Lowe, Brockenbrough & Company

First Quarter 2016
Investment Review

The Financial Markets

- The financial markets began the year on a sour note, and continued to weaken until Janet Yellen suggested that the pace of interest rate hikes would be more gradual than previously conveyed. Following the more dovish tone from the Federal Reserve, markets began to recover.
- During the first quarter, the S&P 500 Index retreated 11% through early February, then rebounded to finish the quarter up 1.3%. The Dow Jones Industrial Average was up 2.2%, while the Nasdaq fell 2.4%. The Russell Mid Cap and Small Cap Indices returned +2.2% and -1.5%, respectively.
- The Telecommunications, Utilities and Consumer Staples sectors were the best performing groups for the first quarter, while Healthcare, Financials and Consumer Discretionary showed the weakest performance.
- International equities delivered mixed results. The MSCI All Country World ex-U.S. Index of developed markets returned -0.4% during the quarter. The MSCI Emerging Markets Index increased 5.7%, as some countries recovered a bit from deeply oversold valuations.
- Bond prices rallied. The yield on the 10-year Treasury note fell 50 basis points to 1.77%, while the 2-year note yield decreased 33 basis points to 0.72%. The slope of the yield curve flattened.
- Credit strategies performed well in the second half of the quarter, as risk appetite improved for investment grade corporate bonds and high-yield debt.
- Commodities bounced during the quarter, with the Bloomberg Commodities Index up 0.4%. Gold jumped nearly 16% as the market shook off fears of a more hawkish Federal Reserve. The Bloomberg Composite Crude Oil Index dropped 26% through February 11, but rebounded 27% through the end of the quarter. The spot price for West Texas Intermediate crude oil rose 3.5%.

The Economy

- U.S. real gross domestic product (GDP) increased 1.4% in the fourth quarter of 2015, down from 2.0% growth in the third quarter. The Atlanta Fed GDPNow prediction for first quarter 2016 GDP is just 0.3%, while Ned Davis Research surveys suggest that GDP may well have grown 1.9% in the first quarter.
- Both the services and manufacturing segments of the economy are growing, according to the latest ISM surveys. The ISM's Non-Manufacturing Index (NMI) rose to 54.5 in March from 53.4 in February, while the Manufacturing Index rose to 51.8 from 49.5. Measures above 50 signal growth, while levels below 50 indicate contraction.
- The U.S. labor market continues to generate solid job gains. Nonfarm payrolls increased 215,000 in March and a revised 245,000 in February. The four week average of weekly unemployment claims continues to trend lower. Initial jobless claims are near the lowest in decades.
- Wage growth has averaged just 2.2% annually over the past 3 years. Despite more companies and states adopting higher minimum wages, there has yet to be a breakout in average wages.

The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226

804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com

The Economy (continued)

- In January, the Case-Shiller House Price Index decreased 0.2% for the month, but was 5.7% higher than a year ago. Mortgage rates have fallen to their lowest point in 2016 and are slightly lower than a year ago. Refi applications had previously slowed down, but volume is now picking back up with the decline in rates.
- Retail sales were weak in the first quarter, falling 0.3% in March, after an unchanged February and 0.4% decline in January. Auto sales have also cooled from the record pace of last year, though they are still up 3.1% so far in 2016.
- Evercore ISI reports that China's nominal GDP accelerated from 6.0% in the fourth quarter to 7.2% in the first quarter. The latest measure of year-over-year real GDP growth in China was 6.7%. China Internet Company quarterly revenues are up 42% year-over-year on average.
- Corporate profits have declined for the last three quarters, mainly due to the severe impact of lower oil and other commodity prices on energy, materials and mining company earnings. However, core earnings (ex. energy, financials and utilities) have been growing at mid-single digit rates.

