New Albany Investment Management

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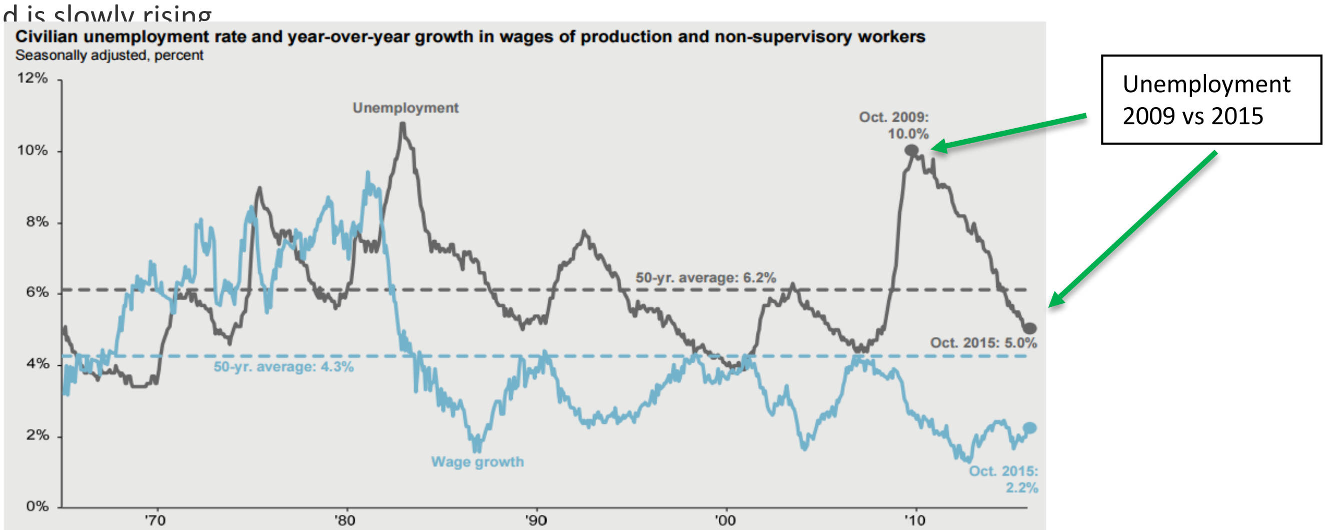
Market Insight: Year End Wrap
Economy Finishing Moderately Stronger; Markets Stalled

It has been a tumultuous year for global equities. Major headwinds such as a crash in commodity prices, a rising dollar and the long anticipated Fed rate hike have kept the markets in a churning and volatile state for most of the year. Growth across many economies around the globe became divided. Those more dependent on manufacturing, such as China, Asia, and most emerging countries, saw growth decline due to a huge drop in demand and price for commodities. Other countries such as the US, Japan and Europe, which have a more service led economy, experienced improving growth due to an increase in job creation and healthier consumer balance sheets. The effect of this division in growth rippled across all sectors of the financial markets and caused a wide dispersion in performance between winners and losers. For the year, despite moderate global growth, 2015 has been a grinder for both stocks and bonds.

So what is in-store for 2016? Will it be another flat year for the markets? This addition of Market Insight is a high level view of some of the key fundamentals driving the markets and the Fed for 2016.

