Insights: December 2015

Market Overview and Performance

After recording a strong gain of over eight percent in October, equity markets sputtered to a flat finish for the month while bonds actually declined somewhat. It was a period marked by a good deal of back and forth trading action with not much progress at the end of the day. If this narrative sounds familiar, that is because it is reflective of what has been occurring in the market throughout 2015. Two steps forward and one step back as they say. During November stocks declined over three percent by mid month only to rally back to even by Thanksgiving. Similarly for all of 2015, equities climbed higher until late summer when they corrected by over 10 percent, only to rally back into positive territory by the close of November.

In fact, this November was even reminiscent of November 2014 when the price of oil declined sharply on news that OPEC would not be reducing their production levels. One thing that is different from last year however, is the levels of returns. At the end of November 2014, The S&P 500 was up almost 14 percent for the year and the Barclay's Aggregate Bond Index was up almost six percent. This year those returns are three percent and less than one percent respectively reflecting the confluence of mixed signals seen throughout the period. However, December, and a potential rate hike, could mark the beginning of a new period for the markets.

As always, thank you for reading our monthly Insights.

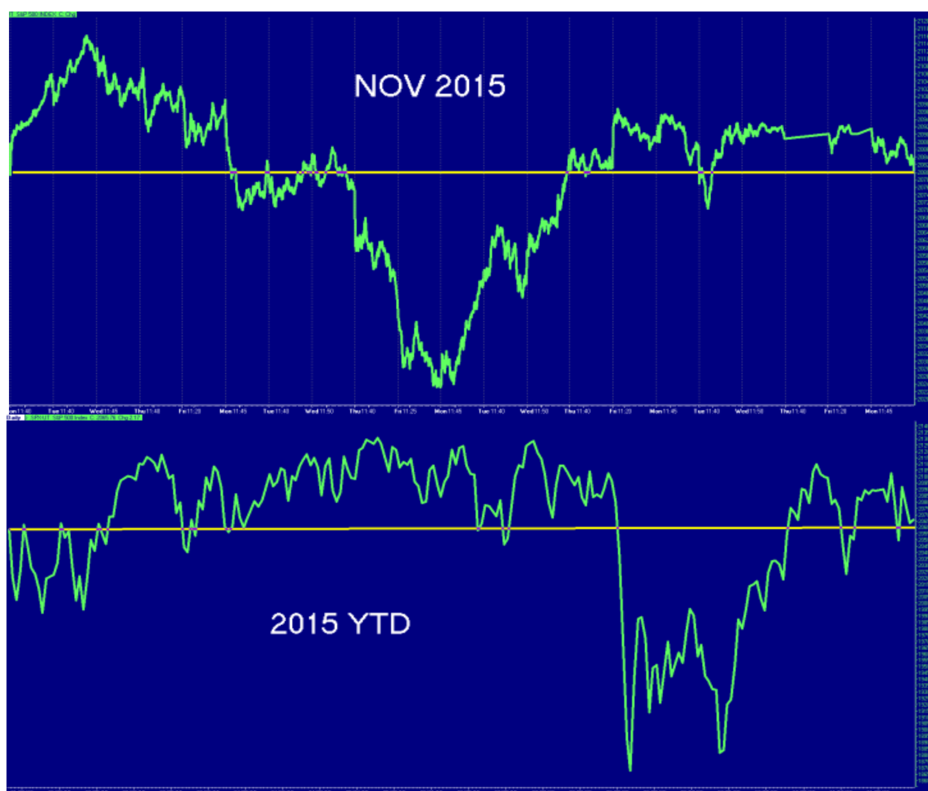
	Month to Date	***Year to Date***
Equity	***Percentage Change (USD$)***	***Percentage Change***
S&P 500 Index	0.30	3.01
Russell 2000 Index	**3.25**	0.64
MSCI EAFE Index	-1.56	0.54
MSCI Emerging Markets Index	**-3.90**	**-12.98**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-0.26**	0.86
Barclay's U.S. Credit Index	**-0.22**	**-0.01**
Barclay's Corporate High Yield Index	**-2.22**	**-2.00**
Barclay's Municipal Bond Index	0.40	2.58
Macro Measures		
Gold	-6.67	-10.03
Crude Oil	**-10.60**	**-21.81**
CBOE Volatility Index	7.03	-15.99
USD Dollar Index	3.38	10.99

