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INVESTMENT COUNSEL

2016 INVESTMENT OUTLOOK

The domestic capital markets were buffeted by many competing forces in 2015 and, despite considerable volatility, concluded the year largely where they began it. Among the positive factors impacting the markets last year were the continued U.S. economic expansion which aided the ongoing improvement in the job market, low energy prices which put more money in consumers' pockets, rising home prices which contributed to an increase in household net worth and the persistent low interest rate environment which encouraged investors to seek higher returns albeit while accepting greater risks. On an inflation adjusted basis, corporate stock buybacks approached record high levels last year as did merger and acquisition activity, both of which benefited investors in the year just ended. Offsetting these impacts were the negatives of slowing overseas growth, recession-like conditions facing many commodity producing countries and companies, turmoil in certain lower credit quality fixed income instruments, an increase in terrorist activity both here and abroad and numerous geopolitical flashpoints that raised investors' concerns at various points throughout the year.

Of course the most important determinant of stock prices on a long term basis, corporate profits, also impacted investors in 2015. Data released thus far indicate that aggregate corporate profits fell through the first three quarters of last year with a further decline expected once fourth quarter results are reported. It bears mentioning, however, that as a result of the stock repurchase activity noted above that corporate profits per share may actually show a modest year over year increase in 2015 as lower earnings are spread among fewer shares outstanding. It is also worth noting that excluding the energy and materials sectors, both of which are suffering their worst downturns in many years, overall profits are expected to increase at a mid-single digit rate for the full year.

As shown in the table below, both the Dow Jones Industrial Average and the broad-based S&P 500 experienced price declines in 2015 in the worst year for investors since 2008. On a total return basis (i.e. including the impact of dividends) both indices were modestly positive for the year. Investors in the NASDAQ fared better though gains there were driven by very narrow leadership of a select group of stocks that we view as more than fully priced. Reflecting challenges abroad, investors in foreign markets suffered high single digit losses. Not shown, but also important, the benchmark ten year U.S. Treasury note ended the year with a yield of 2.27%, not dramatically different than the 2.17% level of one year ago despite the first Federal Reserve rate increase in nearly nine and one half years.

Year to Date Market Returns (excluding income)

	12/31/15 Price	Change From Year End
Dow 30 Industrials	17,425	-2.2%
S&P 500	2,044	-0.7%
NASDAQ Composite	5,007	+5.7%
MSCI ACWI-exUS*	242	-8.0%

**MSCI All Country World Index excluding U.S*

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Current Developments and Outlook

Many of the same factors that impacted the capital markets in 2015 will be relevant again in the New Year and there will be some new dynamics as well. As we enter 2016, the global economic environment appears similar to what was experienced last year. U.S. growth is expected to continue at a rate in the neighborhood of 2.5% which should be sufficient to allow domestic corporate profits to grow at a mid-single digit rate as the drag from lower energy sector earnings will fade unless oil prices fall further from current levels. The unemployment rate may tick down slightly from the current level of 5.0% as job growth, which averaged 210,000 per month last year compared to 260,000 in 2014 and 199,000 in 2013, is expected to continue. Despite the improvement in the job picture, wage growth remains subdued with the trend in average hourly earnings of approximately 2%, only slightly ahead of inflation. The percentage of workers in the labor force at 62.5% remains near multi-decade lows indicating both an aging population and the impact of discouraged workers who have given up seeking employment. Home price increases have bolstered households' net worth as the latest S&P/Case-Shiller home price index showed a 5.2% annual gain. Oil prices, which fell over 30% in 2015, also benefited consumers' bottom lines though much of that benefit was directed toward paying down debt and increasing savings as the U.S. savings rate recently hit 5.6%, its highest point in nearly three years. However, there have also been some negative ramifications of the energy price decline. In this country, as noted, energy sector earnings have plummeted some 50% which has dragged down stock prices in that industry. Not surprisingly, capital expenditures and employment have also declined precipitously in the sector. More recently, the industry has experienced distress as weaker companies heavily financed with debt have declared bankruptcy which has sent ripples throughout the high yield bond market causing yield spreads to widen meaningfully as bond prices fall.

