Quarterly Report- 4th quarter 2015

On the Markets...

-According to the Chinese calendar, 2016 is the year of the monkey and it brings to mind this story...One day a stranger appeared in a small forest village announcing that he would buy monkeys for $10 each. The villagers, seeing that there were many monkeys around, started catching them. The man bought dozens at $10, but, as it got harder to find them, village enthusiasm waned, and fewer monkeys were sold. Then the man increased his offer to $20. The villagers went deeper into the forest and started catching monkeys again. But soon the supply diminished even further, and people returned to the village. When the offer was raised to $25 the monkey trade increased. But soon the supply of monkeys became so thin that it was an effort to even see a monkey, let alone catch one.

Then the man declared that he would buy monkeys at $50! However, since he had to go to the city on some business, his assistant would now purchase in his place. The assistant told the villagers, “Look at all these cages filled with monkeys the man has collected. I will sell these monkeys to you at $35 and when the man returns from the city, you can sell them to him for $50 each.” The villagers put all their money together and bought all the monkeys. The man never returned, and the assistant disappeared. They were never seen again, only monkeys, everywhere!. . .
While the author is unknown,* perhaps this is a cautionary tale of how markets work...

After 6 positive years, the market has disappointed. In 2015 the S&P500 was down a negative .73%. The Dow lost 2.23%. However, this fails to reveal the full story of a more complicated market environment. In the S&P 500 as a whole, the average stock ended the year roughly 20% below its

52-week high. Beneath the surface of a market lead by a narrow handful of expensive, growthy names, the average stock has already suffered a bear market. The gap between those outperformers and the average stocks hasn’t been this wide in 16 years.

*Rest assured: No monkeys were injured in the telling of this story.
It cannot be overstated how important Apple, Amazon, Alphabet, Facebook, and Microsoft have been to the performance of the U.S. stock market in 2015. These five stocks and one other, Netflix, have accounted for the vast majority of the market capitalization gain in the S&P 500 Index, and the absolute strength of their stock prices, in the face of broader market weakness, has kept the capitalization-weighted stock market indexes, like the Dow Jones Industrial Average, the NASDAQ and the S&P 500 Index from showing far greater losses on a full year basis.

In looking ahead, most Wall Street firms are projecting that 2016 will be a continuation of the slow-growth economy that we have seen for the past 7 years. However, Wall Street's "experts" aren't any better at predicting the future than anyone else.

According to a study of Wall Street strategists done by Birinyi Associates, the 22 strategists surveyed have forecasted single-digit returns for the stock market in 2016, which is the same forecast they've had for each of the last five years. And yet, the S&P 500 has put up double digit gains in four of those five years, and failed to show a gain in the fifth, suggesting that this time, they might be right.

To be fair, economic forecasting is extremely difficult and that difficulty is most explicitly exposed when extrapolating from current trends.
One humorous example comes from Shepherd Mead’s, *How to Get to the Future Before It Gets to You*. He imagines going back in time to 1860, when horse manure was a health problem in New York City streets. Manure averaged 1 inch in the middle of New York City roads. Ten years earlier, it was half an inch. Therefore, using prevailing growth rates, one would project the dismal forecast of 170 feet of manure in the streets by 1970!

Pattern seeking and pattern recognition is a critically useful skillset. It certainly conferred an evolutionary survivorship bias on our ancestors who could successfully distinguish between healthy and poisonous mushrooms, and those who could cleverly discern the tiger crouching in the bush, despite the camouflage of his stripes. So we are pattern seekers by nature; but no pattern is perpetual. In looking back at 25+ years of dutifully navigating the equity markets, I am not sure I can recall a time that has been so consistently difficult to manage growth and income portfolios. We've soldiered through difficult market environments before, of course. The global financial crisis of 2008, and the dotcom bubble collapse of 2000 come readily to mind. But the volatility of this present, range-bound market is particularly enigmatic because it refuses to present a discernible pattern. Three times in 2015, for example, the Dow has had 100-point moves for 7 consecutive days. Compare that to the previous several years, when it didn't happen even once.

We continue to believe we are entering the final phase of a multi-year bull market and as we have noted, bull markets do not simply die of old age. Historically, their passing coincides with a broader economic recession. We remain vigilant, but continue to observe that the various historically-reliable, leading indicators we follow continue to reflect less than a 5% probability of recession within the next 3 months. However, the market does appear to be forming a topping pattern and longer-term, leading indicators are signaling greater caution.

We can identify several elements which have consistently exerted a powerful influence on driving markets higher and lower. Absent "black swan" events, such as geo-political eruptions or other unforeseen catalyst which suddenly and unpredictably create widespread uncertainty, the primary influence on a significant change in market direction has been monetary policy, that is, a marked change in interest rates. As we have seen for the last 7 years, lower rates can powerfully influence investor behavior and force markets higher, even in periods of disappointing economic growth. When central banks begin to tighten and raise rates, they effectively withdraw liquidity from the system, restricting the life-blood of capital markets. In its December meeting, the Federal Reserve met market expectations and raised short-term interest rates by .25%. They were also careful to reassure nervous market participants that they will be slow and deliberate in assessing future decisions to move rates higher at a modest and gradual pace.

This does not mean that investors should automatically move to cash however. Stocks usually do well in the beginning phase of tightening, recognizing that rates are being raised because economic conditions are improving. And, as the Central Banks throughout Asia and Europe have continued to lower rates, especially over the past 18 months, and made clear their willingness to move further in this direction, if they determine it necessary, interest rates in the U.S., even while remaining stable over this same period, had, in effect, already started to rise even without an official change in policy. This provided further proof that moderately rising rates can have a beneficial effect on markets, as more attractive rates in the U.S. continued to draw significant inflows of foreign capital.

Interest rates are not the only concern overhanging the market. There is the extreme behavior of China’s juvenile stock market, and its ambitious but necessary attempt to move from an export-based economy to a domestic consumption-based economy. Further, there is the collapse in the price of commodities, most notably, the price of oil and the implications for energy-related debt. And there remains our own sluggish economy that has been unable to accelerate in a similar fashion to previous recoveries, still restrained by a lack of confidence and risk-taking. The critical question remains: how much of this concern is already priced into this market?

A best-case scenario would be that global stimulus begins to take hold and prevents a further contraction in the global economy, which in turn helps to support oil, commodities, and resource-related sectors. In such a scenario, we could see a very strong finish to the final stages of the bull market, similar to 1998-2000 and 2005-2007.

The second scenario is decidedly more bearish. Its interpretation would be that the weakness in commodity prices is foreshadowing the next recession. Thus, high yield bonds, at their current levels, could be fairly priced, not mispriced, and if that is the case, they are indicative of a fair value of 1650 for the S&P 500 Index, which would be a 15% decline from its value as I write this. Under this scenario, with valuations where they are today, the markets could gather momentum on the downside, so the ultimate sell-off could cut much deeper, hence the greater risk.

To be sure, it has been a very frustrating year, but here is a potential pattern of hope. Typically following a flat year (no more than +/- 5%), the next year has been a good one for stocks. Since 1980, such "flat years" have occurred 7 times, and in 6 of those 7 times, the S&P 500 was higher the following year 86% of the time with the exception being 2008. There is

an argument to be made that many stocks have already been through a bear market. So while the bears see a deteriorating market ready to roll over & decline, bulls view this as a yearlong consolidation following a 200%+ rally, gathering itself to move higher.

In any event, we are alert and operating from a defensive mindset.

Sincerely,

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