Quarterly Commentary 2015 | Q4

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"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." - Peter Lynch-

For perhaps the first time since 2011, when volatility disrupted a two year assent in asset valuations, investors found themselves forced to seriously examine their convictions last year. The on-going slide in oil prices, a slowdown in China and the increasing probability of the first interest rate increase since The Great Recession, prompted investors to seriously consider whether the advance in equity valuations could continue.

At first, investors were not sure how to explain the decline in oil prices and had little perspective on how markets and the economy would respond to a rate hike. Uncertainty is almost always problematic.

Yet overall, the fourth quarter was relatively positive, particularly in the United States. Domestic indices generally outperformed global, developed and emerging-market indices. Consumer confidence improved, spending increased, home prices continued to rise, and inflation (CPI) was stable.

Perhaps most encouraging, job creation remained steady, with unemployment pegged at 5%, indicative of what most economists consider full employment. By most measures, the economy appeared to be moving forward with its slow and somewhat painstaking recovery.

When the Federal Reserve finally moved forward with an interest rate increase in December, the reaction was muted. After the intense buildup which fueled rampant fear in the markets, the news seemed almost anticlimactic, failing to elicit much of a reaction from either the economy or the markets.

Unfortunately, the modest strength of the fourth quarter was not sufficient to pull major indices into positive territory for the year. The S & P 500 and the Dow ended 2015 down 0.7% and 2.2% respectively.

A Closer Look at Equities…

Although major domestic indices ended down for the year, many companies performed well and continued to produce notable results for investors. As evidenced by the Morningstar chart below, energy was the biggest detractor for the year.

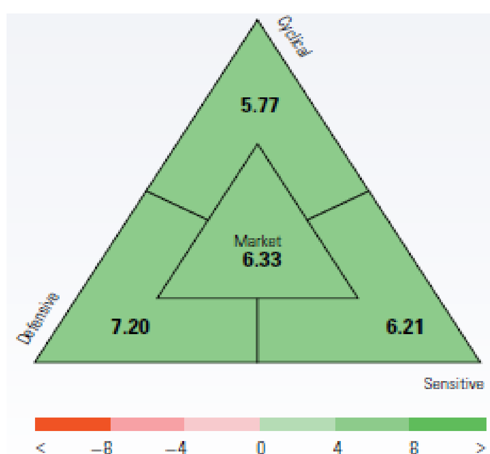
Sector	Quarter	1-Year	3-Year
Cyclical	**5.77**	**1.37**	**15.27**
Basic Materials	9.70	–8.97	4.67
Consumer Cyclical	4.99	6.29	18.13
Financial Services	5.36	(0.26)	16.72
Real Estate	6.88	1.58	9.97
Sensitive	**6.21**	**–2.70**	**11.61**
Communication Svs	4.87	5.68	12.05
Energy	–1.02	–22.69	–3.54
Industrials	6.74	–2.78	14.70
Technology	8.57	4.01	16.71
Defensive	**7.20**	**5.08**	**19.57**
Consumer Defensive	6.97	5.57	16.41
Health Care	8.52	7.13	24.38
Utilities	1.88	–4.62	11.58

Defensive stocks offered the best return for investors during the fourth quarter with healthcare leading the way. Johnson &

Johnson, Amgen, Bristol-Myers Squibb and Allergan were among the key drivers. Stocks classified as sensitive did well during the quarter, but not for the year. Microsoft, Google (now Alphabet Class C and A) and Facebook all posted solid returns of 26%, 25%, 22% and 16%. Apple, however, was down for the quarter, falling 4%.

Tech returns were muted by the decline in energy. Kinder Morgan dropped 45% after yet another dividend cut. Investors seeking yield, who often saw the dividends historically generated by energy-focused master limited partnerships as a given, were forced to re-think that position.

Cyclical stocks delivered a modest return for the quarter and the year. Amazon continued to outperform, ending the quarter up 32%. Banks such as JP Morgan Chase, Wells Fargo and Bank of America also fared well following the rate increase, which offered some much needed relief for net interest rate margins.



Q4 2015 Morningstar Sector Delta and Return %

As the New Year began, however, investors continued a sell-off that had begun in December. In the wake of plunging oil prices, the prospect of a continued slowdown in China and the anticipation of further Fed tightening, selling intensified. By the third week of January, the S & P 500 had fallen 8.95%, the Dow 9.41% and the Nasdaq 10.57%. All three indices had reached correction territory.

Fixed Income…

Fourth quarter returns in the domestic fixed income markets were dampened by rising interest rates, which was to be expected. When the Fed finally moved to raise interest rates, the yield curve flattened. The uptick in rates pushed bond prices down more than the underlying yield could offset. Much to the surprise of some fixed income investors, rates on short-term bonds rose more quickly than those on long-term bonds.

The 2-year Treasury bond rose 42 basis points to end the year at 1.06%, while the 5-year Treasury bond rose 38 bps to 1.76%, the 10-year rose 21 bps to 2.27% and the 30-year 14 bps to 3.02%. Conversely, Treasury Inflation-Protected Securities fell, as demand decreased, due to lower inflation expectations resulting from falling oil prices.

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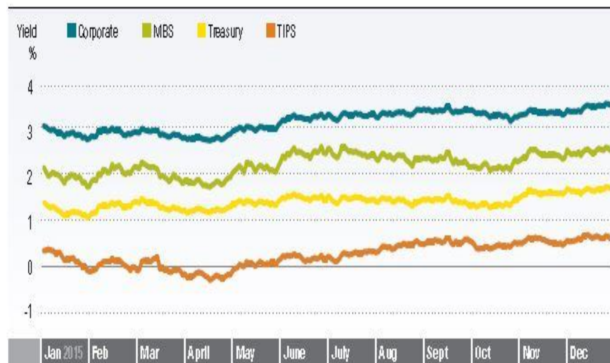
US Bond Indexes: Average Yields



The Link Between Markets and Oil…

For many investors, the impact of oil on the markets has been something of an anomaly, Historically, equities and oil have had very little correlation, as evidenced by the graph below, but this time, oil's slide is mirroring, if not driving, market declines. Investors are questioning whether credit markets will be able to withstand the precipitous fall in oil price and trying to gauge the impact it will have.