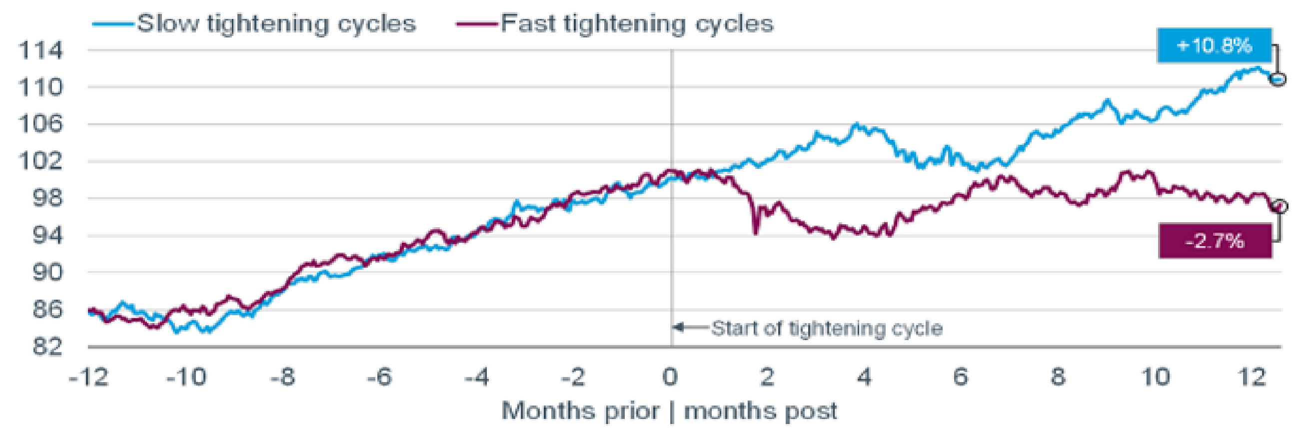
The Fed & Fundamentals: As a primary leader of the global markets, all eyes will continue to closely monitor what the Fed does and says. Now that the long awaited rate rise has occurred, the markets will be assessing when and how much the Fed will move again. Janet Yellen made it quite clear however, that any change is dependent on two factors: employment & inflation. In the most recent policy statement the Fed said: *"The committee judges that there has been considerable **improvement in labor market conditions** this year, and it is reasonably confident that **inflation will rise**, over the medium term, to its 2 percent objective."* So in this case, the **Fed move is a positive** endorsement of their confidence in the economy and explains why the Fed raised the Fed Funds rate this past week.

The chart below shows the change in the unemployment and wages (a measure of inflation) since 1960. Notice the recovery in unemployment (black line) from 2008. Wage growth (blue line) has bottomed and is slowly rising.



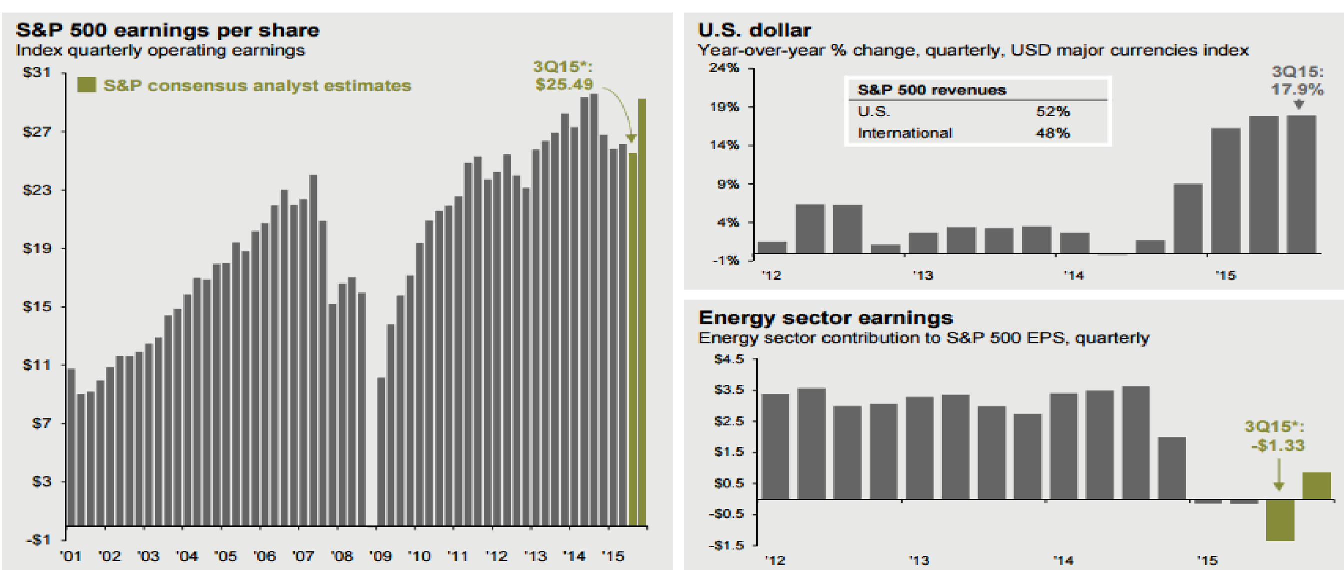
Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of November 30, 2015.