December Themes – November Was an Echo of the Full Year – More Volatility But Little Progress; Market Leadership Now Clearly Defined for the Year; Energy Continues its Fall; Fed Rate Rise "A Sure Thing"

Another Flat Month…

November proved to echo the patterns we have seen for all 2015. In prior Insights, we have used the term "treadmill market" and with an average daily change of just 0.01 percent for the S&P 500 through the end of November, one could not be blamed for thinking little progress has been made.

November, Like All of 2015, Was Volatile But Flat

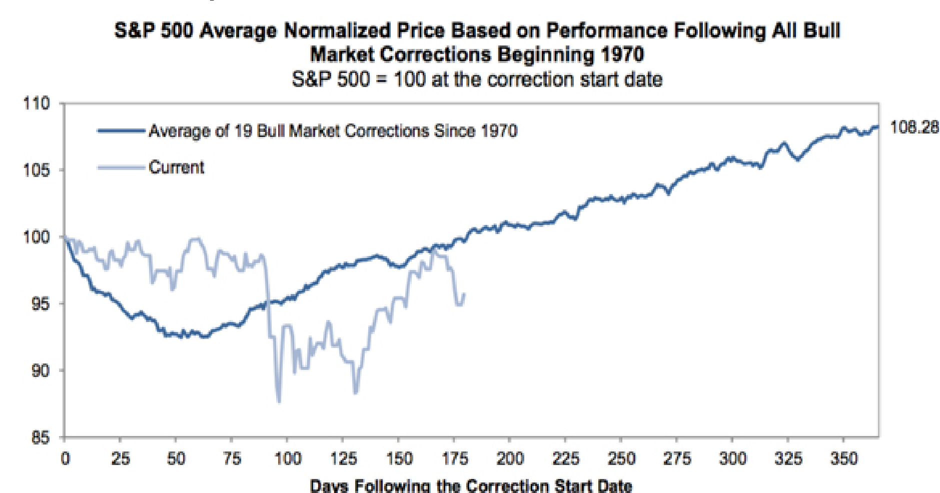


Source: S&P Dow Jones; Thomson One

We however, believe that the market has been remarkably resilient in 2015. The S&P 500 is up three percent (just one percent in price change but three total including dividends) Bonds have held in steady despite the fact that there have been significant headwinds present this year. These include strains on the future of the European Union via Greece, a global growth scare spurred by a slowdown in China, an oil and commodity collapse, a potential rising interest rate environment in the U.S. and several episodes of global unrest and terrorism. The so-called "wall of worry" is very real. That is a large reason why we have experienced so much back and forth it would seem. Each piece of encouraging economic data or policy development is seemingly met the next month with a conflicting signal. As we have said many times before, if one takes the time to look just a bit deeper there is a very constructive tale to be told about the current economic environment and the prospects for improved returns in the future. However, the tide of mixed headlines this year has left many investors skeptical and wary. That's not such a bad thing.

As we spoke about in last month's Insights, the long-awaited correction in stocks that came in August and September, while unpleasant at the time, was eventually viewed as healthy for the market because it had been such an extended period of time since the last 10 percent pullback. And as the chart below from BMO Capital Markets highlights, corrections that have occurred within an up market have led to 8+ percent gains over the following 12 months.

Since 1970, Bull Market Corrections Led to 8% Gains



Source: BMO Capital Markets Investment Strategy Group; Bloomberg

Additionally, while few of us would be overly excited about a three percent gain on equities for the year and flat bond returns, it would not be a bad result given the challenges that have arisen throughout the year as noted. Perhaps more compelling though is the historical evidence concerning the performance that follows a "mediocre" market depicted by low returns. Sam Stovall, Chief Strategist at S&P Capital IQ found that, "Since 1945, there have been 10 times

that S&P closed up less than 3% or down less than 3%. In the subsequent calendar year, the S&P was up an average of 12.8% and was higher 80% of the time." The Stock Traders Almanac published similar findings, claiming that the average return after a +/-3 percent year since 1960 was 18.25 percent with *ALL* years being double digit positive. Now, we are not suggesting that the market is destined for an up 20 percent year in 2016, but history suggests that a modest final year end tally can lead to future positive returns.

