy

- **Macro-Economic Indicators:** While the dollar's strength and weak international economies are definite headwinds to the U.S. economy, most weakness in the domestic economy is contained in the Energy sector. Low unemployment, continuing low interest rates and low oil prices are all stimulative to consumer spending. So far, our leading indicators are not forecasting a recession in the next 6 months.
- **Interest Rates:** Currently, the Fed is out of synch with most central banks around the world, which continue to utilize extraordinary measures to sustain accommodative monetary policy. The recent strength in the dollar and declines in oil prices will continue to exert downward pressure on U.S. inflation, which could stymie the Fed's plan to normalize interest rates. Dimmer prospects for global growth and subdued inflation are keeping bond yields low.
- As the expected return for bond investors remains meager, we are positioning taxable bond portfolios defensively with durations below benchmarks, with an emphasis on investment grade corporate bonds. Municipal bonds ended 2015 at expensive levels with low yield ratios to Treasuries, yet remain a haven for investors seeking a tax-free stream of income.
- **Sentiment:** With the equity market's sudden decline in January, sentiment levels have fallen to levels last seen in August/September. The Investors Intelligence survey of professional investors reports that 35.7% of the survey respondents are categorized as Bears. This is the highest level in years and can be viewed as a contrarian signal for the stock market's near-term direction. Major corrections in the market usually occur when the level of Bears is much lower.
- **Valuation:** The recent drop in the stock market has brought valuations back closer to longer term averages. Modest growth in non-energy corporate earnings has allowed the market's multiple of trailing operating earnings to decline to 18.2x versus a long-term median level of 17.4x. Similarly, other valuation measures suggest that the market has become more reasonably valued, but is not inexpensive. Any recovery in the Energy sector could lead to the overall level of corporate earnings recovering more quickly than anticipated. Likewise, if sectors outside Energy and Materials begin to reflect slowing earnings, stock prices could see further downward pressure.
- While valuation levels on U.S. equities remain slightly elevated, pockets of opportunity should begin to emerge assuming continued modest economic growth and no acceleration in interest rates and inflation. International equity market valuations appear relatively attractive, though opportunities in those markets will depend on further dollar strength and whether the Chinese government can engineer a soft economic landing. Overall, we expect heightened volatility throughout the equity markets in the coming months as investors sort out a plethora of economic and market-related crosscurrents. Given this backdrop, our focus in 2016 will be on macroeconomic and corporate earnings trends, while maintaining reasonable diversification in client portfolios.



2016 Outlook

2015 was another year of modest economic growth across the globe with continued low levels of inflation and interest rates. Volatility picked up in the capital markets, especially in the second half of the year. Returns across asset classes were muted - U.S. equities were essentially flat, developed international equity markets were up in local currencies but down in U.S. dollar terms as the dollar appreciated during the year, and emerging markets sold off significantly. High quality bonds rose modestly in the U.S., while high-yield debt declined for the first time since 2008, primarily due to spread-widening in energy and commodity-oriented bonds. Commodities were the worst performing asset class during the year, as persistent pressure on oil and natural gas prices led commodity indices lower.

Our base case for 2016 is continued modest economic growth and low interest rates and inflation across the globe, with slightly more risk to the downside. Volatility is likely to stay elevated in 2016, as investors deal with many of the same concerns that they faced in 2015: Federal Reserve interest rate hikes, pressure on manufacturing and industrial production from low commodity prices, slower growth in China as it transitions from a manufacturing-based to a consumer-based economy, and geopolitical risks.