S&P 500 vs. Crude Oil Futures

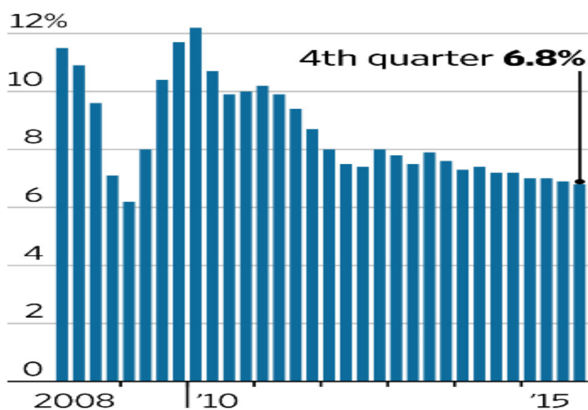
The oil business is capital-intensive. Most firms have to borrow well in advance of actual production and therefore do not have the flexibility needed to adjust to significant price swings. Since mid-2014, oil prices have fallen over 80%, prompting widespread concern that many drillers will not be able to repay their loans.

Many producers may be facing bankruptcy and lenders may be left holding notes that will never be satisfied. Wells Fargo reported an additional $90 million in losses during the fourth quarter on its oil and gas portfolio, while Citigroup added $250 million to its reserves to cover bad energy loans.

Looking Forward….

Although we will never attempt to predict how markets will react during any finite period of time, we do feel that the stabilization of oil prices will be necessary for equity markets to regain equilibrium. Decreasing oil prices can be seen as a sign of economic weakness, however, when prices plunge, investors begin to fear adverse effects on credit markets, which are essential for continued revenue growth.

Most analysts agree that the rate of growth in China will continue to slow in coming months and years. When Chinese officials recently reported that China's economy grew at 6.9% in 2015, the Wall Street Journal's headline astutely noted that the growth rate was the slowest in 25 years.



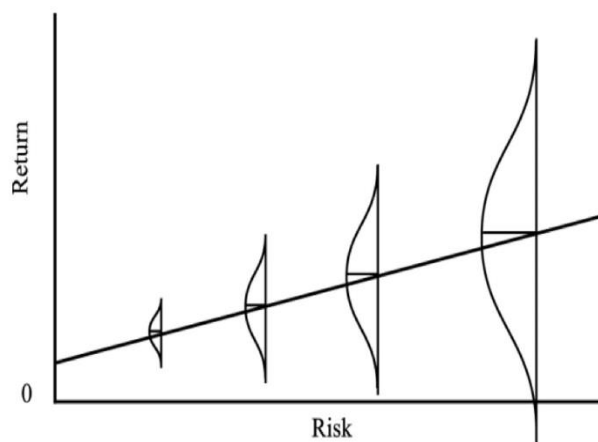
As sovereign economies continue to mature, they simply can not maintain the same level of growth they enjoyed in their infancy. While it is unlikely that the Chinese government will be able to re-invigorate the economy to achieve the growth rates of past years, it is very likely that government officials will take whatever measures—without opposition—that are needed for relative economic stability.

Markets will also be keeping a keen eye on Europe, particularly the European Central Bank (ECB). Many of the countries that comprise the Eurozone have never regained firm footing since the great recession. ECB president, Mario Draghi, recently assured the markets that the bank will take whatever steps are necessary to prop up and ensure the continued survival of the Eurozone.

Stateside, the Federal Reserve will likely continue to weigh low rates and stimulus against higher rates and tightening. The inevitable concern will be how to balance the need for continued economic growth with the need to contain inflation and prevent speculative asset bubbles. The deflationary effects of weak commodity prices and the strengthening dollar have mitigated the need for more assertive action.

In the end, markets will continue to rise and fall, just as they always have. Investors are paid to accept this risk. Those unwilling to do so should expect to earn a return similar to the Three Month Treasury Bill, currently yielding approximately .25%, widely regarded as the risk-free rate.

With that said, it is very important that investors refrain from accepting a level of risk that is neither understood nor justified, in light of the investor's objectives and time horizon. Any viable risk assessment should account for fluctuations in value (volatility), calculating a projected dispersion of returns within a 95% confidence interval. Only then can an investor determine whether a proposed level of risk is both warranted and manageable.



This graph developed by Oaktree Capital Management, L.P. illustrates how the range of possible outcomes widens and becomes

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more severe as investors move further out on the risk spectrum.

As we have noted in previous writings, most investment plans fail, not because they are poorly designed or executed, but because investors simply can not accept the inherent risk. When volatility strikes, investors often become fearful and want out. They lock in losses just to liquidate.

A recent study conducted by Dalbar, a highly-regarded financial research firm, found that the average U.S. investor earned 3.7% annually over the past 30 years, while the S&P 500 returned 11.1% annually. To paraphrase the words of legendary investor, Warren Buffet, the markets are extremely efficient at reallocating wealth from investors who are not patient to those who are.

If you have questions about your investment approach, we have tools to help you statistically quantify your risk tolerance and devise an appropriate allocation, given your objectives and time horizon. The success of your investment plan rests not on what free markets will or will not do, during any specific period of time, but on your unwavering commitment to control the variables which are ultimately the most important.

Sincerely,
Capital Asset Management, Inc.

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