+/-3% Return Years Followed by Double Digit Gains

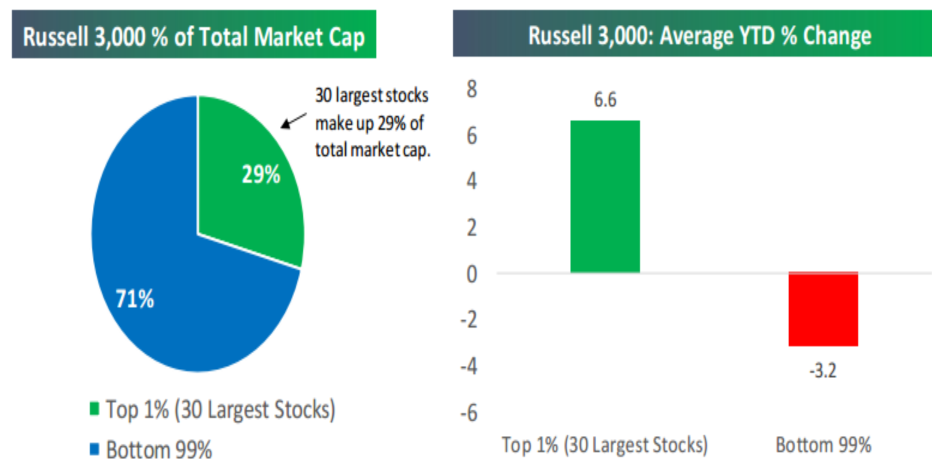
Year	S&P 500	Next Year
1960	-3.0%	+23.1%
1970	+0.1%	+10.8%
1978	+1.1%	+12.3%
1984	+1.4%	+26.3%
1987	+2.0%	+12.4%
1994	-1.5%	+34.1%
2005	+3.0%	+13.6%
2011	No change	+13.4%

Source: Stock Trader's Almanac; Navellier and Associates

Narrow Market Leadership

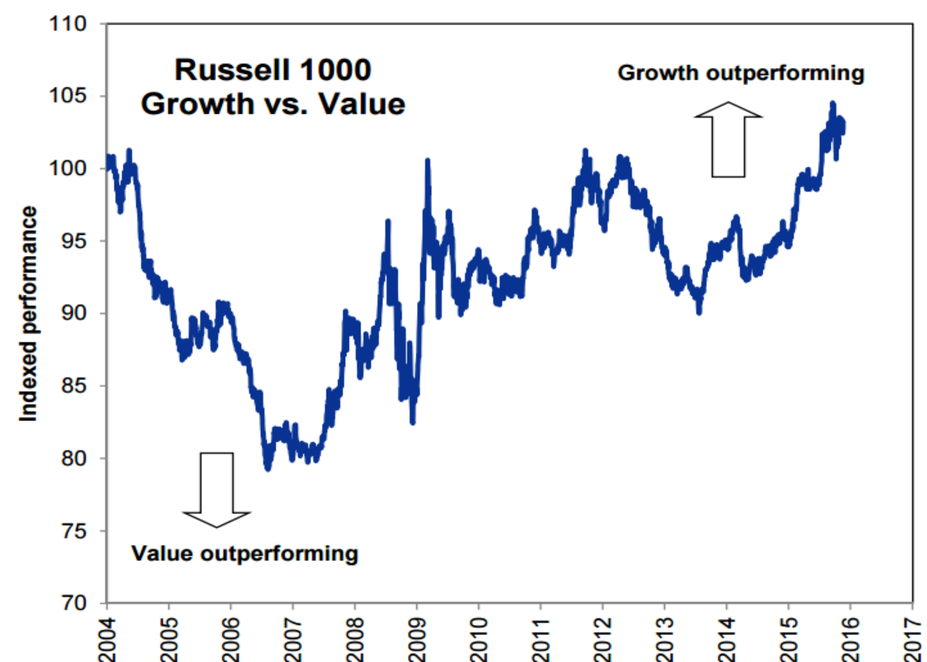
One of the most important effects that has resulted from a fairly flat market this year is that market leadership has been become focused in just a few areas, a narrow market in other words. Obviously, there are fundamental drivers of why a stock is performing well, but from a sentiment perspective, in a back and forth market where the average stock is not providing much return, investors tend to gravitate toward names that have been working well. Additionally, when investor concern is high, as is the case at present, large liquid U.S. stocks attract capital as well. The following chart from Bespoke Investment Group highlights the fact that the top 30 largest market cap names in the Russell 3000 Index, a broad measure of the stock market, have returned 6.6 percent so far this year versus -3.2 percent for the rest of the market. Further, market leadership has been focused on cyclical growth sectors like consumer discretionary and technology rather than traditionally value oriented areas of the market as seen in the second chart from Goldman Sachs.