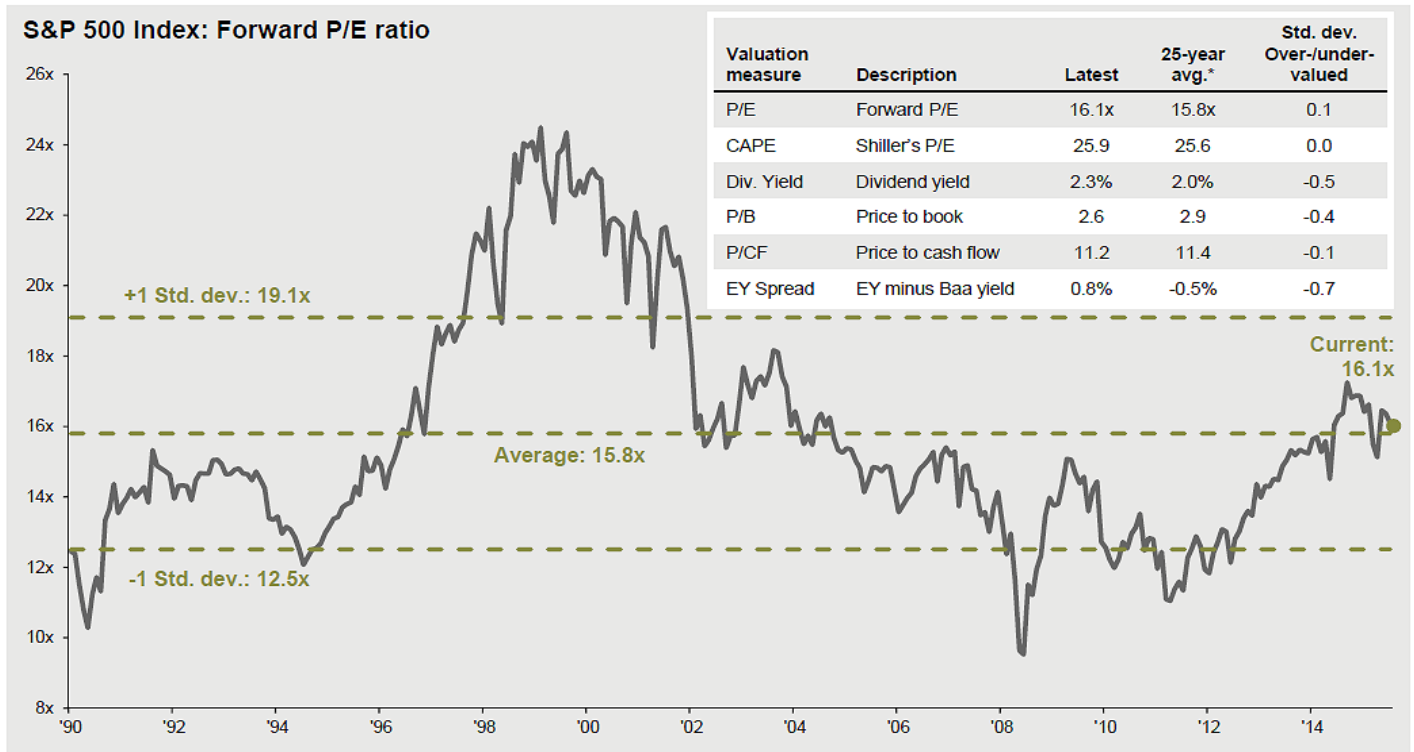
With the first hike in interest rates in December since 2006, the Federal Reserve began what the market believes will be a very gradual path of interest rate increases. While market volatility has historically picked up around the first rate hike, equity markets often advance after the initial increase in the Fed Funds rate, especially when the pace of rate hikes has been as gradual as what we expect this time. Valuations typically compress during rate hike cycles, leaving further equity market advances more dependent on earnings increases.

Overall earnings for the S&P 500 have been under pressure over the past several quarters, largely due to the increase in the U.S. dollar and the impact on Energy sector earnings from falling oil and natural gas prices. While earnings for S&P 500 companies outside of the Energy sector expanded modestly in 2015, the losses experienced by energy companies are likely to result in an overall earnings decline for the S&P in the mid-single digits. Energy companies are expected to post their first absolute decline in earnings in the past 48 years.

For 2016, current expectations are for S&P 500 earnings to grow by high-single digits to low-double digits, with estimates currently ranging from \$117 to \$126 per share. Using the most conservative of these estimates and the price of the S&P 500 after the decline in the first week this year, the price/earnings ratio on forecasted 2016 earnings is 16.4X. This is above the long term average of approximately 15X, but about in-line with average valuations for periods with very low interest rates and inflation.

2016 Outlook (continued)

The chart below shows the valuation of the S&P 500 since 1990 - a period of relatively low interest rates similar to what we are experiencing today.