Future Fed Moves & the Market performance: Janet Yellen's statement regarding future rate hikes was very dovish in that she made it quite clear, **further rate moves would be very gradual** and of course, dependent on continual strengthening in the economy. According to Charles Schwab: "**slow rate hiking cycles have typically been positive for stocks.**" But Schwab also pointed out, "with almost a decade having passed since the last hike, **volatility is likely to persist**." History shows the rate of change or trajectory rates is a big influence on equity market performance. Since 1936, there have been 12 rate hike cycles; five of which were "slow" cycles, and seven of which were "fast" cycles. The chart below shows **when the Fed was moving slowly (not raising rates at every, or even most FOMC meetings in a cycle), stocks performed quite well (+10.8%) in the year following the initial rate hike.** Conversely, when the Fed was moving more quickly (raising rates at most consecutive FOMC meetings in a cycle), the market suffered a small loss (-2.7%) in the year following the initial hike. In other words, from a market perspective, a slow rise in rates is good.



Fast cycle dates: 11/20/67, 1/15/73, 9/26/80, 9/4/87, 2/4/94, 6/30/99, 6/30/04. Slow cycle dates: 4/25/46, 4/15/55, 9/12/58, 7/17/63, 8/31/77. Cycles were set at, or indexed to, 100 to enable growth comparisons. Past performance is no guarantee of future results. Source: Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2015 (c) Ned Davis Research, Inc. All rights reserved.).

Energy Weakness & US Dollar Strength have been a major drag to earnings this year. Oil has fallen over 40% in the last 12mos and 60% in since October of 2014. At the same time, the US dollar has risen over 17%. **If these two factors stabilize in 2016, earning growth will likely be positive again.**



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management, (Top right) Federal Reserve, S&P 500 individual company 10k filings, S&P Index

Positive Fundamentals for 2016: The long term projection of the markets is highly dependent on the underlying economic fundamentals and projected earnings growth. With three major central banks (ECB, BOJ, and China) continuing an aggressive easing policy, global growth is expected to modestly accelerate. And with a healthier consumer (due to an improving jobs market), corporate earnings are likely to grow. However with weakness likely to persist for several more years in the commodity markets, the markets will likely remain volatile.

The chart below is a forecast of Earnings and GDP growth for 2016 and shows modest improvement.

2016 estimates at a glance

Country/Region	2015 GDP	2016 GDP	Next 12 Months Earnings Growth	2016 Central Bank Policy
US	2.6%	2.8%	13%	Tightening
Eurozone	1.5%	1.6%	15%	Easing
Japan	0.6%	1.0%	14%	Easing
Emerging Markets	4.0%	4.5%	18%	Mixed

Summing it up: The global environment for stocks in 2016 may again be defined by opposing economic forces. Investors will be quick to avoid areas of weakness and be highly selective in their search for return. At the same time, the central bank actions and local politics around the globe will likely play a significant role in driving market volatility and investor sentiment. The continued improvement in the U.S. consumer and the European economies will be the bright spots for the global markets. And the effect of lower commodity prices, while a drag for many countries, should ultimately be a positive for future spending. But at the same time, manufacturing must adapt to the new low pricing structure which will take several years to work through the system. On top of all this, it is an election year in the US. Net, 2016 looks to be challenging, but the economic footings are solid and improving and will provide a positive foundation for the financial markets.

Investment Strategy remains broadly diversified with emphasis on long term growth and exposure to solid asset sectors across the global markets.

May the gift of Life and Love celebrated this season, be with you and your family all the days in the year to come.

Warm Regards,

Barbara

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