Top 1% Largest Companies Notably Leading in 2015



Source: Bespoke Investment Group

Growth Has Been Significantly Outperforming Value



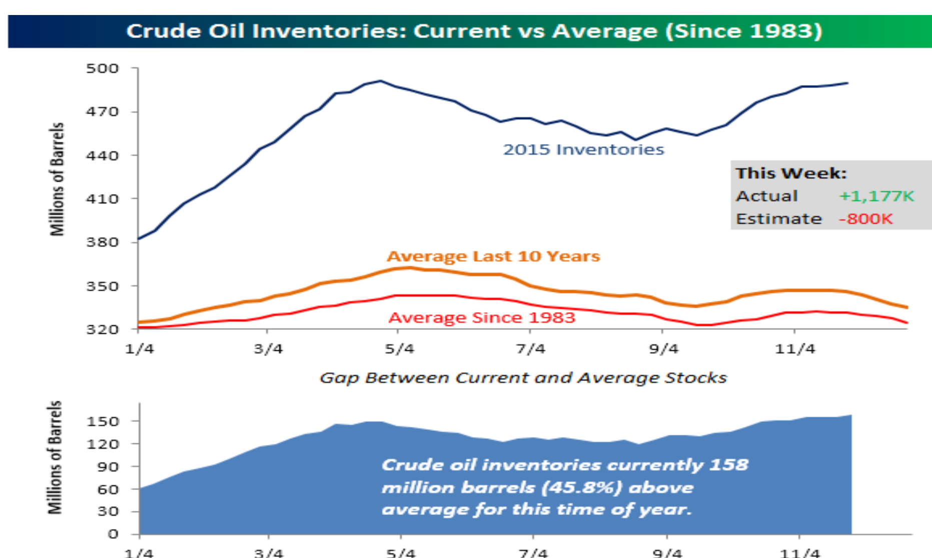
Source: Goldman Sachs Global Investment Research

Oil Continues Its Fall

It's no secret that what has clearly not led the market this year is the energy sector. We have discussed oil and broader energy dynamics at length in previous Insights, particularly in last December's letter when we saw a similar downdraft in oil as the result of a lack of an expected cut in production from OPEC. While the debate surrounding the root cause of the price declines since last year had centered around both demand and supply, by the end of this November,

it became clear that supply in the market was simply overwhelming any other factors. The general thinking was that OPEC and Saudi Arabia in particular were willing to let the price of oil decline to a level that would be unsustainable for the U.S. producers. Rapidly increased U.S. production has clearly had a dramatic impact on the amount of oil available worldwide, however, the Saudis and others firmly believed that at certain reduced price levels, U.S. producers would have to shutter production that is no longer economically viable. But things have not quite worked out that way.

Oil Inventories at Record Levels, 45% Above Normal



Source: Bespoke Investment Group

While U.S. producers have reduced the number of oil rigs in production, they have been selective. Older, less efficient, largely exhausted wells are the ones that have been closed down first while the newer more efficient and promising wells have maintained production. The result is that the new swing producer, the U.S., did not "blink" as OPEC had hoped.