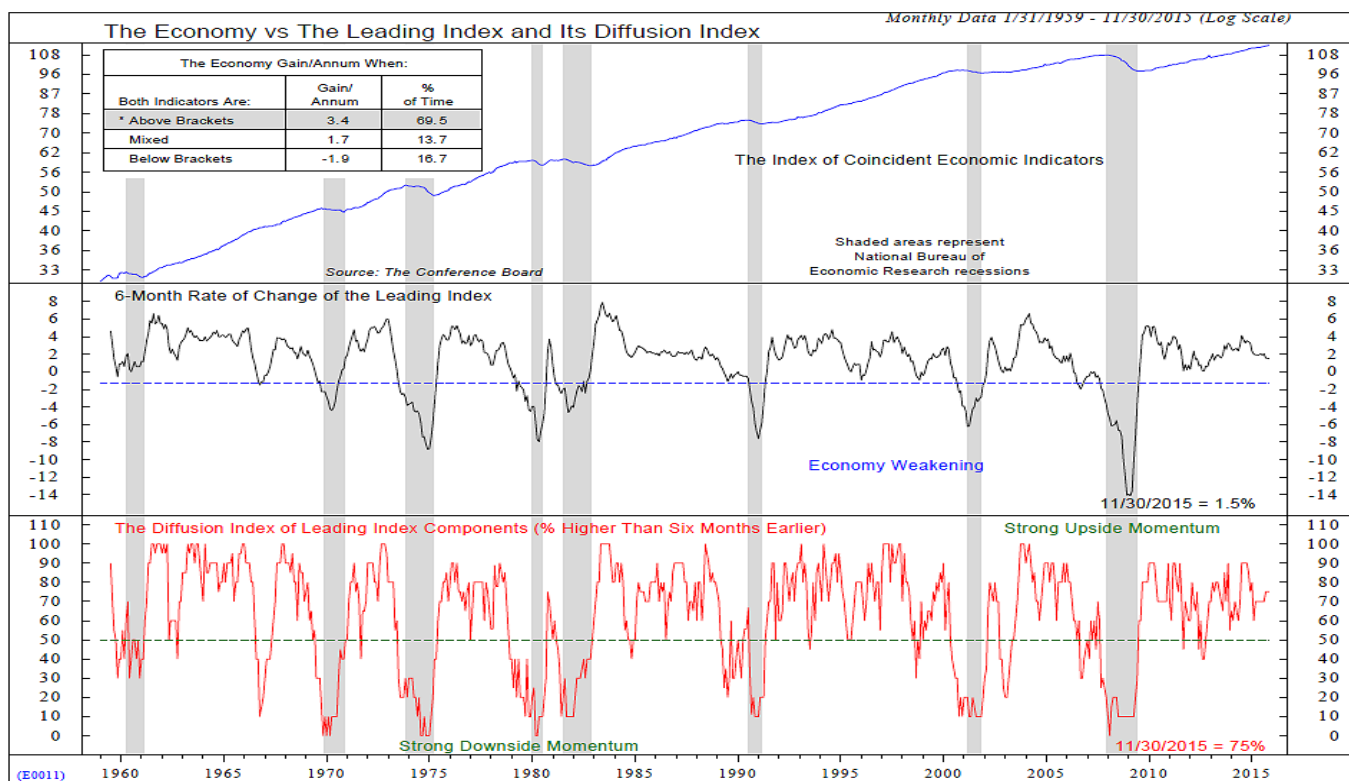


Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
 Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow data availability.
 Guide to the Markets – U.S. Data are as of December 31, 2015.

The ultimate level of earnings in 2016 will likely depend heavily on some recovery in energy prices, which appears more likely in the second half of the year, and moderation in the appreciation of the U.S. dollar, which has pressured earnings for multinational companies in the past 12 months. The biggest risk to earnings remains a more significant global economic slowdown or recession. While our current indicators do not suggest that a recession is imminent, global economic growth is slowing at the fastest rate since 2012, when the crisis in Europe was at its peak. While further deterioration in our indicators toward a recession would lead to more defensive actions across portfolios, that does not currently represent our base case.

2016 Outlook (continued)

One of our favorite measures of economic risk, the 6-month change in Leading Economic Indicators (shown below), has historically done a good job of indicating when the likelihood of a recession is elevated. Like most of our other useful indicators, this measure of change currently signals slower economic growth, but is not forecasting a recession.