Declining oil prices have also caused major setbacks to many foreign nations' economic prospects. Several exporters including Russia, Brazil, Canada and Saudi Arabia are currently either experiencing recessions or running unsustainable budget deficits. Dramatically falling prices are not contained to the energy sector but are being felt broadly across numerous commodities thereby increasing the financial strain on many emerging market economies around the world. This could prove to be particularly troublesome as developing countries' debt has ballooned in recent years. The International Monetary Fund (IMF) estimates that emerging market liabilities are now twice the size of their equity assets whereas only four years ago those two figures were at par. This increase in debt has been fueled by the corporate sector which the IMF projects has grown to a roughly $18 trillion market in developing economies up from about $4 trillion only a decade ago. Much of this borrowing is denominated in dollars and the repayment of that debt, along with other money being pulled due to poor investment returns, led to the first net outflow of capital last year from emerging markets since the 1980s. According to Standard & Poor's, emerging market corporate debt defaults are already at their highest levels since the Great Recession of 2009 and the fact that emerging market currencies have declined versus the dollar only adds to the burdens these economies face. Challenges confronting these markets matter more than ever to the overall global picture as emerging markets now account for over 35% of world GDP compared to about half that amount merely twenty years ago.

China is typical of many developing economies in that its growth has slowed dramatically in recent years as its export led development model fueled by increasing leverage has been pressured as global GDP and trade has moderated. With a total debt level of 242% of GDP according to credit rating agency Fitch, China has little room to increase borrowing to maintain its historic growth rate. Instead, it has relied on interest rate cuts, currency devaluation and other more interventionist policies as a way to prop up its economy. We can expect China to continue and possibly expand these policies in the coming quarters.

Developed countries are also resorting to similar policies in an attempt to jumpstart their economies and to deal with the consequences of previous poor decisions. Both the Japanese and European central banks have eased policy recently. It is estimated that the European banking system is still burdened with over $1 trillion in bad loans. In contrast to the U.S system, which has spent the last six plus years issuing equity and hoarding profits in order to shore up its financial position, the European banking system has a bad loan to total loan ratio of twice that of its U.S. counterpart. With overall European indebtedness remaining near record high levels, Europe is likely to see more austerity, currency devaluation, restructuring and low interest rates in 2016, policies which have enjoyed limited success thus far.

In contrast to many other central banks, the U.S. Federal Reserve tightened policy in December 2015 and indicated that even higher short term rates are likely in the year ahead. Such moves are expected to occur at a measured pace, however, as the Fed does not want to repeat the mistakes made in Europe in 2011 which saw the European Central Bank raise rates too soon causing it to quickly reverse course as tighter monetary policy derailed the fragile recovery. An important pillar of the Fed's current policy is to stimulate asset prices, thereby strengthening household net worth which should lead to increased consumption and demand in a virtuous, self-reinforcing cycle. Raising rates too quickly could upset the housing market recovery and may also spook stock investors should investor sentiment shift. Indeed, the broad stock market has barely advanced since the Fed ended its last quantitative easing policy in late 2014, possibly indicating an ongoing link between the capital markets and central bank policies. All else equal, divergent central bank agendas may lead to further appreciation of the dollar against other global currencies. While this will help keep a lid on inflation as it curtails import prices, it also will hurt American exporters whose products become more expensive on the global markets. This trend also has important implications for the stock market in the year ahead as foreign based sales result in lower reported earnings once translated back into the home currency.

Below average global growth will continue to pressure top line results of corporate America. Managements will likely respond as they did in 2015 by focusing on cutting costs, buying back stock, increasing dividends and pursuing mergers and acquisitions. Many of these trends were encouraged by activist investors which played perhaps as large a role as ever in the stock market last year. Merger and acquisition activity in 2015 on a global basis topped $4.7 trillion surpassing 2007's record level of $4.3 trillion, though this trailed the 2007 level of about $4.9 trillion on an inflation adjusted basis. With interest rates expected to remain at relatively low levels on a historical basis, we expect merger and acquisition activity to remain robust this year. Dividends, too, should increase in the coming year building upon the record 2015 payout. Goldman Sachs estimates that common stock dividends totaled nearly $400 billion last year while Howard Silverblatt of S&P Dow Jones Indices notes that dividends have grown in excess of 10% for four years running. While the rate of growth may slow, full year payments in 2016 should exceed last year's level. Given that dividends, and the reinvestment thereof, have accounted for about one-third of the stock market's total return over the last sixty years, investors should welcome the continuation of recent trends on this front. Inexpensive borrowing costs and a reluctance to make significant capital expenditure investments have also allowed for increased stock repurchase activity in recent quarters. The latest data available for the third quarter of 2015 show that stock buybacks reached $600 billion on an annualized basis, the third highest quarterly total ever. Given managements' questionable record of deploying shareholder capital in this manner, however, this activity may be cause for legitimate concern among investors as stock buybacks historically have peaked near market tops and have been curtailed dramatically once markets fall to new lows.