After putting up with this less profitable scenario for over a year, it was widely expected that OPEC would announce production cuts at their annual meeting in late November. Instead, they announced that they were abandoning production targets altogether, sending the price of oil down 10 percent this month and back to levels not seen since the global financial crisis in 2009. Saudi Arabia as the head of OPEC has long held a policy that maintaining market share is of the utmost importance regardless of where prices fall.

However, other more resource constrained members like Venezuela, Iran, Nigeria, etc., can't afford such rigid strategies. As a result, you get the following. As the chart from Bloomberg illustrates, even if OPEC had reduced their production target there is a long, well established history of over-producing as members each try to continue generating revenue for their respective region.

OPEC Has A Long History of Over Producing

Above Target

OPEC's crude production has exceeded its target for 18 months straight. Now the group has set aside any limits on output and endorsed the current level.

Source: Bloomberg

Potential Warning Signs

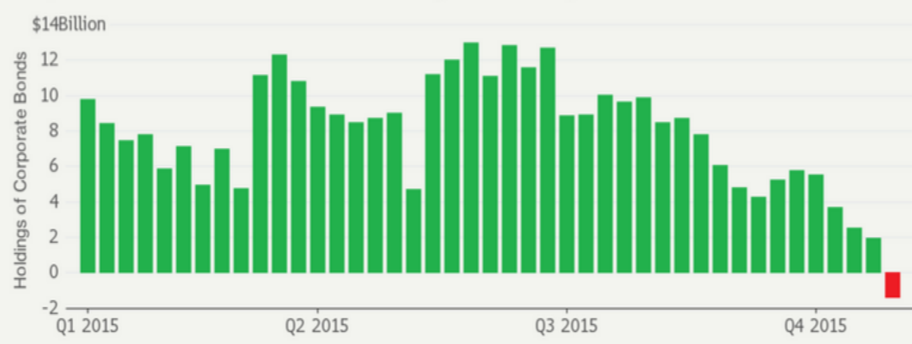
The low price of oil certainly has its benefits. Low energy costs help spur global growth and the average price of gasoline nationally in the U.S. is just $2.03 right now. However, there can be negative consequences. One of the warning signs of potential problems that we have highlighted in the past are high yield bond spreads. Essentially, there are an indication of how risky the market views the credit of a given entity. When the yield is higher, the credit is being assessed as more risky and inventors therefore demand more return for the their money. These spreads have been increasing since mid-2015.

High Yield Spreads Have Widened – Energy a Factor

Source: Federal Reserve of St. Louis; BoA Merrill Lynch

In the past, increasing high yield spreads have been a pre-cursor to a fall in equity markets. We have been watching this indicator closely given its past reliability, however, the fall in oil prices has been heavily influencing the measure. Small energy companies that have to borrow capital have suffered in the current environment, in some cases pushing their debt to distressed levels. S&P Capital IQ has said that while the spreads overall are around 800 basis points as seen in the previous chart, energy spreads are closer to 1110 basis points. The rest of the broader market is closer to 500 basis points. That does not indicate a cause for concern. Things could become problematic however if other industries begin to show signs of stress especially given the chart below. The chart shows that there really is no corporate bond inventory available at banks. This is a significant risk since a lack of liquidity could potentially lead to a bond market selling panic.

