

**Market Comments**  
**January 11, 2016**

S&P 500                      1924  
10 Year Treasury            2.17%

U.S. equities posted positive returns in the fourth quarter, as summarized in the following table, which also provides total return data for the full year, and since year-end 2008, which marked the approximate bottom of the 2008-09 financial crisis:

<u>Index</u>	<u>Q4</u>	<u>2015</u>	<u>Since 2008</u>	<u>Annualized 2008</u>
S&P 500	7.03	1.38	162.76	14.79
S&P 400 Midcap Index	2.60	-2.18	188.33	16.32
S&P 600 Small Cap Index	3.70	-2.00	172.58	15.40
MSCI EAFE Index	4.80	-0.19	77.44	8.53
MSCI Emerging Markets Index	0.52	-14.80	68.88	7.77
Barclays U.S. Aggregate Bond Index	-0.57	0.55	32.41	4.09

In 2015, large capitalization U.S. equities were the best-performing asset class, with the S&P 500 posting a total return of 1.38% for the year. Midcap and small cap stocks had slight negative total returns for the year, as did developed country international equities; emerging market stocks were by far the worst-performing asset class in 2015, declining almost 15% during the year. High quality bonds had marginally positive returns, as the Barclays U.S. Aggregate Bond Index returned 0.55%; the yield on the 10-year Treasury rose slightly during 2015, from 2.17% at year-end 2014 to 2.27% at year-end 2015.

2015 was a very challenging year for investors. U.S. equities traded in a relatively narrow range, roughly 1865 to 2134 on the S&P 500, but volatility within that range was high. Essentially, stocks covered a lot of ground in 2015, but ended the year without much price change. Market breadth (essentially, a measurement of the number of stocks keeping up with the S&P 500) deteriorated throughout the year; most of the S&P 500's positive return was attributable to a relatively small number of stocks (many of which were very large companies that carried very high valuations, such as Amazon, Facebook, and Netflix) that did exceptionally well. The average stock trailed the S&P 500's return by 4-5%, making outperforming the broad market indexes more difficult than usual. The S&P 500 returned -3% on a geometric average basis (weighting each S&P component company equally), versus its 1.4% total return on a market capitalization weighted basis.

Energy stocks were by far the worst performers, as oil prices extended the decline that started in the fall of 2014. The best performing stocks were those companies that showed exceptionally strong earnings growth during the year; investors bid valuations for those companies significantly higher as overall, earnings growth became scarce.

Overall, corporate earnings growth slowed markedly over the second half of 2015, due to three primary factors: 1) weak oil and commodity prices hurt the earnings of energy and related companies; 2) continued low interest rates depressed the earnings of many financial service companies, particularly those that profit from lending activities; and 3) a continued strong dollar, which penalized the earnings of companies that derive meaningful sales outside the U.S. As result, earnings for the S&P 500, which were estimated to be \$125-130 per share at the outset of 2015, will likely come in around \$117-118. Excluding energy companies, it is likely that corporate earnings grew 5-6% in 2015, a bit below the long-term trend.

We expect corporate earnings will do a bit better in 2016, if energy prices stabilize, interest rates move a little higher, and the dollar's ascent moderates, flattens out, or declines a little. We currently expect S&P 500 earnings will approximate \$125-130 in 2016.

The key risks to our outlook for stocks include: 1) faltering corporate earnings growth that could stem from a combination of persistently weak international economic conditions and a continued rise in the dollar relative to other major currencies; 2) the onset of recession in the U.S.; 3) economic disruptions emanating from further weakening in oil prices; and 4) an escalation of global political instability and/or terrorism.

We have established a 2016 year-end fair value target range of 2200-2275 for the S&P 500 (about 17.5x estimated 2016 earnings of ~\$125-130), which implies upside of roughly 8-10% from the S&P's 2015 year-end level of 2044. Our preliminary year-end 2017 fair value target range is 2375-2450 (~17.5x estimated 2017 earnings of ~\$135-140).

We remain constructive on the intermediate to long-term outlook for U.S. equities, but we expect the stock market will see continued elevated levels of day-to-day volatility. It would not surprise us to see stocks either 20% lower and/or higher in 2016, implying a trading range of 1700-2400. In this environment, we believe an opportunistic, flexible, and valuation-driven investment approach will be important. A substantial correction in 2016 should provide us with an opportunity to initiate or add to positions in great companies at attractive valuation levels for investors with multi-year time horizons.

As was the case at the beginning of 2015, equity valuations currently are at the upper end of "average" long-term valuations for U.S. equities, and current valuations are arguably below the valuation levels that might be expected, and could be supported, given the current low interest rate environment and given the solid (if unspectacular) corporate earnings growth that most U.S. companies are currently generating. Absent a sharp deterioration in corporate earnings, and/or a sharp rise in interest rates, we expect stock valuations to remain near current levels; with a slight bias to higher valuations should interest rates remain at or below current levels.

We continue to focus on those companies which we believe offer investors the best combination of 1) exceptional business franchise and balance sheet strength, 2) long-

term business growth prospects, and 3) attractive valuation characteristics. We continue to emphasize those companies that can show solid business value growth in a challenging and sluggish global economic environment, and that are able to increase their dividends in line with ongoing growth in free cash flow.

International and emerging stocks ended 2015 with negative returns, as economic conditions outside the U.S. remained weak. Notably, since the financial crisis of 2008-09, U.S. economic growth and corporate earnings have been far stronger than economic growth outside the U.S., which is reflected in the total returns shown in the table above. We remain underweighted in international equities in client portfolios; we will look for opportunities to increase our international exposure once better earnings growth outside the U.S. begins to materialize.

Interest rates may have finally bottomed in 2015, culminating in the Fed raising interest rates in December, the first interest rate increase since 2007. The ten-year Treasury yield rose marginally on balance in 2015, from 2.17% to 2.27%, after making an intra-year low at 1.64% in January. Sluggish U.S. GDP growth during 2015 was offset by very low inflation.

We believe the outlook for bond returns going forward remains poor because nominal and real interest rates remain near historic lows, and credit spreads are not exceptionally attractive. We believe many bond investors remain overly complacent: they are either underestimating the downside risk to bond prices if/when interest rates begin to rise and move back toward long-term historic norms, or they believe that they will be able to quickly reduce or exit bond exposures if/when rates eventually have a sustained upward move.

Our continued defensive approach to bonds remains in effect, because as long as nominal and real interest rate levels are low, we believe bonds offer an unattractive risk-reward trade-off. We remain under-weighted in terms of allocations to bonds relative to long-term portfolio asset allocation targets, and we continue to maintain bond portfolio durations that are shorter than long-term portfolio targets in order to minimize interest risk. We will look for opportunities to allocate more capital to bonds, and extend bond portfolio durations, once higher interest levels create a more favorable long-term risk-reward tradeoff.

In sum, we expect 2016, like 2015, to be a very challenging year, marked by elevated levels of bond and stock price volatility. We continue to expect that stocks will outperform bonds on balance over the next several years, given current valuations and the intermediate and long-term total returns implied by those valuations.

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