Equity Market Monitor

- Interest Rates/Credit (+): The Fed's more dovish stance, combined with additional monetary easing by the European Central Bank and the Bank of Japan, means that bond yields are likely to remain at current low levels for a while longer.
- Sentiment (N): With the market's rapid decline to begin 2016, sentiment levels had fallen to levels last seen in August/September. Since the mid-February bottom in the market, sentiment has recovered somewhat, but is not yet at an extreme level of optimism.
- Macro-Economic Indicators (N): While the dollar's strength and weak international economies are definite headwinds to the U.S. economy, most domestic economic weakness is contained in the Energy sector. Recent bank reports have also noted some negative impacts from Energy. Low unemployment, continuing low interest rates and low oil prices are all supportive of consumer spending. Since the beginning of the year, our macroeconomic indicators are down slightly but have recovered in recent weeks. Our leading indicators continue to forecast no recession in the next 6 months.
- Valuation (N/-): The recent recovery in the stock market combined with the decline in S&P 500 earnings (driven primarily by Energy corporate earnings) has lifted valuations slightly. Modest growth in non-energy corporate earnings has allowed the market's multiple of trailing operating earnings to rise to 19.9x versus a long term median level of 17.4x. The ten year cyclically-adjusted price earnings multiple (sometimes called the Shiller PE) has risen to 26x reported earnings versus a long-term median of 20x. Both of these valuation measures suggest that the market is fully valued, although more in-line with long-term averages within the context of the low level of interest rates. An Energy sector recovery could lead to the overall level of earnings in the market recovering more quickly that currently anticipated.
- Taken together, the four components of our Equity Market Monitor point to a neutral to modestly favorable environment for equities. However, given current market valuation measures, a softening of corporate earnings would represent a strong headwind to higher prices.

Lowe, Brockenbrough
& Company

First Quarter 2016 Commentary and Outlook

Overview

Lowe, Brockenbrough reaffirms our views on asset allocation and long term investing - stay the course, for now; let time and compounding work their magic. While we acknowledge returns in stocks and bonds will likely be uneven and somewhat below long-term averages, we continue to believe that investment capital should be committed to the markets.

Generally speaking, we have made only modest changes to portfolios since the beginning of the year. Equities ended the quarter little changed. The Utilities and Staples sectors, as well as gold, benefited during the period as investors shunned risk. Bonds outperformed equities, confounding those market observers expecting higher interest rates. Our equity strategies remain positioned for positive economic and earnings growth, while fixed income portfolios continue to be defensively positioned with respect to rates, with an emphasis on corporate credit. Following is a more detailed discussion of our view of the investment landscape.

The Devil You Know

Despite what we characterize as convincing evidence that the U.S. economy, while sluggish, is generally in good shape, equity markets wilted in a recession scare to start the year before recovering by the end of the quarter. With this unpleasantness past, an easing of the market's dark mood could be expected, yet melancholy persists. The fact is there's profound unfamiliarity with some of our current guideposts: shockingly low or even negative interest rates, persistently anemic economic growth, fiscal and monetary policy impotency, a uniquely different Presidential race. The strangeness of this environment is almost impossible to ignore. And even if one tried, we are regularly saturated with the media's dark prognostications. Of course, no one has forgotten the 2008 financial crisis, or the 2002 bust for that matter. Both wounds still occasionally throb. It's quite clear that investors are in a shoot first mood, hence the swoons last August and in January. And, with nearly $7 trillion in government bonds (European and Japanese) priced to deliver negative returns, some are literally willing to pay to avoid perceived risk. The phrase 'the devil you know' couldn't be more apt.

So it seems everyone is obsessed with sidestepping the next big decline. No one is anxious to relive a 2008-style beating. That's understandable, but we simply don't see a looming disaster (more on that in the next section), and run-of-the-mill recessions are notoriously hard to predict. Market action can be very convincing, but it isn't great at predicting recessions, and neither are economists or Fed Governors. In fact, we don't know anyone with a foolproof system for timing the markets. We wouldn't stay in business if we panicked every time the market sold off - lose ten percent, get out, miss the recovery, get back in; lose ten percent, get out, miss the recovery, etc. You get the picture. Lasting wealth has rarely been built by jumping in and out of the markets, but much has been lost that way.

Slower for Longer

Global growth has indeed downshifted, and the U.S. isn't completely immune. Domestic fourth quarter GDP growth was a paltry 1.4%, but we were relatively optimistic that would set up a somewhat stronger first quarter result. Apparently, that will not be the case – first quarter growth will probably come in around 1%. This recovery will be forever remembered for its sluggishness. There are a number of factors at work here, and we'll touch on a few.