Lack of Bond Inventory Could Cause Liquidity Issues

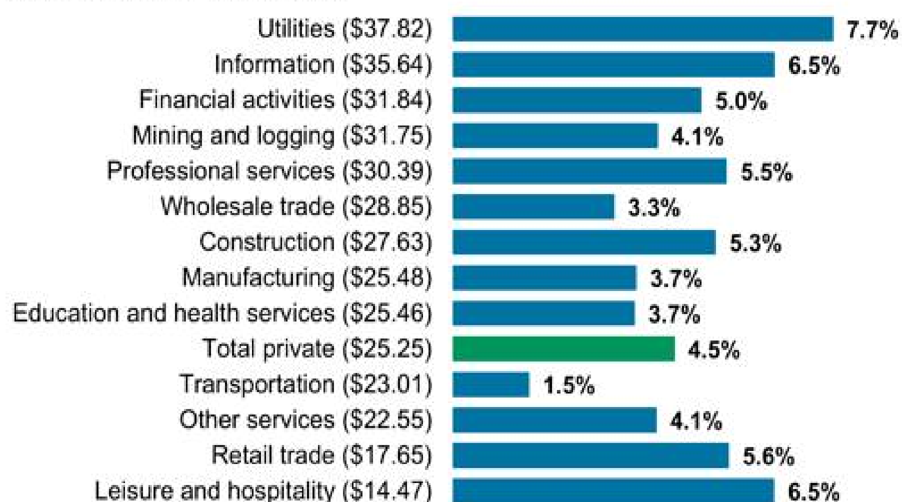


Source: Bloomberg; Zero Hedge;

The Fed – December Rate Rise Priced In

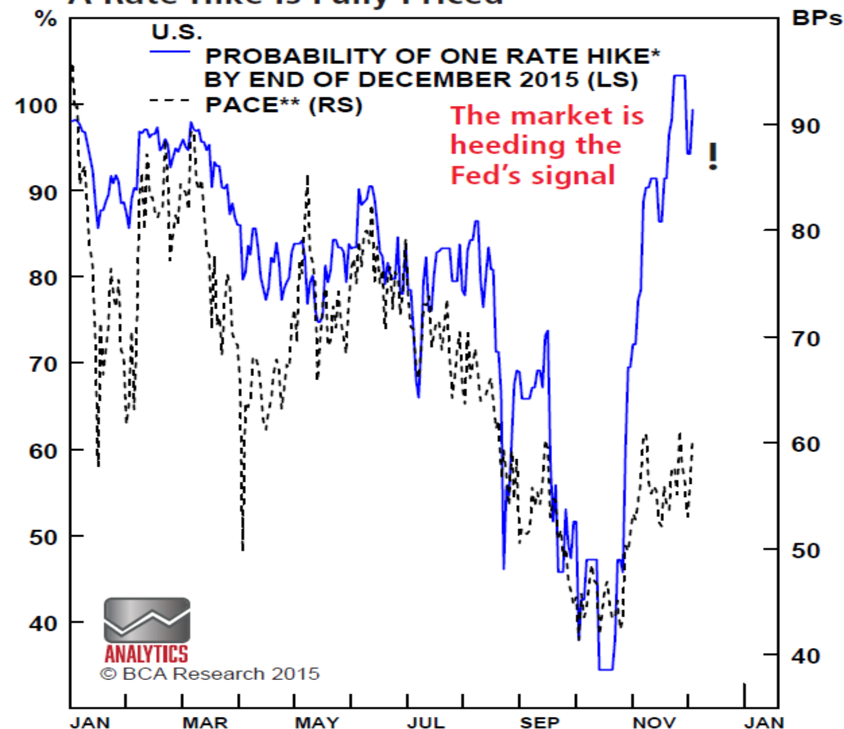
As we discussed last month, given the cumulative positive economic data in the U.S. the Fed is finally ready to raise interest rates this month. We have long talked about the robust health of the labor market, solidified by a very strong November jobs report. Up to this point, what has kept the Fed on the sidelines is the lack of inflation in the economy. While overall inflation remains at very subdued levels, we now have evidence that wage growth pressures are increasing as jobs simply become harder to fill. The chart below highlights the growth in wages across a wide variety of industries. This factor, combined with that last data point in November confirming strong hiring and low unemployment, has convinced the market that now is the time. With both components of the Fed's dual mandate seemingly having been met, the probability of a December rate hike soared to almost 100 percent.

