2015 Review of the Markets

Index	4th Qtr Return	YTD Return
S&P 500	7.04%	1.4%
MSCI ACWI Ex USA	3.2%	-5.7%
Barclay's Bond Index	-0.6%	0.6%
Consumer Price Index	0.1%	0.7%

Investment Commentary

2015 was appropriately described in a recent headline, "The Year Nothing Worked: Stocks, Bonds, Cash Go Nowhere." The S&P 500 turned in the highest return of major U.S. indices with only a 1.4% return after a bumpy ride throughout the second half. Negative performance in energy and materials was offset by essentially four stocks – Facebook, Amazon, Netflix, and Google (now Alphabet). These four have become known as the FANGs and were up between 34% and 134% during the year. When a relatively small number of companies determine the direction of the market, it is known as a market that lacks breadth which can be an indication of weak market footing. Small cap U.S. stocks, as measured by the Russell 2000, fared significantly worse than large cap stocks and ended the year down 4.4%.

Outside the U.S., emerging markets weighed heavily on international indices. International stocks, as measured by ACWI Ex USA, finished the year down 5.7%. A strong U.S. dollar hurt the returns of unhedged U.S. based investors and decreased total return on foreign stocks by 6%. Foreign stocks ended the year up less than one percent in their local currencies.

In perhaps the most telegraphed increase in the federal funds rate ever, The Federal Reserve raised the target range for the federal funds rate by 0.25%. There was no substantial movement in the yield of the 10 year U.S. Treasury bond following the rate hike, and the U.S. interest rate bellwether ended the year essentially where it started. Short term interest rates, however, did move meaningfully throughout the year with the 2 year U.S. Treasury increasing from 0.7% to 1.1% over the past twelve months as expectations of future Fed interest rate hikes were priced into the market.

Bonds from all but high quality borrowers struggled meaningfully during the second half of the year, with high yield corporate bonds ending the year down 4.6% on a total return basis. Poor returns in high yield bonds were largely the result of two factors: (1) concerns regarding possible bankruptcies in the energy sector, which accounts for a substantial portion of most high yield bond indices and (2) concerns regarding liquidity in the high yield corporate bond market. Liquidity concerns were partially sparked by the announcement in December that the Third Avenue Focused Credit Fund would be liquidated and would be blocking investors from taking money out of the fund. While the fund primarily trafficked in distressed debt markets, which are generally regarded as much riskier than the high yield bond market, high yield bond prices certainly moved to the downside in December due to the negative headlines. In the fourth quarter high yield bond prices dropped to the lowest levels we've seen in 4 years.

Economic Outlook

The economic impact of the Fed's rate increase remains to be seen. Banks were quick to increase borrowing rates, such as Prime, but mortgage rates remain very low, albeit a few basis points higher than the end of 2014. With the absolute cost of longer term money remaining low, we do not expect an unwillingness to take on debt to purchase durable goods or homes. We believe a flattening yield curve is a likely scenario, where short term interest rates increase at a higher rate than long-term rates. A flattening yield curve could decrease banks' willingness to lend and slowing credit growth would pose a threat to the U.S. economy.

We expect the Federal Reserve to continue its rate increases at a gradual pace. Furthermore, we do not see any major foreign central banks tightening their monetary policy in the near future. Therefore, we expect the dollar to remain strong – a potential headwind for U.S.-based multinational companies and tailwind for their foreign counterparts. While the Fed's rate hike could potentially add to the uncertainty of the current economic landscape, we believe that beginning the process of normalizing interest rates is the prudent course of action. However, while we believe that keeping short term interest rates at zero indefinitely would have likely only created larger problems, the case for increasing interest rates based on the state of the U.S. economy was stronger 12 months earlier than it was when the action was finally undertaken in December. In 2013 we pointed out the majority of stock market returns came from multiple expansion (an increase in the price investors are willing to pay for earnings). We believe that source of return has far less room to run than it did at that time, so it's important to realize we could have a reasonably strong economy while multiples are contracting and decreasing the return of equity markets, potentially pulling them negative.