- Capital spending, a potent and traditionally dependable source of economic growth, has been conspicuously restrained in this cycle, and the only major bright spot had been in Energy, which recently collapsed with oil and gas prices. This being economics, unprovable theories abound for this spending deficit. The most tangible would be the downshift in Chinese growth. Their unprecedented debt-fueled investment cycle, which propelled much of the emerging world's growth, is waning. Fortunately, the U.S. and Chinese economies are only tangentially connected, so this has caused no major bleeding, though there have certainly been a thousand little cuts.
- Less tangible would be a general lack of animal spirits - a reluctance to risk capital. Pundits blame regulation, higher taxes, Federal Reserve meddling, debt proliferation, and a lingering hangover from the Great Recession, among other things.

(continued on next page)

- Then there is U.S. dollar strength, a result of our superior growth and higher interest rate. This has clipped U.S. exports, but the fact is our economy is dominated by consumption, which is the principal beneficiary of a strong dollar, low inflation and low energy prices.
- Also important, measured worker productivity growth is disappointing, as the economy matures and the workforce continues to age. While not an immediate threat, this could be a serious roadblock for long-term economic growth.
- Energy prices are an obvious concern, but we don't believe their collapse signals much about the health of the U.S. economy. Energy spending and production unexpectedly soared on exploration advancements, cheap credit and a near-religious faith that prices would remain high. Certainty is the magical force behind most boom-bust cycles. Many energy companies were certain that prices would never fall, and they borrowed and spent accordingly. Fortunately, the energy bust doesn't appear to be a huge problem for U.S. banks. The debt is mostly held by investors in the form of high-yield bonds. And recent price action may indicate a bottom has been found. On balance, cheap energy is good for the economy.

We're in the in the seventh year of this expansion - long in the tooth by historical standards - and every deceleration is accompanied by a funeral dirge. However, stalled growth isn't the same thing as an earnings recession. Core earnings (a measure excluding Energy, Financials and Utilities) have been growing in the mid-single digits. Companies are generally in good health, though profit margins may have peaked, as we have discussed previously. Key drivers of the economy such as employment, housing, and autos all appear to be on solid footing. Banks are in good shape. A wide range of measures indicate a relatively healthy consumer. Vigorous recoveries sow the seeds of their own destruction, with excesses in capital spending, employment and wage inflation. This recovery is notable for its lack of excess, energy excluded. We see no concrete reason to prepare for the end of this cycle. Slower for longer seems very logical.

However, some point to the Fed's December quarter point hike as evidence of trouble. And it's true that recent economic cycles have come to an end after the Fed raised interest rates to address building excesses. It won't be found in transcripts or the minutes, but the Fed raised rates to pop the tech bubble in 1999, and again from 2004 to 2006 to squash the bubble in housing prices. The distinguishing characteristic of the current expansion is its underwhelming pace and lack of excess; no such bubble exists. The Fed isn't trying to pop anything. They fully expected zero percent interest rates to ignite a vigorous recovery into which they could safely raise interest rates. Instead, they have faced a halting recovery that has given them little room for reestablishing normalcy. Nevertheless, zero rates forever is not a tenable policy. It's completely unnatural, penalizes savers (our most valuable citizens) and leaves no room for maneuvering in the next crisis. Hence, the Fed raised the fed funds rate to 0.25% in December. We shall see if they can manage it higher, as they claim. But this is a global market, and with trillions of dollars in European and Japanese debt having negative yields, the current pressure on U.S. rates is down, not up. It could be a while before rates completely normalize.

Unfamiliar but Stable Territory

As we've said, our read of the current environment is that one should expect an uneven and unnaturally long economic cycle. However, the unusual nature of this particular cycle cannot be described as comforting. The fast money crowd seems particularly nervous and prone to action, not unlike the human fight or flight response. So, we wouldn't be surprised to see a couple of bouts of unsettling volatility over the next couple of years; we hope to keep our heads and take advantage. An anecdote seems appropriate here: A portfolio manager from one of the largest and most successful institutional fixed income managers in the world was recently asked on the morning financial news what he thought of Bank of America bonds, given that the stock market has treated financials like they have the plague. He responded that he was an enthusiastic buyer of their debt because they're in a strong position to repay it. Pressed about their slow growth, he shrugged and reiterated that he was certain he'd be repaid. The investment environment is truly unfamiliar, but it's not scary.