Wage Inflation is Clearly Present Across the Economy



Source: Labor Department; Wall Street Journal

December Fed Rate Hike Probability Close to 100%

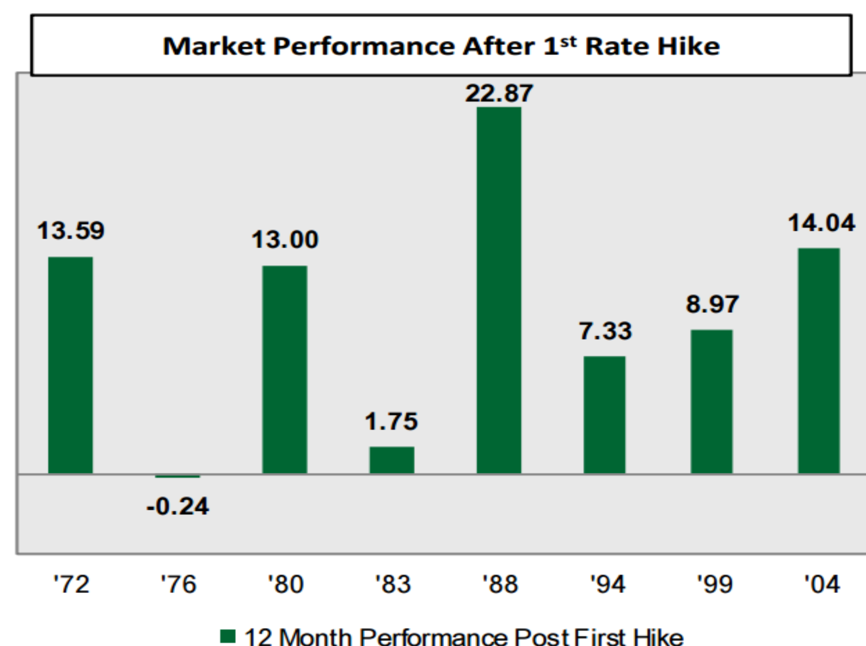


Source: BCA Analytics

And as we discussed last month, somewhat surprisingly, equity markets tend to rise after the rate hike cycle begins. As Cornerstone Macro points out in the following chart, the 12 months following the first rate hike of the past eight cycles have been overwhelmingly positive with an average

return of 10.2 percent and 7 out of 8 years seeing positive returns. This makes intuitive sense, since the factors that encourage the Fed to raise rates, a decent pace of growth and a solid labor market, also provide a very positive backdrop for stock markets.

Equity Returns Tend to Be Positive After First Hike



Source: Cornerstone Macro

Going Forward

Last month we stated that despite recent declines in certain areas of the market we remained confident in the narrative that global fundamentals were sound. We still hold this conviction and believe that the fall in prices has presented an opportunity for good entry points in selected long-term oriented investments. We therefore put money to work in equities during October and November. Given the overall improvement in the global economy and the seasonal factors that are now coming into play, combined with what is generally poor market sentiment, we feel that the investment environment could now be setting up for potential further gains as we look to 2016.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, selected health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy. Additionally, given the fact that we are likely about to enter a rising interest rate environment selected securities in the financial and energy sectors have been a focus for us since these sectors historically have done well when rates begin to climb higher.

While we are believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular remain attractive. Both of these global regions are firmly entrenched in a very accommodative policy environment which provides a tailwind for equity markets generally. Despite the fact that measures announced in November from Mario Draghi, the Head of the European Central Bank underwhelmed expectations, the ECB is still acting in a very asset friendly manner and there is increasing evidence that the recovery is Europe is being driven by consumption which is a very good sign going forward.

We remain underweight traditional fixed income. With an anticipated move away from emergency level rates likely coming in a matter of weeks, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has benefitted us thus far this year relative to the broader fixed income market. For reasons discussed, we have been actively avoiding exposure to the high yield market.

Commodities remain structurally challenged in our view. As a group, commodities are down over 30 percent so far this year as reflected by the S&P GSCI Commodity Index. With regard to oil, the fundamental outlook for the next 12 to 18 months is not likely to improve with sentiment extremely poor and inventories historically high. However, we believe that high quality names within the sector represent good long term value with the price of oil seemingly having stabilized somewhere in the $35 to $50 range for the foreseeable future.

Thank you for taking the time to read our thoughts on the markets this month.

Happy Holidays!

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