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Navigating a Sea of Crosscurrents

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Reflections & Perceptions

The S&P 500's fourth quarter performance of 7.04% propelled the Index into positive territory for 2015, with a 1.38% total return. Following the market's third quarter decline of 6.44% when only one of the Index's 10 economic sectors posted positive performance (Utilities, +5.40%), all sectors were in the black for the last three months of the year. The Materials sector (+9.69%) was the surprise top performer despite soft commodity markets, thanks largely to the December 11 merger announcement between Dow (DOW) and DuPont (DD). Health Care logged the second best quarterly performance, up 9.22%, with Information Technology (+9.17%), Industrials (+7.64%), Consumer Staples (+7.64%) and Telecom (+7.61%) all outperforming the Index. The Energy sector was the quarter's worst laggard with a 0.20% return, as the price of oil (WTI) declined another 25% during the period to 11 year lows.

For the year, the S&P 500's price was down 0.73%, from 2058 to 2043, with its 2.1% dividend yield accounting for the year's positive return. We expect 2016 to be another challenging, though likely positive, year for returns as a number of crosscurrents buffet the financial markets and economy. Our thinking is:

<u>The broad-based earnings growth that supported stocks' gains since the March 2009 bear market low has stalled while valuations have increased</u>. The S&P 500's trailing 12-month earnings bottomed in mid-2009 at approximately $40 while the Index hit its bear-market low of 676 on March 9 that year, for a trough price/trough earnings valuation of 13.5x. By December 2009, trailing 12-month earnings rebounded to almost $57 and grew steadily through December 2014 to almost $115, resulting in a 187% increase (20% CAGR*) in just under 6 years. (Source: Standard & Poor's) Over the same period, the Index rallied 205% (from 676 to close 2014 at 2058), giving it a P/E multiple of 17.8 on 2014 earnings.

S&P 500 earnings for 2015 are expected to be flat compared to 2014 due to the negative impact of the strong dollar and lower energy prices. With the Index down 15 points for 2015 to end the year at 2043, its valuation remains in the 17x-18x range.

Looking into 2016, current S&P 500 earnings estimates are in the $120 to $125 range, implying year-over-year growth of between 4% and 8% and a P/E multiple between 16x and 17x. On balance, we do not view valuation as a major threat unless earnings do not come through as projected. On a bottom-up basis, however, we do view certain areas of the market as having more risk due to valuation. For example, the Utilities sector and many Consumer Staples companies are selling at the high end of their historical valuation range because investors are reaching for yield. We also note the turbulence experienced toward year-end in the high-yield market and among some of the so-called "unicorn" private equity (>$1 billion value) companies as a "shot across the bow" warning on valuations.

<u>Healthy bull markets have strong levels of participation. Even though the S&P 500 closed the year within 3% of its May 2015 all-time high, it is evident that this bull market's breadth is narrowing.</u> It is being led by the largest of the large caps, which is typical in the later stages of a bull market. This is evidenced by the strength of the large cap indices during a time when a growing percentage of stocks across the capitalization range have already experienced declines 20% or more from their highs.

<u>The Fed finally increased interest rates 0.25% on December 16 after almost 7 years at 0%.</u> The beginning of the tightening cycle is often viewed as positive as the decision to raise rates is associated with firmer economic conditions and an improving outlook. However, we cannot think of a single major trading partner that is contemplating a rate increase, which could mean that the dollar will strengthen further in 2016, making U.S. products less competitive in the global marketplace and negatively impacting the foreign sales/income of U.S.-based companies.

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With the December increase, the Fed laid the groundwork for a series of rate hikes in 2016. Given our view for continued sub-par domestic economic growth, as well as the potential costs of higher rates in terms of a stronger dollar and the Treasury's debt expense, we expect the Fed to show great prudence before pulling the trigger on additional rate increases.

2016 is expected to be another year of positive global growth. According to the World Bank's January 2016 "Global Economic Prospects, Spillovers Amid Weak Growth," global growth will be 2.9% in 2016 (vs. 2.6% in 2015), with developing countries growing at an average rate of 4.8%. Economic growth in "High Income" countries (United States, Euro Area, Japan, UK and Russia) is expected to be at 2.1%, with the U.S. at 2.7%. We note that China's growth is expected to be at its lowest since 1990, at 6.7%.

Energy remains a wild card. The price of crude (WTI) is down almost 70% in the last 18 months to levels not seen in 11 years, resulting in squeezed profits among the Energy sector and capital spending budget cuts among a broader swath of the economy including the Energy and Industrial sectors, as well as the loss of many high-paying jobs. We have yet to see lower energy prices translate into discernibly higher consumer spending. The unseasonably warm weather during the all-important holiday shopping season further clouded the consumer picture. Housing has been a bright spot for consumer spending after years of underinvestment, although a handful of home-related retailers have mentioned the negative impact of lower oil prices on their operations in certain geographies, like Houston.

2016 is a presidential election year. We expect the market to have knee-jerk reactions to candidates' comments from time to time which will likely increase volatility in the short-run while shifting focus from the fundamentals. Time will tell whether our elected leaders can make any meaningful progress on entitlement program solvency and the Federal debt, as well as the geopolitical and national security risks we face.

Corporate America has managed through the sub-par recovery, producing solid profit margins and greatly improved balance sheets since 2009. One tangible sign of progress is seen in higher dividend payments to shareholders. Total dividends paid by common stocks (non-funds) listed on the major U.S. exchanges for the 12 months ending 11/30/15 were $40.87 billion, up $1.17 billion (2.9%) over the prior 12-month period. This is a 25% increase over the $32.72 billion in dividends paid in 2009, while the S&P 500's payout ratio of 35% remains well below the historical average of 50%. Importantly, though, dividend increases have slowed over the past two years while cuts have increased, predominantly in the Energy sector. According to Standard & Poor's, the average cash dividend increased 13.1% in 2015, compared to 17.5% in 2014, 20.4% in 2013 and 20.2% in 2012 with the decelerating growth a reflection of earnings expectations.

With narrowing market breadth, bottom-up portfolio construction and positioning will continue to be paramount to outperformance in 2016. The portfolio continues to be overweighted to the Consumer Discretionary, Financials, Health Care and Industrials sectors where our bottom-up analysis indicates better opportunities for earnings growth coupled with rational valuations. Portfolio underweights to the Utilities and Consumer Staples sectors are a reflection of our view of the valuations in those sectors, while the underweight to Energy is due to the lack of earnings visibility and potential dividend cuts.

*CAGR: Compounded Annual Growth Rate