Investment Update

Fourth Quarter 2015

2015 was only the third year since 1995 that all broad asset classes failed to register a return better than 10%, and in fact most did not even approach that level. Shares of large US companies were essentially flat, but they were a better place to be invested than smaller companies' shares or those of international companies in developed or emerging markets. Investments in fixed income did not do much better, with US Treasuries close to flat depending on time to maturity and credit spreads widened particularly for lower-quality corporate bonds. Returns in publicly traded real estate and commodities were in the single digits and sharply negative respectively. That is not to say that 2015 was a quiet year. Volatility in the second half was high, with sharp equity selloffs in August and September followed by similarly sharp rebounds in the final quarter. A handful of the very largest US companies did have strong returns in 2015 without which S&P 500 returns would otherwise have been several percentage points worse.

Equity Markets (Total Return)	**4th Qtr**	**1-Year**
Dow Jones Industrials	7.69%	0.22%
S&P 500	7.04%	1.38%
S&P Mid-Cap	2.60%	-2.18%
S&P Small-Cap	3.72%	-1.97%
MSCI All-Country World	4.64%	-4.26%
MSCI Foreign Developed Markets	5.11%	-2.74%
MSCI Foreign Emerging Markets	0.26%	-16.96%
US Bond Markets (Total Return)	**4th Qtr**	**1-Year**
Barclays US Gov't/Credit Intermediate	-0.97%	0.93%
Barclays US Gov't/Credit Long	-1.60%	-4.04%
Barclays Municipal Intermediate	0.96%	3.10%

The Fed finally started its much anticipated interest rate liftoff in December, reacting largely to a strengthening employment picture but there are few other signs of economic strength that would argue for rate increases now. Manufacturing output has been weighed down by trouble in the energy sector and pressure on export volumes from the strong dollar. Inflation is well below the Fed's 2% goal and falling commodity prices are a further indication of a very soft global economy. Additional interest rate increases will put Fed policy increasingly at odds with the rest of the world's central banks which are years behind in experimenting with the most accommodative of policies the Fed has employed since 2008.

Global stock markets have had an infatuation with central bank policies, often rising and falling on every shift in perceptions about future actions with less regard for other relevant considerations. However, after seven years of extraordinarily accommodative US monetary policy that has only produced a well below average recovery, there seems to be growing recognition of the limitations of monetary policy in driving actual growth. This hopefully improves the chance of tax and regulatory reforms which may be more effective catalysts. Along those lines, Congress' last-minute budget deal in December contains some very business and investment-friendly provisions and with significant bipartisan support, the odds of corporate

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tax reform in 2016 or 2017 seem to be improving. A greater political focus on expanding the economic pie rather than fighting over how to divide up a static or shrinking pie would be distinctly positive. China too may be realizing the limits of monetary tools and is formulating, in its own words, “supply-side measures”, including tax and regulatory reforms to boost growth with less emphasis on monetary stimulus and capital investment.

2015 saw companies spend a nominal record amount of $4.7 trillion on mergers and acquisitions (2007’s inflation-adjusted amount was $4.9 trillion) and a significant amount on share buybacks. M&A activity signals that growth is seen to be cheaper and easier to buy than build through internal investment. Net buybacks can be interpreted in many ways, but they imply at least a reluctance to invest for the future if not necessarily a dearth of opportunities. Such investment by companies has been lacking for years as they focused more on on keeping costs constrained. The economy would be better served by companies investing in capacity to facilitate long-term growth and increase the total amount of their earnings, not just the amount attributable to a single share which is increased by buybacks.

Overall S&P 500 earnings suffered in 2015 because of the fall in energy companies’ earnings and the strengthening of the dollar, but both look to be less of a headwind in 2016. While there may be more downside in the former, the impact will be dampened as they now make up a small portion of total S&P 500 earnings. Also, despite the Fed’s stated intention to keep raising interest rates, it does not seem that the US economy is strong enough to necessitate numerous rapid interest rate increases so we may have seen the last of significant dollar appreciation. Stocks are not particularly cheap with revenue growth hard to come by and profit margins at all-time highs from years of cost cutting. However, for US stocks in 2016, even low-single digit earnings-per-share growth, a 2% dividend yield, and a 2% reduction in share count through stock buybacks would result in returns of mid- to high single digits. We continue to favor stocks but look to be more defensive to protect against the rising risks of an economic slowdown, potentially signaled by widening credit spreads, a flattening yield curve and falling commodity prices.

In fixed income, with US economic growth still slow and the effect of Fed rate increases mostly limited to the short end of the curve, we think that high-quality intermediate bonds are attractive. Also, we are looking to add some variety within fixed income allocations such as floating-rate preferred securities.

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