By and large, the actions that the Fed undertook during the financial crisis and the subsequent recovery have been unprecedented in nature and their long-term effects are certainly an open question at this point. While central bank actions may have saved the global economy from falling into the abyss in late 2008 and early 2009, the now even greater debt load (in both absolute terms and as a percentage of GDP) presents a unique challenge for central bankers to manage moving forward. Even if the unwinding of high levels of debt on a global basis is handled relatively well, the deleveraging coupled with slowing population growth should mean that economic growth will likely remain modest. It will likely be quite a long time before the global economy can sustain the relatively high rates of GDP growth that characterized much of the second half of the twentieth century.

China is a wild card. The nation borrowed massive amounts to develop infrastructure, stimulating its economy with everything from factories to luxury apartments. Even though its impact on the U.S economy should be minimal (you may remember from last quarter's Review that exports from the U.S. to China represent less than 1% of total U.S. GDP), a hard landing in China could reverberate around the world and into the U.S. in unknown ways.

Investment Strategy

As a function of U.S. equity valuations that we consider to be reasonable, but certainly not cheap, we began reducing equity positons for risk profiles that had been overweight. We believe the risk/reward profile of U.S. stocks is less attractive now than in years past (when many of our client's portfolios were meaningfully overweight stocks). In general, we have continued to avoid U.S. small cap stocks which, despite a period of relatively poor performance, continue to look expensive to us in a historical context and are generally more volatile during market weakness.

Internationally, we continue to believe neutralizing currency risk is an important tool as we harness the benefits of easy monetary policy overseas for our clients. Our thesis behind increasing foreign equities (as a percentage of our clients' equity allocations) early this year is still in place, so where we have reduced equity exposure it has primarily been through decreasing U.S. equity exposure.

Going back to 1997, high yield bonds are meaningfully cheaper than average, and much cheaper than the average ex-financial crisis. Given our relatively low expectations for future returns in stocks, these volatile bonds, which possess qualities of both equities as well as fixed income securities, could play an increasing role in portfolios going forward. On the investment grade side, we continue to find that intermediate term bonds to offer the most attractive risk/reward profile due to the shape of the yield curve.

2016 Update

Given the time of this writing, we would be remiss if we did not mention the high levels of volatility that have characterized markets throughout early 2016. Much like the volatility we experienced in the late summer of 2015, the headlines have mostly surrounded the ongoing changes in the Chinese equity markets and economy. We would remind clients that since 1980 the S&P 500 has experienced a drawdown of 10% or more in 56% of years. However, an S&P 500 investor who was willing to ride out the volatility and experience the drawdowns would have had an average annualized return of 11.5% over that period.

Given the volatile start to the year, we have been asked whether or not we are in the early stages of a bear market. In our opinion, the odds of a recession are currently low, albeit higher than in recent years. In the absence of a recession, we believe the case for a bear market is tough to make given that equity markets have not been flooded with hot money and valuations are certainly not excessive at this point.

Frequent readers of our reviews may know that we have long been cautioning that volatility would return to the markets and to expect as much after many years with very little volatility and high returns. As such, since the equity market's recovery late last year, we have in general returned to what we consider to be "normalized" equity allocations. While we concede that the levels of uncertainty reflected by the market may appear high now, our process is built upon a discipline of investing for the long term to accomplish our clients' goals. While it may feel uncomfortable to be a market participant in a high volatility environment, our discipline dictates that this volatility is part of the price to be paid for returns greater than the risk free rate, which today is near zero. Furthermore, we are always mindful that as an assets price goes down, its long term expected return increases by definition.

Volatile periods tend to be telling regarding a client's true tolerance for risk. Risk tolerance and preference is something that should be an ongoing part of client discussions. That being said, it is very rare that client goals change so dramatically that it is wise to change their risk profile. Major life events are certainly one instance, but even then it is rare that wholesale, overnight changes are advisable. Perhaps the worst case scenario is a client who reduces their overall risk profile in reaction to down equity markets, realizing losses and decreasing the probability of recovering those losses. Investing is in many ways a counterintuitive discipline and one that favors those who can be unemotional in their observations yet always mindful of the sentiment of other market participants.

Our clients are all unique and the most important thing we can do is to ensure that we build diversified portfolios that can stand the test of time, that our clients can stick to their portfolio allocations in higher volatility environments, and that we can help them to accomplish their long term goals. We welcome the chance to speak to our clients about their portfolios, their long term goals or markets in general.