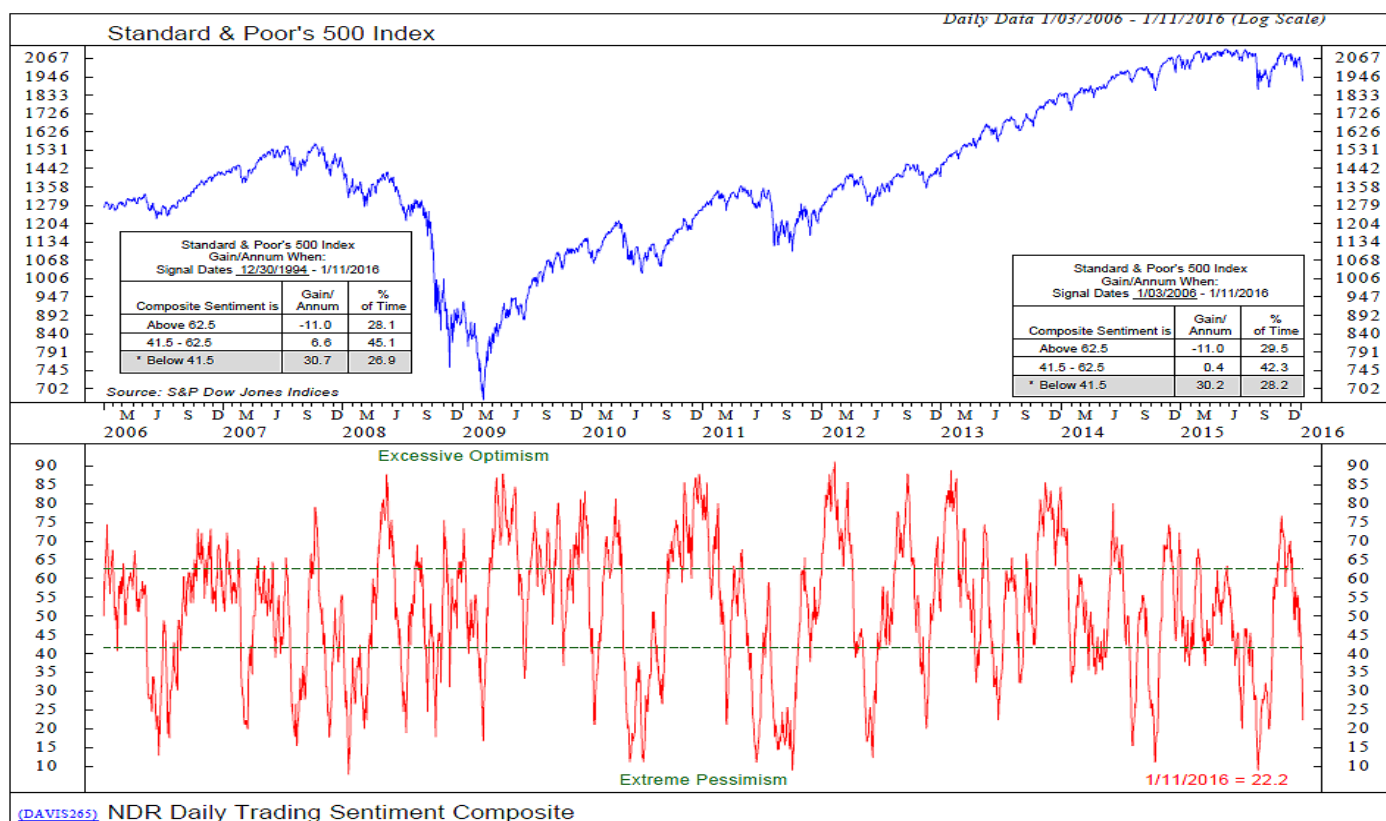
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Despite the increase in short-term interest rates by the Federal Reserve, yields further out the interest rate curve have not increased significantly. This is typical behavior for rate hike cycles, as short-term interest rates increase more than long-term rates and the yield curve flattens. The shape of the yield curve will be an important trend to watch in 2016, as a flat or inverted yield curve is usually a reliable predictor of economic stress. Another trend that bears watching closely is the recent increase in corporate spreads, particularly in high-yield bonds. To date, most of the spread-widening has occurred in high-yield bonds in the Energy and Mining sectors that are stressed by the massive declines in energy and other commodity prices.

While the U.S. Federal Reserve has begun to tighten, other central banks around the globe are continuing their easy monetary policies, providing liquidity to financial markets and helping to support the modest growth that global economies are currently experiencing. Central banks in Japan and Europe are still pursuing quantitative easing programs, which we expect they will continue for the foreseeable future. Meanwhile, the Chinese central bank has cut rates several times to help support economic growth, and it will likely enact additional cuts in 2016 if growth slows further.

2016 Outlook (continued)

2016 has gotten off to a difficult start, as equity markets have fallen significantly in the first two weeks of the year, driven by dramatic declines in the Chinese equity and currency markets, and further deterioration in the price of oil. Early economic reports have been mixed, continuing the theme of economic divergence that emerged in 2015, with manufacturing and industrial production being pressured by declining capital spending in energy and commodity markets, while measures of services and consumer-led growth showing more positive trends. Following the global downdraft in equities, sentiment has quickly become very negative as we head into earnings season. Our sentiment indicators are back to levels last seen during the August-September 2015 market sell-off, which may help to mitigate further declines during this pullback.



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While overall valuation levels on U.S. equities remain neutral to slightly elevated, we expect pockets of opportunity to emerge as long as economic growth is similar to last year and interest rates and inflation do not accelerate to the upside. International equity market valuations appear relatively attractive, while yields on high-yield bonds reflect concerns about the current economic environment. Given this backdrop, our focus in 2016 will be on maintaining proper portfolio diversification, and keeping a close eye on macroeconomic and corporate earnings trends.