Geopolitical events must always be kept in mind even though it is nearly impossible to predict exactly when and how these events may impact the markets. On balance, the sheer number of concerns in the current environment is a reason for caution. Past *Investment Outlooks* have mentioned the threats posed by a slowing Chinese economy combined with a rising Chinese military. Russia continues to complicate our overseas interests while ongoing and extremely complicated Middle East affairs remain a seemingly permanent fixture in American politics. Meanwhile, the European refugee crisis is a significant and immediate humanitarian concern and has potentially far reaching implications should it cause greater divisions among nations on the European continent. Unfortunately, terrorism has become a regrettable fact of life as demonstrated by recent attacks in Paris, California and elsewhere. At home, we have an important presidential campaign under way and this firm would hope that candidates and politicians of both parties rise above the typical election year rhetoric and focus on addressing the challenges facing our great nation. Congress and the White House recently agreed on a long term budget deal in a possible sign for optimism on this front. Tax and regulatory reform would be another welcome sign but may be too much to ask in the current political climate.

The narrowness of the market's advance last year is worth mentioning. Six of ten S&P 500 sectors posted losses last year. Even more notable, it has been reported that the top ten stocks in the S&P 500 by market capitalization were up nearly 26% on average while the remaining 490 stocks experienced an average 1.1% decline. Overall, 220 stocks posted gains, 281 experienced losses while three were flat. This concentration in the stock market at a time when profit margins are near record high levels, earnings are advancing at only very modest rates and valuations are above long term trend lines are all reasons investors may want to temper their expectations as we head into the New Year.

Investment Conclusion

As we enter 2016, we remain highly focused on the philosophy and strategies necessary to achieve investment success on behalf of our clients. By understanding near term needs along with longer term goals, we are able to carefully construct portfolios that can preserve and prudently grow client capital on a long term basis while paying strict attention to minimizing the risks inherent in investing. Combining the meticulous study of the underlying fundamentals of our investments with the discipline to purchase those securities only when their valuations suggest reasonable buying opportunities remains a time tested strategy for success. Of course, a reasonable portfolio withdrawal rate is another key to allowing one's capital to grow on an inflation adjusted basis over time as no investment strategy can overcome large cash outflows year after year.

In any environment as we seek to make long term investments, we strive to balance the opportunities we identify with the risks surrounding those investments. All things considered in the current climate, we find ourselves paying more attention to the many risks that exist today. The volatility that characterized the capital markets in 2015 is likely to continue in the New Year so we are inclined to remain patient in investing excess cash reserves. Should the stock market experience a meaningful decline in the months to come, it will be important to remember that a portfolio is a diverse set of assets with a likely majority of those assets (i.e. stocks) geared toward long term goals, so if those long term goals haven't changed, then one's asset allocation shouldn't necessarily change simply based on one's emotions during a market downturn. On the contrary, times such as these will present serious long term investors with exceptional opportunities as stock market swoons have always been followed by recoveries that lead to new record high levels. Historically, having surplus cash and short term bond reserves accessible during unstable market periods has been a key driver of long term returns as sound investments become available at bargain prices.

While we continue to be mindful of the near term challenges facing investors, we are as hopeful as ever about the long term prospects for investment success. The U.S. economy remains among the strongest in the world and our financial system's recovery is well ahead of that of most of our global counterparts. American companies continue to innovate and are among the best positioned globally while U.S. investors can take for granted the best legal and accounting protections available in the world. Given this backdrop, we'll remain patient as we seek profitable investments in the highest quality assets.

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